

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF ATMOS)	CASE NO.
ENERGY CORPORATION FOR AN)	2018-00281
ADJUSTMENT OF RATES)	

ORDER

Atmos Energy Corporation (Atmos) is a natural gas distribution company that operates in eight states and serves about 3 million customers.¹ Atmos's Kentucky/Mid-States division is one of six operating divisions that provide natural gas service in Kentucky, Tennessee, and Virginia.² Atmos serves approximately 176,800 customers in central and western Kentucky.³ The most recent adjustment of Atmos's base rates was in May 2018 in Case No. 2017-00349.⁴

BACKGROUND

On August 21, 2018, Atmos submitted a notice of intent to file an application for a general rate case based upon a forecasted test period. On September 28, 2018, Atmos submitted its application based on a forecasted test period ending March 31, 2020,

¹ Direct Testimony of Mark A. Martin (Martin Testimony) at 4.

² *Id.*

³ Application at 3.

⁴ Case No. 2017-00349, *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC May 3, 2018).

seeking an increase in revenues of \$14,455,538,⁵ or 15.8 percent, with a proposed effective date of October 28, 2018.⁶ The average monthly bill for consumers would increase approximately \$4.41, or 8.6 percent, for residential customers; \$14.45, or 6.6 percent for commercial and public authority consumers; and \$909.82, or 15.8 percent, for industrial and transportation customers.⁷ Atmos subsequently revised its proposed revenue increase to \$14,374,606.⁸ Atmos submitted a depreciation study in support of its application and requested that its proposed depreciation rates be approved.⁹

Atmos states that the reasons for the requested rate increase are declining return on equity (ROE) and inadequate revenue to continue to provide the quality of service required by the Commission and demanded by its customers.¹⁰ Atmos further asserts that the revised rates are necessary to allow Atmos the opportunity to recover its reasonable operating costs, earn a reasonable return on its investment, provide sufficient revenue to maintain its facilities, and attract additional capital.¹¹

In addition to seeking a base rate increase, Atmos is requesting to cancel its current Pipeline Replacement Program (PRP) and delete the corresponding Rider tariff

⁵ See Atmos's response to Commission Staff's Second Request for Information (Staff's Second Request), Item 64. Atmos revised its requested increase to \$14,509,652 based upon adjustments for errors acknowledged in response to both the Commission Staff's and the Attorney General's discovery.

⁶ Application at 3.

⁷ Application at 4.

⁸ Rebuttal Testimony of Greg K. Waller (Waller Rebuttal Testimony) at 2.

⁹ Direct Testimony of Dane A. Watson (Watson Testimony) at 3 and 17.

¹⁰ Application at 4.

¹¹ *Id.*

in order to align its “commitment to replace bare steel pipe with the provisions” of the final Order in Case No. 2017-00349.¹² Atmos also is requesting minor text changes to its demand-side management (DSM) tariff relating to the timing of the adjustment for the distribution charge for residential and commercial G-1 sales,¹³ and seeking an increase in various customer charges.¹⁴ Lastly, Atmos is requesting to update the time period used to weather normalize revenues to the 20-year period ending June 2018, or in other words, the period of July 1998 through June 2018.¹⁵

A review of the application revealed that it did not meet the minimum filing requirements of 807 KAR 5:001, Section 16(7)(d); a notice of filing deficiencies was issued on October 5, 2018. Atmos filed information on October 9, 2018, to cure the noted filing deficiencies. A notice that Atmos’s deficiencies had been cured was issued October 12, 2018, stating that the application met the minimum filing requirements as of October 9, 2018. Based on an October 9, 2018 filing date, the earliest possible date Atmos’s proposed rates could become effective was November 8, 2018.

Pursuant to KRS 278.190(2), the Commission issued an Order on October 26, 2018, suspending the effective date of Atmos’s proposed rates for six months, up to and including May 7, 2019. Further, the October 26, 2018 Order established a procedural schedule for the processing of this matter, providing for: a deadline to file intervention requests; two rounds of discovery upon Atmos’s application; a deadline for the filing of

¹² Application at 5.

¹³ *Id.*, Martin Testimony at 12.

¹⁴ Martin Testimony at 12–13.

¹⁵ *Id.* at 15.

intervenor testimony; one round of discovery upon any intervenor testimony; an opportunity for Atmos to file rebuttal testimony; a public hearing; and an opportunity to file post-hearing briefs. The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (Attorney General) is the only intervenor in the pending case.

The Commission held a formal hearing on the proposed rate adjustment for the purpose of cross-examination of witnesses on April 2, 2019, and April 3, 2019, at its offices in Frankfort, Kentucky. Pursuant to the Commission's April 3, 2019 Order, both Atmos and the Attorney General filed responses to post-hearing requests for information as well as post-hearing briefs. The case now stands submitted for a decision.

TEST PERIOD

Atmos proposed the 12 months ending March 31, 2020, as its forecasted test period to determine the reasonableness of its proposed rates.¹⁶ The Attorney General did not object to the proposed test period or suggest an alternative test period; it did, however, criticize Atmos's development of certain items contained in the proposed test period, as discussed herein. The Commission finds Atmos's forecasted test period to be reasonable and consistent with the provisions of KRS 278.192 and Kentucky Administrative Regulation (KAR) 5:001, Section 16(6), (7), and (8). Therefore, we will accept the forecasted test period proposed by Atmos for use in this proceeding.

¹⁶ Application at 4.

VALUATION

Rate Base

Atmos proposed a net investment rate base for its forecasted test period of \$496,111,427, based on the 13-month average for that period.¹⁷ In response to errors identified in discovery, Atmos revised this amount to \$495,967,913.¹⁸ In its rebuttal testimony, Atmos further revised its proposed rate base to \$496,005,827 to reflect adjustments caused by updates to its capital structure.¹⁹

The Attorney General proposed to reduce Atmos's rate base to \$330,448,117.²⁰ The Attorney General proposed to: (1) remove PRP plant additions after September 30, 2018;²¹ (2) reduce non-PRP plant additions to reflect a historic 3-year average;²² (3) adjust accumulated depreciation and accumulated deferred income taxes (ADIT) to reflect the Average Life Group (ALG) procedure instead of the Equal Life Group (ELG) procedure; (4) remove Construction Work in Progress (CWIP),²³ and; (5) reduce cash working capital to reflect the Attorney General's adjustments to Atmos's as-filed lead/lag

¹⁷ Application, Volume 7, FR 16(8)(b).

¹⁸ Atmos's response to Staff's Second Request, Item 64, Attachment 1, Schedule A.

¹⁹ Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule A-1.

²⁰ Kollen Testimony, Attachment Atmos_Rev_Req_-_AG_Recommendation.xlsx, Tab Rate Base; See also Attorney General's response to Commission Staff's Post-Hearing Request for Information (Staff's Post-Hearing Request), Item 6, Attachment. The Attorney General revised its recommended rate base to \$396,074,915 based upon adjustments for errors acknowledged in response to discovery.

²¹ Kollen Testimony at 14–20.

²² *Id.* at 20–26.

²³ *Id.* at 27–35.

study.²⁴ The Attorney General subsequently proposed a further reduction of \$2,112,592 to remove previously capitalized Allowance for Funds Used During Construction (AFUDC).²⁵

As discussed later in this Order, the Commission has determined that Atmos's net investment rate base is \$424,928,655, as shown below. Cash working capital has been reduced to reflect the lead/lag study Atmos filed with its application.

	Atmos Proposed	Adjustment	Adjusted
Utility Plant in Service	\$ 724,669,367	\$ (29,362,001)	\$ 695,307,366
Construction Work in Progress	39,130,198	(39,130,198)	-
Total Utility Plant	\$ 763,799,565	\$ (68,492,199)	\$ 695,307,366
LESS:			0
Accumulated Depreciation and Amortization	\$ 194,453,459	\$ 1,354,650	\$ 195,808,109
Net Utility Plant	\$ 569,346,106	\$ (69,846,849)	\$ 499,499,257
ADD:			
Cash Working Capital Allowance	\$ 2,692,759	\$ (987,582)	\$ 1,705,177
Inventory and Prepayments	9,023,857	-	9,023,857
Subtotal	\$ 11,716,616	\$ (987,582)	\$ 10,729,034
			\$ -
DEDUCT:			
Customer Advances for Construction	\$ 747,234	\$ -	\$ 747,234
Regulatory Assets / Liabilities	33,020,670	79,883	33,100,553
Deferred Inc. Taxes and Investment Tax Credits	50,663,356	788,492	51,451,848
Subtotal	\$ 84,431,261	\$ 868,375	\$ 85,299,636
NET INVESTMENT RATE BASE	\$ 496,631,462	\$ (71,702,807)	\$ 424,928,655

Capitalization

Atmos conducts utility operations in eight states through unincorporated operating divisions, which are not separate legal entities and comprise the Atmos Energy Corporation. All debt or equity funding of each division is issued by Atmos as a whole.²⁶ Atmos states that this consolidated capital structure is appropriate for ratemaking in

²⁴ *Id.* at 36–39.

²⁵ Attorney General's Brief, Exhibit 1.

²⁶ Direct Testimony of Joe T. Christian (Christian Testimony) at 6.

Kentucky because Atmos Energy Corporation provides the debt and equity capital that supports the assets serving Kentucky customers.²⁷ Atmos proposes to update its total capitalization for the forecasted test period to \$9,211,086, to reflect financing activities through March 2019.²⁸ The Attorney General recommended adjustments to the proposed capitalization amount as discussed below. The Commission accepts Atmos's proposed capitalization amount.

REVENUE REQUIREMENT ADJUSTMENTS

Atmos developed an operating statement for its forecasted test period based on its budgets for the 2019 fiscal year. As required by 807 KAR 5:001, Section 16(6)(a), the financial data for the forecasted test period was presented by Atmos in the form of pro forma adjustments to its base period – the 12 months ending December 31, 2018.²⁹ Based on the assumptions built into its budgets, Atmos calculated its test year revenues and operating and maintenance (O&M) expenses to be \$169,717,866 and \$142,015,942, respectively.³⁰ Based on these adjusted revenues and O&M expenses, Atmos's test period operating income was \$27,701,923, which based on its proposed rate base, results in a 5.58 percent overall rate of return.³¹ Based on a proposed ROE of 10.40 percent,

²⁷ *Id.*

²⁸ Rebuttal Testimony of Joe T. Christian (Christian Rebuttal Testimony) at 11.

²⁹ Application, Volume 7, Schedules D.1 and D.2.

³⁰ Application, Volume 7, Schedule C.1; Through rebuttal testimony, Atmos revised its O&M expense projections to \$142,188,086; See Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule C.1.

³¹ Application, Volume 7, Schedule C.1. Atmos's revised O&M expense result in a test period net income of \$27,529,780 and 5.55 percent overall rate of return. See Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule C.1.

Atmos determined that it required a revenue increase of \$14,455,544, which would produce an overall return on rate base of 7.95 percent.³²

The Attorney General, based on a number of proposed adjustments to Atmos's test period results and a 9.70 percent ROE, recommended a decrease in revenues of \$7,969,875.³³ Based upon corrections identified in discovery responses and additional recommendations made in his post-hearing brief, including a 9.45 percent ROE, the Attorney General updated his proposed revenue reduction for Atmos to \$9,731,022.³⁴

The Commission will accept components of Atmos's test period and certain proposed adjustments, but will also accept some of the Attorney General's proposed adjustments. A discussion of the individual adjustments accepted, modified, or rejected by the Commission, and the impact of those adjustments on Atmos's revenue requirement follows.

Pipeline Replacement Program

In 2010, the Commission initially approved Atmos's PRP to be a 15-year program to replace 250 miles of bare steel pipe and services at an estimated total cost of \$124 million.³⁵ Atmos subsequently discovered that there were an additional 100 miles of bare

³² Application, Volume 7, Schedule A.1. Based on Atmos's revised O&M expense and rate base, Atmos determined that it required a revenue increase of \$15,838,372 to produce a 7.93 percent overall rate of return. See Waller Rebuttal Testimony, Exhibit GKW-R-1, Schedule A.

³³ Kollen Testimony at 4.

