

I.	INTRODUCTION AND OVERVIEW OF THE CASE .....	4
II.	PROCEDURAL HISTORY AND NOTICE .....	6
	A.    Procedural History .....	6
	B.    Notice.....	7
III.	JURISDICTION .....	7
	.....	7
	A.    Original .....	7
	.....	8
	B.    Appellate .....	8
IV.	INTERVENING PARTIES AND PROTESTANTS .....	8
V.	ISSUES ADDRESSED IN INTERIM ORDERS .....	9
VI.	HEARING AND WITNESSES .....	11
VII.	BOOKS AND RECORDS .....	11
VIII.	COMPLIANCE WITH THE REPORTING REQUIREMENTS OF GUD NO. 9670.....	12
IX.	INTERIM RATE ADJUSTMENTS .....	12
X.	RATE BASE.....	12
	A.    Introduction.....	12
	B.    Cash Working Capital.....	13
	a.    Overview.....	13
	b.    Commission should set the CWC requirement to a negative 1/8 of O&M.	14
	c.    Collection Lag.....	16
	d.    Billing Lag .....	18
	e.    Bank Lag.....	19
	f.    Gas Cost Payment Lead .....	20
	g.    Other O&M: Labor Lead Days .....	21
	h.    Other O&M: Non-Labor Lag Days .....	22
	i.    Payroll Tax Lag Days .....	23
	j.    Municipal Franchise Fee Lead Days .....	24
	k.    Prepayments (DOT and State Gross Receipt Tax). .....	25
	C.    Prepayments.....	26
XI.	EXPENSES.....	26
	A.    Shared Services – Allocation Factors .....	26
	a.    Introduction.....	26

b.	Adjust the Customer Count.....	29
c.	Proposed Revision to GUD No. 9670 Four-Factor Formula .....	30
B.	Shared Services –Adjustments to Specific Cost Centers.....	36
a.	Amarillo and Waco Call Center.....	36
b.	Cost Center 1116 Taxation .....	38
c.	Cost Center 1129 Income Tax .....	39
d.	Cost Center 1132 Investor Relations .....	40
e.	Cost Center 1142 Rates and Cost Center 1154 Rates and Regulations .....	41
f.	Cost Center 1350 Non - Utility Operations .....	42
g.	Cost Centers 1904 Performance Plan and Cost Center 1908 Dallas Sebp .....	43
h.	Cost Center 1905 Outside Director Retirement .....	46
C.	Shared Services — Depreciation .....	47
a.	Introduction.....	47
b.	Account 397.00, Communications Equipment .....	49
c.	Accounts 399.01 - 399.03 Servers – Hardware, Network, and Network – Hardware.....	50
d.	Account 399.08, Application Software.....	51
e.	Account 399.24, General Startup Cost .....	53
D.	Shared Services – Affiliate Labor Expense .....	54
E.	Property Insurance Cancellation Fee .....	54
F.	Injuries and Damages.....	55
G.	Uncollectible Expense Level .....	56
H.	Denton Settlement.....	58
I.	Outside Services – Account 923.....	58
J.	Ad Valorem Taxes .....	60
L.	Affiliate Status of Atmos Pipeline .....	61
XII.	CAPITAL STRUCTURE AND RATE OF RETURN .....	62
A.	Introduction.....	62
B.	Capital Structure .....	63
C.	Cost of Equity .....	64
a.	Introduction.....	64
b.	Comparable firms.....	64
c.	DCF Analysis, CAPM Analysis, and other Economic Factors .....	64
d.	RRM Effects .....	69
D.	Examiners’ Recommendation: Cost of Equity and Overall Return.....	69
XIII.	FUNCTIONALIZATION, CLASSIFICATION, AND ALLOCATION .....	73
A.	Introduction.....	73
B.	Allocation of FERC Accounts 870, 880, and 881 .....	73
C.	Allocation of FERC Accounts 885 and 894 .....	74
D.	Allocation of Non-Standard Contract Customers.....	75
E.	Operation of the Allocation Model.....	76

XIV.	RATE DESIGN AND TARIFFS .....	77
A.	Rate Review Mechanism .....	77
a.	Introduction.....	77
b.	Rate Calculation Methodology: Prospective Rates and True-Up.....	77
c.	Rate Review Procedures .....	78
d.	Arguments of the Parties.....	79
B.	Recovery of Gas Cost Portion of Uncollectible through GCR.....	85
D.	Conservation & Energy Efficiency (CEE) Tariff .....	87
E.	Weather Normalization Adjustment.....	88
F.	Class Base Revenue Spread.....	89
G.	Customer Charge .....	90
H.	Declining Block Rate Structure .....	91
XV.	CONCLUSION.....	92



## I. INTRODUCTION AND OVERVIEW OF THE CASE

On October 26, 2007, Atmos Energy Corp., Mid-Tex Division, (referred to herein as Atmos Mid-Tex, the Company or Applicant) filed with the Railroad Commission of Texas (Commission) its statement of intent to change rates within the unincorporated areas served by the Atmos Energy Corp., Mid-Tex Division gas utility system pursuant to TEX. UTIL. CODE ANN. (TUC), Title 3, Subtitle A (Gas Utility Regulatory Act, §§101.001, *et seq.*); TEX. UTIL. CODE ANN., Title 3, Subtitle B (Regulation of Transportation and Use, §§121.001, *et seq.*); and, specifically, TEX. UTIL. CODE ANN., Chapter 104, Subchapters A-C, §§104.101-104.111 and 104.301 (Vernon 1998 and Supp. 2006). The Statement of Intent was docketed as GUD No. 9762.

Prior to the filing of the Statement of Intent at the Commission, Atmos Mid-Tex filed, on September 20, 2007, Statements of Intent in the various municipalities served by the Company. The municipalities either approved the request, denied the request, or reached an agreement with Atmos Mid-Tex regarding the requested rate increase. The municipalities that reached an agreement entered into that agreement on January 9, 2008 (January Settlement). Atmos Mid-Tex appealed the denial of its statement of intent by several municipalities that did not reach an agreement with Atmos Mid-Tex and those cases were ultimately consolidated into this docket.

As discussed below, Atmos Mid-Tex ultimately reached an agreement with all municipalities in which it filed a statement of intent except the City of Dallas. The Statement of Intent filed by Atmos Mid-Tex included a proposed revenue requirement of \$412,858,037. In that filing, Atmos Mid-Tex indicated that current base revenues were \$363,775,855. Thus, Atmos Mid-Tex sought an increase in base revenues of \$49,082,182. Two errata filings were made during this proceeding in response to specific issues raised in the discovery phase. As a result Atmos Mid-Tex reduced its original request to \$409,943,780. This change, combined with an adjustment to the current base revenue calculation, resulted in a proposed increase of \$46,910,156.

At the municipal level the consultant for the City of Dallas submitted a report that recommended rejection of the proposed increase. In that report the consultant indicated that the appropriate revenue requirement was \$360,800,965. This would have resulted in a base revenue increase of \$2,230,922. This increase is based upon the calculation of current base revenues included in the most recent errata filing made by Atmos Mid-Tex of \$363,031,887. In testimony filed in this case, the City of Dallas indicated that the appropriate base revenue calculation was \$347,902,591. That figure was revised in an errata, and the final figure was \$349,678,804. This would result in a base revenue decrease of \$15,129,296.

The State of Texas did not file testimony providing a comprehensive adjustment to the cost of service study provided by Atmos Mid-Tex. Instead, the State of Texas took the position that Atmos Mid-Tex failed to meet its burden of proof.

After reviewing the evidence in this proceeding and the briefs filed by the parties. The Examiners find that Atmos Mid-Tex has not established that a revenue requirement of \$409,943,780 is just and reasonable. The Examiners find that a revenue requirement of \$375,734,647 is reasonable. This would result in an overall revenue increase over current base revenue of

\$13,440,743. The relative position of the parties is set out in Table 1 below.

Table 1  
Relative Position of the Parties

Party	Base Revenue	Current Revenue	Proposed Increase/Decrease
Atmos Propose Revenue Requirement	\$409,942,043	\$363,031,887	\$46,910,156
Examiners' Recommendation	\$375,734,647	\$363,031,887	\$12,704,670
City of Dallas	\$349,678,804	\$363,031,887	(\$13,353,083)

Included in this filing was a proposed Revenue Recovery Mechanism (RRM) which would modify the procedure traditionally used in filing rate cases. The Examiners have recommend the RRM as filed be rejected. The Examiners recommend approval of an RRM, however, that removes the true-up portion of the RRM and conforms certain provisions with the requirements of GURA.

The Examiners recommend approval of the customer charge requested by the utility. As a result of the reduced increase customer charge for the Industrial and Transportation customers was reduced to reflect the reduce revenue that class is required to generate. Thus, the Examiners recommend that the customer charge for that class be reduced from \$500 to \$400.

## II. PROCEDURAL HISTORY AND NOTICE

### 1. Procedural History

In addition to the Statement of Intent that was filed to change rates within the unincorporated areas served by Atmos Mid-Tex, GUD No. 9762, Atmos Mid-Tex filed the following petitions for de novo review of the denial of the statement of intent by various municipalities:

GUD No. 9763 Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the Cities of Balch Springs, Belton, Caldwell, *et al.* The appeal was filed on October 26, 2007 and consolidated with GUD No, 9762 on November 15, 2007.

GUD No. 9764 Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the Cities of Austin, Bandera, Chillicothe *et al.* The appeal was filed on November 1, 2007, and was consolidated with GUD No, 9762 on November 15, 2007.

GUD No. 9771, Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the Cities of Bartlet, Bryan, Cedar Park *et al.* The appeal was filed on November 14, 2007 and consolidated with GUD No, 9762 on November 15, 2007.

GUD No. 9777, Petition for De Novo Review of the Denial of The Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the City of Lampasas. The appeal was filed on December 13, 2007 and consolidated with GUD No. 9762 on December 19, 2007.

GUD No. 9781, Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the Cities of Fredricksburg and Hutto. The appeal was filed on January 10, 2008 and was consolidated with GUD No. 9762 on February 22, 2008.

GUD No. 9785, Petition for De Novo Review of the Denial of the Statement of Intent Filed by Atmos Energy Corp., Mid-Tex Division by the Cities of Bloomberg Grove and Rogers. The appeal was filed on January 31, 2008, and consolidated with GUD No. 9762 on February 22, 2008.

GUD No. 9786, On February 12, 2008, Atmos filed its Petition for De Novo Review of the Denial of the Statement of Intent filed by Atmos Energy Corp., Mid-Tex Division by the City of Dallas. The appeal was filed on February 12, 2008 and consolidated with GUD No. 9762 on February 22, 2008.

## B. Notice

Atmos Mid-Tex complied with all applicable notice requirements, including those provided in 16 Tex. Admin. Code § 7.235 and GURA § 104.103.<sup>1</sup> Atmos Mid-Tex published notice once each week for four consecutive weeks in newspapers of general circulation in each county in which Atmos Energy Corporation provides gas service. Generally, that notice was published during the last two weeks of October, 2007 and the first two weeks of November, 2007. The procedural schedule was established on February 14, 2008. The Notice of Hearing was issued on February 14, 2008. A revised Notice of Hearing was issued on February 7, 2008, and March 14, 2008.

## III. JURISDICTION

The Commission has jurisdiction over Atmos Mid-Tex and over the matters at issue in this proceeding pursuant to TEX. UTIL. CODE ANN. §§ 102.001, 103.003, 103.051, 104.001, 121.051, 121.052 and 121.151. The Commission is vested with the authority and power to ensure compliance with the obligations of the Gas Utility Regulatory Act and to establish and regulate rates of gas utilities.<sup>2</sup> Gas utilities are affected with a public interest, are monopolies, and are therefore subject to the jurisdiction, control, and regulation of the Commission.<sup>3</sup>

The statutes and rules applicable to this proceeding included, but were not limited to all sections of TEX. UTIL. CODE CHAPTERS 101, 102, 103, 104, and 121; and all Commission rules in 16 TEX. ADMIN. CODE, Chapters 1, 7, and 8; and 16 TEX. ADMIN. CODE §3.70 (2003).

### A. Original

The Commission has exclusive original jurisdiction over the rates and services of a gas utility that distributes natural gas in areas outside a municipality and distributes natural gas in areas inside a municipality that surrenders its jurisdiction to the Commission. The Commission also has exclusive original jurisdiction over the rates and services of a gas utility that transmits, transports, delivers, or sells natural gas to a gas utility that distributes the gas to the public.<sup>4</sup> More specifically, the Commission has exclusive original jurisdiction over the Company's statement of intent filed at the Commission, the schedule of rates and services to be charged to customers that are served by the Applicant, the schedule of rates and services to be charged to all environs customers served by the Applicant, and the schedule of rates and services to be charged to customers located in any municipality located in the distribution system.

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<sup>1</sup> Atmos Ex. 8 and Atmos Ex. 8A.

<sup>2</sup> TUC §101.002 (Vernon 1998 and Supp. 2007).

<sup>3</sup> TUC §101.002 (Vernon 1998 and Supp. 2007); TUC §121.051 (Vernon 1998).

<sup>4</sup> TUC §102.001(a) (Vernon 1998 and Supp. 2007).

## B. Appellate

The Commission has exclusive appellate jurisdiction to review an order or ordinance of a municipality exercising exclusive original jurisdiction regarding a statement of intent.<sup>5</sup> At the same time Atmos Mid-Tex filed its statement of intent with the Commission on, May 31, 2006, Atmos Mid-Tex also filed with each municipality located in its system a statement of intent to increase rates for all customers. The statements of intent filed with each municipality are the same as that filed at the Commission. As noted above, Atmos Mid-Tex appealed to the Commission the decisions of the governing bodies of the municipalities regarding the Applicant's statement of intent.

## IV. INTERVENING PARTIES AND PROTESTANTS

The Atmos Texas Municipality (ATM) intervened in these proceedings: Austin, Balch Springs, Bandera, Belton, Bryan, Burnet, Cameron, Cisco, Clifton, Coleman, Copperas Cove, Corsicana, Denton, Dublin, Electra, Fredericksburg, Frost, Gatesville, Georgetown, Goldthwaite, Granbury, Grandview, Greenville, Groesbeck, Hamilton, Henrietta, Hillsboro, Hutto, Lampasas, Leander, Llano, Longview, Lometa, Mexia, Olney, Pflugerville, Ranger, Riesel, Round Rock, San Saba, Somerville, Star Harbor, Thorndale, Trinidad, Whitney, and Wortham. In addition to ATM the City of Dallas also intervened.

The State of Texas intervened in this case on behalf of State agencies. The state agency account the Atmos service area consist of a wide range of customer types, including a large number of small accounts, such as offices, laboratories, and a small number of large consumption accounts, including universities, hospitals and correctional facilities. Approximately fifty percent of the expenditures by the State agencies were for service in the Commercial class. In addition, State agencies also purchased a significant amount of natural gas transportation service from Atmos during the test-year under tariffs and non-standard contracts.

The following additional parties intervened: Industrial Gas Users (IGU), Railroad Commission of Texas (Staff), and Coserv Gas, Ltd.

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<sup>5</sup> TUC §102.001 (Vernon 1998 and Sup. 2004).

On February 11, 2008, Atmos Mid-Tex reached an agreement with several municipalities that were not party to the January Settlement (February Settlement). As a direct result of the settlement agreement Atmos Mid-Tex filed a notice of withdrawal of petitions for review from the actions of the following municipalities: Austin, Balch Springs, Bandera, Bartlett, Belton, Blooming Grove, Bryan, Caldwell, Cameron, Cedar Park, Clifton,, Chandler, Chillicothe, Commerce, Copperas Cove, Corsicana, Denton, Electra, Fredericksburg, Gatesville, Georgetown, Goldthwaite, Granger, Granbury, Greenville, Groesbeck, Hamilton, Henrietta, Hickory Creek, Hico, Hillsboro, Hutto, Kerens, Lampasas, Leander, Lometa, Longview, Mart, Mexia, Nevada, Olney, Pflugerville, Ranger, Reenville, Rice, Riesel, Rogers, Robert Lee, Round Rock, San Angelo, Sanger, Somerville, Star Harbor, Saint Joe, Sunnyvale, Talty, Trinidad, Trophy Club , Whitehouse, and Whitney.<sup>6</sup> On March 14, 2008, CoServ filed a Motion to Withdraw as an Intervenor indicating that CoServ and Atmos had resolved and settled the matters in dispute between them.<sup>7</sup> As a result of the February Settlement, Atmos Mid-Tex filed a motion to dismiss the following proceedings: GUD No. 9763, 9764, 9771, 9777, 9781 and 9785. Accordingly, the Examiners recommend that these proceedings be dismissed and the motions to with draw granted.

#### V. ISSUES ADDRESSED IN INTERIM ORDERS

On February 12, 2007, the Commission issued an Interim Order (February 12<sup>th</sup> Interim Order) limiting certain issues in this proceeding. First, in its *Statement of Intent*, Atmos Mid-Tex proposed the use of the equal life group (ELG) as a method of calculating depreciation expense. The Commission found that the methodology has been previously reviewed and found to be a just and reasonable depreciation methodology for Atmos Mid-Tex by the Commission in the following dockets:

1. Tex. R.R. Comm'n, *Petition for De Novo Review of the Reduction of the Gas Utility Rates of Atmos Energy Corp., Mid-Tex Division, by the Cities of Blue Ridge, Caddo Mills, et al, Atmos Energy Corporation Statement of Intent to Change Rates in the Atmos Energy Corp., Mid-Tex Division Gas Utility System, and Petition of Review from the Actions of Municipalities Denying Rate Request*, Docket No. 9670 (Gas Utils. Div. June 13, 2007) (final order granting application) ("GUD No. 9670").
2. Tex. R.R. Comm'n, *TXU Gas Company Statement of Intent to Change Rates in the Company's Statewide Gas Utility System*, Docket No. 9400 (Gas Utils. Div. May 25, 2004) (final order granting application) ("GUD No. 9400").
3. Tex. R.R. Comm'n, *Appeal of TXU Gas Distribution From the Action of the City of Dallas, the City of University Park, and the Town of Highland Park, Texas and the Statement of Intent filed by TXU Gas Distribution*, Docket Nos. 9145 - 9148 (Gas Utils. Div. November 20, 2000) (final order granting application) ("GUD No. 9145 - 9148").

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<sup>6</sup> Notice of Withdrawal filed on March 11, 2008, March 24, 2008, and March 25, 2008.

<sup>7</sup> CoServ *Motion to Withdraw as an Intervenor*, March 14, 2008.

4. Tex. R.R. Comm'n, *Statement of Intent to Change the City-Gate Rate of TXU Lone Star Pipeline, Formerly Known as Lone Star Pipeline Company Established in GUD No. 8664*, Docket Nos. 8976 (Gas Utils. Div. November 20, 2000) (final order granting application) ("GUD No. 8976").

In each of those cases the Commission concluded that it is reasonable for this utility to have used the ELG depreciation method.

Second, In its *Statement of Intent*, Atmos Mid-Tex has proposed that the accrual of depreciation expense should cease once an account is fully accrued. This methodology for the treatment of fully accrued depreciation accounts has been affirmed as a just and reasonable depreciation methodology for Atmos and its predecessors in interest by the Commission in the following dockets: (1) GUD No. 9670, (2) GUD No. 9400 , (3) GUD Nos. 9145 - 9148, and (4) GUD No. 8976.

Third, In its *Statement of Intent*, Atmos Mid-Tex proposed that sales, transfers of property, outliers, and reimbursed retirements should be excluded from the life and salvage analysis used to calculate depreciation. The Commission determined, that the methodology for the treatment of sales, transfers of property, outliers, and reimbursed retirements in determining the life and salvage analysis used to calculate depreciation has been affirmed as a just and reasonable depreciation methodology for Atmos and its predecessors in interest by the Commission in the following dockets: (1) GUD No. 9670, (2) GUD No. 9400, (3) GUD Nos. 9145 - 9148, (4) GUD No. 8976.