³⁴ See Attorney General's Brief at 5; Attorney General's response to Staff's Post-Hearing Request, Item 6. Because the Attorney General did not quantify the adjustment, this does not include the proposed disallowance of Mr. Mark Martin's salary.

³⁵ Case No. 2009-00354, *Application of Atmos Energy Corporation for an Adjustment of Rates* (Ky. PSC May 28, 2010); See also Case No. 2017-00349, *Atmos* (Ky. PSC May 3, 2019), Order at 37.

steel pipe to be replaced, and further added the replacement of the Shelbyville Line, at a cost of \$21.7 million, and the Lake City Line, at a cost of \$5.7 million, both due to safety and reliability concerns.³⁶ In reviewing Atmos's 2017 annual filing to update its PRP rates,³⁷ the Commission found in its final Order that the significant increase in the cost of Atmos's PRP Rider since it was approved in Case No. 2009-00354³⁸ warranted a more detailed review in Case No. 2017-00349.³⁹

In Case No. 2017-00349, Atmos estimated the cost of the pipeline replacement program to be \$438 million for 350 miles of bare steel pipes and services and the two additional projects.⁴⁰ Thus, the cost per mile for replacing the bare steel pipe and services more than doubled, from just under \$500,000 per mile to over \$1.17 million per mile.⁴¹ In the final Order of Case No. 2017-00349, the Commission stated that the eligible bare steel pipeline replacements, for which Atmos's PRP was approved, could not be reasonably made and funded by ratepayers at the levels estimated by Atmos.⁴² The Commission further noted that Atmos's annual recovery for the PRP should be limited, and that it could be limited without risk to public safety.⁴³ The Commission found that the

³⁶ Case No. 2017-00349, *Atmos*, (Ky. PSC May 28, 2010), Order at 37.

³⁷ Case No. 2017-00308, *Electronic Application of Atmos Energy Corporation for PRP Rider Rates* (Ky. PSC Oct. 27, 2017).

³⁸ Case No. 2009-00354, *Atmos* (Ky. PSC May 28, 2010).

³⁹ Case No. 2017-00349, *Atmos* (Ky. PSC May 3, 2018), Order at 40.

⁴⁰ *Id.* at 37.

⁴¹ *Id.* at 37–38.

⁴² *Id.*

⁴³ *Id.*

time frame of Atmos's PRP should be extended and the annual ratepayer-funded PRP investment should be limited to \$28 million, barring identification of a PRP-eligible pipeline-related hazard that could not have been reasonably foreseen.⁴⁴ The Commission also asserted that "\$28 million in annual investment should cause the remaining PRP for bare steel replacement to be complete in 8 - 9 years beginning in 2019 with estimated completion in 2027, adding two years to the originally approved 15-year timeframe."⁴⁵ The Commission found that the annual investment amount of \$28 million was reasonable based on Atmos's average actual annual PRP investment from 2012 through 2017.⁴⁶

The Commission also questioned the reliability of the estimates and the reasonableness of the PRP as it had been structured due to Atmos basing its PRP investment projections on a 12 percent annual escalation instead of specific projects.⁴⁷ Thus, the Commission ordered that Atmos's recovery of the PRP investment should be based on actual spending, subject to the \$28 million cap, in a historic 12-month period, and that budget estimates for funding a future PRP period would no longer be accepted as the basis for calculating the PRP Rider rate.⁴⁸

⁴⁴ *Id.* at 41.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 41–42.

⁴⁸ *Id.* at 42.

In the pending application, Atmos requests to cancel the PRP and delete the associated PRP tariff “in light of the Commission’s Order in Case No. 2017-00349.”⁴⁹ Atmos states that it is agreeable and committed to achieving the PRP investment target of \$28 million per year for the bare steel replacement and to the modified completion timeline.⁵⁰ However, Atmos contends that the modification of the PRP to historical, lagged recovery of investment as required by the final Order in Case No. 2017-00349, as opposed to the prospective treatment that was previously afforded to Atmos, is financially detrimental.⁵¹ Atmos argues that for utilities such as it, which employ frequent comprehensive forward-looking rate cases pursuant to KRS 278.192, integrating a historical test-year PRP rider creates significant mathematical and accounting challenges.⁵² Atmos insists that timely recovery of costs associated with high levels of capital investment is financially essential, and that recovery lagged for historic test year filings would strand unavoidable costs.⁵³ Atmos further states that the historical recovery for the PRP investment results in a regulatory construct that systematically prevents earning its authorized return on equity (ROE).⁵⁴

Finally, Atmos maintains that KRS 278.509, which is the statute that governs the recovery of costs for investment in natural gas pipeline replacement programs, is a

⁴⁹ Martin Testimony at 14; Application at 5.

⁵⁰ Martin Testimony at 14–15.

⁵¹ *Id.*

⁵² Atmos’s Post-Hearing Brief (Atmos’s Brief) at 22.

⁵³ *Id.*

⁵⁴ Direct Testimony of Gregory K. Waller (Waller Testimony) at 11.

permissive statute, and as such, Atmos is not required to have a PRP or a PRP Rider.⁵⁵ Thus, Atmos proposes to withdraw the PRP, delete the associated PRP Rider, and to avail itself of KRS 278.192 for all of its pipeline replacement recovery, thereby transferring the ratemaking for the replacement of facilities that would have qualified under the PRP to an annual forward-looking rate case.⁵⁶

The Attorney General argues that Atmos's request to cancel the PRP and delete the associated PRP tariff is an attempt to circumvent the customer safeguards that the Commission imposed upon Atmos's PRP in Case No. 2017-00349.⁵⁷ The Attorney General avers that Atmos's pending proposal would significantly change the timing of cost recovery by allowing Atmos to recover in rate base both the actual PRP costs incurred through the historic period ending September 30, 2018, and also the forecasted PRP costs from October 1, 2018, through March 31, 2020.⁵⁸ Rather than limiting the total cost recovery for the PRP to \$28 million, the Attorney General asserts that Atmos is now seeking to include an additional \$42 million in PRP costs in the base revenue requirement.⁵⁹ Based upon the final Order from Case No. 2017-00349, the Attorney General states that the PRP costs incurred from October 1, 2018, through September 30,

⁵⁵ Rebuttal Testimony of Mark A. Martin (Martin Rebuttal Testimony) at 4.

⁵⁶ Atmos's Brief at 22; Martin Testimony at 6 and 14.

⁵⁷ Attorney General's Post-Hearing Brief (Attorney General's Brief) at 15; Direct Testimony of Lane Kollen (Kollen Testimony) at 16.

⁵⁸ Attorney General's Brief at 16; Kollen Testimony at 17.

⁵⁹ Attorney General's Brief at 17–18; Kollen Testimony at 18. (Mr. Kollen breaks down the \$42 million PRP costs from October 1, 2018 through March 31, 2020 as follows: \$28 million in fiscal year 2019 from October 1, 2018 through September 30, 2019, plus \$14 million in fiscal year 2020 from October 1, 2018 through March 31, 2020.)

2019, would not have been eligible for recovery through the PRP Rider until March 1, 2020.⁶⁰ Likewise, the costs incurred from October 1, 2019, through March 31, 2020, would not have been eligible for recovery through the PRP Rider until March 1, 2021.”⁶¹

The Attorney General recommends that Atmos’s request to terminate the PRP be rejected, and that Atmos be directed to continue the PRP and recover PRP associated investment as prescribed in the final Order of Case No. 2017-00349.⁶² In rebuttal to the Attorney General’s arguments concerning the historical, lagged recovery, Atmos states that the Attorney General’s position to require it to utilize the PRP to replace bare steel pipeline through 2027 on a historic, lagged basis would be confiscatory.⁶³

The Commission’s history of supporting and encouraging natural gas pipeline replacement through approval of reasonable PRP programs, tariffs, and riders is well known and speaks for itself.⁶⁴ The Commission’s previous steps to limit Atmos’s PRP recovery were in response to the record developed in Case No. 2017-00349, regarding an unconscionable level of projected PRP investment by Atmos. The Commission has never before withdrawn approval of a forward-looking PRP program in favor of historical recovery based on actual spending for any other natural gas utility, and the Commission urges Atmos to take note of this fact.

⁶⁰ Attorney General’s Brief at 16.

⁶¹ *Id.*

⁶² *Id.*, Kollen Testimony at 19–20.

⁶³ Martin Rebuttal Testimony at 6.

⁶⁴ *See, e.g.*, the Commission’s establishment of a PRP Rider for Duke Energy Kentucky, Inc. in 2002, prior to the enactment of KRS 278.509.

The Commission agrees in part with the Attorney General in that continued use of the PRP is the most appropriate method for accelerating the replacement of aging and unsafe bare steel pipelines by Atmos. Therefore, we will require Atmos to continue utilizing the PRP to accelerate the replacement of bare steel pipelines in its system. The Commission has consistently found that the public interest is served by replacing potentially unsafe, aged gas pipelines through the adoption of pipeline replacement programs that have been approved as being fair, just, and reasonable. To the extent that the pipeline eligible for replacement poses a safety risk to the utility's customers, service areas, and employees, the Commission reiterates that it is in favor of accelerated replacement. The Commission believes that pipeline replacement programs improve public safety and reliability of service for customers. These policy objectives were the Commission's motivation to initially allow Atmos to implement the PRP in Case No. 2009-00354, and the reason that the Commission still believes that the accelerated replacement of bare steel pipelines in Atmos's system should be performed under the provisions of its existing PRP.

Through the PRP process, the Commission is able to separately review and scrutinize each project and expenditure annually, with the opportunity for the Attorney General, and potentially others, to intervene in the PRP proceedings. The Commission finds that the already established separate review for the accelerated replacement of bare steel pipelines in Atmos's system to be a more streamlined and efficient process than Atmos's proposal to include the PRP projects in an annual base rate case. During a base rate case, a multitude of issues are examined in detail by the parties and the Commission.

If PRP projects are also included in the base rate case then the Commission and the intervenors may not have adequate time to review and analyze the proposed projects.⁶⁵

However, the Commission also agrees in part with Atmos, that based upon the magnitude of the PRP investment, it is reasonable for it to continue to be given prospective treatment in order to avoid the regulatory lag inherent in the historical treatment adopted in Case No. 2017-00349. Atmos states in the pending application that it is “agreeable and committed to achieving the investment target” for the PRP as designated by Case No. 2017-00349,⁶⁶ and attests that Atmos is committed to completing the remaining 188 miles of bare steel pipeline replacement by 2027.⁶⁷ It appears that the only modification to the PRP that Atmos finds impracticable is the historical, lagged recovery. The Commission is persuaded by Atmos’s argument that integrating the historical test-year PRP rider can create mathematical and accounting challenges for Atmos because it has consistently utilized forward-looking rate cases pursuant to KRS 278.192.

No customer safeguards will be eroded by allowing Atmos to utilize prospective treatment with regard to the PRP filings because the annual ratepayer-funded PRP investment for bare steel pipeline replacement will still be limited to \$28 million and the

⁶⁵ In Atmos’s Reply Brief in Case No. 2017-00349, Atmos asserts “...PRP expenditures are susceptible to more scrutiny in a stand-alone annual PRP filing[s] [sic] than in a regular rate case where literally thousands of other pieces of financial information are presented for review by the Commission.” Atmos further stated that placing the PRP projects in base rate cases would “necessarily limit the time and depth of analysis currently afforded to the Commission.”

⁶⁶ Martin Testimony at 14–15.

⁶⁷ Atmos’s response to Commission Staff’s First Post-Hearing Request for Information (Staff’s First Post-Hearing Request), Item 7.

program will be completed by 2027, barring the identification of a PRP-eligible pipeline-related hazard that could not have been reasonably foreseen. The Commission finds no merit in Atmos's argument that because the statutory provision for creating a PRP is voluntary, the Commission lacks the authority to deny a request to terminate an existing PRP. Once a rate such as the PRP is approved by the Commission as being fair, just, and reasonable, it can be discontinued only upon a subsequent similar finding by the Commission. Here, we find that discontinuing the PRP would not be fair, just, or reasonable. Furthermore, pursuant to KRS 278.509, the Commission will continue to only allow Atmos recovery of PRP investment costs that have been deemed fair, just, and reasonable.

The Commission's decision to continue Atmos's PRP utilizing forward-looking estimates of capital expenditures, as used since its adoption in 2010, does not include approval of pipeline replacements beyond what it is currently authorized, as the pace of replacements and the magnitude of customer surcharges remain a concern. The amounts included in the forecasted test-period for PRP-eligible projects for the period October 1, 2019, through March 31, 2020, were based on Atmos's fiscal year 2019 budget. The Commission will reinstate Atmos's PRP Rider on a forecasted basis. Therefore, the Commission finds that the estimated amounts of PRP-eligible capital additions included after September 30, 2019, should be removed from base rates and recovered through the PRP Rider. This reduces Atmos's rate base by \$4,998,962; depreciation expense by \$90,707; and ad valorem taxes by \$34,190, which results in revenue requirement reductions of \$502,528; \$91,346; and \$34,431 respectively, for a total revenue requirement reduction of \$628,305.

Depreciation Expense

Atmos proposes to change its depreciation rates at the beginning of the test year to reflect the results of a depreciation study submitted with its application.⁶⁸ Atmos proposes the continued use of the ELG procedure in developing its depreciation rates.⁶⁹ The Attorney General recommends the Commission adopt the ALG procedure in developing Atmos's depreciation rates.⁷⁰ The Attorney General contends that the ALG methodology is the predominant procedure used by other electric and gas utilities, including all other investor-owned electric and gas utilities in the Commonwealth of Kentucky, for developing depreciation rates.⁷¹ The Attorney General explains that under the ELG methodology, the capital recovery periods are accelerated and shortened and, thus, the depreciation rates are greater than if the ALG procedure were used.⁷² The Attorney General insists that the ALG procedure is as accurate as the ELG procedure, but the ALG procedure smooths the data so that the depreciation rates for the group of assets tend to remain constant, all else being equal over the service life of the group.⁷³ Use of the ALG procedure will decrease Atmos's depreciation expense by \$7,352,738, for a revenue requirement reduction of \$7,404,568.

⁶⁸ Direct Testimony of Dane A. Watson (Watson Testimony) at 3 and 17.

⁶⁹ *Id.* at 6–7.

⁷⁰ Kollen Testimony at 7–14.

⁷¹ *Id.* at 7.

⁷² *Id.* at 11.

⁷³ *Id.* at 13–14.

This Commission has previously found that the ELG procedure does not accurately match revenues and expenses, is front-loaded, and should not be allowed for ratemaking purposes.⁷⁴ The Commission finds that Atmos's proposed ELG procedure does not produce fair, just and reasonable rates, and that Atmos's depreciation rates should reflect the ALG procedure. While a reduction of the full amount is warranted, the Commission, in light of Atmos's historic use of the ELG procedure, will only reduce Atmos's revenue requirement by half the Attorney General's proposed amount, and will require Atmos to establish a regulatory liability without carrying charges for the remainder, the amortization of which will be addressed in Atmos's next base rate case. This gradual approach will ensure that Atmos's customers receive the full benefit of the reasonable deprecation methodology, while limiting the impact of the change on Atmos. This adjustment results in an expense reduction of \$3,676,784, for a reduction in Atmos's revenue requirement of \$3,702,701, and also increases Atmos's rate base through the reduction in accumulated depreciation and ADIT of \$1,805,638 and \$450,507, respectively, for an increase in Atmos's revenue requirement of \$226,802. The net impact to Atmos's revenue requirement is a decrease of \$3,475,899.

Other Capital Expenditure Adjustments

In the pending case, Atmos does not argue that the Commission's limitation on its annual capital spending for the replacement of bare steel pipes of \$28 million is unreasonable. However, although Atmos accepts this limitation on the rate at which it

⁷⁴ Case No 2017-00321, *Electronic Application of Duke Energy Kentucky, Inc. for: 1) An Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New Tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approvals and Relief* (Ky. PSC Apr. 13, 2018), Order at 26–27.

may replace bare steel pipes, it made no change in its total projected capital spend for its fiscal years 2019 and 2020.⁷⁵ Rather, Atmos simply shifted the capital it expected to spend on bare steel replacement to other capital projects, referred to alternatively by the parties as non-PRP and non-bare steel projects, such that there was no change in Atmos's budget for fiscal years 2019 and 2020.⁷⁶ As a result of that shift, Atmos's spending on non-PRP capital projects went from \$33.9 million in 2018 to \$58.7 million in 2019 and \$68.7 million in 2020.⁷⁷ Moreover, that increase was in addition to an increase from \$18.6 million in 2015 to \$34.2 million in 2016.⁷⁸

Atmos did not obtain a Certificate of Public Convenience and Necessity (CPCN) for any of the projects it claims account for the spending identified above.⁷⁹ Rather, Atmos asserted its belief that none of the projects required a CPCN, because they were in the ordinary course of business. Atmos based that argument, in part, on its contention that none of the projects materially impacted its financial condition, because they did not exceed two percent of its plant in service.⁸⁰ However, a number of projects identified by

⁷⁵ Atmos's Response to Commission Staff's Fourth Request for Information (Staff's Fourth Request), Item 4(a).

⁷⁶ See Atmos's Response to Staff's Fourth Request at Item 4(b)(Atmos acknowledges that the non-PRP spending, also discussed as the non-bare steel spending, increased by approximately the same amount that the PRP spending decreased due to the limitation).

⁷⁷ Atmos's Response to Staff's Third Request, Item 22(a).

⁷⁸ *Id.*

⁷⁹ April 2, 2019, Hearing Transcript at 2:07-2:08 (Atmos's witness indicated that he was not aware of Atmos requesting any CPCNs).

⁸⁰ Atmos's Response to Staff's Third Request, Item 27.

Atmos did fall outside of Atmos's own standard.⁸¹ More importantly, a utility is prohibited from engaging in capital spending for the construction of facilities that would result in wasteful duplication, regardless of whether a CPCN is required.⁸²

Atmos primarily argues that its proposed non-PRP capital expenditures, which it referred to as non-bare steel capital expenditures, were necessary to maintain and accelerate the pace of the replacement of aging facilities in its Kentucky distribution system and to address other non-bare-steel materials.⁸³ Specifically, although Atmos acknowledged its system is currently safe and reliable, Atmos argues that the accelerated replacement of certain non-bare-steel facilities — including Aldyl-A pipes, other early polyethylene pipes, low-pressure systems, and unlocatable pipes — will increase the safety and reliability of its system.⁸⁴ Atmos argues that “a critical aspect to ensuring safety and reliability of the Company’s system in Kentucky is dependent on the Company continuing its targeted investment for non-bare steel [non-PRP] projects.”⁸⁵ Thus, Atmos

⁸¹ See April 2, 2019 Hearing Transcript at 2:07–2:08 (Atmos’s witness indicated that Atmos did not do many projects that came close to the \$10 million level, i.e. the two percent threshold identified by Atmos); Atmos’s Response to Staff’s Second Post-Hearing Request, Item 1, Attachment 1 (identifying a number of projects in fiscal 2019 alone that exceeded \$10 million).

⁸² KRS 278.020(1), in relevant part, prohibits a utility from constructing any plant, equipment, property, or facility without the Commission’s approval, except for “ordinary extensions of existing systems in the usual course of business. The Commission will not grant a CPCN unless the utility establishes that the facility the utility intends to construct will not result in “wasteful duplication.” *Kentucky Utilities Co. v Pub. Serv. Comm’n*, 252 S.W.2d 885 (Ky. 1952). Further, pursuant to 807 KAR 5:001, Section 15(3) a facility is not considered to be in the ordinary course of business if it results in wasteful duplication. Thus, regardless of whether a CPCN is required, a utilities construction of any plant, equipment, property, or facility may not result in wasteful duplication. See also Atmos’s Brief at 53 (“The issue is whether based on the evidence in this record, Atmos Energy has demonstrated that its replacement proposal, its budgeting reliability and its efforts to maintain a safe pipeline system in Kentucky is reasonable.”)

⁸³ Atmos’s Brief at 25.

⁸⁴ Atmos’s Brief at 25–31.

⁸⁵ Atmos’s Brief at 32.

contends that the Commission should permit Atmos's projected non-PRP capital spending at the levels proposed by Atmos.

However, the Commission is unable to find from the evidence that Atmos's proposed level of spending on non-PRP projects is reasonable or necessary. First, the increase in spending on non-PRP capital projects in 2019 and 2020 was driven primarily by the Commission's limitations on the bare steel spending through the PRP.⁸⁶ Atmos indicates that, absent the \$28 million limitation on bare steel investment, spending on non-PRP projects would have been limited to the pre-2019 levels.⁸⁷ Atmos's witness also reluctantly acknowledged that Atmos would have been required to delay some of the proposed non-PRP projects if the capital that was allocated to those projects had been used to fund bare steel projects.⁸⁸ Thus, the Commission finds Atmos would not have proposed to increase its capital spending above pre-2019 levels for the non-PRP projects if Atmos's spending on bare steel had not been limited. The Commission further finds that there is no reasonable basis to assume that Atmos's need to spend on non-PRP projects has increased simply because its spending on PRP projects has been limited to \$28 million. The willingness of Atmos to fund capital projects on an accelerated basis

⁸⁶ Kollen Testimony at 23 ("There is no question that Atmos is intentionally and aggressively driving up its annual capital expenditures year after year. Atmos has met the Commission's attempt to limit the annual PRP investment to \$28 million with staggering increases in annual non-PRP investment. The Atmos forecast total direct investment is unaffected by the Commission's attempt to reign in its PRP investment.").

⁸⁷ See Atmos Response to Staff's Fourth Request, Item 4 (Atmos acknowledges that the non-PRP spending, also discussed as the non-bare steel spending, increased by approximately the same amount that the PRP spending decreased due to the limitation); April 2, 2019 Hearing Transcript at 1:52:00 – 1:55:30.

⁸⁸ April 2, 2019 Hearing Transcript at 1:52:00 – 1:55:30; See also Case No. 2017-00349, *Atmos* (Ky. PSC May 3, 2018); Atmos's Response to Commission Staff's Third Post Hearing Request for Information, Item 3 ("The Company currently has identified at-risk pipe such as early generation and un-locatable plastic which it anticipates proposing for replacement under the PRP starting in 2023.").

does not make those investments necessary and does not obligate the Commission to allow recovery of accelerated investments in the absence of a showing of need by Atmos.

Moreover, although Atmos claims it presented a detailed record of the prudence of its projects,⁸⁹ Atmos's proposed level of spending is not justified by the projects it presents in support of that spending. Atmos's proposed capital spending in the forecasted test year is only supported by actual projects in the first six months of the test year.⁹⁰ In the last six months of the forecasted test year, Atmos simply carries forward its proposed capital spending for the same month of the previous year.⁹¹ It is unlikely that amounts spent on specific projects in a given month would be the same as amounts in the same month of the previous year. Thus, the Commission questions the accuracy of those projections.

More importantly, Atmos failed to demonstrate that the accelerated replacement of certain facilities it contends present safety or reliability issues justify its accelerated level of spending. For instance, Atmos refers to Pipeline and Hazardous Materials Safety Administration (PHMSA) advisories to support an accelerated level of replacement of Aldyl-A pipes and other vintage polyethylene pipes, but the PHMSA notice placed in the record suggested monitoring those pipes and does not mandate or recommend

⁸⁹ Atmos's Brief at 32.

⁹⁰ See Atmos's Response to Staff's Third Request at Item 27, Attachment 1 (in which Atmos presented the projects that it claims support its proposed capital spending); see also April 2, 2019 Video at 1:59:00-2:03 (where Mr. Smith indicated that he was not aware of any other document in the record in which Atmos identified capital projects in support of its proposed spending).