Fourth, in its *Statement of Intent*, Atmos Mid-Tex proposed that a thirteen-month time period be applied for the calculation for materials, supplies, and prepayments for purposes of its test-year analysis. This methodology was adopted for the Applicant and its predecessors in interest in GUD No. 9670 and GUD No. 9400.

Fifth, as reflected in Schedule F- 6, of the *Statement of Intent* filed by Atmos, the Company seeks the approval of an income tax factor of 0.5385 to the dollar return to equity included in the revenue requirements. The Commission determined that the income tax factor is computed based upon the statutory income tax rate of 35 percent. The Commission determined that the proposed income tax rate and factor reflected in Schedule F-6 have been determined by the Commission to be just and reasonable in the following dockets: (1) GUD No. 9670, (2) GUD No. 9400, (3) GUD No. 9145 - 9148, and (4) GUD No. 8976.

Sixth, Atmos Mid-Tex seeks the approval of the use of a minimum distribution system with 2 inch pipe as method for allocation of a portion of the distribution system. The Commission found that the concept of a minimum distribution system with 2 inch pipe as the minimum system has been approved to allocate certain components of rate base in the following docket: GUD No. 9670 and GUD No. 9400. As reflected in the *Statement of Intent*, Atmos Mid-Tex proposes that system-wide rate designs be applied in this case.

Seventh, a system-wide rate design was proposed for Atmos Mid-Tex in GUD No. 9400 and adopted by order of the Commission on May 25, 2004. As noted in GUD No. 9400, the Company's intent to set system-wide rates is consistent with 16 TEX. ADMIN. CODE § 7.220 (2005).

Eighth, the Poly 1 pipe issues addressed in GUD No. 9400 and GUD No. 9670 should not be litigated further in this case.

Ninth, in the February 12<sup>th</sup> Interim Order the Commission severed the issue of rate case expenses for GUD No. 9762. Those issues will be considered by the Commission in accordance with TEX. UTIL. CODE ANN. § 103.022 (Vernon 2005), § 104.008 (Vernon 2005), and Tex. Admin. Code § 7.5530, in a separate proceeding.

## VI. HEARING AND WITNESSES

The Hearing in this matter was conducted from March 28, 2008 through April 1, 2008. The following witness presented evidence on behalf of the direct case of Atmos Mid-Tex: John Paris, President of the Mid-Tex Division of Atmos Mid-Tex, Christopher T. Forsythe, Director of Financial Reporting for Atmos Energy, Thomas H. Petersen, Director of Rates for Atmos Energy, Barbara W. Myers, Regulatory Accounting Manager for Atmos Energy Corporation, Daniel M. Meziere, Director of Accounting Services for Atmos Energy, Dane A. Watson, Alliance Consulting Group, Laurie M. Sherwood, Vice President Corporate Development Treasurer for Atmos Energy, C.W. Guy, Vice President of Rates and Regulatory Affairs for Atmos Energy, Donald Murry, C.H. Guernsey & Company, Gary L. Smith, Director of Customer Revenue Management for Atmos Energy, Brown, Williams, Moorhead & Quinn, Inc., James S. Powell, Vice President of Operations in the Mid-Tex Division of Atmos Energy, Paul H. Raab, an independent economic consultant, Craig G. White, Director of Customer Program Management for Atmos Energy Corporation.

The following witnesses presented testimony on behalf of the City of Dallas: Basil Copeland, Jr., Chesapeake Regulatory Consultants, Inc., Jacob Pous, Diversified Utility Consultants, and Sara Coleman, Diversified Utility Consultants. Testimony was presented on behalf of the State of Texas by the following witnesses: Paul S. Delaney, Office of the Attorney General, Consumer Protection and Public Health Division, Public Agency Representation Section, Kit Pevoto, Consultant, Eugenio Miravete, Associate Professor of Economics, University of Texas at Austin. The following witnesses testified on behalf of Staff of the Railroad Commission: Mark Brock, Utility Analyst and Daniel E. Bivens, Program Specialist.

Rebuttal testimony was presented by the following witnesses on behalf of Atmos Mid-Tex: John Paris, Gary Smith, Barbara Myers, Christopher Forsythe, Alan R. Lovinger, John E. Ellerman, Towers Perrin, James S. Powell, Laurie M. Sherwood, Pace MacDonald, Director of Taxes for Atmos Energy Corporation, Thomas H. Petersen, Dane A. Watson, Paul H. Raab, Donald A. Murry.

## VII. BOOKS AND RECORDS

Dan Meziere and Christopher Forsythe testified that Atmos Mid-Tex maintains its books and

records in accordance with the Commission's regulations. Namely, Rule 7.310 requires that each gas utility shall utilize the Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts prescribed for Natural Gas Companies subject to the provision of the Natural Gas Act for all operating and reporting purposes. The FERC Uniform System of Accounts shall be applicable to all gas utility and gas utility related operations. In GUD No. 9670, several issues were raised regarding the books and records of the utility. In this case, those issues have not been raised and the Examiners find that Atmos Mid-Tex established that it has fully complied with the requirements of Rule 7.310.

#### VIII. COMPLIANCE WITH THE REPORTING REQUIREMENTS OF GUD NO. 9670

The Examiners note that while issues were raised in GUD No. 9670 regarding certain expenditures of the Shared Services Unit (SSU), those issues were not raised in this case. Staff of the Railroad Commission provided specific testimony indicating its opinion that Atmos Mid-Tex has removed that category of expenditures from its rate request.<sup>8</sup> That testimony has not been contradicted in this proceeding. Atmos Mid-Tex provided specific testimony indicating that procedures had been implemented to ensure that such expenditure would not be included in this proceeding. Additionally, in a random sampling of expense reports requested by the Examiners in this proceeding, no evidence was found indicating that such expenditures were included. The Examiners also find, based on the testimony presented by Mr. Powell, that the requirements set out in Finding of Fact No. 109 regarding IRA project reports, have been satisfied.<sup>9</sup>

#### IX. INTERIM RATE ADJUSTMENTS

Atmos Mid-Tex filed its an interim rate adjustment pursuant to Texas Utilities Code § 104.301 for 2006 at the Railroad Commission and at the municipal level. None of the expenditures included in that interim rate adjustment filing have been challenged in this proceeding.<sup>10</sup> Further, as noted above, the Examiners also find, based on the testimony presented by Mr. Powell, that the requirements set out in Finding of Fact No. 109 regarding IRA project reports, have been satisfied.<sup>11</sup> Accordingly, no modification to the interim rate adjustment to rate base is required in this proceeding and those expenditures are deemed to be just and reasonable.

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<sup>8</sup> Tr. Vol. 3, pp. 196 - 197.

<sup>9</sup> Atmos Ex. 38, Powell Rebuttal, p. 9, ln. 9 - p. 12, ln. 14.

<sup>10</sup> Based upon prior filings made in this case, it appears that the City of Dallas and Atmos Mid-Tex are engaged in litigation at the District Court level regarding the procedures employed to in the interim rate adjustment filings. As noted in a March 4, 2008, Memorandum Regarding the setting of Interim Rates, the Examiners find that the dispute regarding those procedures is unaffected by this rate case.

<sup>11</sup> Atmos Ex. 38, Powell Rebuttal, p. 9, ln. 9 - p. 12, ln. 14.

## X. RATE BASE

### 1. Introduction

Atmos Mid-Tex requested rate base totals \$1,177,121,322, as adjusted for known and measurable changes.<sup>12</sup> The proposed rate base consists of net plant in service in the amount of \$1,245,156,559, which excludes the investment in Poly 1.<sup>13</sup> Atmos Mid-Tex, in its Initial Brief, asserted that with the exception of the allocation methodology used to allocate plant amounts from the Shared Services Units, the reasonableness and necessity of the net plant amounts have not been challenged. It is correct that the only rate base item directly challenged by the Intervenor was Cash Working Capital. Other issues raised in this proceeding, however, have an impact on the figures included in rate base. Specifically, it is evident from the filing that the Shared Services Allocation impacts the following figures included as part of net plant: (1) Gross Plant – \$2,076,879,946;<sup>14</sup> (2) Accumulated Depreciation – \$831,723,388;<sup>15</sup> (3) Injuries and Damages Reserve – \$4,471,117;<sup>16</sup> (4) Accumulated Deferred Income Taxes – \$28,638,709;<sup>17</sup> and (5) Rate Base Adjustment – \$10,369,609, which would be adjusted to account for changes in the capitalized expenses if the shared services allocation is revised.<sup>18</sup> The impact on net plant is specifically noted in the testimony presented by Mr. Pous.<sup>19</sup> Further, the City of Dallas, as part of its adjustment to injuries and damages expense, proposed an adjustment to the injuries and damages reserve incorporated into the rate base calculation.

### B. Cash Working Capital

#### a. Overview

Cash working capital represents an amount of cash that a utility must have available to meet current obligations as they arise, due to the time lag between payment of expenses and collection of revenues.<sup>20</sup> The need for working cash has long been recognized by regulatory bodies and the courts.<sup>21</sup> An allowance of cash working capital, however, is not guaranteed as a matter of course and the utility carries the burden of establishing the need for cash working capital.<sup>22</sup> Atmos prepared a lead-lag study to determine the cash working capital needs of the Atmos Mid-Tex

<sup>12</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule B, ln. 19.

<sup>13</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule D, Col.(e), ln. 91.

<sup>14</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Schedule C, Ins. 35 - 88.

<sup>15</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Schedule D, Ins. 35 - 86.

<sup>16</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Schedule WP\_B-2, Ins. 3 - 6.

<sup>17</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Schedule WP\_B-3, Ins. 21 - 53.

<sup>18</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Schedule WP\_F.2.7, ln.

<sup>19</sup> Dallas Ex. 2, Pous Direct, p. 33, Ins. 16 - 23.

<sup>20</sup> *Alabama-Tennessee Natural Gas Co. v. Federal Power Commission*, 203 F.2d 494, 498 (3<sup>rd</sup> Cir. 1953); *People's Counsel v. Public Service Commission*, 399 A.2d 43, 46 (D.C. Cir. 1979).

<sup>21</sup> *Smyth v. Ames*, 169 U.S. 466 - 418 (1898).

<sup>22</sup> *Southern Union Gas Co. v. Railroad Commission of Texas*, 701 S.W.2d 277 (Tex. App. — Austin 1986 (Gas utility failed in its burden of proof regarding its working capital needs)); *Peoples Counsel v. Public Serv. Comm'n*, 399 A.2d 43, 45.

system.<sup>23</sup> A lead-lag study empirically identifies the difference in timing between outward cash flow for labor, materials and supplies, inventory, and other expenses, and inward cash flow of revenue from payments to customers.<sup>24</sup>

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<sup>23</sup> See, Atmos Ex. 45, (March 19, 2008 Errata), Cash Working Capital Study.

<sup>24</sup> *Colorado Municipal league v. Public Util. Comm'n*, 687 PR 2d, 416, 420; *Cent. La. Elec. Co. Inc. v. La. Publ. Serv. Comm'n*, 373 So.2d 123, 130 (La. 1979).

Cash working capital requirements may be positive or negative. Positive working capital is investor-supplied. In contrast, negative working capital reduces the need for investor-supplied capital and arises when the utility receives customer payments before service is rendered, or when it receives funds before it must satisfy a corresponding liability. To illustrate the concept of cash working capital, if one assumed that the utility paid for natural gas before it supplied the natural gas to the consumer, then the utility would be using positive cash working capital, i.e., money from its investors, to pay for natural gas until the consumer paid the utility. In that case, the investors have an expectation of receiving a reasonable return on its investment. If, however, the consumer paid the utility in advance for use of the product, the company has negative cash working capital and the investor would have no expectation of return because the investor's capital was not being used.<sup>25</sup>

The CWC component feeds in directly to the calculation of rate base. The Cash Working Capital component approved in GUD No. 9670 was a negative \$46,376,097.<sup>26</sup> In the Statement of Intent that was initially filed, Atmos Mid-Tex increased the Cash Working Capital Request by approximately \$61,225,599.<sup>27</sup> The Statement of Intent that was filed on October 26, 2007, included a Cash Working Capital Request of a positive \$14,849,502.<sup>28</sup> An errata filed by Atmos on December 12, 2007, revised the request to \$13,201,880 for CWC.<sup>29</sup> In the second errata filed on March 19, 2008, Atmos Mid-Tex again modified the cash working capital request and reduced it to \$8,450,672.<sup>30</sup> The overall impact on the revenue requirement of these changes resulted in a decrease of \$732,369 from the original rate request.<sup>31</sup> The City of Dallas and the State of Texas oppose the cash working capital request of Atmos Mid-Tex.

- b. Commission should set the CWC requirement to a negative 1/8 of O&M.

- i. *Introduction*

The regulations of the Public Utility Commission provide that the cash working capital requirement may be set at 1/8 of operations and maintenance expenses if two conditions exist. First, the utility did not perform a cash working capital study. Second, in the event that a cash working capital study was prepared, the study was so flawed as to be unreliable.<sup>32</sup>

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<sup>25</sup> *Zia Natural gas Company v. New Mexico Public Utility Commission*, et al., 2000 WL 358390 (March 1, 2000).

<sup>26</sup> GUD No. 9670, Final Order, Schedule E-1, p. 2, ln. 11.

<sup>27</sup> Dallas Ex. 2, Pous Direct, p. 16, ln. 1 - 7.

<sup>28</sup> Statement of Intent, October 26, 2007, Schedule B, ln. 7, col. (d).

<sup>29</sup> December 12, 2007 Errata, Schedule B, ln. 7, col. d.

<sup>30</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule B, ln. 7, col. d.

<sup>31</sup> The revenue requirement reflected in the original filing was \$412,858,037. The impact of reducing the CWC from 14,849,502 to 8,450,672 on the revenue requirement was to reduce it to \$412,125,668.

<sup>32</sup> 16 Tex. Admin. Code § 25.231(C)(2)(b)(iii)(V) (2006) (Public Util. Comm'n):

If cash working capital is required to be determined by the use of a lead-lag study . . . and either the electric utility does not file a lead lag study or the electric utility's lead-lag study is determined to be so flawed as to be unreliable, in the absence of persuasive evidence that suggests a different amount of cash working capital, an amount of cash working capital equal to negative one-eighth of operations and maintenance expense including fuel and purchase power will be presumed to be the reasonable

ii. *Argument of the Parties*

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level of cash working capital.

Mr. Pous, who testified on behalf of the City of Dallas argued that the Commission should set the CWC requirement of 1/8 of operations and maintenance expense including fuel and purchased power. Based upon this recommendation, Mr. Pous estimated that the cash working capital requirement should be set at a negative \$154,504,503. Mr. Pous maintained that in prior cases Atmos Mid-Tex has included a request for a cash working capital that varied widely. For example, in GUD No. 9145, TXU Gas Distribution included a negative cash working capital request in the amount of a negative \$3,521,872.<sup>33</sup> The Commission ultimately approved a negative cash working capital in the amount of a negative \$6,565,411.<sup>34</sup> In GUD No. 9400, the utility operating this system requested a cash working capital requirement of negative \$53,763,162.<sup>35</sup> The Commission ultimately approved a negative \$61,241,394.<sup>36</sup> In GUD No. 9670, Atmos Mid-Tex requested a positive \$188,700 cash working capital requirement.<sup>37</sup> The Commission ultimately approved a negative \$46,376,097 cash working capital requirement.<sup>38</sup> The impact of Mr. Pous recommendation would be to reduce the revenue requirement by approximately \$18,650,875.

Mr. Peterson who testified on behalf of Atmos Mid-Tex noted that Mr. Pous did not make this recommendation when he testified at the municipal level. Mr. Peterson noted that the PUC rule cited by Mr. Pous was inapplicable to the facts of this case. The PUC rule imposes the 1/8 calculation if two conditions are met: (1) there is no lead lag study or the study is so flawed as to be unreliable, and (2) in the absence of evidence suggesting a different amount of CWC. Mr. Petersen argued that there was a lead lag study in this case and that the evidence indicated that a negative \$154,504,503 was not reasonable. Further, Mr. Petersen noted that the RRC Rate Review Handbook does not apply the negative 1/8 rule.<sup>39</sup>

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<sup>33</sup> Tex. R.R. Comm'n, *Appeal of TXU Gas Distribution From the Action of the City of Dallas, the City of University Park, and the Town of Highland Park, Texas and the Statement of Intent filed by TXU Gas Distribution*, Docket Nos. 9145 - 9148 (Gas Utils. Div. November 20, 2000) (Proposal for Decision) ("GUD No. 9145 - 9148"), Schedule B, ln. 7.

<sup>34</sup> GUD No. 9145 - 9148, Final Order, Schedule B, ln. 7

<sup>35</sup> Tex. R.R. Comm'n, *TXU Gas Company Statement of Intent to Change Rates in the Company's Statewide Gas Utility System*, Docket No. 9400 (Gas Utils. Div. May 25, 2004) (Proposal for Decision) ("GUD No. 9400") GUD No. 9400, PFD, p. 146.

<sup>36</sup> GUD No. 9400, Final Order, Schedule E(D), ln. 7.

<sup>37</sup> GUD No. 9670, Final Order, Schedule B, ln. 8.

<sup>38</sup> *Id.*

<sup>39</sup> Atmos Ex. 41, Petersen Rebuttal, pp. 3 - 9.

iii. *Examiners' Recommendation*

As noted below, although the Examiners find that there are errors in the CWC lead lag studies, the errors in the study do not invalidate the overall result of the study. Application of the PUC rule in this particular case is not justified, as the City of Dallas has not established that the study was so flawed as to be unreliable. Correcting the errors noted below, results in a cash working capital requirement based, in large measure, on the underlying methodology of the proposed study and suggests that a different amount of cash working capital than the amount indicated by the PUC regulation. Adopting the proposal would be the equivalent to a conclusion that Atmos Mid-Tex has access to approximately \$154 million of free capital every year. Such a conclusion is not reasonable. Furthermore, the City of Dallas argued that the fact that the cash working capital request was revised is evidence of the infirmity of the cash working capital study. The Examiners find that imposition of the of the 1/8 Rule because a utility made corrections to the cash working capital study would have a chilling effect on a utility's willingness to concede errors in its cost of service study.

c. *Collection Lag*

i. *Introduction*

Collection lag is the average number of days between issuing a bill and receiving payment.<sup>40</sup> In GUD No. 9400, the collection lag calculated was based upon an examination of sample customer accounts. One hundred customer transactions for residential and commercial customers and fifty transactions for each of the other customer classes was evaluated.<sup>41</sup> Applying that same methodology in GUD No. 9670, the Commission determined that a collection lag of 16.65 days was reasonable.<sup>42</sup> The City of Dallas argued that the same methodology applied in this case results in a collection lag of 16.43 days.<sup>43</sup> Nevertheless, the City of Dallas did not propose that the collection lag be reduced. Instead, the City of Dallas proposed that the collection lag should be maintained at 16.65 days. The impact of the proposed adjustment is to reduce the revenue requirement by approximately \$2,353,385.

ii. *Argument of the Parties*

The City of Dallas asserts that Atmos Mid-Tex has twice changed its methodology for calculating the collection lag.<sup>44</sup> Although the methodology approved in GUD No. 9400 was based upon an analysis of a sample of bills, Atmos Mid-Tex proposed calculation of collection lag based upon the use of month-end accounts receivable balances.<sup>45</sup> In this case Atmos Mid-Tex calculated the collection lag by dividing the average daily accounts receivable balance by the average daily revenue.<sup>46</sup> The methodology approved and the methodologies proposed in the various cases are

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<sup>40</sup> Atmos Ex. 19, Petersen Direct, p. 13, lns. 10 - 12, GUD no. 9670, FOF No. 130.