⁹¹ See Atmos's Response to Staff's Third Request, Item 27, Attachment 1 (in which Atmos presented the projects that it claims support its proposed capital spending); Atmos's response to Staff's Second Request, Item 64, Attachment 2, KY_Plant_Data-2018_case.xlsx, Tab Capital Spending.

immediate replacement.⁹² Moreover, the PHMSA notice refers to pre-1973 Aldyl-A as presenting an issue,⁹³ but Atmos argues for the replacement of all Aldyl-A in its system.⁹⁴ Similarly, Atmos justified its spending on farm taps based on PHMSA rules, but PHMSA has indicated an intent to stay enforcement of those rules.⁹⁵ Atmos's witness also acknowledged that pipe Atmos identified as presenting safety or reliability issues either had been replaced in many of the densely populated areas where it would present a greater risk or was located outside those areas.⁹⁶

The Commission affirmatively supports allowing the accelerated replacement of facilities that present safety or reliability issues. As Atmos pointed out, the Commission recognized concerns about Aldyl-A in Case No. 2018-00086.⁹⁷ However, in that case, Delta Natural Gas Company, Inc. acknowledged that all Aldyl-A did not need to be replaced immediately, but rather indicated that it had identified specific sections of Aldyl-A that should be immediately replaced and that it anticipated replacing the remainder of its Aldyl-A over the next 15 to 19 years. Conversely, the evidence indicates that Atmos

⁹² See April 2, 2019 Hearing Transcript at 2:13–2:14 (in which Mr. Smith acknowledged it does not require immediate replacement); See also Smith Rebuttal at Exhibit GWS-R-1 (discussing monitoring and other risk mitigation options).

⁹³ Smith Rebuttal at Exhibit GWS-R-1 (in which the PHMSA notice refers to Aldyl-A manufactured prior to 1973).

⁹⁴ See April 2, 2019 Hearing Transcript at 1:59–2:02; April 2, 2019 Hearing Transcript at 2:48–2:50.

⁹⁵ April 2, 2019 Hearing Transcript 2:30:30–2:31:39 (indicating that PHMSA issued a stay of enforcement while they consider withdrawing rules).

⁹⁶ April 2, 2019 Hearing Transcript 2:43–2:48; See also April 2, 2019 Hearing Transcript 2:39–2:42 (Atmos's witness acknowledged that federal safety regulations do not require the repair of Grade 3 leaks, which Atmos attempts to repair within 36 months).

⁹⁷ Case No. 2018-00086, Electronic Adjustment of the Pipe Replacement program Rider of Delta Natural Gas Company, Order (KY PSC, August 21, 2018).

intends to replace Aldyl-A as quickly as it can obtain capital to do so regardless of the specific need to replace any particular section of pipe. It is this type of capital investment that concerns the Commission, particularly given the significant increases in Atmos's overall capital spending. Thus, the Commission is not able to find that Atmos's proposed level of spending on non-PRP capital projects is reasonable and necessary at this time.

The Commission acknowledges that some level of non-PRP spending is necessary, but Atmos has not shown that it is reasonable to increase non-PRP spending to include the capital that would have been spent on PRP projects but for the \$28 million limitation. It is not possible nor appropriate for the Commission to determine the adequate level of non-PRP spending by reviewing and prioritizing individual projects. Historic investment in the system has resulted in a safe and reliable system, according to Atmos' testimony. Atmos indicated in its testimony that the number of pipeline leaks detected has decreased, even in light of better detection equipment and more frequent leak surveys. Therefore, projected capital spending on non-PRP projects should be limited to a 5-year 2014 through 2018 historical average of \$29.26 million. Prioritizing individual non-PRP projects within that limit on capital spending is a task to be performed by Atmos.

Atmos performs an assessment and analysis of its pipelines as required by PHMSA. These plans, the Distribution Integrity Management Plan (DIMP) and the Transmission Integrity Management Plan (TIMP), are provided to the Commission's pipeline safety inspectors. Capital project spending should be consistent with the DIMP and TIMP as well as limited to the 5-year historical average of capital spending on non-PRP projects. This reduces Atmos's rate base by \$28,089,966; depreciation expense by \$491,659; and ad valorem taxes by \$193,209, which results in revenue requirement

reductions of \$2,823,783; \$495,125; and \$194,571, respectively. The net impact of this adjustment is a revenue requirement reduction of \$3,513,478.

Moreover, while the Commission is not imposing a specific limit on Atmos's non-PRP capital spending in years after the forecasted test period, the Commission may prohibit a return of and on investments that it finds unreasonable or unlawful. Atmos should ensure that the projects it selects to construct are consistent with its DIMP or TIMP. Moreover, if its total non-PRP capital spending exceeds the 5-year rolling average, Atmos should scrutinize the justification for its projects closely and be prepared to provide supporting documentation showing how each project is consistent with its DIMP or TIMP. Significant increases in capital spending would raise questions about the necessity of the spending and may require additional scrutiny by the Commission.

AFUDC or CWIP

Utilities can include either CWIP or AFUDC in rate base to recover financing costs of construction projects. Historically, the Commission has allowed Atmos to include CWIP, net of AFUDC, in rate base; however, in response to discovery, Atmos revealed that AFUDC capitalized in prior periods is still included in rate base as a component of net plant. Atmos argues that removal of CWIP introduces regulatory lag on projects that will be in service and proposes that the Commission make any changes on a prospective basis.⁹⁸ Atmos further argues that the removal of allocated CWIP from divisions that do not record AFUDC results in denial of return on investment and AFUDC.⁹⁹

⁹⁸ Waller Rebuttal Testimony at 9–10.

⁹⁹ *Id.* at 10.

The Attorney General recommends removing CWIP and previously capitalized AFUDC from rate base.¹⁰⁰ The Attorney General argues that Atmos was not authorized to record AFUDC for ratemaking purposes and advocates for the construction finance costs to be capitalized and recovered over the service lives of the assets.¹⁰¹

The Commission agrees with the Attorney General that Atmos is entitled to only include either AFUDC or CWIP in rate base. Atmos does not have the vintage data to calculate AFUDC currently included in net plant before 2006.¹⁰² The Commission finds that CWIP should be excluded from rate base, a revenue requirement reduction of \$3,933,618.

Atmos states that if CWIP is removed from rate base then short-term debt must be removed from the capital structure because short-term debt is primarily used to finance CWIP.¹⁰³ However, Atmos has not shown that it can trace the use of capital such as short-term debt to demonstrate that CWIP is supported solely by short-term debt and that absent CWIP there would be no short-term debt. This argument is unpersuasive as other

¹⁰⁰ Attorney General's Brief at 19–22.

¹⁰¹ *Id.*

¹⁰² Atmos's response to Commission Staff's Fifth Request for Information (Staff's Fifth Request), Item 10.

¹⁰³ Christian Rebuttal Testimony at 14; Atmos's Brief at 6.

utilities that exclude CWIP include short-term debt in their capital structures¹⁰⁴ and the Commission finds that no change to the capital structure is warranted.

Atmos's Benefits/Salaries/Wages/SERP

The Commission is in agreement with the level of salaries and wages for Atmos's forecasted test year. Consistent with Commission precedent in Case No. 2017-00349, Atmos made reductions to its revenue requirement to remove for ratemaking purposes its 401(k) matching contributions in the amount of \$518,619 for those employees also under a defined benefit plan, incentive compensation of \$962,983, and director's stock expense of \$189,721.¹⁰⁵ Through discovery, it was determined that Supplemental Executive Retirement Program (SERP) expenses of \$148,405 were paid by Atmos during the forecasted test year.¹⁰⁶

The Attorney General raised the issue of SERP compensation expenses at the hearing. While the Commission has traditionally denied compensation tied to financial performance standards, the record in this proceeding does not include the basis for SERP compensation. For this reason, the Commission finds the record in this proceeding does

¹⁰⁴ See Case No. 2016-00162, *Application of Columbia Gas of Kentucky, Inc. for an Increase in Base Rates* (Ky. PSC Dec. 22, 2016); Case No. 2017-00179, *Electronic Application of Kentucky Power Company for (1) A General Adjustment of Its Rates for Electric Service; (2) An Order Approving Its 2017 Environmental Compliance Plan; (3) An Order Approving Its Tariffs and Riders; (4) An Order Approving Accounting Practices to Establish Regulatory Assets and Liabilities; and (5) An Order Granting All Other Required Approvals and Relief* (Ky. PSC Jan. 18, 2018); and Case No. 2017-00321, *Electronic Application of Duke Energy Kentucky, Inc. for: 1) An Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New Tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approvals and Relief* (Ky. PSC Apr. 13, 2018).

¹⁰⁵ Application, Volume 7, Schedules F.10 and F.11.

¹⁰⁶ Atmos's responses to the Attorney General's First Request for Information, Item 53, and Commission Staff's First Post-Hearing Data Request, Item 31.b.

not support the adjustment to disallow Atmos's SERP expenses as requested by the Attorney General. Nonetheless, the Commission will require Atmos to address the inclusion of the SERP expenses in rates in its next base rate proceeding, and based upon the evidence in the record at that time, may make an adjustment to disallow the SERP expenses.

Composite Allocation Factors

The Attorney General avers that the composite factors used to allocate expenses from Atmos's Shared Service Division and General Office Division to Atmos are unreasonable and recommends a revenue requirement reduction of \$724,553, to account for the modification of the composite factors.¹⁰⁷

While the Attorney General's proposed revision to the composite factors would result in less expense to Atmos, the Commission is unable to find that those revisions are appropriate. Atmos provided the allocation factors for fiscal years 2018 and 2019 for the Share Service Division and General Office Division for all states in which it operates and the allocation factors totaled 100 percent.¹⁰⁸ Therefore, the Commission finds the allocation factors proposed by Atmos to be reasonable and no adjustment should be made to the composite factors.

Cash Working Capital Allowance

Atmos filed a lead/lag study with its application in this proceeding. Atmos proposes to include a cash working capital requirement of \$2,692,759 in the test-year rate base.¹⁰⁹

¹⁰⁷ Attorney General's Brief at 32–33.

¹⁰⁸ Atmos's response to Staff's Fifth Request, Item 1.

¹⁰⁹ Application, Volume 7, Schedule B.1 F.

The Attorney General proposed a reduction to the revenue requirement of \$845,932 to reflect cash working capital based on the removal of non-cash items from the lead/lag study.¹¹⁰

The Commission finds that the cash working capital allowance included in Atmos's rate base should be based upon the lead/lag study as filed, adjusted for expenses found reasonable herein. Accordingly, the Commission will reduce Atmos's rate base by \$987,582, a revenue requirement reduction of \$99,278.

Rate Case Regulatory Asset and Amortization

Atmos proposes to include \$255,014 in rate base for the 13-month average of a regulatory asset for its expenses related to this proceeding.¹¹¹ Atmos also proposed a 3-year amortization period for this regulatory asset, resulting in amortization expense of \$112,435.¹¹² Atmos projected rate case expenses of \$337,304 but only actually incurred \$189,861.¹¹³ Updating Atmos's proposed amounts to actuals reduces the 13-month average balance by \$79,883 and the amortization amount by \$49,147. The decreased regulatory asset balance results in a revenue requirement reduction of \$49,494 and the decreased amortization expense results in a revenue requirement reduction of \$8,063.

¹¹⁰ Attorney General's Brief at 22–24.

¹¹¹ Application, Volume 7, Schedule F.6.

¹¹² *Id.*

¹¹³ *Id.*; Atmos's supplemental response to Commission Staff's First Request for Information, Item 58, Attachment 1 (filed Mar. 29, 2019).

PRO FORMA ADJUSTMENTS SUMMARY

The effect of the Commission's adjustments on Atmos's pro forma test-period operations is as follows:

	Atmos Forecasted <u>Test Period</u>	Commission Accepted <u>Adjustments</u>	Commission Adjusted <u>Test Period</u>
Operating Revenues	\$169,717,866	\$ -0-	\$ 169,717,866
Operating Expenses	<u>142,015,942</u>	<u>(4,278,864)</u>	<u>137,737,078</u>
Net Operating Income	<u>\$ 27,701,923</u>	<u>\$ 4,278,864</u>	<u>\$ 31,980,788</u>

RATE OF RETURN

Capital Structure and Cost of Debt

The Kentucky/Mid-States Division of Atmos Energy Corporation is not a separate legal entity, and therefore Atmos Energy Corporation issues all debt or equity funding. For ratemaking purposes, the proposed capital structure is equivalent to the Atmos Energy Corporation capital structure as of June 30, 2018, with an adjustment to the outstanding long-term debt. This proposed capital structure consists of 38.31 percent long-term debt at a cost of 4.72 percent; 3.44 percent short-term debt at a cost of 2.40 percent; and 58.24 percent common equity with a proposed ROE of 10.40 percent.¹¹⁴ The adjustment to the long-term debt reflects the then-anticipated March 2019 refinancing of \$450 million, plus any other costs associated with this refinancing at an interest rate of 5.07 percent.¹¹⁵

¹¹⁴ Atmos's response to Staff's Second Request, Item 64, Schedule J.1.