<sup>41</sup> GUD No. 9670, Order on Rehearing, FOF No. 131

<sup>42</sup> GUD No. 9670, Order on Rehearing, FOF No. 140.

<sup>43</sup> Dallas Ex. 2, Pous Direct, p. 21, ln. 19 - p. 22, ln. 3.

<sup>44</sup> Dallas Ex. 2, Pous Direct, p. 20, lns. 12 - 18.

<sup>45</sup> Atmos Ex. 41, Petersen, p. 13, lns. 7 - 14, GUD No. 9670, Proposal for Decision, p. 88.

<sup>46</sup> Atmos Ex. 19, Petersen Direct, p. 13, lns. 10 - 18.

summarized in Table 7.1 below:

Table 7.1  
Methodologies Applied to Calculation Collection Lag

Docket	Methodology Proposed/Approved
GUD No. 9400	Methodology Approved: Examination of sample customer accounts
GUD No. 9670	Proposed: Month-end accounts receivable balances Approved: Examination of sample customer accounts
GUD No. 9762	Proposed: Average daily accounts receivable balances

Mr. Pous pointed out that there is a large disparity between the average daily revenue and the daily accounts receivable balances. The large disparity raised questions concerning the validity of the reporting practices relied on by Atmos Mid-Tex in performing its calculation.<sup>47</sup> He also noted that an examination of samples gathered by Atmos Mid-Tex revealed a revenue lag of less than 19 days. Once the analysis was corrected for obvious errors and outliers were removed, the collection lag was reduced to 16.43 days. As a consequence, Mr. Pous recommended that the collection lag be maintained at the level it was set in GUD No. 9670.<sup>48</sup>

Mr. Petersen responded to the issues raised by the City of Dallas by pointing out that an error identified by Mr. Pous in the methodology proposed by Atmos Mid-Tex was corrected. The error changed the requested collection lag from 22.31 days to 22.28 days.<sup>49</sup> Mr. Petersen also argued that the Commission's rejection in GUD No. 9670 was not based solely on the methodology proposed in that case. Citing the PFD, he argued that the Commission's principle concern was that the applicant in that case used month-end accounts receivable balances rather than daily accounts receivable balances. He maintained that in this case Atmos Mid-Tex has cured that defect.<sup>50</sup> Finally, Mr. Petersen argued that the adjustments made to the sample by Mr. Pous were not adequately explained. The unadjusted sample resulted in 18.94 days, not 16.43 as alleged by Mr. Pous.<sup>51</sup>

<sup>47</sup> Dallas Ex. 2, Pous Direct, p. 21, Ins. 6 - 17.

<sup>48</sup> Dallas Ex. 2, Pous Direct, p. 21, ln. 19 - p. 22, ln. 3.

<sup>49</sup> Atmos Ex. 41, Petersen Rebuttal, p. 13, Ins. 16 - 22.

<sup>50</sup> Atmos Ex. 41, Petersen Direct, p. 13, Ins. 7 - 15.

<sup>51</sup> Atmos Ex. 41, Petersen Direct, p. 14, Ins. 1 - 19.

iii. *Examiners' Recommendation*

In GUD No. 9400 and in GUD No. 9670 the Commission approved a collection lag that was calculated based upon a methodology that relied on actual samples. As noted by the Examiners in GUD No. 9670, the most accurate method of calculating the collection lag would be to examine each customer bill and calculate the collection lag associated with each bill. In the alternative, the Examiners found that the most accurate method was the method adopted in GUD No. 9400. That method relied on an evaluation of customer samples.<sup>52</sup> Atmos has not established in this case that the change in collection lag was not due simply to a change in the methodology selected. Further, the Examiners find that the proposed adjustment to the samples were amply justified by Mr. Pous: (1) The sample contained negative amounts billed to customers, (2) dates were missing from data included in the sample, (3) the sample contained a disproportionate number of very late payments compared to the total population of customers, and (4) outliers were removed. Outliers were defined as those data elements that were three standard deviations above the mean.<sup>53</sup> Atmos Mid-Tex noted that if the outliers were removed the collection lag calculation, based upon the sample, was 18.94 days.<sup>54</sup> The Examiners find that the basis for the removal of the outliers was established and that it was reasonable to remove the outliers.

d. *Billing Lag*

i. *Introduction*

The billing lag represents the period of time between when a meter is read and a bill is issued.<sup>55</sup> In GUD No. 9400, Atmos Mid-Tex requested, and the Commission approved, a billing lag of zero days.<sup>56</sup> In GUD No. 9670, Atmos Mid-Tex requested a billing lag of 4.47 days.<sup>57</sup> Based upon the evidence provided in GUD No. 9670, the Commission approved a one day billing lag.<sup>58</sup> As

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<sup>52</sup> GUD No. 9670, Proposal for Decision, p. 89.

<sup>53</sup> Dallas Ex. 2, Pous Direct, p. 21, ln. 22 - p. 22, ln. 3. Mr. Petersen concurred that for some purposes it is not unreasonable to adjust out some of the extreme data points. Tr. Vol. IV, p. 153, lns. 4 - 8.

<sup>54</sup> Atmos Ex. 41, Petersen Rebuttal, p. 14, lns. 5 - 10.

<sup>55</sup> Atmos Ex. 19, Petersen Direct, p. 11, lns. 1 - 2.

<sup>56</sup> Dallas Ex. 2, Pous Direct, p. 22 lns. 19 - 22.

<sup>57</sup> GUD No. 9670, Final Order, FOF No. 118.

<sup>58</sup> GUD No. 9670, Final Order, FOF No. 126.

this case was originally filed, Atmos Mid-Tex requested a billing lag of 2.94 days.<sup>59</sup> The errata filed on December 19, 2007, did not modify the request.<sup>60</sup> The errata filing made on March 19, 2008, reduced the billing lag to 2.72 days. Mr. Petersen testified that the adjustment was made as a result of additional facts that were revealed during discovery.<sup>61</sup> Mr. Pous argued that the billing lag established in GUD No. 9670 should be maintained in this case. The proposed adjustment would reduce the revenue requirement by \$719,037.

ii. *Argument of the Parties*

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<sup>59</sup> Statement of Intent, October 26, 2007, Schedule THP-CWC2, ln. 9.

<sup>60</sup> December 12, 2007 Errata, Schedule THP-CW C2, ln. 9.

<sup>61</sup> Atmos Ex. 41, Petersen Rebuttal p. 12, ln. 15 - p. 13, ln. 2.

As described by Mr. Petersen, customers are assigned to meter routes and meter routes are assigned to one of twenty cycles for billing. Up to four days before bills are issued a meter route is generated. Between the time the meter route is established and the issuance of bills meters must be read. The average billing lag was established by analyzing the billing lag for bills issued in two months: (1) January – a heating season month, and (2) June – a non-heating season month. The average billing lag for the majority of customers was 2.19 days. The average billing lag for complicated bills during the test year was 15 days. The overall weighted average billing lag was 2.72 days.<sup>62</sup>

Mr. Pous argued that it was inappropriate for Atmos Mid-Tex to recover additional costs because the bill handling process of the company is inefficient. Mr. Pous argued that Atmos Mid-Tex builds in four days from the time the meter route information is available for downloading to the handheld devices used by the meter reading personnel until the information is required for billing preparation. Mr. Pous argued that the Company has the ability to process the bills in a more efficient manner and inefficient procedures should not be rewarded.<sup>63</sup> Further, evidence presented in the hearing in GUD No. 9670, indicated that a sample of bills were processed on the day the meter was read.<sup>64</sup>

iii. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has established that the proposed billing lag of 2.72 days is reasonable. As noted by the Examiners in GUD No. 9670, the CWC witness in that case did not appear to be familiar with the billing process at Atmos Mid-Tex nor was the witness able to describe how the billing lag was calculated. In this case, the CWC witness has described the billing process and has described how the billing lag was calculated.

e. Bank Lag

i. *Introduction*

The bank lag is the one-day lag between receiving payment and having funds available to draw at the bank.<sup>65</sup> In GUD No. 9670 the bank lag requested was 1.33 days.<sup>66</sup> The request was

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<sup>62</sup> Atmos Ex. 19, Petersen Direct, p. 11, ln. 1 - p. 12, ln. 14.

<sup>63</sup> Dallas Ex. 2, Pous Direct, p. 22, ln. 11 - p. 23, ln. 27.

<sup>64</sup> GUD No. 9670, Proposal for Decision, pp. 85 - 87.

<sup>65</sup> Atmos Ex. 19, Petersen Direct, p. 13, lns. 20 - 23.

<sup>66</sup> In its Initial Brief, Atmos Mid-Tex appears to suggest that the Commission approved bank lag of zero days. See, Atmos Mid-Tex, Initial Brief, p. 9. It does not appear from the order issued in that case that the bank lag was set to

approved. In this case, Atmos Mid-Tex has requested a bank lag of one day. The City of Dallas maintains that the bank lag request should be rejected. The effect of the proposed change is to reduce the requested rate increase by \$417,808.

ii. *Arguments of the parties.*

The City of Dallas raised three issues regarding the bank lag. First, Mr. Pous contented that the bank lag was an unsubstantiated estimate. Second, Mr. Pous argued that Atmos Mid-Tex may engage in a “lock box” arrangement. A “lock box” arrangement allows an entity that receives large quantities of payments to have access to the funds at issue on the same day as they are received. Third, Mr. Pous alleged that Atmos Mid-Tex failed to recognize that a portion of the receipts are by bank draft. Accordingly, any bank lag is eliminated.<sup>67</sup> In response, Mr. Petersen argued that the City of Dallas has offered no explanation for deviating from the Commission’s determination in GUD No. 9670, nor has the City of Dallas provided any support for the zero day recommendation proposed by the City of Dallas.

iii. *Examiners’ Recommendation*

The Examiners find that a one day bank lag is reasonable and no evidence was presented to support a deviation from the 1.33 day bank lag approved in GUD No. 9670. Atmos Mid-Tex has reduced the proposed bank lag, and no contradictory evidence is in the record upon which to base the elimination of the bank lag.

f. Gas Cost Payment Lead

i. *Introduction*

The average purchased gas cost payment lag for gas cost was calculated using actual payments for the twelve months of the test year. In the initial filing Atmos Mid-Tex calculated that lag as 40.47 days. In an errata that was filed on March 19, 2008, the utility adjusted the calculation to incorporate a check clearing lag and recalculated the lag as 41.54 days.<sup>68</sup> Mr. Pous maintained that the gas cost payment lag should be revised to 41.93 days. The effect of the proposed change is to reduce the requested revenue requirement by \$118,394.

ii. *Argument of the parties*

Mr. Pous argued that in several instances Atmos Mid-Tex made payments prior to the date required under its contractual agreements. For example, on several occasions Atmos paid prior to the twenty-fifth day of the month following the month in which service was provided. Mr. Petersen responded that certain payments were made early, in December, for example to avoid the Christmas holidays. Regardless of the reason, the City of Dallas argued that an adjustment should be made to reflect the early payments.

iii. *Examiners’ Recommendation*

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<sup>67</sup> Dallas Ex. 2, Pous Direct, p. 24, Ins. 1 - 24.

<sup>68</sup> Atmos Ex. 19, Petersen Direct, p. 14, Ins. 5 - 13.

The Examiners agree that an adjustment should be made to account for payments that were made early. The justification provided for the prepayment was insufficient to support the reasonableness of the decision to make an early payment. Accordingly, the Examiners recommend that the gas cost lead be set at 41.93 days.

g. Other O&M: Labor Lead Days

i. *Introduction*

The labor lead days measures the payment lag, the average number of days between the end of the pay period and the payment date. In the original filing, Atmos included a labor lag of 20.42 days. That figure was revised in the March 19, 2008, errata which included a labor lag of 25.66 days. The City of Dallas maintains that the labor lag should be 30.12 days. The overall impact on the requested revenue requirement of the proposed adjustment is to reduce it by \$84,688.

The focus of the issues raised by the City of Dallas involve the calculation of the lead/lag associated with paid time off (PTO). The calculation of the labor lead days necessarily involved a calculation of the lead days associated with PTO. During the test year, the employees received PTO instead of vacation time. The PTO creates a lag which is incorporated into the calculation of the labor lead days.<sup>69</sup> The City of Dallas disputed the accuracy of the PTO calculation made by Atmos Mid-Tex.

ii. *Argument of the parties*

The City of Dallas alleged three errors. First, Atmos Mid-Tex did not make a pro forma adjustment to normalize the PTO payroll with the level that should be accrued by its employees given their length of service. Second, Atmos Mid-Tex failed to correctly calculate the actual lead days for the PTO. Third, Atmos Mid-Tex erred by not including a check float for PTO related payments.<sup>70</sup>

As to the first issue, while Atmos Mid-Tex argued that the City of Dallas has perhaps overstated the total adjustment that should be made, the company conceded to the adjustment in its errata.<sup>71</sup> Likewise, regarding the third issue, Atmos Mid-Tex agreed that a check float amount should be included.<sup>72</sup>

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<sup>69</sup> Atmos Ex. 19, Petersen Direct, p. 15, lns. 8 - 19, Schedule THP - CWC4.

<sup>70</sup> Dallas Ex. 2, Pous Direct, p. 26, ln 1- p. 27, ln. 25.

<sup>71</sup> Atmos Ex. 41, Petersen Rebuttal, p. 17, ln. 11 - p. 18, ln. 3.

<sup>72</sup> Atmos Ex. 41, Petersen Rebuttal, p. 16, lns. 12 - 13.

The second issue raised by the City of Dallas was that Atmos Mid-Tex failed to accurately calculate the lead days. In the original filing, Mr. Petersen indicated that the lead days for PTO was 91.50. Mr. Pous argued that Atmos Mid-Tex failed to recognize that PTO carried over from the previous year must be used in the first quarter. He argued that the proper recalculation, based on the 2006 data, yielded a value of 130.91 days.<sup>73</sup> In response, Atmos Mid-Tex revised its calculation of the payment lag for PTO. The revision, however, reduced the lag further from 91.50 days to 83.48 days. Mr. Petersen testified that a more detailed month-by-month calculation was made based upon the assumption that in each month of the year the same percent of total PTO would be taken as was taken in calendar 2006. The result of the analysis was an average lag of 83.48 days.<sup>74</sup>

iii. *Examiners' Recommendation*

The Examiners find that there is no evidence in the record to support Mr. Petersen's revised calculation. Instead the rebuttal testimony provides support for the original estimate of 91.50. Mr. Petersen testified that he recalculated his original estimates using revised dates and the revised lead day using those dates was 91 days.<sup>75</sup> Further, Mr. Petersen's testimony is contradictory. He testified that the detailed month-by-month calculation supported the reasonableness of his "original proposal."<sup>76</sup> Finding that the original proposal was reasonable, however, Mr. Petersen proceeded to revise that number and changed it to 83.48 days. The Examiners find that the City of Dallas has correctly pointed out that Atmos Mid-Tex failed to properly account for PTO carried over from one year to the next. Finally, the Examiners find that an adjustment must be made to normalized the level of PTO available to the employees and that the figure reflected in the March 19, 2008, errata properly reflects that level. Thus, the correct labor lead days is 30.12.

h. Other O&M: Non-Labor Lag Days

i. *Introduction*

This category of expense relates to those operations and maintenance expenses that are necessary for the utility to perform its routine day-to-day operations.<sup>77</sup> Atmos Mid-Tex calculated the lag days for other O&M expenses by evaluating payments made during the test year through the

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<sup>73</sup> Dallas Ex. 2, Pous Direct, p. 27, lns. 4 - 13.

<sup>74</sup> Atmos Ex. 41, Petersen Rebuttal, p. 17, ln. 1 - p. 18, ln. 3.

<sup>75</sup> Atmos Ex. 41, Petersen Rebuttal, p. 17, lns. 1 - 5.

<sup>76</sup> Atmos Ex. 41, Petersen Rebuttal, p. 17, lns. 5 - 9.

<sup>77</sup> State Ex. 1, Delany Direct, p. 9, lns. 1 - 11.

nine-month period ended March 31, 2007.<sup>78</sup> In the initial filing, Atmos Mid-Tex included a lag for O&M of 32.31 days.<sup>79</sup> The request was modified in the errata that was filed on March 19, 2008, and increased to 34.60 days.<sup>80</sup> The City of Dallas argued that the lag associated with O&M should be 37.23 days.<sup>81</sup>

ii. *Argument of the parties*

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<sup>78</sup> Atmos Ex. 19, Petersen Direct, p. 16, Ins. 12 - 14.

<sup>79</sup> Statement of Intent, October 26, 2007, Schedule E-1, ln. 8, col. (f).

<sup>80</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule E-1, ln. 8, col (f).

<sup>81</sup> Dallas Ex. 2, Pous Direct, p. 29, Ins. 1 - 3.

The City of Dallas contended that the check float portion of the non-labor O&M lag should be three days.<sup>82</sup> The City of Dallas contended that Atmos Mid-Tex included both negative values and pre-payments which should be excluded.<sup>83</sup> The State of Texas argued that Atmos Mid-Tex had incorrectly calculated the lead days associated with this expense and that the methodology proposed was inconsistent with GUD No. 9400 and GUD No. 9670. Mr. Delaney argued that a problem with the proposed methodology was that by using the invoice date as opposed to the date the services was actually provided, it was impossible to ascertain the lag time between the date the service was provided and the date the bill was paid. An additional problem alleged by the State of Texas was that the lead-lag study failed to consider the possibility that the invoices were being paid prematurely. That issue was considered in prior cases regarding this utility.<sup>84</sup>

Mr. Petersen responded to the City of Dallas and alleged that Atmos Mid-Tex already included a check lag of 3.11 days in its analysis and that no further adjustment was necessary. As to issues related to “prepayments” and “negative items,” Mr. Petersen responded that although Mr. Pous raised the allegation regarding “prepayments” and “negative items,” Mr. Pous offered no evidence in support of the allegation.<sup>85</sup> In response to the allegations raised by the State of Texas, Mr. Petersen raised three points. First, while it would be ideal to calculate the service period for all items, it is simply not possible to accomplish that task for every invoice. Second, Mr. Delaney’s proposed adjustment does not materially affect the calculation and, both Atmos Mid-Tex and the State of Texas accomplish results that are consistent with the prior case. Third, underlying Mr. Delaney’s testimony is the assumption that all bills are paid exactly on the due date. A task which is simply not possible given the volume of bills handled by the utility.<sup>86</sup>

iii. *Examiners’ Recommendation*

The Examiners find that Atmos Mid-Tex has already included a check lag of 3.11 and no further adjustment is necessary. The Examiners also find that, consistent with the Commission’s order in GUD No. 9670, “prepayments” and “negative items” should not be included in a cash working capital analysis. The City of Dallas, however, provided no evidence to support its allegation that those items were included in the study. Accordingly, the Examiners find that no further adjustment is required and that Atmos Mid-Tex has established that the O&M non-labor lag proposed, 34.60, is reasonable.

i. Payroll Tax Lag Days

i. *Introduction*

In the original filing, Atmos Mid-Tex included a lag of 21.91 for payroll taxes in the CWC

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<sup>82</sup> Dallas Ex. 2, Pous Direct, p. 28, Ins. 18 - 20.

<sup>83</sup> Dallas Ex. 2, Pous Direct, p. 28, Ins. 13 - 20.

<sup>84</sup> State Ex. 1, Delaney Direct, p. 9, ln. 1 - p13, ln. 15.

<sup>85</sup> Atmos Ex. 41, Petersen Rebuttal, p. 18, Ins. 5 - 16.

<sup>86</sup> Atmos Ex. 41, Petersen, Rebuttal, p. 23, ln. 10 - p. 24, ln. 18.

lead-lag study.<sup>87</sup> Atmos Mid-Tex revised that figure in the errata filed on March 19, 2008. The revised figure was 32.42 days.<sup>88</sup> The City of Dallas maintained that the appropriate lag associated with payroll taxes was 38.40 days. The proposed change would reduce the revenue requirement by approximately \$5,937.

ii. *Argument of the parties*

Mr. Pous argued that the Atoms Mid-Tex failed to provide the proper timing of the payment period. He argued that the service period for these areas of payroll are longer than the standard payroll level and he maintained that it was more appropriate to take the actual dollar weighted payroll lead days, remove the check float as the actual payroll tax payments are made by wire, and add five days to reflect the third business day after each Friday payday. Mr. Petersen adopted the suggestion of the City of Dallas that the service period should match that payroll service period. He contended, however, that instead of adding five days, as suggested by Mr. Pous, the actual payment schedule of FICA payments should be used.

iii. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has properly matched the service period with the payroll service period. Additionally, the Examiners find that it was reasonable for Atmos Mid-Tex to use the actual payment schedule for FICA payments rather than adding five days.

j. Municipal Franchise Fee Lead Days

i. *Introduction*

Atmos Mid-Tex proposed a negative 13.73 lead days associated with municipal franchise fee lead days. The City of Dallas argued, however, that Atmos Mid-Tex does not prepay municipal franchise fees. The City of Dallas proposed that this component of the lead/lag study be revised to 97.29 days. The proposed adjustment would reduce the revenue requirement by approximately \$2,021,150.

ii. *Argument of the Parties*

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<sup>87</sup> Statement of Intent, October 26, 2007, Schedule E-1, In. 13, col. (f).

<sup>88</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule E-1, In. 13, col (f).

Mr. Pous noted that this issues was litigated in GUD No. 9400 and noted that in GUD No. 9670, Atmos Mid-Tex recognized that local gross receipt payments were made in arrears and are not prepayments. Mr. Pous also testified that there was litigation in District Court on this issue. The settlement agreement between Atmos Mid-Tex and various cities in that case referenced the fact that these payments are payments in arrears.<sup>89</sup> Mr. Petersen testified that Atmos Mid-Tex maintains individual municipal agreements with over 430 local governments and that the overwhelming majority of those contracts are prepaid. He noted, however, that there are some exceptions and that approximately four percent of the cities are paid in arrears.<sup>90</sup>

iii. *Examiners' Recommendation*

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<sup>89</sup> Dallas Exhibit 2, Pous Direct, p. 29, ln. 22 - p. 30, ln. 30.

<sup>90</sup> Atmos Exhibit 41 Petersen Rebuttal, p. 20, ln. 5 - p. 20, ln. 4.

The Examiners find that Atmos Mid-Tex has failed to meet its burden of proof that the fees are paid in advance. The issue has been previously litigated and the Commission has determined that these fees are paid in arrears. Further, during the hearing, Mr. Petersen testified that while four percent of the cities are paid in arrears that the four percent represents at least thirty-eight percent of the franchise fees.<sup>91</sup> While this is a minority, evidence in the record suggested that the underlying data was not accurate and the amount that was actually paid in arrears is substantially greater than thirty-eight percent.<sup>92</sup>

k. Prepayments (DOT and State Gross Receipt Tax).

i. *Introduction*

Mr. Petersen included a calculation for lead days for Department of Transportation (DOT) fee payments and payment of State Gross receipt taxes. The City of Dallas argued that these were prepayments and are not appropriately included in the cash working capital study. The State of Texas noted that two corrections should be made. One correction would correct an alleged error related to the calculation of the mid-point. Another correction would be made to accurately reflect early payments.

ii. *Arguments of the Parties*

As already noted, the City of Dallas argued that prepayments are accounted for in rate base and that those prepayments should be accounted for there.<sup>93</sup> Mr. Petersen included prepayments in the lead-lag study for both DOT and State Gross receipt payments. Mr. Petersen conceded that the proposed treatment is equally appropriate but declares a preference for the method adopted in the lead-lag study.<sup>94</sup> In response to the allegation made by Mr. Delaney regarding the calculation of the mid-point and the timing of the DOT payment, Mr. Peterson responded that the errata filing made on March 19, 2008, reflected that correction.<sup>95</sup> The State of Texas also raised the issue regarding the timing of the payment made to DOT.

iii. *Examiners' Recommendation*

The Examiners find that it is not appropriate to include prepayments in the lead-lag study and they should be accounted for separately in rate base. Otherwise, Atmos Mid-Tex has made the

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<sup>91</sup> Tr. Vol. 4, p. 157, ln. 22 - p. 158, ln. 5.

<sup>92</sup> Tr. Vol. 2, p. 31 - 51, Tr. Vol. 4, p. 158, ln. 21 - p. 159, ln. 3.

<sup>93</sup> Dallas Ex. 2, p. 31, lns. 1 - 16.

<sup>94</sup> Atmos Ex. 41, Petersen Rebuttal, p. 20, lns. 6 - 17.

<sup>95</sup> Atmos Ex. 41, Petersen Rebuttal, p. 24, lns. 15 - 18.

changes recommended by the State of Texas.

C. Prepayments

The City of Dallas noted that if DOT and State Gross Receipt Taxes were removed from the cash working capital analysis, an adjustment would have to be made to rate base. The Examiners agree that such an adjustment should be incorporated and it is reflected in Schedule WP\_B-1 attached to this schedule. As described by Mr. Pous, the monthly average amount of the amounts removed from cash working capital must be added to rate base – based upon a thirteen month average. Specifically, the amounts associated with DOT Pipeline user fee, \$48,565, and State Gross Receipts Tax, \$27,142,222, have been removed. The thirteen month average has been added to rate base.<sup>96</sup>

XI. EXPENSES

A. Shared Services – Allocation Factors

a. Introduction

Atmos Energy Corporation operates its utility business in twelve states through seven operating divisions. Six of the divisions are local gas distribution utilities. Atmos Energy operates one regulated intrastate pipeline – Atmos Pipeline Texas – and four wholly owned subsidiaries.<sup>97</sup> In addition to its utility business Atmos also has non-utility operations. The non-utility business is operated through a number of subsidiaries which include one division and several separate legal entities. Technical and support services are provided to the operating divisions and subsidiaries by centralized shared services departments primarily located at the Atmos headquarters in Dallas. The shared services department is referred to as the Shared Services Unit (SSU) and is comprised of eighty cost centers.<sup>98</sup>

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<sup>96</sup> Pous Direct, p. 31, Ins. 1 - 16 & p. 33, ln. 26 - 31.

<sup>97</sup> Atmos Exhibit 26, Lovinger Direct, p. 5, Ins. 1 - 18.

<sup>98</sup> Atmos Exhibit 21, Meziere Direct, Exhibit DMM - 1 (CAM), p. 2; Atmos Ex. 27, Lovinger Direct, p. 4, Ins. 9 - 14 and p. 5, Ins. 12 - 13.

Cost allocation is the process of allocating various common costs that are incurred for the benefit of two or more of the division of Atmos Energy.<sup>99</sup> The common costs of the SSU are divided among the various divisions and affiliates of Atmos Energy Corporations through cost allocation.<sup>100</sup> SSU common costs generally fall into two categories: (1) Shared Services – General Office, and (2) Shared Services – Customer Support. Accounting, human resources, legal, rates, risk management are examples of services provided by Shared Services General Office. Shared Services – Customer Support provides services such as billing, customer call center functions and customer support. The customer support divisions provide services applicable only to LDCs.<sup>101</sup>

Atmos proposed to allocate the SSU common costs through the application of several different allocation factors. In general, the Shared Services General Office were allocated using a composite factor consisting of three ratios: (1) gross plant investment, (2) operations and maintenance, and (3) customer count. The three ratios are summed and divided by three to determine the ratio – the composite allocation factor.<sup>102</sup> The composite allocation factor was identified as Rate 7. Examples of cost centers that were proposed to be allocated on that basis are listed in Table 11.1 below:

Table 11.1  
Cost Centers Allocated using Rate 7

➤	Cost Center 1001, Dallas Chairman, President & CEO,
➤	Cost Center 1101, Dallas Chief Financial Officer,
➤	Cost Center 1105, Dallas Audit,
➤	Cost Center 1106, Dallas Treasurer,
➤	Cost Center 1107, Dallas Treasury
➤	Cost Center 1114, Dallas Vice Pres. & Controller,
➤	Cost Center 1116, Dallas Taxation
➤	Cost Center 1117, Dallas Acctg Services
➤	Cost Center 1119, Dallas General Accounting
➤	Cost Center 1120, Dallas Accounts Payable
➤	Cost Center 1121, Dallas Plant Accounting
➤	Cost Center 1125, Dallas Financial Reporting
➤	Cost Center 1126, Payroll Accounting
➤	Cost Center 1128, Dallas Property & Sales Tax
➤	Cost Center 1129, Dallas Income Tax
➤	Cost Center 1130, Dallas Business Planning and Analysis
➤	Cost Center 1132, Dallas Investor Relations
➤	Cost Center 1133, Dallas Corporate Communications
➤	Cost Center 1150, Dallas Strategic Planning
➤	Cost Center 1161, Dallas Benefits and Payroll Accounting
➤	Cost Center 1162, Dallas Benefits Accounting
➤	Cost Center 1201, Dallas Sr. Vp Utility Operations
➤	Cost Center 1501, Dallas Legal

<sup>99</sup> Atmos Exhibit 26, Lovinger Direct, p. 7, ln. 23 - p. 9. ln. 1.

<sup>100</sup> Atmos Exhibit 27, Lovinger Direct, p. 4, lns. 14 - 15.

<sup>101</sup> Atmos Exhibit 20, Myers Direct, p. 5, ln. 1 - p.6, ln. 19, Atmos Exhibit 27, Lovinger Direct, p. 5, lns. 12 -

<sup>102</sup> Atmos Exhibit 27, Lovinger Direct, p. 6, lns. 1 - 3.

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|---|---|
| ➤ | Cost Center 1502, Dallas Corporate Secretary        |
| ➤ | Cost Center 1903, Dallas Controller – Miscellaneous |
| ➤ | Cost Center 1905, Outside Director Retirement Cost  |
| ➤ | Cost Center 1915, Dallas Insurance                  |
| ➤ | Cost Center 1950, Dallas Customer Support           |
| ➤ | Cost Center 1953, Dallas Atmos Finance Committee    |
| ➤ | Cost Center 1954, Dallas Diversity Council          |

Shared Services Customer Support was allocated based upon one of four factors. First, the rate identified as Rate 2, was allocated based upon the relative ratio of customers among the various local distribution utility divisions of Atmos Energy Corporation. This was not a composite factor. The remaining factors, Rate 1, Rate 3, and Rate 6, are composite factors. The components of the factors used to determine those rates were the following: (1) gross plant investment, (2) operations and maintenance, and (3) customer count. Once again, the three ratios were summed and divided by three to determine the ratio for the assignment of cost center expense.

Although the underlying ratios used to compute Rate 1, Rate 3, and Rate 6 are similar to the Shared Services General Office factor, they are distinct. The Shared Services General Office ratios were calculated using most of the operating divisions and affiliates of Atmos Energy Corporation. The Shared Services Customer Support ratios were calculated using either the local distribution utility divisions exclusively, or the local distribution utility divisions plus Atmos Pipeline. Rate 1 was also used to allocate the rate base component of the Shared Services Unit associated with Customer Support and Rate 1 was used to allocate the rate base component of the Shared Services Unit associated with General Office.<sup>103</sup> Table 11.2 provides a summary of the various ratios as calculated by Atmos Mid-Tex.

Table 11.2  
Summary of Composite Allocation Ratios

Identification	Allocation Factor	Type of Factor	Divisions used to compute factor
Rate 1	45.83%	Composite – Three Factor	Local distribution utility divisions.
Rate 2	49.07%	Single Factor	Local distribution utility divisions.
Rate 3	41.23%	Composite – Three Factor	Local distribution utility division and Atmos Pipeline

<sup>103</sup> Atmos Ex. 45, (March 19, 2008 Errata), Ins. 35 - 59 and Ins. 62 - 86. The Examiners note that it is not clear why the General Office General Plant component of rate base is based upon an allocation factor that does not include all of the utility divisions and affiliates of Atmos Energy, Rate 7, and is allocated instead based upon an allocation factor that includes only the regulated entities of Atmos Energy, Rate 3. Mr. Lovinger noted that SSU provided the use of common facilities such as office buildings, communication and computer systems, and operating software for Atmos utility divisions and affiliates. Atmos Ex. 27, p. 4, Ins. 19 - 22. The issue, however, was not raised at the hearing, the methodology is consistent with GUD No. 9670, and the overall impact on the revenue requirement, based upon a difference of 1.18%, does not appear to be material.

Rate 6	8.24%	Composite – Three Factor	Local distribution utility division and Atmos Pipeline
Rate 7	40.05%	Composite – Three Factor	Local distribution utility division and Atmos Pipeline other non-utility operation

In GUD No. 9670, the Commission determined that an allocation factor based upon four factors should be used to allocate these costs. The factors included the three factors proposed by the utility plus net operating income. In this case, the City of Dallas raised two principle arguments with regards to the SSU cost allocation methodology. First, Mr. Pous, argued that the customer count should be adjusted to reflect a higher customer count for Atmos Pipeline. Second, he asserted that the four factor allocation methodology approved in GUD No. 9670, should be modified, but otherwise maintained. Although he posited that a different allocation factor should be applied, not similar to the composite allocation factor proposed by Atmos, he acknowledged the decision in GUD No. 9670 and recommended that the fundamental methodology be maintained.

b. Adjust the Customer Count

i. *Introduction*

Several allocation factors described in Table 9.1 above, are dependent upon the relative percentage of customers served by the various divisions of Atmos Mid-Tex. The City of Dallas did not challenge the customer allocation factor identified as Rate 2. That factor is based upon the relative ratios of customers within the local distribution utility divisions of Atmos: (1) West Texas Division, (2) Colorado/Kansas Division, (3) Louisiana Division (4) Midstates Division, (5) Mississippi Division, and (6) Mid-Tex. On the other hand, the City of Dallas takes issue with Rate 3, Rate 6, and Rate 7. Unlike Rate 2, these rates are a composite factor based upon a ratio of three components. One of those components is the customer ratio. The customer ratio component is only marginally different from Rate 2 because, as presented by Atmos Mid-Tex, Atmos Pipeline has only 262 customers and the remaining non-utility operations have fewer than 900 customers. On the other hand, the regulated divisions have over three million customers. The City of Dallas, challenged the calculation of this component. The proposed change would reduce the revenue requirement by approximately \$3,798,465.

ii. *Argument of the parties.*

Mr. Pous argued that reliance on the average number of customers is not valid because the number of customers associated with Atmos Pipeline Texas. Atmos Mid-Tex contended that Atmos Pipeline Texas had an average of 262 customers during the test year. Mr. Pous argued that this figure was incorrect because it did not include farm tap customers or each individual city gate. Further, Mr. Pous argued that the customers of Atmos Mid-Tex were ultimately also customers of Atmos Pipeline. Mr. Pous stressed that the customer figure alleged by Atmos Mid-Tex of 262 customers resulted in a disproportionate allocation to Atmos Mid-Tex, as Atmos Mid-Tex recorded

1,520,465. In order to correct the allegedly inequitable result, Mr. Pous suggested that an additional 1,520,465 customers should be imputed to Atmos Mid-Tex for purposes of adjusting the factors. This would alter the factors described above as set out in Table 9.3 below:

Table 11.3  
Impact on Composite Allocation Factors of  
Adjusting Additional Customers to Atmos Pipeline

	Atmos	Dallas	Difference
Rate 3	41.23%	35.84%	5.39%
Rate 6	8.24%	7.17%	1.07%
Rate 7	40.05%	34.67%	5.38%

In response Atmos Mid-Tex pointed out that the customer count ratio applied in this case is the same factor that was used by the Commission in GUD No. 9670 in developing the four-part composite allocation factor in that case. Mr. Powell, who testified on behalf of Atmos Mid-Tex indicated that Atmos Pipeline Texas has five primary types of customers: (1) local distribution companies (“LDCs”), (2) interruptible end-use transportation customers served pursuant to a filed tariff, (3) interruptible transportation negotiated rates, (4) customers in need of storage services, and (5) customers in need of ancillary services.<sup>104</sup> Mr. Powell testified that the farm tap customers are actually customers of Atmos Mid-Tex and has included them in the Atmos Mid-Tex customer count. Atmos Pipeline has no direct contractual relationship with those customers, does not own the meter that serves those customers, does not maintain facilities at the customer’s location, does not resolve service issues with the customers directly, and does not bill those customers.<sup>105</sup> Mr. Powell also noted that customer service of the two divisions was segregated and that there was no reason for a customer of Atmos Pipeline to contact Atmos Mid-Tex nor would a customer on the Atmos Mid-Tex contact Atmos Pipeline.<sup>106</sup>

### iii. *Examiners’ Recommendation*

The Examiners find that Atmos Mid-Tex has correctly calculated the customers for Atmos Pipeline in this case. The City of Dallas has not established a reasonable basis to add an additional 1,520,465 customers. The Examiners recommend that not further adjustment be made to the customer count of Atmos Pipeline Texas. The Examiners find that the type of customer, the service provided, and the customer support functions are handled separately.

<sup>104</sup> Atmos Ex. 38, Powell Rebuttal, p. 3, lns. 18 - 24.

<sup>105</sup> Atmos Ex. 38, Powell Rebuttal, p. 4, ln. 1 - p. 5, ln. 2.

<sup>106</sup> Atmos Ex. 38, Powell Rebuttal, p. 7, ln. 1 - p. 8, ln. 2.

c. Proposed Revision to GUD No. 9670 Four-Factor Formula

Atmos Mid-Tex proposed the use of a three factor formula to calculate the various composite allocation factors described in Table 9.3 above. As already noted, the components for each composite factor included the following ratios: (1) Gross plant, (2) average number of customers, and (3) operations and maintenance. Once those ratios were calculated, the composite factor was determined by calculating the simple average of the three ratios. As noted above, the difference in the individual rates was based upon the fact that certain factors were developed using the ratio of local distribution utilities only, local distribution utilities and all divisions, and the regulated divisions and other non-regulated operations of Atmos Energy. Table 11.4 below provides a summary describing the calculation of the proposed allocation factors.

Table 11.4  
Summary of calculation of the Composite Allocation Factors

Rate 3 <sup>107</sup>				
	Ratio Allocated to utility division other than Mid-Tex	Ratio Allocated to Mid-Tex	Ratio Allocated to Atmos Pipeline	
Gross Plant <sup>108</sup>	49.59%	37.08%	16.32%	
<u>Av. No. Cust.</u>	<u>50.92%</u>	<u>49.07%</u>	<u>0.01%</u>	
O&M <sup>109</sup>	47.59%	37.53%	14.89%	
Composite	48.37%	<b>41.23%</b>	10.41%	
Rate 7				
	Ratio Allocated to utility division other than Mid-Tex	Ratio Allocated to Mid-Tex	Ratio Allocated to Atmos Pipeline	Ratio Allocated to other divisions. <sup>110</sup>
Gross Plant	46.01%	36.62%	16.12%	1.24%
<u>Av. No. Cust.</u>	<u>50.91%</u>	<u>49.06%</u>	<u>0.01%</u>	<u>0.03%</u>
O&M	43.72%	34.48%	13.68%	8.12%
Composite	46.88%	<b>40.05%</b>	9.94%	3.13%

The City of Dallas maintained at the hearing, that the use of the average number of customers as part of the calculation of the ratios was not reasonable.

<sup>107</sup> Rate 6 is twenty percent of Rate 3.

<sup>108</sup> Total (99.99%) less than 100% due to rounding in calculating the ratios.

<sup>109</sup> Total (100.01%) greater than 100% due to rounding in calculation the ratios.