¹¹⁵ *Id.*

The Attorney General raises concern over the capital structure, noting an increase in the common equity ratio paired with the requested ROE.¹¹⁶ The Attorney General points out that the common equity portion has increased from 52.57 percent, as approved in Atmos' last rate case, Case No. 2017-00349,¹¹⁷ to 58.24 percent in the pending case.¹¹⁸ The Attorney General notes that the increase in common equity, paired with Atmos' proposed ROE of 10.4 percent, significantly increases the cost of capital and base revenue requirement.¹¹⁹ The Attorney General also maintains that the proposed capital structure and cost of debt does not reflect the October 2018 Long-Term Debt Issuance for \$600 million at 4.30 percent interest.¹²⁰ The Attorney General recommends capping the common equity portion of the capital structure at 54.3 percent, which is the capital ratio after adjusting for the October debt issuance.¹²¹ In further support of the common equity cap, the Attorney General points out that the average common equity ratio for the proxy group used in the ROE analysis is approximately 53 percent.¹²²

The Attorney General also proposes to reduce the cost of the forecasted March 2019 Long-Term debt issuance.¹²³ As proposed by Atmos, the 5.07 percent interest rate

¹¹⁶ Kollen Testimony at 39–48.

¹¹⁷ Case No. 2017-00349, *Atmos* (Ky. PSC May 3, 2018).

¹¹⁸ Kollen Testimony at 39–40.

¹¹⁹ *Id.* at 40.

¹²⁰ *Id.* at 42.

¹²¹ *Id.* at 41.

¹²² *Id.* at 40.

¹²³ *Id.* at 43–45.

is the sum of the forecasted 30-year Treasury yield of 3.78 percent plus a 1.00 percent credit spread and 0.29 percent issuance fees.¹²⁴ The Attorney General recommends using a more current 30-year Treasury yield of 3.10 percent, plus the credit spread and issuance fees, for a forecasted rate of 4.39 percent.¹²⁵

In rebuttal, Atmos rejects the Attorney General's proposed cap for the common equity and argues that the common equity ratio in the proposed capital structure is within the 50 – 60 percent range that is common today, and is the result of increased investment in infrastructure across Atmos's distribution utilities.¹²⁶ Atmos further argues that a higher common equity ratio is characteristic of the current trend for utilities to strengthen the equity portion of their balance sheets in order to counter the impact that the Tax Cuts and Jobs Act has had on financial metrics.¹²⁷ Atmos avers that it has intentionally improved its credit metrics through increased equity and decreased reliance on debt financing for more favorable access to capital markets.¹²⁸

Atmos agrees that the cost of long-term debt should be adjusted to reflect the October 2018 debt issuance, but believes that all of the capital structure components should also be updated, including an equity issuance in November 2018 and the March 2019 debt issuance. Updating the capital structure with these known and measurable adjustments, including an update to the short-term debt rate, results in a capital structure

¹²⁴ *Id.* at 44.

¹²⁵ *Id.*

¹²⁶ Christian Rebuttal Testimony at 5–6.

¹²⁷ *Id.* at 6.

¹²⁸ *Id.* at 7.

of 39.73 percent long-term debt at a cost of 4.56 percent; 2.21 percent short-term debt at a cost of 3.40 percent; and 58.06 percent common equity.¹²⁹

In the post-hearing brief, the Attorney General reemphasizes his position that the common equity ratio is out of proportion not only to Atmos' needs but also in comparison to its peer companies.¹³⁰ In support of this position, the Attorney General provided the common equity ratios from the most recent SEC Form 10-K filings of each proxy group company, and found the average to be 50.2 percent, hence revising his position to cap common equity at 50.2 percent, or, at a minimum, the amount approved in the last rate case of 52.57 percent.¹³¹ The Attorney General further justifies a lower common equity portion by noting that Atmos's proposed capital structure directs more of its required rate of return to shareholder profits.¹³² The Attorney General observes that 76.30 percent of the revenue impact resulting from the cost-of-capital return on the proposed rate base relates exclusively to shareholder return.¹³³ The Attorney General agrees with Atmos's updated actual long-term debt rate of 4.56 percent for the October 2018 and March 2019 debt issuances, but is silent on all other capital structure updates.¹³⁴

The table below lists the common equity ratios for Atmos's present and past three rate cases:

¹²⁹ *Id.* at 8–11.

¹³⁰ Attorney General's Brief at 25.

¹³¹ *Id.*

¹³² *Id.* at 27.

¹³³ *Id.*

¹³⁴ *Id.* at 26.

Case No.	Common Equity Ratio
Pending Case	58.06%
2017-00349 ¹³⁵	52.57 %
2015-00343 ¹³⁶	None specified
2013-00148 ¹³⁷	49.16 %

Atmos’s common equity ratio has had average annual increases of 18.10 percent.¹³⁸ This increase in common equity is also illustrated in Exhibit JTC-R-1 of the Rebuttal Testimony of Joe T. Christian. As noted above, Atmos admits to strengthening the equity component and contends that this upward movement is the result of increased investment.¹³⁹ Atmos provides the capital structure ranges since 2012 from Atmos Energy Corporation’s SEC Form 10Ks noting that the parent company raised the top of its range to 60.00 percent in 2017 in order to maintain a strong balance sheet and credit rating.¹⁴⁰

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

¹³⁵ Case No. 2017-00349, (Ky. PSC May 3, 2018), Order at 20.

¹³⁶ Case No. 2015-00343, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Aug. 4, 2016).

¹³⁷ Case No. 2013-00148, *Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications* (Ky. PSC Apr. 22, 2014) at 9.

¹³⁸ This increase in common equity is also illustrated in Exhibit JTC-R-1 of the Christian Rebuttal Testimony.

¹³⁹ Christian Rebuttal Testimony at 5.

¹⁴⁰ *Id.*

and 59.37 percent equity.¹⁴¹ 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 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.

Return on Equity

In its application, Atmos developed its proposed ROE using the Discounted Cash Flow (DCF) method, two Risk Premium (RP) methods, and two Capital Asset Pricing Model (CAPM) methods.¹⁴² Deriving it from the cost of capital evaluations, Atmos proposes an ROE, adjusted for flotation costs, of 10.4 percent based on the average of the model outputs.¹⁴³ Atmos maintains that an ROE of 10.4 percent is conservative because the financial risk of the comparable companies used in the models is less than the financial risk associated with the lower equity ratio used in Atmos's ratemaking capital structure.¹⁴⁴ The table below summarizes Atmos's ROE estimates:¹⁴⁵

¹⁴¹ *Id.* at 6. Value Line excludes short-term debt. The calculation for Atmos also excludes short-term debt and is based upon Atmos's filed rebuttal capital structure.

¹⁴² Direct Testimony of James H. Vander Weide, Ph.D. (Vander Weide Testimony).

¹⁴³ *Id.* at 4.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 46.

STUDY	ROE
DCF	9.2%
Ex Ante Risk Premium	10.9%
Ex Post Risk Premium	10.2%
CAPM – Historical	9.7%
CAPM - DCF Based	11.7%
Average	10.4%

The Attorney General did not provide a specific ROE witness, but analyzed Atmos's DCF model and Regulatory Research Associates' Inc. (RRA) averages of authorized gas ROE's.¹⁴⁶ The Attorney General only focused on the DCF model, stating that the Commission has historically relied on the DCF methodology for ROE analysis.¹⁴⁷ The Attorney General eliminated all floatation costs, noting that historically the Commission has rejected the use of flotation costs.¹⁴⁸ Using Atmos's DCF model, the Attorney General states that the average of the proxy group, without flotation costs, is 9.1 percent.¹⁴⁹ The Attorney General also provided the RRA's average authorized ROEs for general gas rate cases for 2017 and up to September 2018, of 9.72 and 9.62 percent, respectively.¹⁵⁰ The Attorney General initially recommended an ROE of 9.7 percent,

¹⁴⁶ Kollen Testimony at 45–48.

¹⁴⁷ Kollen Testimony at 46.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 47.

noting that is in excess of the DCF model, without flotation costs, but is consistent with recently authorized returns for other gas utilities.¹⁵¹

In response to the Attorney General, Atmos maintains that a 10.4 percent ROE represents the average cost of equity when applying various cost-of-equity methods to the proxy group, and notes that frequently various methods are used to estimate the cost of equity.¹⁵² Atmos criticizes the Attorney General's witness for not providing any evidence to support his recommendation of a 9.7 percent ROE and notes that this is the same ROE awarded in Atmos's previous rate case, Case No. 2017-00349.¹⁵³ Atmos then criticizes the Commission for not explaining precisely how it arrived at the awarded 9.7 percent ROE in Case No. 2017-00349, and further points out disagreements it has with the Commission's conclusions concerning the ROE from the 2017 case.¹⁵⁴ Specifically, Atmos disagrees with the Commission's ruling regarding the exclusion of flotation costs, claiming that the Commission is not allowing Atmos to recover its full cost of stock issuances.¹⁵⁵ Atmos also speaks to the Commission's exclusion of South Jersey Industries as a proxy company for the DCF analysis and argues that the cost of equity recommendation should depend on multiple cost equity models, not a single model such as the DCF model.¹⁵⁶ In addition, Atmos offers its differing opinion regarding the

¹⁵¹ *Id.*

¹⁵² Rebuttal Testimony of James H. Vander Weide (Vander Weide Rebuttal Testimony) at 1–3.

¹⁵³ *Id.* at 3–10.

¹⁵⁴ *Id.* at 4.

¹⁵⁵ *Id.* at 4–5.

¹⁵⁶ *Id.* at 6.

consideration of other authorized ROEs in the gas utility industry and alludes to this data being stale.¹⁵⁷ Finally, Atmos mentions Duke Energy Kentucky's ROE award of 9.725 percent.¹⁵⁸

In the rebuttal testimony, Atmos notes that the Commission referred to the average earned ROE in the natural gas utility industry in its Final Order in Case No. 2017-00349, and that the Commission encouraged Atmos to look not only at other regulatory decisions but also at capital markets and expected returns from similar risk utilities.¹⁵⁹ Atmos presents similar information, updated for 2018. This data, based upon the earned and expected ROEs from Value Line for natural gas utilities, reports the average to be 10.4 percent for 2018 and forecasts 10.6 percent for 2022–2024.¹⁶⁰ Atmos states that these data further support its position that the Attorney General's recommended ROE is too low and that Atmos's proposed ROE of 10.4 percent is reasonable.¹⁶¹ Atmos also provides updated cost-of-equity studies supporting a 10.5 percent ROE.¹⁶²

In his post-hearing brief, the Attorney General addresses the 9.7 percent ROE awarded in Case No. 2017-00349, and emphasizes that the 9.7 percent ROE was for a

¹⁵⁷ *Id.* at 7–10.

¹⁵⁸ This awarded ROE was for Duke Energy Kentucky's electric division. The Commission follows the common industry belief that the risk associated with electric utilities is greater than that of natural gas utilities.

¹⁵⁹ Vander Weide Rebuttal Testimony at 9.

¹⁶⁰ *Id.* at 8.