<sup>110</sup> The other divisions include AESI, Atmos P/L Storage, Atmos Energy Power, Atmos Energy, and Atmos Energy Marketing.

ii. *Arguments of the Parties*

Although the City of Dallas expressed the opinion that different factors should be used, the City of Dallas, in recognition of the precedent in GUD No. 9670 recommended that the allocation factors established in that case be maintained here. Mr. Pous testified that a more appropriate composite factor would be comprised of the following ratios: (1) Gross plant, (2) net operating income, and (3) labor. The City of Dallas noted that the FERC allocation process is a three factor formula that uses labor instead of O&M.<sup>111</sup> Mr. Pous stated that labor is a more appropriate factor to include because the costs of corporate control and management are related more to labor-related charges.<sup>112</sup> The City of Dallas also declared that the FERC allocation process used revenues rather than average number of customers.<sup>113</sup> Mr. Pous concluded that the use of a customer related factor does not appropriately reflect the cost causation relationship experience related corporate control and management costs.

Several issues were raised by Mr. Pous regarding the component based upon the average number of customers. First, he asserted that the customer allocation falsely assumes that all customers have an equal effect on the need for corporate overheads. In support of this proposition, Mr. Pous posited two examples. In the first example, he maintained that a system that has a higher density, such as an urban system, requires less investment and labor expense than a service area with a lower density. In his second example, he argued that customer accounts larger than the typical residential and commercial customer place different demands on the type of services offered by the Share Services Unit that cannot be accurately measured through the number of customers. Namely, industrial and transportation customers require more labor intensive services from SSU such as contract negotiation and particularized billing requirements that require temperature and pressure adjustments. He concluded that a system the size of the Atmos Mid-Tex Division, that encompasses thousands of square miles in Texas and covers numerous rural as well as suburban areas, cannot be allocated costs accurately or simply on a customer basis.

Second, Mr. Pous also pointed out that the Commission's Rate Review Handbook, which includes a discussion regarding the allocation of common costs, does not include a methodology which references the number of customers.<sup>114</sup> Third, he noted that an examination of the weights provided by the two other factors in the three factor formula reveal that Atmos Pipeline's burden on costs is substantially higher than is suggested by the customer component. For example, Gross Plant component of Rate 3 suggests that 16.38% of the costs should be allocated to Atmos Pipeline. The

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<sup>111</sup> Dallas Ex. 2, Pous Direct, p. 50, Ins. 1 - 2.

<sup>112</sup> Dallas Ex. 2, Pous Direct, p. 50, Ins. 7 - 12.

<sup>113</sup> Dallas Ex. 2, Pous Direct, p. 49, ln. 24 - p. 50, ln. 2 & Ins. 14 - 20, p. 51, Ins. 11 - 20.

<sup>114</sup> Dallas Ex. 2, Pous Direct, p. 51, ln. 21 - p. 52, ln. 5

operations and maintenance component suggests that 13.68% of the costs should be allocated to Atmos Pipeline.<sup>115</sup> On the other hand, the customer count factor fails to assign any meaningful costs to that entity.<sup>116</sup>

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<sup>115</sup> Dallas Ex. 2, Pous Direct, p. 53, ln. 14 - p. 54, ln. 2.

<sup>116</sup> Dallas Ex. 2, Pous Direct, p. 50, lns. 2 - 5.

In the initial filing, Mr. Lovinger, on behalf of Atmos Mid-Tex noted that the methodology proposed by Atmos Mid-Tex should be adopted to ensure jurisdictional and historical consistency. He argued that the single jurisdictional and historical aberration, the allocation methodology approved in GUD No. 9670, should be reversed. Atmos Energy has applied the same methodology in all of the jurisdiction in which it provides gas distribution service for several years and it has never been rejected, with the single exception of GUD No. 9670.<sup>117</sup> Mr. Lovinger explained that Atmos used the same method of allocating shared services for each division and affiliates in all jurisdiction in which the company operates.<sup>118</sup> He asserted that the equitable recovery of costs is jeopardized if a regulatory body adopts an allocation methodology that differs from the method consistently applied in other jurisdictions. Accordingly, he urged that the Commission take a broad view and consider the results rendered for each recipient of a shared service rather than simply developing a particular allocator that produces the lowest cost for customers in other jurisdictions.

He also asserted that FERC does not use a formula for calculation of an allocation factor which includes net operating income (NOI). He opined that the use of NOI produced inconsistent results and argued that the opinion in *Distrigas of Massachusetts Corp. (Distrigas)*, 41 FERC § 61,2005, upon which the proposition to include NOI is based, is not a well reasoned FERC opinion. In rebuttal testimony, he noted that FERC recently rejected the *Distrigas* opinion.<sup>119</sup>

He also argued that there is significant confusion as to the composition of the NOI. In *Distrigas*, FERC appeared to indicate at one point that NOI was determined after income taxes and interest cost was removed. At another point FERC indicated that NOI should be reduced by income taxes but not interest cost. The intervenors in GUD No. 9670, and the Commission order, appears to have determined net operating income based upon net income prior to the deduction of income taxes and interest expense.<sup>120</sup>

In response to criticism raised regarding the validity of customer count as a factor, Mr. Lovinger asserted that customer count meets the cost causation principle.<sup>121</sup> Lovinger maintained that the more customers served, the more management time needs to be devoted to provide service to those customers.<sup>122</sup> While Mr. Lovinger acknowledged that FERC does not incorporate customer count into a determination of the composite factors applied at agency, he argued that the reason for it is because the customers served by the regulated entities are fundamentally different from LDC

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<sup>117</sup> Atmos Ex. 27, Lovinger Direct, p. 10, ln. 18 - p. 11, ln. 21 & p. 19, ln. 21 - p. 20, ln. 4.

<sup>118</sup> Atmos Ex. 27, Lovinger Direct, p. 10, ln. 10 - 17.

<sup>119</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 15, lns. 4 - 16.

<sup>120</sup> Atmos Ex. 27, Lovinger Direct, p. 14, lns. 5 - 23.

<sup>121</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 17, ln. 16 -

<sup>122</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 16, lns. 1 - 3.

customers.<sup>123</sup>

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<sup>123</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 16 ln. 13 - p.

Mr. Lovinger urged that NOI could lead to illogical results because, for example, the use of NOI may result in the assignment of less costs to an entity experiencing negative earnings.<sup>124</sup> In addition, NOI can fluctuate drastically from year to year based upon extraordinary business events or simply changes in accounting methodology. Further, if an operating division or affiliate experienced a net operating loss in a particular year, no service cost would be assigned.<sup>125</sup> He also noted that an NOI factor may be affected by accounting methodologies unique to the unregulated entities of Atmos Energy that are not within the utility's control. On the other hand, the earnings of the regulated utility divisions are not affected by these accounting methodologies.<sup>126</sup> Mr. Lovinger also asserted that Mr. Pous use of the NOI effectively double counts operation and maintenance cost, once as a separate allocation factor and the other in the determination of net operating income. The result is that operation and maintenance is over emphasized. Finally, Mr. Lovinger observed that the rate setting process operates to set a cap on the revenues of the regulated entities whereas the unregulated entities are not capped. Mr. Lovinger concluded that in GUD No. 9670, the Commission did not consider all of the factors he has raised here. Accordingly, the Commission should reverse its decision in GUD No. 9670.

Mr. Lovinger argued, however that if the Commission declines to adopt the three factor formula proposed by Atmos, the Commission should, at a minimum revise the income factor considered. He maintained that the use of gross income is more appropriate than NOI and avoids many of the pitfalls he attributed to NOI. For example, gross income is an industry standard used at FERC, and it would minimize the possibility of an entity having a negative ratio associated with that entity. He asserted that a negative gross income is extremely unlikely. Additionally, gross income has a cost causation relationship with management efforts and the impact of certain accounting practices, that would impact NOI, would not impact gross income.<sup>127</sup>

iii. *Examiners' Recommendation*

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<sup>124</sup> Atmos Ex. 36, Lovinger Direct, p. 19, lns. 1 - 19.

<sup>125</sup> Atmos Ex. 27, Lovinger Direct, p. 15, ln. 11 - p. 16, ln. 6.

<sup>126</sup> Atmos Ex. 36, Lovinger Direct, p. 20, lns. 1 - 16 - p. 21, ln. 13.

<sup>127</sup> Atmos Ex. 36, Loving Rebuttal, p. 23, ln. 8 - p. 25, ln. 9 and Exhibit ARL-R-2.

In GUD No. 9670, the Commission found that it was important that the cost allocation methodology for SSU generate cost allocations that are just and reasonable and the Commission specifically stated that a cost allocation methodology that ignores operating income and revenues ignores an important indicator of resources allocation. After reviewing the evidence presented by the parties in this case, the Examiners find that insufficient evidence was presented to support a change from the Commission's prior decision. On the contrary, evidence presented in this case underscores the fallibility of including customer count as factor in determining the cost allocation factor. Other than the testimony of Mr. Lovinger, no supporting evidence was provided to justify inclusion of a component that allocates less than one tenth of one percent to the non-regulated entities for services such as taxation<sup>128</sup>, accounting and general accounting services<sup>129</sup>, and property and sales tax<sup>130</sup>. Atmos Mid-Tex provided no supporting evidence for the proposition that costs related to investor relations<sup>131</sup>, and corporate communications<sup>132</sup> could reasonably be allocated in such a manner to include one factor that essentially allocates zero dollars to the non-regulated entities. Those entities account for over thirteen percent of the gross revenue and a substantially higher percentage of the net income. These facts suggest that they would be an important consideration for the investor relations cost and the corporate communications cost center. If, as Mr. Lovinger, suggests the primary judgment should be based upon the overall results, the inclusion of a factor that essentially allocate zero expenses related to the incentive plans is not reasonable.

The determination of the cost allocation method should be based on a careful evaluation of the results.<sup>133</sup> Mr. Lovinger stated that as long as there is a logical nexus between a particular cost category and the resulting assignment of cost among the participants the proposed cost allocation methodology is reasonable.<sup>134</sup> In this case, Atmos has failed to establish that including the customer component in the calculation of the composite factor produces a "logical nexus between a particular cost category and the resulting assignment of costs." An allocation component that allocates less than one percent to a division that accounts for over 12% of the gross income is not reasonable. Further, as noted in GUD No. 9670, a cost allocation factor that excludes any consideration of revenues is not reasonable.

Atmos Mid-Tex argued that NOI may lead to incongruous results. A division or affiliate that experiences diminished income will be the recipient of greater attention from management. Atmos has not established, however, that it will receive greater attention from the type of services offered by SSU. Mr. Lovinger noted affiliates provide their own human resource services, perform many of their own accounting functions and have many of their own information technology systems to run

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<sup>128</sup> Cost Center 1116 include costs associated with management of income tax and property and tax preparation. See, Atmos Ex. 35, Forsythe Rebuttal, Exhibit CTF-R-3.

<sup>129</sup> Cost Center 1117 Dallas Acctg Services which includes costs related to management of general accounting, accounts payable, plant accounting and payroll departments. Atmos Ex. 35, Forsythe Rebuttal, Exhibit CTF-R-3.

<sup>130</sup> Cost Center 1128, Dallas Property & Sales Tax which includes costs associated with the handling of the company's property and sales tax activities. Atmos Ex. 35, Forsythe Rebuttal, Exhibit CTF-R.

<sup>131</sup> Cost Center 1132, Investor Relations includes costs associated with investor relations. Atmos Ex. 35, Forsythe Rebuttal, Exhibit CTF-R

<sup>132</sup> Cost Center 1133, Corporate Communication includes costs associated with internal and external corporate communications. Atmos Ex. 35, Fositythe Rebuttal, Exhibit CTF-R.

<sup>133</sup> Atmos Ex. 27, Lovinger Direct, p. 9, Ins. 12 - 14.

<sup>134</sup> Atmos Ex. 27, Lovinger Direct, p. 11, Ins. 8 - 11.

their business.

Consistent with the Commission's determination in GUD No. 9670, the Examiners find that a cost allocation that ignores revenues is not reasonable. Further, the Examiners find that the customer allocation component of the three factor formula proposed by Atmos Mid-Tex is not reasonable because it suggest that less than one percent of costs should be allocated to the non-regulated entities. Further it is not disputed that FERC does not incorporate a customer allocation factor.<sup>135</sup> Accordingly, the Examiners recommend that the allocation factor proposed by Atmos Mid-Tex be rejected. The Examiners find that adding a fourth factor that incorporate revenues is reasonable and reasonably balances the effect of the customer component. The Examiners find that the NOI determined based upon net income prior to the deduction of income taxes and interest expense, is a reasonable factor to include as a fourth factor.

B. Shared Services –Adjustments to Specific Cost Centers

1. Amarillo and Waco Call Center

i. *Introduction.*

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<sup>135</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 16, lns. 18 - 19.

Atmos Mid-Tex operates two call centers: (1) the Amarillo Call Center and (2) the Waco Call Center. As originally filed the expenses associated with the Amarillo Call Center were \$16,612,481 and the expenses associated with the Waco Call Center were \$14,729,932. Only a portion of these expenses were allocated to Atmos Mid-Tex. In the initial filing Atmos Mid-Tex allocated a total of \$15,379,723 in expenses.<sup>136</sup> A portion of the expenses related to the call center was also capitalized That amount was \$2,517,601.<sup>137</sup> As a result of a change to the expenses associated with the Amarillo Call Center, the total amounts allocated to Atmos Mid-Tex were reduced. In the errata filed on March 19, 2008, Atmos Mid-Tex sought to allocate \$14,889,023 in expenses to Atmos Mid-Tex for the Amarillo Call Center.<sup>138</sup> Of that amount, Atmos Mid-Tex maintained that \$2,436,123 should be capitalized.<sup>139</sup> The City of Dallas argued that none of the costs associated with the Amarillo Call Center should be allocated to Atmos Mid-Tex. Additionally, the City of Dallas contended that the Waco Call Center expenses should be reduced to reflect calls handled for other divisions of Atmos Mid-Tex. The combined effect of these proposals is to reduce the revenue requirement by approximately \$233,418.

ii. *Argument of the Parties*

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<sup>136</sup> Statement of Intent, October 26, 2007, Schedule WP\_F2.7. Amarillo call center expenses allocated to Atmos Mid-Tex were at line 42, col (g): \$8,151,745. Waco Call Center expenses allocated to Atmos Mid-Tex were at line 44, col (g): \$7,227,978. The sum of these expenses are \$15,379,723.

<sup>137</sup> Statement of Intent, October 26, 2007. Amarillo call center capitalized amounts are at line 42, col (f): \$1,353,549. Waco Call Center expenses capitalized are at line 44, col (f): \$1,164,052. The sum of these capitalized amounts is \$2,517,601.

<sup>138</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule WP\_F2.7. Amarillo call center expenses allocated to Atmos Mid-Tex were at line 42, col (g): \$7,661,045. Waco Call Center expenses allocated to Atmos Mid-Tex were at line 44, col (g): \$7,227,978. The sum of these expenses are \$14,889,023.

<sup>139</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule WP\_F2.7. Amarillo call center capitalized amounts are at line 42, col (f): \$1,272,071. Waco Call Center expenses capitalized are at line 44, col (f): \$1,164,052. The sum of these capitalized amounts is \$2,436,123.

The City of Dallas raised three fundamental issues with regards to the allocation of costs related to the two call centers. First, the City of Dallas argued Atmos Mid-Tex has failed to justify the allocation of costs from the Amarillo Call Center because it does not provide service to Atmos Mid-Tex commensurate with the proposed allocation amounts. The City of Dallas argued that the Amarillo Call Center only provided overflow call handling for the Mid-Tex Division during peak periods. Mr. Pous noted that this was the same situation that existed when GUD No. 9670 was litigated.<sup>140</sup> The fact that the Amarillo Division provides little support for the Mid-Tex division is a fact that was not refuted by Atmos Mid-Tex. On this basis, Mr. Pous argued that none of the Amarillo Call Center costs should be allocated to Atmos Mid-Tex. He rejected the argument that the call centers should be treated as an integrated unit because of the disparity in the per-call costs between the two call centers.<sup>141</sup> Second, the City of Dallas argued that the Waco Call Center allocation to Atmos Mid-Tex should be increased to 100% and proposed an adjustment for call handling that was not directly related to Atmos Mid-Tex.<sup>142</sup> Third, Mr. Pous argued that no testimony was provided to support the level of costs associated with the call centers.<sup>143</sup>

Mr. Forsythe does not challenge the fundamental assertion of the City of Dallas that the Amarillo Call Center handled only a small volume of overflow costs for Atmos Mid-Tex. Instead, he maintained that the Amarillo Call Center allows flexibility to decrease call waiting times for Mid-Tex customers during especially heaving calling periods and it adds a level of security to the system that ensure that the calls of Atmos Mid-Tex customers will be received if something should interrupt the availability of the Waco Call Center.<sup>144</sup> Mr. Forsythe testified that the level of costs requested in this case cannot be compared to the costs approved in GUD No. 9670. The test year used in that case involved a transitional year. Atmos Mid-Tex operated the system for only a portion of that year. In addition to a full year of data related to the call centers, this filing incorporated increased labor costs, due to increased benefits expenses, and increased software maintenance costs required to maintain the call center infrastructure.<sup>145</sup> Although Mr. Pous generally challenged the expense level of the call centers, Mr. Pous offered no evidence to demonstrate that any investment or expense item has been unreasonably incurred.<sup>146</sup>

iii. *Examiners' Recommendation*

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<sup>140</sup> Dallas Ex. 2, Pous Direct, p. 40, ln 17 - 20.

<sup>141</sup> Dallas Ex. 2, Pous Direct, p. 40, ln. 24 - p. 41 ln. 15.

<sup>142</sup> Dallas Ex. 2, Pous Direct, p. 42, lns. 1 - 5.

<sup>143</sup> Dallas Ex. 2, Pous Direct, p. 40, ln 1 - 4, 21 - 22, and 26 - 27.

<sup>144</sup> Atmos Mid Ex. 35, Forsythe Rebuttal, p. 8, lns. 1 - 10.

<sup>145</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 4, ln. 1 - 22.

<sup>146</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 6, lns. 1 - 11.

The Examiners find that Atmos Mid-Tex has failed to establish that the proposed allocation methodology is reasonable. It is evident from the record in this case, and the record in GUD No. 9670, that the Amarillo Call Center handles a small volume of calls for the customers of Atmos Mid-Tex. This fact is not disputed. On that basis alone, Atmos Mid-Tex proposed to allocate \$7,661,045 to Atmos Mid-Tex. Although the Amarillo Call Center provides additional flexibility and security, Atmos Mid-Tex has not established that the allocation methodology is reasonable.

The vast majority of calls handled by each call center appears to be related to a particular division. For example, the vast majority of calls handled by the Waco Call Center are related to Atmos Mid-Tex. The small volume of calls that are not directly associated with that division may be assigned by a more accurate methodology. Evidence in the record established that the total number of calls for each call center are tracked.<sup>147</sup> Evidence in the record established that the division served by each called handled is also tracked.<sup>148</sup> For example, the City of Dallas proposed to remove expenses associated with calls handled by the Waco Call Center that were not related to Atmos Mid-Tex. Thus, the costs associated with each call center may be directly assigned. The Examiners find that the methodology proposed by Mr. Pous is reasonable.

## 2. Cost Center 1116 Taxation

### i. *Introduction*

During the test year this cost center booked \$613,461. Of that amount, Atmos Mid-Tex proposed that \$245,691 be allocated to Atmos Mid-Tex as an expense and that \$6,676 be capitalized.<sup>149</sup> In GUD No. 9670, the Commission considered the expenses associated with this cost center and concluded that Atmos Mid-Tex established that the allocation of costs related to it were just and reasonable.<sup>150</sup> The City of Dallas maintained that this expense should be removed which would reduce the revenue requirement by \$242,274.

### ii. *Argument of the Parties.*

Mr. Pous clarified that this cost center is involved in the management of income taxes as well as property and sales tax. He asserted that the management of sales tax is part of the computerized billing system and requires a relatively minimal level of effort. Further Atmos Mid-Tex retains a portion of the sales tax as the handling agent for the state and estimated that the Mid-Tex Division retains \$180,000 of sales tax. He maintained that since it appeared that only one fourth of the activity of this cost center is associated with the management of Federal income taxes, and Atmos Mid-Tex benefits from a sales tax collection discount, all of the expenses associated with this cost center should be disallowed. In the alternative, he argued that the allocated amount should be reduced by \$181,205.<sup>151</sup> Mr. McDonald, the manager of this cost center testified that the cost center is responsible for ensuring compliance with applicable income tax laws and regulations of the

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<sup>147</sup> Atmos Ex. 35, Forsythe Rebuttal, Exhibit CTF-R-2.

<sup>148</sup> Dallas Ex. 2, Pous Direct, p. 42, Ins. 1 - 5.

<sup>149</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 25.

<sup>150</sup> GUD No. 9670, Order on Rehearing, FOF No. 61.

<sup>151</sup> Dallas Ex. 2, Pous Direct, p. 47, Ins. 7 - 26.

Internal Revenue Service (IRS).<sup>152</sup> As to the amounts retained, Mr. McDonald explained that an adjustment was made in the cost of service schedules to account for these revenues.<sup>153</sup> Ms. Myers testified further that the tax departments are responsible for calculation of taxes in the current filing, including calculation of the Accumulated Deferred Income Taxes, and noted that while federal income tax calculations may appear to be straight forward they are necessary for providing service to customers.<sup>154</sup>

### iii. Examiners' Recommendation

The Examiners find that Atmos Mid-Tex has established that the costs associated with Cost Center 1116 are just and reasonable. Compliance with tax regulations is necessary to the operation of Atmos Mid-Tex and compliance with the legal obligations related to taxes is necessary of the provision of gas service. The Examiners find that the ratepayers ultimately benefit by professional tax experts who administer the calculation of tax liability to ensure that no more taxes are paid than required by law. Additionally, no further adjustment is required for amounts of the sales tax retained as the handling agent for the state. Those amounts have been incorporated into the cost of service study provided by the utility. Finally, Atmos Mid-Tex has established that this cost center, and Cost Center 1129, are involved in the determination of deferred tax – a component of the cost of service calculation.

## 3. Cost Center 1129 Income Tax

### i. Introduction

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<sup>152</sup> Atmos Ex. 40, McDonald Rebuttal, p. 12, Ins. 13 - 16.

<sup>153</sup> Atmos Ex. 40, McDonald Rebuttal, p. 17, Ins. 4 - 13.

<sup>154</sup> Atmos Ex. 34, Myers Rebuttal, p. 16, Ins 8 - 17.

During the test year this cost center booked \$670,944. Of that amount, Atmos Mid-Tex proposed that \$268,713 be allocated to Atmos Mid-Tex as an expense and that \$2,859 be capitalized.<sup>155</sup> In GUD No. 9670, the Commission considered the expenses associated with this cost center and concluded that Atmos Mid-Tex established that the allocation of costs related to it were just and reasonable. Specifically, the Commission found that evidence was not presented that the costs that were included in that cost center were reasonable and necessary to the provision of natural gas service.<sup>156</sup> The City of Dallas maintained that this expense should be removed which would reduce the revenue requirement by \$269,483.

ii. Argument of the Parties

Mr. Pous argued that the entire amount associated with this cost center should be disallowed. He asserted that the processing of actual income taxes are investor-related activities rather than a customer-related activity. The revenue requirements for customers are based on a hypothetical tax calculation rather than actual taxes. He reasoned, therefore, that it is the shareholders that benefit from the actual process by collecting funds from customers for such taxes but not paying such taxes to the government on a contemporary time frame. He concluded that it was inappropriate to require customers to pay rates based on a hypothetical tax basis that requires minimal calculation, yet be burdened with extensive processing expense associated with actual taxes.<sup>157</sup>

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<sup>155</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 25.

<sup>156</sup> GUD No. 9670, FOF No. 63.

<sup>157</sup> Dallas Ex. 2, Pous, Direct, p. 46, ln. 18 - p. 47, ln. 5.

Mr. Forsythe noted that the Commission rejected the same arguments in GUD No. 9670. He countered that Mr. Pous offered no evidence in this case to justify a different result. Mr. Forsythe also testified that determining income tax liability is a necessary and normal business expense and the amount of tax liability represents a critical element in determining the revenue requirement.<sup>158</sup> Witnesses for Atmos Mid-Tex noted that the Commission previously found the expenses related to this cost center to be just and reasonable and asserted that this was a reasonable result given the necessity of properly calculating and addressing the tax liability of Atmos Mid-Tex.<sup>159</sup> Mr. McDonald concurred Ms. Myers in their opinion that the tax departments are responsible for calculation of taxes in the current filing, including calculation of the Accumulated Deferred Income Taxes, and noted that while federal income tax calculations may appear to be straight forward they are necessary for providing service to customers.<sup>160</sup>

iii. *Examiners' Recommendation.*

The Examiners find that Atmos Mid-Tex has established that including expenses from this cost center is reasonable. As with Cost Center 1116, Atmos Mid-Tex has established that Compliance with tax regulations is necessary to the operation of Atmos Mid-Tex and compliance with the legal obligations related to taxes is necessary of the provision of gas service. The Examiners find that the ratepayers ultimately benefit by professional tax experts who administer the calculation of tax liability to ensure that no more taxes are paid than required by law.

4. Cost Center 1132 Investor Relations

i. *Introduction*

During the test year this cost center booked \$871,889. Of that amount, Atmos Mid-Tex proposed that \$349,195 be allocated to Atmos Mid-Tex.<sup>161</sup> In GUD No. 9670, the Commission considered the expenses associated with this cost center and concluded that Atmos Mid-Tex did not establish that the allocation of costs related to it were just and reasonable. Specifically, the Commission found that evidence was not presented that the costs that were included in that cost center were reasonable and necessary to the provision of natural gas service.<sup>162</sup> The City of Dallas maintained that this expense should be removed which would reduce the revenue requirement by \$353,972.

ii. *Argument of the Parties*

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<sup>158</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 20, ln. 1 - p. 21, ln. 2.

<sup>159</sup> Atmos Ex. 40, McDonald Rebuttal, p. 12, ln. 1 - p. 15, ln. 23.

<sup>160</sup> Atmos Ex. 34, Myers Rebuttal, p. 16, lns 8 - 17.

<sup>161</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 25.

<sup>162</sup> GUD No. 9670, FOF No. 63.

The City of Dallas argued that the cost center tracks expenses associated with the company's relationship to its shareholder's. Such expenses are for the benefit of shareholders and not for the benefit of customers or for the provision of service to customers. Mr. Pous argued that similar to expenses related to donation expenses that Atmos Mid-Tex incurs to provide services to its shareholders should also be borne by the shareholders.<sup>163</sup>

In response, Mr. Forsythe maintained that investor relation activities of this cost center include costs related to dissemination of information to the public as a whole – not just shareholders. Parties who benefit from that activity include customers, debt investors, financial institutions, regulatory agencies, rate case intervenors, and shareholder.<sup>164</sup>

iii. *Examiners' Recommendation*

Consistent with the Commission's treatment of these in GUD No. 8664, GUD No. 9400, and GUD No. 9670, the Examiners' find that the costs associated with these expenses should be removed.<sup>165</sup> Atmos Mid-Tex failed to establish that expenses for this cost center are for the purpose of providing safe and reliable service to customers. Further, the Examiners find that Atmos Mid-Tex has failed to establish that the overall allocation methodology is appropriate for this cost center. Although Mr. Forsythe testified generally regarding information, there is no evidence in the record that establishes the information provided or explains how that information is necessary to the provision of natural gas service. On the contrary, the evidence in the record established that the bulk of the activities associated with this cost center relate to investor activities and Atmos Mid-Tex has failed to establish the reasonableness of imposing nearly fifty percent of the expenses associated with this division on it, nor the reasonableness of imposing over ninety percent of these costs on the regulated division. Atmos Mid-Tex proposed an allocation methodology that imposed on the non-regulated divisions 3.14% of the costs associated with this cost center.

5. Cost Center 1142 Rates and Cost Center 1154 Rates and Regulations

i. *Introduction*

During the test year \$1,563,395 was booked to these cost centers. Of that amount, Atmos Mid-Tex proposed that \$644,588 be allocated to Atmos Mid-Tex as an expense.<sup>166</sup> In GUD No. 9670, issues regarding these cost centers were not raised by the intervening parties. The allocation factor applied to Cost Center 1142 proposed by Atmos Mid-Tex is substantially higher in this case. Whereas in GUD No. 9670 Atmos Mid-Tex proposed an allocation factor of 9.95%, resulting in an allocation of \$93,980, the allocation factor proposed in this case for the same cost center is 41.23%, resulting in an allocation of \$489,151. Costs related to Cost Center 1154 do not appear to have been included in the SOI filed in GUD No. 9670. The City of Dallas argued at the hearing that Atmos

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<sup>163</sup> Dallas Ex. 2, Pous Direct, p. 43, ln. 1 - p. 44, ln. 5.

<sup>164</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 12, ln. 11 - p. 13, ln. 23.

<sup>165</sup> GUD No. 8664, FOF No. 49.

<sup>166</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 31 & ln. 32.

Mid-Tex has not established that costs associated with these cost centers are just and reasonable. The revenue impact of removing the expenses associated with these cost centers is to reduce the revenue requirement by \$653,400.

ii. *Argument of the Parties*

The City of Dallas argued that these expenses are not recurring, since Atmos Mid-Tex has no routine rate case filing obligation. Mr. Pous argued that actual rate related costs can be addressed when, and if, they occur in the future.<sup>167</sup> Mr. Forsythe noted that the City of Dallas did not object to these expenses in GUD No. 9670. Further, he explained that the costs currently captured in Cost Center 1154 were not booked to a cost center within the SSU. Instead, those costs were embedded in direct O&M costs for the Atmos Mid-Tex Division. During the current test years those costs were moved to Shared Services to the newly created Cost Center 1154.<sup>168</sup> Mr. Forsythe also testified that the costs associated with these cost centers are related to costs associated with the oversight and preparation of rate filings but are not limited to formal rate cases. The activities undertaken by these cost centers include preparation of annual regulatory filings, formula ratemaking clauses, filings made pursuant to the RRM approved by several municipalities, as well as monitoring actual returns against authorized returns. He also testified that the costs associated with these cost centers are, in fact, recurring costs.<sup>169</sup>

iii. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has established that the costs associated with these costs centers is just and reasonable. To the extent that costs were included as part of the operations and maintenance expense approved in GUD No. 9670, it would be unreasonable to exclude those expenses simply because Atmos Mid-Tex has shifted those operations to a cost center within SSU. Further, as regards to Cost Center 1142, it is evident that the Commission approved those expenditures as part of the revenue requirement in GUD No. 9670. Although Atmos Mid-Tex has increased the cost allocation factor applied to this cost center, the allocation factor is appropriately selected as it includes all regulated divisions of Atmos Mid-Tex.

6. Cost Center 1350 Non - Utility Operations

i. *Introduction*

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<sup>167</sup> Dallas Ex. 2, Pous Direct, p. 45, lns. 11 - 21.

<sup>168</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 16, lns. 13 - 17 & Fn 2.

<sup>169</sup> Atmos Ex 35, Forsythe Rebuttal, p. 16, ln. 13 - p. 18, ln. 2.

During the test year this cost center booked \$717,218. Of that amount, Atmos Mid-Tex proposed that \$59,142 be allocated to Atmos Mid-Tex as an expense and \$29,407 be capitalized to Atmos Mid-Tex.<sup>170</sup> In GUD No. 9670, the Commission considered the expenses associated with this cost center and concluded that Atmos Mid-Tex did not establish that the allocation of costs related to it were just and reasonable. Specifically, the Commission found that evidence was not presented that the costs that were included in that cost center were reasonable and necessary to the provision of natural gas service.<sup>171</sup> The City of Dallas maintained that this expense should be removed which would reduce the revenue requirement by \$30,126.

ii. *Argument of the Parties*

Mr. Pous pointed out that expenses associated with this cost center were denied in GUD No. 9670. He argued that the Senior Vice President of Non-Utility Operations is not there on behalf of the regulated customers. Mr. Forsythe testified that the allocation of this cost center has been revised. In GUD No. 9670, Atmos Mid-Tex proposed an allocation methodology that would allocate 38.84% of those costs to Atmos Mid-Tex.<sup>172</sup> In this case, Atmos Mid-Tex seeks to apply an allocation methodology which would allocate 8.25% of the costs associated with this cost center.<sup>173</sup> Mr. Forsythe explained that the Senior Vice President of Non-Utility Operations is a member of the Management Committee which is responsible for making decisions that impact Atmos Energy a whole. These decisions impact the operations of Atmos Mid-Tex.<sup>174</sup>

iii. *Examiners' Recommendation*

The Examiners find that while the proposed allocation methodology is more reasonable than the methodology proposed by Atmos Mid-Tex in GUD No. 9670, the company has not established that this cost center provides a service to the regulated divisions, including Atmos Mid-Tex, necessary to provide natural gas service to residential and commercial customers. Mr. Forsythe testified that the Senior Vice President of Non-Utility Operation is a member of the Management Committee which is responsible for making decision that impact Atmos Energy as a whole. It is on this basis that the Atmos Mid-Tex proposed allocation of expenses to the utility system. The purpose of the participation of the Senior Vice President of Non-Utility Operations at the

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<sup>170</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 25.

<sup>171</sup> GUD No. 9670, FOF No. 63.

<sup>172</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 14, ln. 17 - p. 15, ln. 19. GUD No. 9670, Order on Rehearing, Schedule WP F-2.2b, ln. 46.

<sup>173</sup> If the proposal of the City of Dallas regarding allocation is adopted, the amount allocated would be reduced further.

<sup>174</sup> Atmos Ex. 35, Forsythe Rebuttal, p. 15, ln. 8 - 19.

Management Committee, however, is to represent the interests of the non-utility operations of Atmos Energy - not the utility operations of Atmos Mid-Tex. Thus, consistent with the Commission's determination in GUD No. 9670, the Examiners recommend that the costs associated with this cost center not be included in the revenue requirement calculation.

7. Cost Centers 1904 Performance Plan and Cost Center 1908 Dallas Sebpa

i. *Introduction*

During the test year these cost center booked \$12,387,670. Of that amount, Atmos Mid-Tex proposed that \$5,107,347 be allocated to Atmos Mid-Tex as an expense and \$2,121,433 be capitalized to Atmos Mid-Tex.<sup>175</sup> Atmos Mid-Tex offers three incentive compensation plans: (a) Variable Pay Plan (VPP), (b) Management Incentive Plan (MIP), and (3) Long-Term Incentive Plan for Management ("LTIP").<sup>176</sup> In GUD No. 9400 similar expenses were excluded.<sup>177</sup> In GUD No. 9760, the Commission found that Atmos Mid-Tex failed to establish that costs related to Cost Center 1904 were just and reasonable. In the Proposal For Decision, the Examiners recommended that the expenses associated with this cost center be disallowed for two reasons. First, no evidence was provided that the witness who testified regarding the amounts charged actually examined expenses associated with this account to determine that the amounts were just and reasonable. Second, the evidence in the record indicated that the expense in those account were primarily driven by the earnings of Atmos Mid-Tex.

ii. *Arguments of the Parties*

The City of Dallas recommends that expenses associated with these accounts be disallowed for the same reasons. Ms. Coleman testified that the incentive compensations are tied directly to the profit of the company and are driven by earnings that benefit the shareholders. She argued that there are no changed circumstances in this case. In its Reply Brief, the City of Dallas maintained that the additional compensation offered was based upon a rather low standard of performance and that employee that simply met expectations was entitled to compensation under the plans. This relatively low level of performance indicated that the compensation plan was based upon earnings per share and did not result in added value to the ratepayer.<sup>178</sup> The City of Dallas also argued that if the RRM mechanism is approved, the mechanism itself will feed into the amount and entitlement to an incentive pay.<sup>179</sup>

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<sup>175</sup> Atmos Ex. 45, (March 19, 2008 Errata) WP\_F-2.7, p. 3, ln. 80 & p. 4, ln. 82.

<sup>176</sup> Atmos Ex. 37, Ellerman Rebuttal, p. 3, lns. 16 - 21.

<sup>177</sup> GUD No. 9400, FOF 71 & 72.

<sup>178</sup> Reply Brief, City of Dallas, pp. 25 - 26.

<sup>179</sup> Reply Brief, City of Dallas, p. 26.

Atmos Mid-Tex proffered two witness to testify about these cost centers and the incentive compensation plan of Atmos Mid-Tex. Mr. Ellerman provided testimony regarding the three plans, VPP<sup>180</sup>, the MIP<sup>181</sup>, and the LTIP.<sup>182</sup> Mr. Ellerman argued that these incentive plans afford the flexibility regarding base salaries and employee benefit levels. Mr. Ellerman emphasized repeatedly that the grant of additional compensation pursuant to those plans was dependent on a number of factors including customer service, and safety and reliability.<sup>183</sup> In general, these program include customer-oriented aims such as controlling costs and providing superior customer service.<sup>184</sup> He argued that Atmos Mid-Tex would have to increase base salaries and employee benefit levels in order to provide a competitive rewards package in terms of total value if the programs were not offered. The result would be higher fixed costs.<sup>185</sup> This later point was echoed by Mr. Lovinger who argued that if the incentive compensation plans were not offered Atmos Mid-Tex would be at a competitive disadvantage.<sup>186</sup>

Mr. Lovinger emphasized four main points. First, he argued that most regulated utilities use incentive compensation based on profitability, and it is an industry standard and that he has never noted a situation in which a regulator proposed disallowing the expenditure.<sup>187</sup> Second, he argued that the incentive compensation, that is based upon profitability, benefits both customers and stockholders. In this context, he concluded that providing incentive compensation operates to keep customer rates lower and increase profitability by expansion of the customer base and increased efficiencies.<sup>188</sup> Third, he argued that Atmos Mid-Tex has meet its burden because the company has established that managers and executives must be compensated and no one has challenged the total compensation. Therefore, he a claimed that Atmos Mid-Tex has meet its burden on this issue.<sup>189</sup> Fourth, Mr. Lovinger argued that ratepayers are not harmed by an incentive compensation plan that is tied to profitability.

### iii. *Examiners' Recommendation*

The Examiners recommend that the expenses related to these cost center not be included in the cost of service. Atmos Mid-Tex has not established that expenses associated with these cost centers are reasonable and necessary to the provision of natural gas service. In GUD No. 9670 and in GUD No. 9400, the Commission disallowed this expense, in part, because the expense was not known and measurable, and the award of the compensation pursuant to the plans was at the discretion of the managers. In this case, Atmos Mid-Tex has established that these expenses are known and measurable and that, as a general matter, the amounts included in the cost of service study are awarded.<sup>190</sup> That is not an issue in this case. Further, in GUD No. 9670, the Examiners

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<sup>180</sup> Atmos Ex. 37, Ellerman Rebuttal, pp. 4, ln. 1 - 8, ln. 7.

<sup>181</sup> Atmos Ex. 37, Ellerman Rebuttal, pp. 8, ln. 7 - p. 11, ln. 14,

<sup>182</sup> Atmos Ex. 37, Ellerman Rebuttal, pp. 11, ln. 16 - p. 15, ln. 19.

<sup>183</sup> Atmos Ex. 37, Ellerman Rebuttal, p. 6, ln. 18 - 22 (VIP), p. 10, lns. 2 - 5 (MIP), and p. 13, lns. 6 - 14 (LTIP).