¹⁶¹ *Id.*

¹⁶² *Id.* at 9–10.

test-year ending just recently, on March 31, 2019.¹⁶³ The Attorney General continues by stating that since Atmos's rates were set 11 months ago long-term interest rates have decreased.¹⁶⁴ The Attorney General reiterates that the Commission has never allowed for a flotation adjustment and accuses Atmos of further inflating its models by using a quarterly calculation in the DCF model and using forecasted interest rates based on the assumption that they will increase.¹⁶⁵

The Attorney General continues by stating that the evidence of record actually supports a decrease in Atmos's current ROE.¹⁶⁶ The Attorney General cites to the fact that Atmos's own models have decreased 20 basis points from a proposed 10.6 percent ROE in Case No. 2017-00349 to 10.4 percent in the pending case.¹⁶⁷ The Attorney General mentions that Atmos intends to file annual rate cases based upon forecasted test-years that will allow for recovery of all forecasted capital and operating costs, and thus reduce risk associated with the recovery of these costs.¹⁶⁸ The Attorney General uses Atmos's updated DCF analysis and removes the size premium and flotation costs for a model result of 9.44 percent, which he says is also inflated due to the use of a quarterly versus an annual DCF model.¹⁶⁹ The Attorney General recommends the

¹⁶³ Attorney General's Brief at 27.

¹⁶⁴ *Id.* at 28.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 29.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 30.

Commission reject Atmos's CAPM analysis, citing the fact that Atmos's expert witness has rejected his own CAPM analyses in past cases due to the beta coefficient being below one (0.69 in this case), and reject the Risk Premium analysis as the Attorney General is unaware of the Commission ever explicitly approving that method.¹⁷⁰ The Attorney General states that, for all these reasons, he supports a decrease in the current ROE and revises his proposed ROE recommendation to 9.45 percent.¹⁷¹

In the post-hearing brief, Atmos reiterates its position that the Attorney General's witness presents no supporting study or analysis, has no expert experience on the subject of ROE, and merely concludes that the ROE should just be a predetermined ROE from a previous case.¹⁷² Atmos contends that the proposed ROE of 10.4 percent is supported by standard cost-of-equity estimation models such as the DCF, RP, and CAPM models.¹⁷³ Atmos further supports its assertion that the proposed ROE is conservative because it allows for Atmos an opportunity to recover prudently incurred operating expenses and earn a fair rate of return on its incurred investment.¹⁷⁴ Atmos notes that investors' perception of risk is strongly influenced by regulation and investors are aware when a regulator does not allow an opportunity to recover costs in a timely manner and earn a fair and reasonable return on investment.¹⁷⁵

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 31.

¹⁷² Atmos's Brief at 37.

¹⁷³ *Id.* at 37.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 39.

For the DCF model, Atmos employed a quarterly model.¹⁷⁶ Atmos believes a quarterly model is more correct than the annual DCF model since all the proxy group companies pay quarterly dividends.¹⁷⁷ The annual DCF model is more applicable for annual dividend payments. However, Atmos does note that the annual model produces similar results.¹⁷⁸ Atmos offers further support for the filed RP and CAPM models. Regarding flotation costs, Atmos states that regardless of the Commission's prior regulatory policy of disregarding these costs, they are appropriate and based on a recognized economic proposition and that disregarding these costs will not allow Atmos to earn a fair ROE.¹⁷⁹ Atmos further avers that if flotation costs are removed, a company has no incentive to invest in new capital projects.¹⁸⁰

Regarding interest rates, Atmos continues to support its opinion that interest rates will rise as the Federal Reserve System (FED) battles inflation and that a forecasted interest rate allows for a fair return.¹⁸¹ Atmos contends that the use of current interest rates is inconsistent with the fair rate of return standard.¹⁸² Atmos states that even with annual rate cases, forecasted long-term interest rates support its equity models because at each point in time the cost of equity reflects an investor's expected return over the long-

¹⁷⁶ *Id.* at 41.

¹⁷⁷ *Id.*

¹⁷⁸ Vander Weide Testimony at 20.

¹⁷⁹ Atmos's Brief at 42–43.

¹⁸⁰ *Id.* at 43.

¹⁸¹ *Id.* at 44.

¹⁸² *Id.*

term life of the investment, and current long-term interest rates may not reflect investors' estimates of the expected return over the life of the investment.¹⁸³ Atmos reiterates that a fair ROE is forward-looking, provides an opportunity to earn a return over the time rates are in effect, and is on par with the returns investors expect on comparable investments.¹⁸⁴ Atmos concludes that although the updated equity models estimate a 10.5 percent ROE, the utility believes an ROE of 10.4 percent will be consistent with current investor expectations, even with the intention to file annual rate cases and the potential reduction of regulatory lag.¹⁸⁵

The Commission has not altered its opinion regarding flotation costs and agrees with the Attorney General that flotation costs should be excluded from the ROE analysis. Atmos argues that if flotation costs are excluded then the issuing company will not be able to earn a fair ROE and that removal allows no incentive to invest in capital projects. Such an argument is unfounded and unsupported. This Commission has never allowed for the inclusion of flotation costs,¹⁸⁶ yet Atmos' PRP and Non-PRP investment has increased 125 percent since 2013.¹⁸⁷ Furthermore, as reported by Value Line, Atmos' average ROE between 2015 and 2018 is 9.78 percent.¹⁸⁸ Clearly, Atmos is earning a

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 45.

¹⁸⁵ *Id.* at 46.

¹⁸⁶ Attorney General's Brief at 28.

¹⁸⁷ Kollen Testimony at 21. Direct Investment in 2013 was \$35.5 million and \$79.8 million in 2018.

¹⁸⁸ The Value Line Investment survey, Issue 3, March 1, 2019.

return despite the past exclusions of flotation costs.¹⁸⁹ The Commission also rejects Atmos's proposed size premium adjustments.

Atmos testified that interest rates would increase due to the FED's response to inflation.¹⁹⁰ Inflation has remained at or below the FED's target level of 2 percent since 2012.¹⁹¹ There was some concern in 2017 and 2018 about inflation rising, with a corresponding response by the FED.¹⁹² However, inflation worries have eased, as the current level of 1.9 percent inflation rate for the 12 months ending March 2019 indicates, and so have interest rates.¹⁹³ At the recent Federal Open Market Committee meeting, the FED held interest rates steady and indicated that no more increases would be coming this year, revising policy projections made just three months earlier.¹⁹⁴ This change supports the Commission's view that forecasted interest rates are unpredictable and not guaranteed, and that current interest rates are the best measure as they are unbiased and efficient. Atmos contends that there is an upward movement in interest rates and even disagrees with the FED's announcement of no new increases, relying instead on Value Line estimates. These differing forecasts support the proposition that forecasts vary and are uncertain.¹⁹⁵ For further support of the uncertainty in forecasted rates, one

¹⁸⁹ Atmos' response to Staff's Second Request, Item 55; Vander Weide Rebuttal Testimony at 8; Atmos's Response to the Attorney General's First Request for Information, Item 26.

¹⁹⁰ Atmos's Brief at 44.

¹⁹¹ See <https://www.usinflationcalculator.com/inflation/current-inflation-rates/>

¹⁹² See <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>

¹⁹³ See <https://www.usinflationcalculator.com/inflation/current-inflation-rates/>

¹⁹⁴ See <https://www.federalreserve.gov/monetarypolicy/fomcpresconf20190320.htm>

¹⁹⁵ Atmos's response to Staff's First Post-Hearing Request, Item 17.

can look at the 10-year, 20-year, and 30-year Treasury Yields since the final Order in Case No. 2017-00349. These Treasury yields have actually decreased.¹⁹⁶ Atmos's expert witness on ROE, Mr. Vander Weide, stated during the formal hearing that although the interest rates have remained relatively flat since the last rate case, he does not expect this trend to continue.¹⁹⁷ Mr. Vander Weide made the same statement in Case No. 2017-00349, testifying that future interest rates will be higher than current interest rates, when in fact this has not occurred.¹⁹⁸ Mr. Vander Weide stated that a forward-looking return is based on the latest available information in the capital markets, but the Commission believes that in this current economic and low-interest-rate environment, forecasted interest rates are not reliable and the best estimate is the most current interest rate.

For 2017, the average authorized ROE in the natural gas utility industry as reported in the RRA's quarterly review was 9.72 percent and, absent an outlier, 9.63 percent.¹⁹⁹ For general rate cases decided from January 2018 through September 2018, the average authorized natural gas return was 9.62 percent.²⁰⁰ Atmos submitted Value Line's average earned and expected returns on equity for natural gas utilities for 2018, which was 10.4 percent. This average included a 17.1 percent ROE for New Jersey Resources. When Dr. Vander Weide was asked at the formal hearing whether he believed the 17.1 percent ROE was an outlier and if he believed this type of return to be sustainable, he stated that

¹⁹⁶ Atmos's response to Staff's Fifth Request for Information, Item 9.

¹⁹⁷ April 2, 2019 Hearing Transcript at 9:14:09.

¹⁹⁸ Case No. 2017-00349, Direct Testimony of James H. Vander Weide Ph.D. at 31.

¹⁹⁹ Case No. 2017-00349, Atmos (Ky. PSC May 3, 2018), Order at 29.

²⁰⁰ Kollen Testimony at 47; In the April 11, 2019 edition of the RRA Regulatory Focus, the average ROE for natural gas utilities was 9.55 percent for the first quarter of 2019 and 9.59 percent for 2018.

he would not look at the 2018 numbers but at the 2022-2024 estimates of 10.6 percent as a more reliable estimate of investor expectation.²⁰¹ This Commission finds that New Jersey Resources' ROE is an outlier and not sustainable.²⁰² Removing New Jersey Resources results in an average 2018 earnings of 9.61 percent.

Removing the flotation and size premium adjustments²⁰³ and using the current interest rates, Atmos's models produce the following results:

STUDY	ROE
DCF ²⁰⁴	9.1%
Ex Ante Risk Premium ²⁰⁵	9.7%
Ex Post Risk Premium ²⁰⁶	8.8%
CAPM – Historical ²⁰⁷	9.1%
CAPM - DCF Based ²⁰⁸	11.6%
Average	9.66%

²⁰¹ April 2, 2019 Hearing Transcript at 9:29:10.

²⁰² The March 2019 Value Line indicated that the equity's priced has receded about 6.5 percent since November supporting the unsustainability of such a high ROE. The reported ROE as of May 1, 2018 was 13.78 percent (see <https://finance.yahoo.com/quote/NJR/key-statistics?p=NJR>).

²⁰³ This Commission has never allowed for size premium adjustments nor has it ever been explicitly approved or cited in Orders from other States which regulate Atmos. See Atmos's response to Staff's First Post-Hearing Request, Item 20.

²⁰⁴ Atmos's response to Staff's Second Request, Item 54.

²⁰⁵ *Id.*, Item 50; Vander Weide Testimony at 32. Adding the current average yield on A-rated bonds of 4.45 percent of the risk premium of 5.2 percent.

²⁰⁶ *Id.*, Item 50; Vander Weide Testimony at 36. Adding the current average yield on A-rated bonds of 4.45 percent to the midpoint of the risk premium of 4.35.

²⁰⁷ *Id.*, Item 56.

²⁰⁸ *Id.*, Item 57.

The Commission believes that if Atmos files annual rate cases, as it has indicated it will do, regulatory lag will be reduced. Dr. Vander Weide testified that annual rate cases can reduce regulatory lag, but this is dependent upon whether historical or forecasted data is used for expenses, rate base, and capital expenditures, as historical data increases regulatory lag. He further stated that using a forward-looking test year allows the utility to actually earn its required rate of return, but if the data is historical then the utility cannot.²⁰⁹ Atmos is using a forecasted test year, which, coupled with annual rate cases, allows Atmos to mitigate the risk inherent to the regulatory process. In addition, trackers such as the PRP, which is being maintained with forecasted spending levels, allow for more timely capital cost recovery, to the benefit of Atmos and its stockholders. In evaluating Atmos's ROE, the Commission considered this reduction in regulatory lag and the filing of frequent rate adjustment applications based upon forecasted test periods.²¹⁰ Additionally, Atmos's own model results, as adjusted in the table above,²¹¹ of 9.66, the current proxy company yields of 9.61 percent, and the average ROE awarded through September 2018 of 9.62 percent support an awarded ROE that is lower than Atmos's proposed 10.4 percent. The Commission recognizes the expected ROE of 10.6 percent for natural gas utilities, but with annual rate cases, Atmos will have filed two more cases by 2022 and the data in these future cases will more accurately reflect the 2022 – 2024 period. The Commission also recognizes Atmos's current level of equity and the

²⁰⁹ April 2, 2019 Hearing Transcript at 9:02:26.