<sup>184</sup> Atmos Ex. 37, Ellerman Rebuttal, p. 19, lns. 1 - 20.

<sup>185</sup> Atmos Ex. 37, Ellerman Rebuttal p. 16, lns. 8 - 12.

<sup>186</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 9, lns. 1 - 16.

<sup>187</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 7, ln. 15 - p. 8, ln. 20.

<sup>188</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 9, ln. 18 -

<sup>189</sup> Atmos Ex. 36, Lovinger Rebuttal, p. 6, ln. 9 - p. 7, ln 13.

<sup>190</sup> Atmos Ex. 34, Myers Rebuttal, Exhibit BWM-R-2.

identified several issues regarding expenses in SSU that ultimately resulted in the disallowance of several categories of expenses.<sup>191</sup> As noted, Atmos Mid-Tex has addressed this issue in this case. The only remaining issue before the Commission with regards to the expenses associated with these cost centers is the reasonableness of including these expenses in the rates. Although Atmos Mid-Tex offered extensive additional testimony on this issue, the company has not established that the inclusion of those expenses in the cost of service calculation is reasonable.

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<sup>191</sup> GUD No. 9670 FOF 33 - 69.

Although Mr. Ellerman pointed out that some kind of incentive compensation plan is included by most large utilities, it is impossible to ascertain from that testimony the extent to which those programs parallel the program at issue here. Further, Mr. Ellerman conceded that there are some utilities that do not include these programs.<sup>192</sup> Further, although Mr. Lovinger stated that he has not been involved in a case in which this issue has been litigated, it is impossible to ascertain from Mr. Lovinger's testimony whether the other utilities requested that the expenses associated with those programs be recovered from ratepayers. Indeed, evidence in the record in GUD No. 9670 suggested that these type of expenses are not always included in the rate request.<sup>193</sup> Finally, noticeably lacking in the case presented by Atmos Mid-Tex is specific evidence that incentive compensation has actually been awarded on the bases of a standard that resulted an added value to the ratepayer. The evidence indicates that the incentive compensation programs are geared towards increased earnings per share and profitability.

By basing the award on "meets expectations," in other words, average performance there does not appear to be an added benefit to the ratepayer that would warrant the imposition of these added costs. Thus, it appears that the bonus is based solely upon the earnings per share standard. The fact, noted by an Atmos Mid-Tex witness, that at its initiation the awards were denied because the targeted earnings per share was not achieved is another indicator that EPS -- is the key element for bonuses.

## 8. Cost Center 1905 Outside Director Retirement

### i. Introduction

The cost recorded in Cost Center 1905 relates to the annual grant of share units to non-employee directors for their service on the Board of Directors.<sup>194</sup> During the test year this cost center booked \$1,141,388. Of that amount, Atmos Mid-Tex proposed that \$457,126 expense be allocated to it.<sup>195</sup> In GUD No. 9670, the Commission considered the expenses associated with this cost center and concluded that Atmos Mid-Tex did not establish that the allocation of costs related to it were just and reasonable. Specifically, the Commission found that evidence was not presented that the costs that were included in that cost center were reasonable and necessary to the provision of natural gas service.<sup>196</sup> The City of Dallas maintained that this expense should be removed which would reduce the revenue requirement by \$463,423.

### ii. Argument of the Parties

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<sup>192</sup> Atmos Ex. 37, Ellerman Rebuttal, p. 16, Ins. 16 - 17

<sup>193</sup> GUD No. 9670, Proposal for Decision, p. 49 & 50.

<sup>194</sup> Atmos Ex. 36, Forsythe Rebuttal, p. 18, Ins. 10 - 11.

<sup>195</sup> Atmos Ex. 45, (March 19, 2008 Errata), WP\_F-2.7, p. 1, ln. 80.

<sup>196</sup> GUD No. 9670. FOF No. 67.

Mr. Pous testified that this cost center is another case where Atmos Mid-Tex seeks to reverse the Commission's decision in GUD No. 9670. The City of Dallas maintained that Atmos Mid-Tex has provided no additional evidence in support of the reasonableness of the this expenditure.<sup>197</sup> Mr. Forsythe explained that the costs recorded in this cost center relate to the annual grant of share units to non-employee directors for their service on the Board of Directors. He testified that the amount of compensation cost recorded in this cost center is based upon the number of shares granted and the grant date fair value of the stock award. The decisions of the Board of Directors impact Atmos Energy as whole and impact the Atmos Mid-Tex Division.<sup>198</sup>

iii. *Examiners' Recommendation.*

The Examiners find that Atmos Mid-Tex has not established that the costs associated with Cost Center 1905 are just and reasonable expenses necessary to the provision of natural gas service. While Mr. Forsythe's testimony explained the impact of the Board of Directors on operations of Atmos Energy and the potential impact on Atmos Mid-Tex, Mr. Forsthe has not explained the necessity of including non-employee members on the Board of Directors for the provision of natural gas service nor how the participation of the non-employee members contributes to the provision of that service.

i. Cost Center 1905 Mid-Tex Integration and Cost Center 1835 Franklin

The City of Dallas asserted that the expenses associated with these cost centers should be removed. Atmos Mid-Tex concurred and they were removed in the errata that was filed on March 19, 2008. The Examiners find that no further adjustment is required.

C. Shared Services — Depreciation

a. Introduction

The total depreciation expense requested in this case was \$79,409,826.<sup>199</sup> The depreciation expense is composed of depreciation expense for Atmos Mid-Tex direct and an allocated portion of the depreciation expense of the Shared Services Unit (SSU).<sup>200</sup> No party challenged the proposed depreciation expense for Atmos Mid-Tex direct of \$68,188,726.<sup>201</sup> On the other hand, the City of Dallas challenged the component related to SSU.

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<sup>197</sup> Dallas Ex. 2, Pous Direct, p. 46, Ins. 5 - 16.

<sup>198</sup> Atmos Ex. 36, Forsythe Direct, p. 18, ln. 20 - p. 19, ln. 12.

<sup>199</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule A

<sup>200</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-3, ln. 21, ln. 48, and ln. 75.

<sup>201</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-3, ln. 21.

Atmos Mid-Tex requested that the proposed revenue requirement include \$11,221,100 in shared services depreciation.<sup>202</sup> In GUD No. 9670, the Commission approved \$8,700,040 in shared services depreciation.<sup>203</sup> The City of Dallas argued that the SSU depreciation rate in this case is approximately 20% higher than in GUD No. 9670.<sup>204</sup> The City of Dallas argued that the appropriate level of shared services depreciation expense is \$7,737,967.<sup>205</sup> The combined impact of the proposed adjustment would reduce the revenue requirement by approximately \$3,523,552.

In GUD No. 9670, the Commission determined that Atmos Mid-Tex failed to establish that the proposed depreciation rates were just and reasonable. The inability to establish the reasonableness of those rates stemmed, in part, on the overall credibility of the witnesses and the fact that the depreciation study provided in support of those rates was over four years old at the time that case was filed.<sup>206</sup> In this case Atmos Mid-Tex presented a new depreciation study. Generally, Mr. Pous argued that the new study produced unreasonable results and alleged that the study continued what he characterized as the company’s historical practice of being excessively aggressive in determining the service lives of various accounts. As evidence of the alleged practice, Mr. Pous argued that the actual investments last longer than the projections. The result is fully accrued plant accounts even though the plant at issue is still providing service to customers. Mr. Pous pointed out that approximately 40% of the accounts are fully accrued.<sup>207</sup>

The City of Dallas challenged the projected service lives of six accounts. In each case, Mr. Pous asserted that even though a recent study increased services lives for several accounts, the estimated services lives for certain accounts proposed by the utility are still deficient.<sup>208</sup> Mr. Pous proposed an adjustment to six accounts:

Table 11.5  
SSU Depreciation Accounts Challenged

SSU Depreciation Accounts					
Account Number	Description	Atmos Proposal		Dallas Proposal	
		Service Life	Dispersion Curve	Service Life	Dispersion Curve

<sup>202</sup> December 20, 2007, Errata, Schedule F-3, l. 78.

<sup>203</sup> Final Order on Rehearing, Schedule F-3a, ln. 29 & Schedule F-3b, ln. 28.

<sup>204</sup> Dallas, Ex. 2, Pous Direct, p. 59, lns. 7 - 8.

<sup>205</sup> Dallas, Ex. 2, Pous Direct Revised Schedule (JP-4). The revised schedule provided by the City of Dallas cites the figure as \$7,37,967. The difference of \$330 is due, in part to a minor difference in the rate applied by the City of Dallas to Account 399, 399.06, and rounding. The City of Dallas has not explained the proposed change and the Examiners have applied the rates proposed by Atmos Mid-Tex to those accounts.

<sup>206</sup> GUD No. 9670, FOF 185, PFD, 126.

<sup>207</sup> Dallas, Exhibit 2, Pous Direct, p. 59, ln 19 - p. 60, ln. 14.

<sup>208</sup> Dallas, Exhibit 2, Pous Direct, p. 60, ln. 16 - p. 61, ln. 6.

397	Communications Equipment	12	S5	14	S5
399.01	Servers-Hardware	10	SQ	15	SQ
399.02	Servers-Software	10	SQ	15	SQ
399.03	Network Hardware	10	SQ	15	SQ
399.08	Application Software	10	S3	12	SQ
399.24	General Startup Costs	10	SQ	15	SQ

b. Account 397.00, Communications Equipment

Account 397 consists of miscellaneous communication equipment such as microwave equipment, radio equipment, and mobile computing equipment.<sup>209</sup> In GUD No. 9670, the depreciation expense approved for this account was \$394,404.<sup>210</sup> In this case, Atmos Mid-Tex proposed a depreciation expense of \$2,159,498.<sup>211</sup> As in the previous case, only a portion of this expense is allocated to Atmos Mid-Tex based upon the SSU allocation factors. The depreciation rate is determined, in part, by an analysis of the projected future life of assets currently in service. In making that determination, the depreciation analyst will examine an experience band and a placement band.<sup>212</sup> The dispute in this case centers around the application of the appropriate band in order to predict the future life of assets in this account. The City of Dallas argued that Atmos Mid-Tex applied an incorrect band and determined an inappropriate future life for this account. The proposed adjustment would reduce the proposed revenue requirement by \$202,424.

i. *Argument of the parties.*

In the Statement of Intent that was filed in this case, Atmos Mid-Tex proposed to increase the service life for Account 397 from 10 years to 12 years.<sup>213</sup> Mr. Pous criticized Atmos Mid-Tex for limiting its review to five years worth of data and argued that it is artificially impacted by the significantly lower level of retirement exposure over time. Mr. Pous noted that the major movements in the observed life table for the observation period 2002 - 2006 relates to exposures that are only 28% of the level of exposures for the 1989 - 2006 observation period. He reasoned that the longer period contains more data and yielded not only more stable results but also more reliable results.<sup>214</sup>

Mr. Watson recognized that the placement and experience bands from 1986 - 2006 may suggest that the survivor curve selected by the City of Dallas more closely matched the actual experience of the company. He noted, however, that it was only a partial match and neither of the

<sup>209</sup> Atmos Ex. 22, Watson Direct, Exhibit 1, 2006 Shared Services Depreciation Study, p. 25.

<sup>210</sup> GUD No. 9670, Order, Schedule WP F-3a.

<sup>211</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-3, ln. 33 & 60.

<sup>212</sup> Atmos Ex. 43, Watson Rebuttal, p. 7, lns. 3 - 11.

<sup>213</sup> Atmos Ex. 22, Watson Direct, Depreciation Study, p. 2.

<sup>214</sup> Dallas Ex. 2, Pous Direct, p. 61, ln. 13 - p. 62, ln. 19.

survivor curves matched the placement and experience band in this particular time frame. Examination of placement band and experience bands would produce results that more closely matched the survivor curve selected by both Atmos Mid-Tex and the City of Dallas. In fact, he noted, the survivor curve selected by Atmos Mid-Tex was a near match for 1988 - 2006, 1990 - 2006, and 1993 - 2006. He concluded that the life selection made by Mr. Pous did not match for any period that did not include the single placement year that occurred nineteen years ago.<sup>215</sup>

ii. *Examiners' Recommendation*

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<sup>215</sup> Atmos Ex. 43, Watson Rebuttal, p. 6, ln. 17 - p. 12, ln. 8.

The Examiners find that a projected service life of twelve years and the proposed dispersion S5 dispersion curve are reasonable. The Examiners find that Atmos Mid-Tex has reasonably estimated the projected future life of this account. The decision to rely on data that excluded two years (1986 - 1988) was reasonable. In light of the assets that make up this account it was reasonable to rely on more recent data. The proposed projected future life most closely matches the data provided for 1988 - 2006, 1990 - 2006, and 1993 - 2006. The Examiners find that data discussed in the Reply Brief of the City of Dallas supports the proposed service life.<sup>216</sup> The best match there is the graph used an 11.5-year projected service life. The information in the other graphs illustrate that a fourteen-year service life is not a good match. Overall, the best match is observed using the proposed ten-year service life discussed in Mr. Watson's rebuttal testimony. Finally, the Examiners note that Atmos Mid-Tex presented a depreciation study that was recently conducted and the credibility issues that were raised in GUD No. 9670 were not present in this case.

- c. Accounts 399.01 - 399.03 Servers – Hardware, Network, and Network – Hardware

- i. *Introduction*

Account 399.01 is the servers hardware account and holds booked investment and retirement activity for assets such as the disk system, billing server and other server hardware and attendant equipment.<sup>217</sup> Account 399.02 is the servers software account and contains booked investment and retirement activity for software assets including operating system software such as UNIX, HPIX, WIN2000, and LINUX.<sup>218</sup> Account 399.03 is the network hardware account and it tracks investment and retirement activity for assets related to networking activities such as routers, switches, and miscellaneous networking equipment.<sup>219</sup>

The depreciation expense approved for these accounts in GUD No. 9670 was \$2,537,231.<sup>220</sup> In this case, Atmos Mid-Tex proposed a depreciation expense of \$1,790,625 for these accounts.<sup>221</sup> As noted, only a portion of this expense is allocated to Atmos Mid-Tex. The City of Dallas maintained that Atmos Mid-Tex incorrectly estimated the average service lives of each account. Atmos Mid-Tex proposed an average service life of ten years, the City of Dallas argued that it should be fifteen years. The proposed adjustment to Account 399.01 would reduce the requested revenue requirement by \$260,241, and the adjustments to Account 399.02 and 399.03 would reduce

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<sup>216</sup> City of Dallas, Reply Brief, pp. 27 - 29, & Appendix I.

<sup>217</sup> Atmos Ex. 22, Watson Direct, Exhibit DAW-1, p. 12.

<sup>218</sup> Id.

<sup>219</sup> Atmos Ex. 22, Watson Direct, Exhibit DAW-1, p. 13.

<sup>220</sup> GUD No. 9670, Schedule WP F - 3a, Ins. 11, 12, & 13, and Schedule WP F-3b, Ins. 11, 12, & 13.

<sup>221</sup> Atmos Ex. 45, (March 19, 2008 Errata) , Schedule F-3, Ins. 36 - 38 & 63 - 65.

the revenue requirement requested by \$76,868 and \$35,839, respectively.

ii. *Argument of the Parties.*

Mr. Pous noted that Atmos Mid-Tex has acted to increase significantly the estimated life for the investment in these three accounts. He argued, however, that the company's actions have been insufficient. He noted that the data demonstrated that a substantial level of the investment in these accounts has already obtained the age of nine years and it is unlikely that they will be retired in the next year. Therefore, Mr. Pous maintained that the life expectancy of those accounts should be extended to 15 years.<sup>222</sup>

Mr. Watson noted that the average ages of these accounts is not nine years. Instead, the average ages for those accounts are only 4.3, 3.7, and 1.6 years for Accounts 399.01, 399.02, and 399.03, respectively. Mr. Watson emphasized that the equipment that is included in these accounts is computer equipment and that the claim by the City of Dallas that the average service life of computer equipment is fifteen years is simply not credible. In support of this proposition Mr. Watson cited to a AGA-EEI Depreciation Statistic Report. He noted that no company experienced fifteen year or longer life for computer equipment. In fact, most were within the five to seven year range.<sup>223</sup>

iii. *Examiners' Recommendation*

The Examiners find that the service life and dispersion curve proposed by Atmos Mid-Tex is reasonable. Atmos Mid-Tex has not experienced a service life of fifteen years for this account. Further, the report provided by Atmos Mid-Tex described the projected life and dispersion curve for computer equipment among various utilities. The average service life for the seventeen utilities listed was 6.8 years. Again, the Examiners note that Atmos Mid-Tex presented a depreciation study that was recently conducted and the credibility issues that were raised in GUD No. 9670 were not present in this case.

d. Account 399.08, Application Software

1. *Introduction*

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<sup>222</sup> Dallas Exhibit 2, Pous Direct, p. 63, Ins. 1 - 29.

<sup>223</sup> Atmos Ex. 43, Watson, Rebuttal, p. 14, Ins. 8 - 18.

The applications software account holds booked investment and retirement activity for software assets including billing system software, electronic mapping and training software applications, Data Mart System and Power Plant System. It also includes conversion of the TXU Gas CIS software application and the Advantage System application and the Waco Call Center IT build.<sup>224</sup> In GUD No. 9670, the approved depreciation expense for this account was \$11,633,685.<sup>225</sup> In this case, Atmos Mid-Tex proposed that \$13,788,601 be included as a depreciation expense.<sup>226</sup> Again, only a portion of this expense is allocated to Atmos Mid-Tex. The proposed adjustment to Account 399.01 would reduce the requested revenue requirement by \$1,729,770.

ii. *Argument of the Parties*

Mr. Pous noted that Atmos Mid-Tex proposed the retention of the existing ten-year life expectancy for this account.<sup>227</sup> He testified that only a small portion this plant has been retired. The total amount of plant placed in service between 1999 through September 30, 2006 was \$62,571,351. Of that amount, only \$342,897 has been retired. Mr. Pous inferred from these facts that only ½ of 1% of plant has been retired. The proposed ten-year service life-curve combination predicts that approximately 33% of the plant added in 1999 should have been retired. He concluded that the proposed service life analysis does not accurately reflect the reality of this account. Further, Mr. Pous argued that the newer architecture associated with software applications placed in service after the 1990s are now structured to be modified rather than replaced. Thus, it is less likely that the assets in this account will be retired in the same manner as previous software systems. In conclusion, Mr. Pous argued that the service life for this account should be increased to 12 years.<sup>228</sup>

In response, Mr. Watson identified an error in the calculations provided by the City of Dallas which was subsequently corrected.<sup>229</sup> He also argued that Mr. Pous provided no analytical support for his contention that the projected service life should be extended to twelve years.<sup>230</sup> Additionally, Mr. Watson provided an analysis of the proposed curve and compared it to the actual experience that the company has had with regards to this account. He noted that the proposed curve matched the experience of Atmos Mid-Tex closely. On the other hand, the proposed curve provided by the City of Dallas did not.<sup>231</sup> Finally, he argued that the observation made by Mr. Pous regarding the newer

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<sup>224</sup> Atmos Ex. 22, Watson, Direct, , Exhibit DAW-1, p. 16

<sup>225</sup> GUD No. 9670, Order, Schedule WP F-3a.

<sup>226</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-3, ln. 33 & 60.

<sup>227</sup> Atmos Ex. 22, Watson Direct, Depreciation Rate Study, p. 2.

<sup>228</sup> Dallas Ex. 2, Pous Direct, p. 64, ln. 1 - p. 65, ln. 8.

<sup>229</sup> Atmos Ex. 43, Watson Rebuttal, p. 15, lns. 4 - 9 and Pous Direct, Revised Schedule JP-4

<sup>230</sup> Atmos Ex. 43, Watson Rebuttal, p. 15, lns. 10 - 11.