²¹⁰ See, Case No. 2010-00036, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year* (Ky. PSC Dec. 14, 2010).

²¹¹ Adjustments include removal of flotation costs and size premium adjustments and reflects the most current interest rates filed in the record.

decrease in risk associated with an increase in the customer charge, as discussed below. This customer charge increase will remove much of the reliance upon weather for revenue, lowering Atmos' risk of revenue exposure. Therefore, the Commission finds that an ROE of 9.65 provides Atmos with a fair and reasonable rate of return. In this decision, the Commission considers analysts' projections regarding future growth, as used in the DCF analysis. But just as important, the Commission must give consideration to the current economic environment, which is showing signs of slower growth and a dampened momentum. The Commission would also remind Atmos that our role is not to provide modeling, but to evaluate the parties' models and the current economy, and to arrive at an opinion regarding the evidence while balancing the needs of both utilities and consumers when determining rates that are fair, just, and reasonable. The effect of this adjustment is a reduction in the revenue requirement of \$2,928,240.

Rate-of-Return Summary

Applying the cost rates of 3.40 percent for short-term debt, 4.56 percent for long-term debt, and 9.65 for common equity to the proposed capital structure percentages consisting of 2.21 percent, 39.73 percent, and 58.06 percent, respectively, produces an overall cost of capital of 7.49 percent.

REVENUE REQUIREMENTS

Based upon Atmos's revised requested increase of \$14,509,652 and recognizing downward adjustments of \$14,771,421 found reasonable herein,²¹² Atmos's revenue sufficiency is \$261,769.

²¹² See Appendix A to this Order for a summary of adjustments.

PRICING ISSUES

Cost-of-Service Study

Atmos filed three fully allocated cost-of-service studies (COSS), as required by Case No. 2013-00148.²¹³ The Attorney General's testimony did not address Atmos's COSSs and did not include any alternate COSSs. Having reviewed the three COSSs, the Commission finds that the COSSs are acceptable to use as a guide in setting rates for Atmos. The Commission further finds that the directive from Case No.2013-00148 for Atmos to file multiple-methodology COSSs in future rate cases is no longer necessary. However, Atmos may file multiple studies, as Columbia Gas does, if it so chooses.²¹⁴

Revenue Allocation

The process used by Atmos to forecast test period revenues is the same as prior rate case filings, which is normalized based on 20-year average heating degree-days. This method has been found to be reasonable and accepted without adjustment in past rate cases.

Atmos proposes to retain its current rate structure and general balance of fixed and variable cost recovery, which is supported by its filed COSS. While the results of its COSS show that the Residential and Non-Residential Interruptible Sales do not adequately contribute to its cost to serve, it chose to allocate a portion of the requested revenue increase to each customer class.²¹⁵ Atmos proposes to increase the customer

²¹³ Case No. 2013-00148, Application of Atmos Energy Corporation for an Adjustment of Rates and Tariff Modifications (Ky. PSC May 22, 2014). Atmos filed a Customer/Demand study, a Demand/Commodity study, and a Demand-Only study.

²¹⁴ See Case No. 2016-00162, *Application of Columbia Gas of Kentucky, Inc. for an Increase in Base Rates* (Ky. PSC Jan. 22, 2016).

²¹⁵ Martin Testimony at 13.

charges of all classes, and allocate the remainder of each class's increase to volumetric rates.²¹⁶ The results illustrate that the Non-Residential Interruptible Sales Class contributes a minimal to negative return at present rates and that the proposed increase was significantly less than what was necessary to remove any subsidy. Atmos states that the class consists of only ten customers and the usage is significantly lower than the usage in other classes.²¹⁷ Atmos suggests a balanced view of class costs would be to combine this class with the much larger Interruptible Transportation class.²¹⁸ Atmos further notes the rate design dictates the same customer charge and distribution rates for the two Interruptible rate classes, so that any change to one would affect the other.²¹⁹ Atmos submits that as proposed, the revenue distribution is a reasonable movement toward reducing interclass subsidies and the residential class is not subsidizing any other class, including the Non-Residential Interruptible Sales Class.²²⁰ As previously mentioned the Attorney General submitted no COSS and made no recommendation regarding revenue allocations.

The Commission agrees with Atmos's testimony regarding the Non-Residential Interruptible Sales Class and further agrees that currently the residential class is not subsidizing this or any other rate class. The Commission's allocation of the required

²¹⁶ *Id.*

²¹⁷ Atmos's Brief at 49.

²¹⁸ *Id.*

²¹⁹ *Id.* at 50.

²²⁰ *Id.* at 51.

revenue, as reflected in the rates found reasonable herein, and, as discussed below, will be applied to both the base monthly customer charges and the volumetric rates.

Rate Design

Atmos proposed no change in rate design, maintaining a monthly base customer charge and declining block volumetric rates for all rate schedules. It proposed to increase the G-1 Firm Sales Service base customer charge to \$20.50 for residential customers and to \$51.75 for non-residential customers. It also proposed to increase the base customer charge for G-2 Interruptible Sales Service and for T-4 and T-3 Firm and Interruptible Transportation Service customers to \$435.00. Atmos proposed to increase volumetric rates for all customer classes.

As previously mentioned, the Attorney General made no recommendation with regard to rate design in direct testimony, nor did the Attorney General make any specific recommendations as to rates resulting from any decrease or increase in revenues approved by the Commission. The Attorney General did make a recommendation regarding rate design in his post-hearing brief. Here, the Attorney General contends that Atmos has not presented any evidence that the current residential customer charge needs to be increased.²²¹ The Attorney General notes that the Commission rejected the same proposed customer charge in its last rate case, stating the current charges were reasonable and should remain at their current levels for all customer classes.²²²

²²¹ Attorney General's Brief at 33.

²²² *Id.*

The proposed residential customer charge of \$20.50 is supported by the filed COSS's and supports the Commission's movement towards a rate structure that is based upon the cost to serve each customer class. However, based upon the approved revenue requirement, this proposed residential customer charge increase, coupled with the decrease in the volumetric rate, places an overall increase on the average residential customer bill. In keeping with Atmos's proposed percent of revenue contribution from each volumetric block, a residential customer charge of \$18.40 results in a revenue-neutral impact upon the average residential customer. However, the Commission believes that increasing the residential customer charge from \$17.50 to \$18.40 does not move the residential class close enough to the true cost to serve. The Commission finds that increasing the residential customer charge to \$19.30 and decreasing the volumetric rate accordingly, so that the average bill impact is revenue neutral, results in rates that are fair, just, and reasonable. The Commission recognizes that the residential class is not paying its full cost of service. This rate design will further reduce the residential class subsidy and move the entire rate design closer to the cost to serve. Therefore, the Commission will approve a residential customer charge of \$19.30. This increase in the residential customer charge decreases risk and revenue exposure associated with a decreased reliance on weather and this impact is reflected in the awarded ROE. The Commission further finds that the proposed customer charges for the remaining rate classes are within the range of reasonableness and will be approved.

TARIFF ISSUES

Pipeline Replacement Program

Atmos's compliance tariff containing the Commission's requirements in this Order should reflect its PRP tariff as approved prior to the Commission's final order revising the PRP provisions in Case No. 2017-00349.

Demand-Side Management Cost Recovery Mechanism

Atmos requests minor text changes to its DSM tariff related to the timing of the distribution charge adjustment. The Commission finds that these changes are reasonable and should be approved. The Commission also finds that, upon the implementation of new base rates, the DSM Lost Sales Adjustment component of Atmos's DSM cost-recovery mechanism should be reset to zero. Atmos's compliance tariff should reflect this revision to the DSM Cost Recovery Mechanism.

WNA Rider

Atmos is proposing to update the period used to weather normalize revenues for the WNA Rider. The Commission finds that this update is reasonable and should be approved.

MISCELLANEOUS ISSUES

Lobbying Activities

The Attorney General proposes that the Commission disallows for ratemaking purposes the entire salary of Mr. Martin, the Vice President of Rates and Regulatory Affairs for the Kentucky/Mid-States Division of Atmos.²²³ The Attorney General asserts

²²³ Attorney General's Brief at 13.

that Mr. Martin is listed on the March 26, 2019 Kentucky Registered Legislative Employers list as the in-state contact for Atmos Energy.²²⁴ Mr. Martin admits that he does have some communication with Atmos's employed lobbyist, Mr. Raymond "Rusty" R. Ashcraft, and files periodic reports as required by the Legislative Ethics Commission.²²⁵ However, the Attorney General contends that Mr. Martin has not defined how much of his time is spent on lobbying efforts on behalf of Atmos, communication with the legislature, or communication with Atmos's Governmental and Public Affairs Department in Dallas, Texas.²²⁶ The Attorney General also argues that Mr. Martin declined to answer cross-examination questions at the formal hearing regarding certain accounting issues, such as Atmos's election of CWIP vs. AFUDC, as well as the calculation of its rate base and revenue requirement in the pending filing, but instead deferred those lines of questioning to another Atmos witness.²²⁷ Due to these issues, the Attorney General recommends that the Commission disallow Mr. Martin's salary in its entirety.

Commission regulation 807 KAR 5:016 prohibits the inclusion of any expenditures for political advertising for ratemaking purposes. As defined in 807 KAR 5:016, Section 4(1)(a), political advertising is intended to influence "public opinion with respect to legislative, administrative, or electoral matters, or with respect to any controversial issue of public importance." The Commission has historically disallowed lobbying expenses from being included in base rates, including the exclusion of certain portions of

²²⁴ *Id.*; April 2, 2019 Hearing Transcript at 10:42:01–10:46:20.

²²⁵ Attorney General's Brief at 13; Attorney General's Hearing Exhibit 15.

²²⁶ *Id.*

²²⁷ Attorney General's Brief at 14.

employee's salaries that were determined to be lobbying-related, as well as the corresponding portion of the employee taxes and benefits.

The Attorney General did not raise the lobbying issue until the formal hearing, and as such, the Commission finds that there is a lack of evidence in the record to grant the Attorney General's request to disallow Mr. Martin's salary in its entirety. At the formal hearing, Mr. Martin stated that he spends a minimal amount of time handling administrative issues relating to lobbying.²²⁸ Nonetheless, the Commission will require Atmos to prospectively keep adequate records to delineate the time that Mr. Martin, or any Atmos employee, spends on lobbying efforts. The Commission puts Atmos on notice that these records need to be filed with its next base rate case, at which time a determination will be made if any adjustment to employee salaries, taxes, and benefits is needed to reflect lobbying-related activities.

Certificate of Public Convenience and Necessity (CPCN)

Atmos states that its process for determining whether to file an application with the Commission for a CPCN before beginning the construction of any plant, equipment, property, or facility, is to review each project and decide whether it falls within the scope of KRS 278.020 or 807 KAR 5:001(15)(3).²²⁹ Kentucky statute requires that a utility must first acquire a CPCN prior to beginning construction of any plant, equipment, property, or

²²⁸ April 2, 2019 Hearing Transcript at 10:42:01–10:46:20.

²²⁹ Atmos's response to Commission Staff's Third Request for Information (Staff's Third Request), Item 3; April 2, 2019 Hearing Transcript at 11:34:00–11:41:00.

facility, except for certain service connections for electric-consuming facilities and ordinary extensions in the usual course of business.²³⁰

KRS 278.020 provides, in pertinent part, that:

No person, partnership, public or private corporation, or combination thereof shall commence providing utility service to or for the public or begin the construction of any plant, equipment, property, or facility for furnishing to the public any of the services enumerated in KRS 278.010, except retail electric suppliers for service connections to electric-consuming facilities located within its certified territory and ordinary extensions of existing systems in the usual course of business . . . until that person has obtained from the Public Service Commission a certificate that public convenience and necessity require the service or construction.

807 KAR 5:001, Section 15(3), further provides:

Extensions in the ordinary course of business. A certificate of public convenience and necessity shall not be required for extensions that do not create wasteful duplication of plant, equipment, property, or facilities, or conflict with the existing certificates or service of other utilities operating in the same area and under the jurisdiction of the commission that are in the general or contiguous area in which the utility renders service, and that do not involve sufficient capital outlay to materially affect the existing financial condition of the utility involved, or will not result in increased charges to its customers.

The Commission has interpreted this statute and regulation to mean that a CPCN is not necessary “for facilities that do not result in the wasteful duplication of utility plant, do not compete with the facilities of existing public utilities, and do not involve a sufficient capital outlay to materially affect the existing financial condition of the utility involved or to require an increase in utility rates.”²³¹ The Commission has also frequently found, based

²³⁰ KRS 278.020.

²³¹ Case No. 2000-00481, *Application of Northern Kentucky Water District (A) For Authority to Issue Parity Revenue Bonds in the Approximate Amount of \$16,545,000; and (B) A Certificate of Convenience and Necessity for the Construction of Water Main Facilities* (Ky. PSC Aug. 30, 2001), Order at 4.

on specific facts presented by a utility, that the construction of a proposed facility, other than an office building, is in the ordinary course of business and does not require a CPCN if the cost represents less than two percent of the utility's net utility plant, and will not require financing approval by the Commission.²³²

A review of the Commission's records shows Atmos has never filed an application under KRS 278.020 for a CPCN with the Commission to construct a plant, equipment, property, or a facility. The only CPCN request that Atmos has filed with the Commission has been under KRS 278.020(5) for authorization to bid on franchises.²³³ In the pending case, Atmos maintains that none of the capital expenditure projects included in the test period would require the issuance of a CPCN. Atmos asserts that all of the projects are considered in the ordinary course of business, and they do not materially impact Atmos's financial condition based upon the 2 percent of net utility plant parameter applied by the Commission in other cases.²³⁴

²³² See, e.g., Case No. 2015-00284, *Application of East Kentucky Power Cooperative, Inc. for an Order Declaring the Expansion of the Bavarian Landfill Gas to Energy Project to be an Ordinary Extension of Existing Systems in the Usual Course of Business* (Ky. PSC Nov. 20, 2015); Case No. 2012-00269, *Tariff Filing of Warren County Water District to Establish the Rockfield School Sewer Capital Recovery Fee* (Ky. PSC Nov. 19, 2012); Case No. 2007-00058, *Application of Big Rivers Electric Corporation for Approval of an Interconnection Agreement with Kentucky Utilities Company* (Ky. PSC Apr. 16, 2007); Case No. 2002-00474, *Application of East Kentucky Power Cooperative, Inc. for an Order Declaring the Green Valley and Laurel Ridge Landfill Gas to Energy Projects to Be Ordinary Extensions of Existing Systems in the Usual Course of Business* (Ky. PSC Mar. 3, 2003); Case No. 98-508, *Application of Kentucky Turnpike Water District for a Declaration that a Certificate of Public Convenience and Necessity Is not Required or, in the Alternative, for the Issuance of Such a Certificate of Public Convenience and Necessity* (Ky. PSC Nov. 19, 1998); Case No. 92-028, *Application of Kenton County Water District No. 1 for Authority to Perform Maintenance at its Taylor Mill Treatment Plant by Replacing Filer Valves at a Total Cost of Approximately \$700,000* (Ky. PSC Feb. 18, 1992); See also Case No. 2013-00365, *Application of Delta Natural Gas Company, Inc. for an Order Declaring that it is Authorized to Construct, Own and Operate a Compressed Natural Gas Station in Berea, Kentucky* (Ky. PSC Mar. 30, 2015).

²³³ <https://www.psc.ky.gov>

²³⁴ Atmos's response to Staff's Third Request, Item 27 (citing to Commission Staff Opinion 2017-005).

Atmos sets forth a net utility plant for the base period of \$474,449,000, and a forecasted net utility plant of \$564,564,000.²³⁵ Based upon Atmos's reliance upon the 2 percent of net utility plant parameter, Atmos should have filed an application for a CPCN for any capital project that exceeded \$9,488,980 in the base period and \$11,291,280 in the forecasted period. When reviewing Atmos's capital expenditure projects in the pending case, and only analyzing whether Atmos should have filed an application for a CPCN assuming it was utilizing the 2 percent of net utility plant parameter, there are at least three non-PRP projects in which the total cost of each project greatly exceeds \$9,488,980.²³⁶

Atmos has the responsibility to ensure that it follows the Commission's statutes and regulations, and that all statutory and regulatory approvals are properly obtained. Based upon the fact that Atmos has never filed an application for a CPCN with the Commission, except to bid on franchises, coupled with evidence of at least three capital expenditure projects in the pending case that arguably required a CPCN, it does not appear that Atmos has fulfilled this responsibility. In the future, when Atmos is analyzing whether it needs to file an application for a CPCN with the Commission, Atmos should, as a starting point, use the total cost of the construction of the facilities instead of solely fiscal or calendar year costs. Any construction of facilities that creates wasteful duplication, or conflicts with certificates granted to other utilities, or that will materially

²³⁵ Application, Schedule K.

²³⁶ Atmos's response to Commission Staff's Second Post-Hearing Request for Information, Item 1, Attachment 1. (2734 BG Center Line Phase 3, 2739. Hwy 53 to Waddy Line Ph 2, and 2609 ANR Bon Harbor).

affect the utility's financial condition, or that will result in increased charges to customers, is not in the ordinary course of business and does require a CPCN.

The Commission has the authority to assess penalties under KRS 278.990 for utilities that begin construction prior to obtaining a CPCN. Atmos is now on notice that a CPCN is needed for any future construction of facilities that are not in the ordinary course of business and that failure to obtain a CPCN prior to commencing construction may result in a show cause proceeding.²³⁷

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix B to this Order are the fair, just, and reasonable rates for Atmos to charge for service rendered on and after May 8, 2019.
2. The rate of return granted herein is fair, just, and reasonable, and will provide sufficient revenue for Atmos to meet its financial obligations with a reasonable amount remaining for equity growth.
3. The rates proposed by Atmos would produce revenue in excess of that found reasonable herein and should be denied.
4. Atmos's proposal to calculate depreciation rates based on the ELG methodology should be denied and its depreciation rates resulting from the ALG methodology, as discussed in the finding above, should be approved.

²³⁷ In the event that Atmos is unsure of whether a particular project requires a CPCN, it should either request a Commission Staff Opinion or file an application for a declaratory order with the Commission.

5. Atmos should file a new depreciation study using the ALG methodology for Commission review by the earlier of five years from the date of this Order or the filing of its next general rate application.

6. Atmos should establish a regulatory liability in the amount of \$3,676,784 for the remainder of the reduction in depreciation expense, the amortization of which will be addressed in Atmos's next base rate case

7. The PRP and associated tariffs should be modified as discussed herein.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Atmos are denied.

2. The rates in Appendix B to this Order are approved for service rendered by Atmos on and after May 8, 2019.

3. Atmos's proposal to calculate depreciation rates based on the ELG methodology is denied and its depreciation rates shall be calculated using the ALG methodology, as discussed in the finding above.

4. Atmos shall file a new depreciation study using the ALG procedure for Commission review by the earlier of five years from the date of this Order or the filing of its next general rate application.

5. Atmos shall establish a regulatory liability in the amount of \$3,676,784 for the remainder of the reduction in depreciation expense, the amortization of which will be addressed in Atmos's next base rate case.

6. Within 20 days of the date of this Order, Atmos shall file with the Commission the accounting entries made on its books of account to effectuate the creation of the regulatory liability required by ordering paragraph 5.

7. Within 20 days of the date of this Order, Atmos shall file with the Commission, using the Commission's Electronic Tariff Filing System, new tariff sheets setting forth the rates, charges, and revisions approved herein, including those required for the PRP, and reflecting their effective date and that they were authorized by this Order.

8. Absent a request for rehearing, this case will be closed and removed from the Commission's docket upon expiration of the statutory period to request rehearing.

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By the Commission

ENTERED
MAY 07 2019
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:


Executive Director

Case No. 2018-00281

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2018-00281 DATED **MAY 07 2019**

Atmos Energy Corporation - Kentucky Division Summary of Adjustments KPSC Case No. 2018-00281 Test Year Ended March 31, 2020 \$ Millions				Adjustment Amount
Atmos Requested Increase				
Atmos Request Based on Original Filing				\$ 14.456
Atmos Corrections to State Tax Rate, Depreciation, and Other				0.054
Atmos Adjusted Request				14.510
Effects of Operating Income Adjustments on Revenue Requirement				
	Expense Amount	GRCF		
Adjust Depreciation Expense to Reflect Half of Change in Depreciation Rates	(3.677)	1.00705		(3.703)
Remove Depreciation Expense Related to PRP After 9/30/19	(0.091)	1.00705		(0.091)
Remove Ad Valorem Taxes Related to PRP After 9/30/19	(0.034)	1.00705		(0.034)
Reduce Depreciation Expense Related to Reduction of Non-PRP Projected Plant Expenditures	(0.492)	1.00705		(0.495)
Reduce Ad Valorem Expense Related to Reduction of Non-PRP Projected Plant Expenditures	(0.193)	1.00705		(0.195)
Adjustment to Rate Case Expense Amortization	(0.049)	1.00705		(0.049)
Effects of Rate Base Adjustments on Revenue Requirement				
	Net Adjustment	GRCF		
Adjust Accumulated Depreciation and ADIT to Reflect Half of Change in Depreciation Rates	0.169	1.34184		0.227
Remove PRP Plant Additions After 9/30/19	(0.375)	1.34184		(0.503)
Reduce Projected Non-PRP Plant	(2.104)	1.34184		(2.824)
Remove CWIP from Rate Base	(2.932)	1.34184		(3.934)
Cash Working Capital Adjustment	(0.074)	1.34184		(0.099)
Adjustment to Rate Case Expense Regulatory Asset	(0.006)	1.34184		(0.008)
Effects of Rate of Return Adjustments on Revenue Requirement				
Include Effects of October 4, 2018 Debt Issue on Capital Structure and Debt Rate				0.011
Use Actual Debt Rate for March 2019 Refinance				(0.146)
Reflect Return on Equity of 9.65				(2.928)
Total Adjustments				(14.771)
Base Rate (Decrease)/Increase after Adjustments				\$ (0.262)

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2018-00281 DATED **MAY 07 2019**

The following rates and charges are prescribed for the customers 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 this Commission prior to the effective date of this Order.

RATE G-1
GENERAL FIRM SALES SERVICE

Base Charge

\$19.30 per meter per month for residential service
\$51.75 per meter per month for non-residential service

Distribution Charge

First	300 Mcf	\$ 1.3855 per Mcf
Next	14,700 Mcf	\$.9578 per Mcf
Over	15,000 Mcf	\$.7651 per Mcf

RATE G-2
INTERRUPTIBLE SALES SERVICE

Base Charge

\$435.00 per delivery point per month

Distribution Charge

First	15,000 Mcf	\$.8327 per Mcf
Over	15,000 Mcf	\$.6387 per Mcf

RATE T-3
INTERRUPTIBLE TRANSPORTATION SERVICE

Base Charge

\$435.00 per delivery point per month

Distribution Charge for Interruptible Service

First	15, 000 Mcf	\$.8327 per Mcf
Over	15, 000 Mcf	\$.6387 per Mcf

RATE T-4
FIRM TRANSPORTATION SERVICE

Base Charge

\$435.00 per delivery point per month

Distribution Charge for Firm Service

First	300 Mcf	\$ 1.3855 per Mcf
Next	14, 700 Mcf	\$.9578 per Mcf
Over	15, 000 Mcf	\$.7651 per Mcf

Pipeline Replacement Program Rider Rates

	<u>Monthly Customer Charge</u>		<u>Distribution Charge per Mcf</u>
Rate G-1 (Residential)	\$ 0.00		\$0.0000
Rate G-1 (Non-Residential)	\$ 0.00		\$0.0000
Rate G-2	\$ 0.00	1-15,000 Mcf	\$0.0000
		Over 15,000 Mcf	\$0.0000
Rate T-3	\$ 0.00	1-15,000 Mcf	\$0.0000
		Over 15,000 Mcf	\$0.0000

Rate T-4

\$ 0.00

1-300 Mcf	\$0.0000
301-15,000 Mcf	\$0.0000
Over 15,000 Mcf	\$0.0000

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