<sup>231</sup> Atmos Ex. 43, Watson Rebuttal, p. 15, ln. 1 - p. 16, ln. 10.

architecture associated with software application had the opposite effect and resulted in more rapid retirement of assets in this account.

iii. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has established that the proposed depreciation rate for this account is reasonable. The data provided by Mr. Watson supported the contention that the proposed service life closely matched the experience the company has had with assets in this account. Although the City of Dallas argued in the Initial Brief that the reliance on historical experience was misplaced as it was based on software which was no longer in service, the Examiners find that the contention that the assets in this account have a service life that extends twelve years is not credible given the assets in this account.<sup>232</sup> The account contains software related to accounting, jurisdictional reporting, and Oracle database management system.<sup>233</sup> A projected service life of ten years for this type of asset is consistent with the evidence provided regarding accounts 399.01 - 399.03 which contain similar assets. Again, the Examiners note that Atmos Mid-Tex presented a depreciation study that was recently conducted and the credibility issues that were raised in GUD No. 9670 were not present in this case.

e Account 399.24, General Startup Cost

i. *Introduction*

Account 399.24 tracks costs related to the startup and preparation for year 2000 issues, Customer Information System (CIS) and supportive assets. The depreciation study proposed changing the projected service life from twelve years to ten.<sup>234</sup> The depreciation expenses associated with this account in GUD No. 9670 was \$2,732,017.<sup>235</sup> Atmos Mid-Tex proposed a depreciation expense in this case of \$3,682,083.<sup>236</sup> The City of Dallas recommended a projected service life for this account of fifteen years. The revenue impact of the proposed adjustment is \$1,281,241.

ii. *Argument of the parties.*

Mr. Pous argued that the sole basis for reducing the projected service life of this account is the unsubstantiated claim of the consultant recently retained by Atmos Mid-Tex to conduct the depreciation study. Namely, the consultant claimed to be familiar with the lives of similar equipment at other utilities. Mr. Pous appeared to argue, however, that given the unique circumstances surrounding the acquisition of these assets comparable assets at other utilities would have been difficult to identify.<sup>237</sup> He noted that none of the investment placed in service during

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<sup>232</sup> City of Dallas, Initial Brief, pp. 38 - 39.

<sup>233</sup> Examiners' Ex. 2

<sup>234</sup> Atmos Ex. 22, Watson Direct, Exhibit DAW-1, p. 17.

<sup>235</sup> GUD No. 9670, Schedule WP F-3a, ln. 19.

<sup>236</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-3, ln. 45.

<sup>237</sup> Dallas Ex. 2, Pous Direct p. 65, lns. 18 - 22. It is not clear from the testimony why the acquisition of these assets was unique to Atmos Mid-Tex.

1999 has experienced a single retirement through the end of the fiscal year ended September 30, 2007. He contended that the majority of this investment is approximately nine years into the proposed ten-year cost recovery period without a single retirement. Further, he noted that Atmos Mid-Tex admitted that it was possible that the asset would be used for longer than ten years. Based upon this evidence, he concluded that it was not reasonable to shorten the projected service life for this asset. Instead, he argued that the evidence suggested that the service life should be extended to fifteen years.<sup>238</sup>

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<sup>238</sup> Dallas Ex. 2, Pous Direct, p. 65, ln. 10 - p. 66, ln. 10.

In response, Mr. Watson testified that the use of a ten-year service life is generally the norm for enterprise software and that he has only seen a twelve-year life in limited circumstances. He noted that although the company has conceded that the utility may operate these assets for more than ten years, adding fifty percent to the life of this asset is not reasonable given the critical function of the CIS system and the increasingly short life cycle of software and electronic hardware. He noted that a ten-year period is consistent with the results from the 2002 SSU depreciation study as well as the amortization period used by Atmos Mid-Tex for its legacy Customer Information System as approved in GUD No. 9145-9148, 9400, and 9670.<sup>239</sup>

iii. *Examiners Recommendation*

The Examiners find that Atmos Mid-Tex has established that the use of a project ten-year service life is reasonable for this asset. Again, the nature of these assets are similar to the assets contained in accounts 399.01 - 399.02 and 399.08. The proposition that the service life of this category of asset is fifteen years is not credible. A projected service life of ten years for this type of asset is consistent with the evidence provided regarding accounts 399.01 - 399.03 which contain similar assets. Further, a projected service life of ten years is consistent with the amortization calculations made regarding these assets in prior cases. Once again, the Examiners note that Atmos Mid-Tex presented a depreciation study that was recently conducted and the credibility issues that were raised in GUD No. 9670 were not present in this case.

D. Shared Services – Affiliate Labor Expense

The City of Dallas alleged that Atmos Mid-Tex inadvertently included Atmos Power System employee costs in its revenue requirement. Mr. Pous argued that the expenses should not be included in the revenue requirement and recommended that the revenue requirement requested be reduced by \$112,705.<sup>240</sup> In response Ms. Myers argued that Atmos Mid-Tex identified and included the adjustment in the Errata filing made on December 20, 2007, and already reduced the proposed cost of service by that amount. Accordingly, she argued that no further adjustment was required.<sup>241</sup> The Examiners find that the adjustment has already been incorporated into the revenue requirement and no further adjustment is required.

E. Property Insurance Cancellation Fee

a. *Introduction*

During the test year Atmos Mid-Tex made a determination to cancel an existing insurance policy, obtained through OIL, and obtain coverage through an alternate insurer (AEGIS) Atmos was

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<sup>239</sup> Atmos Ex. 22, Watson Direct, p. 17, lns. 1 - 29.

<sup>240</sup> Dallas Ex. 2, Pous Direct, p. 72, lns. 1 - 8.

<sup>241</sup> Atmos Ex. 34, Myers Rebuttal, p. 17, lns. 13 - 23.

assessed a \$709,919 cancellation fee for its property insurance. Atmos seeks to amortize this insurance cancellation fee over a 44-month period. The annual amortization fee is \$193,614. The proposed change would reduce the revenue requirement by \$196,247.

b. *Arguments of the Parties.*

Mr. Pous argued that the fee should be removed from the company's request because it is not a recurring expense. Further, Mr. Pous maintained that the amortization fee far exceeds the benefit customers will receive with the new policy, and therefore is not a proper expense to be included in the revenue requirement.<sup>242</sup> In response, Ms. Sherwood testified that the property insurance losses attributable to the hurricanes doubled the insurance premium for the coverage period of December 31, 2005 through December 31, 2006. The insurance carrier indicated that the higher price would be in effect for the subsequent year. As a result, Atmos Mid-Tex cancelled the policy and obtained insurance coverage from an alternate carrier. The insurance coverage included full flood coverage for all of the service territories and did not include certain limitations imposed by the prior insurer. Ultimately, Atmos Mid-Tex was assessed the cancellation fee. Ms. Sherwood contended that the cancellation fee avoided a substantial increase in property insurance premiums that would have exceeded the amount of the cancellation fee.<sup>243</sup>

c. *Examiners' Recommendation*

Atmos Mid-Tex has established that recovery of the cancellation fee is reasonable. The insurance obtained is for the benefit of all of the service areas and the company has established that it is necessary for the provision of natural gas service to customers. The Examiners recommend a minor adjustment to the amortized amount, if the RRM is not approved. As proposed, Atmos Mid-Tex will fully recover the one-time cancellation fee within 44 months. On the assumption that a statement of intent proceeding is not initiated for five years as required by the interim rate adjustment provisions of GURA, a 44-month amortization period may result in an over recovery. Accordingly, the Examiners recommend that the amortization period be extended to sixty months, resulting in an annual amortization fee of \$141,984, instead of \$193,614. As the Examiners recommend approval of an RRM no adjustment is required.

F. *Injuries and Damages*

a. *Introduction*

In this case Atmos Mid-Tex requested a \$2,476,967 expense for injuries and damages.<sup>244</sup> In GUD No. 9670, the figure included in the cost of service analysis was \$3,720,272.<sup>245</sup> The cost of service calculation in GUD No. 9400 included \$6,302,621 for injuries and damages.<sup>246</sup> The

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<sup>242</sup> Dallas Ex. 2, Pous Direct, p. 66, ln. 19 - p. 67, ln. 11.

<sup>243</sup> Atmos Ex. 39, Sherwood Rebuttal, p. 17, ln. 7 - p. 18, ln. 6.

<sup>244</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-1, ln. 40.

<sup>245</sup> GUD No. 9670, Schedule F-1, ln. 37.

<sup>246</sup> GUD No. 9400, Schedule L-2(D).

calculation in this case included an adjustment of \$400,000 for two accidents. Mr. Pous recommended that the adjustment be removed as he contended that this was a non-recurring event. The proposed change would reduce the revenue requirement by \$497,130.

b. *Argument of the Parties*

The City of Dallas recommended that the request to include an amortized adjustment for expenses associated with this accident be denied. Mr. Pous pointed out that the amortization amount relates to two accidents in Cleburne and Wylie that resulted in deaths. Issues related to those accidents are currently pending in litigation. Further, insurance covers the settlement and litigation costs of this category of losses and Atmos Mid-Tex is responsible for its deductible which is \$1 million per incident. Mr. Pous maintained that the underlying incidents that resulted in the increase in expense are isolated non-recurring events. He argued that rates should be set at a level that is reasonably anticipated to incur during the test year. That is accomplished by removing the \$400,000 non-recurring expense from the Company's proposed level, the recommended Injury and Damages expense drops to \$2,076,967. Mr. Pous noted that the adjustment to the expense request requires a parallel adjustment to the Injury and Damages reserve in rate base to remove the reserve portion.

In response Ms. Myers noted that the historic three-year average level of expense was \$2,967,851, not including the \$400,000 adjustment to amortize the costs booked in June 2007. Thus, the proposed level of expense, inclusive of the proposed adjustment was lower than the historic levels. She also noted that while discrete events that result in injuries and damages expenses are unique, the category of expenses may not be viewed as nonrecurring. Injuries and damages expenses are recurring costs of providing service. She asserted that no adjustment should be made.<sup>247</sup>

c. *Examiners' Recommendation*

The Examiners find that the level of injuries and damages expense included in the cost of service study is reasonable. The level of expense requested is lower than the three-year historic level of expense and is lower than the level of expense included in the cost of service study that formed the basis of the rates approved in GUD Nos. 9400 and 9670.

G. Uncollectible Expense Level

1. *Introduction*

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<sup>247</sup> Atmos Ex. 34, Myers, Rebuttal, p. 21, ln. 4 - p. 22, ln. 22.

Atmos Mid-Tex included an uncollectible expense level of \$11,653,558 in its proposed revenue requirement.<sup>248</sup> The cost of service calculation upon which rates were based in GUD No. 9670 included an uncollectible expense level of \$10,312,415.<sup>249</sup> The total uncollectible expense level approved in GUD No. 9400 was \$3,453,816.<sup>250</sup> Two issues have been raised in this proceeding with regards to the uncollectible expense level. The first issue relates to the level of uncollectible expense included in the revenue requirement request. The City of Dallas contended that the level of uncollectible expense requested was excessive. The proposed adjustment would result in a reduction to the proposed revenue requirement of \$2,194,078. The second issue relates to the proposed recovery of uncollected gas cost through the gas cost recovery mechanism. The rate design issue will be addressed in Section XIV related to rate design. The proposed level of uncollectible expense will be addressed here.

b. *Argument of the Parties*

The City of Dallas acknowledged that Atmos Mid-Tex applied the same methodology in this case as was approved in GUD No. 9670. Namely, the Commission determined that the use of a three-year average was reasonable for the purpose of calculating the uncollectible expense. In that case, an average of the three years produced an uncollectible expense level of 0.62%.<sup>251</sup> In this case, the same methodology resulted in an uncollectible expense factor of 0.748%. Mr. Pous argued the level of expense was unreasonable because the data used to calculate that expense included a year that had unprecedented levels of uncollectible expense. The table below summarizes the levels of uncollectible expense observed by Mr. Pous.

Table 11.6  
Uncollectible Expenses

Year	Amount
2003	\$8,049,190
2004	\$9,038,557
2005	\$7,353,870
2006	\$14,627,901

<sup>248</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-1.

<sup>249</sup> GUD No. 9670, Schedule F-1, ln. 23.

<sup>250</sup> GUD No. 9400, Schedule L(D), ln. 25.

<sup>251</sup> GUD No. 9670, FOF No. 175.

Mr. Pous contended that the rates should not be based on abnormal or non-recurring expenses. He recommended that the rates should be based upon the uncollectible experience observed in GUD No. 9670.<sup>252</sup>

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<sup>252</sup> Dallas Ex. 2, Pous Direct, p. 68, ln. 15 - p. 70, ln. 21.

Mr. Smith responded that in GUD No. 9670, the City of Dallas recommended the use of the methodology employed by Atmos Mid-Tex in this case. Mr. Smith observed, that even though the City of Dallas requested the methodology, and the Commission adopted the methodology, the City of Dallas now seeks to revise the approved methodology. He argued that the mere substitution of the factor calculated in GUD No. 9670, as proposed by the City of Dallas, in this case was unreasonable. Further, he suggested that Mr. Pous ignored the possibility that 2005 resulted in abnormally low levels. Mr. Smith also explained that the conversion of the billing system also had an impact on the levels of uncollectible expense. Mr. Smith also explained that in September of 2005, Atmos Mid-Tex suspended all collection activities for one month prior to system conversion in order to minimize errors in the billing process due simply to the conversion. Atmos Mid-Tex resumed collections proceedings from December through the following March in a staggered method: First past due notices were issued. Second, disconnect service orders were resumed for delinquent accounts. Third, bad debt write-offs for inactive accounts were resumed.<sup>253</sup>

c. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has established that its method of calculating uncollectible expenses is reasonable. While the last year is higher than previous years, there is no evidence in the record to suggest that this level of uncollectible expense will not continue into the future. In light of the economic conditions, it is not clear from the record in this case that this is an aberration and not a trend.<sup>254</sup> Further, the evidence examined by the City of Dallas included periods in which the utility system was operated by TXU Gas. In conclusion, the proposed adjustment – essentially adopting an out of period three-year level of expense– is not reasonable. The proposed approach would exclude test year data; data that is the basis of setting rates.

H. Denton Settlement

Mr. Pous identified \$346,696 in expenses related to the Denton Settlement. He noted that Atmos Mid-Tex had indicated that this amount should be removed.<sup>255</sup> In rebuttal testimony filed by Ms. Myers she noted that this adjustment was made.<sup>256</sup> The Examiners find that no further adjustment is required.

I. Outside Services – Account 923.

a. *Introduction*

Atmos Mid-Tex included \$2,210,951 for expenses related to outside services.<sup>257</sup> In GUD No. 9670, the level of outside services requested, and approved was \$950,200.<sup>258</sup> The City of Dallas contended that six adjustment should be made totaling \$175,418. The proposed adjustment would

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<sup>253</sup> Atmos Ex. 33, Smith Rebuttal, p. 28, ln. 12 - p. 31, ln. 5.

<sup>254</sup> State Ex. 3, p. 3, lns. 14 - 22.

<sup>255</sup> Dallas Ex. 2, Pous Direct, p. 71, lns. 14 -26.

<sup>256</sup> Atmos Ex. 34, Myers, Rebuttal, p. 17, lns. 1 - 11.

<sup>257</sup> Atmos Ex. 45, (March 19, 2008 Errata) Schedule F-1, ln. 38.

<sup>258</sup> GUD No. 9670, Schedule F-1, ln. 35.

result in an approximate reduction of \$140,970 to the revenue requirement.

b. *Argument of the Parties*

Mr. Pous challenged the level of expense associated with Account No. 923 related to outside services. He contended that six adjustment should be made. First he alleged that \$35,540 in legal costs related to GUD No. 9630 should be removed because they were non-recurring costs and because they were related to a complaint that did not involve Atmos Mid-Tex. Instead, the case involved a transportation rate. Second, he claimed that expenses in the amount of \$36,330 associated with the Epstein Group should be removed as no details of the transaction have been provided. Third, he reasoned that \$78,000 of expenses for past period corrections should be removed as those expenses were outside of the test period. Fourth, Mr. Pous took issue with \$5,606 in expenses for spousal and dependent travel. He noted that this category of expense was removed from GUD No. 9670, and they are not recurring. Fifth, Mr. Pous expressed his opposition to inclusion of expenses related to an executive search for rate personnel. Sixth, he maintained that expense related to the acquisition of business records from TXU should also be removed as acquisition issues regarding the merger are unlikely to arise again.<sup>259</sup>

In response Ms. Myers testified that the except for expenses related to the Epstein Group, all other expenses should be included. First, she countered that the \$35,540 in legal costs related to GUD No. 9630 is consistent with the typical type of expense incurred by Atmos Mid-Tex and, thus should be considered a recurring expense. Further, she explained that while GUD No. 9630 did involve transportation, it was related to transportation on the Atmos Mid-Tex system. Thus, it was appropriately included in this case. Second, as already noted, she agreed that expenses related to the Epstein group should be removed. Third, she contended that the \$78,000 in expenses were, in fact, incurred during the test year and represent contract labor expenses incurred during the test year. Fourth, she alleged that an adjustment to remove \$5,457.12 of spousal travel has already been made. Fifth, she argued that removal of expenses for an executive search was unreasonable. Hiring experienced and trained personal is a necessary expenses, and the use of a search firm to accomplish that task is not out of the ordinary. Sixth, with regards to the legal fees expended to obtain documentation she maintained that the expense was appropriate and reflected an ongoing legal expense of Atmos Mid-Tex.<sup>260</sup>

c. *Examiners Recommendation.*

Atmos Mid-Tex has not established that expenses related to spousal and dependant travel have been properly addressed, and an adjustment of \$5,606 should be made to the proposed cost of service. Further, the Examiners find that Atmos Mid-Tex has not established that the \$5,942 in expenses related to access of business records is a recurring expense. It appears that issues related to the access of the business records have been address and it has not been established that this expense is typical of legal expenses that will be incurred in the future. Atmos Mid-Tex has established that expenses related to the Epstein Group have been removed. Further, the company has established

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<sup>259</sup> Dallas Ex. 2, Pous Direct, p 72, ln. 10 - p. 74, ln. 7.

<sup>260</sup> Atmos Ex. 34, Myers Rebuttal, p. 18, ln. 1 - p. 21, ln. 3.

that 34,540 is in the nature of legal expenses that it might expect to incur in the future and that the alleged pas period corrections expense was incurred during the test year. Finally, Atmos Mid-Tex has established that expenses related to the executive search are reasonable and necessary expenses. Every organization must hire talented personnel; the use of search firms is a customary and usual business expense; and, it is reasonable to expect that such expenses will be recurring.

J. Ad Valorem Taxes

Atmos Mid-Tex proposed that the revenue requirement include \$16,028,184 for ad valorem taxes.<sup>261</sup>

The City of Dallas contended that this amount should be reduce to reflect recent legislative changes related to taxes. Mr. Pous explained that the State Legislature implemented a school tax tax reform that resulted in a reduction to property taxes. According to Mr. Pous, school taxers were to decline in two steps by a total of 33% effective 2008 unless a waiver was requested by the school district. The first step of 11% was effective January 2007, and the second step called for a further reduction of 22% to be effective January 1, 2008. In response to these changes Atmos Mid-Tex should have made an adjustment to its ad valorem tax calculation. He recommended that a reduction of 22% be implemented, resulting in a reduction to the proposed ad valorem taxes of \$2,169,034.<sup>262</sup>

Mr. McDonold responded by explaining that legislation only affected one component of the property tax calculation. He noted that the reduction occurred in two stages: One stage affected assessed values as of January 1, 2006 and another as of January 1, 2007. Based upon the timing of this filing, the statement of intent reflected the adjustment made in the first stage, but not in the second. He alleged that the proposed adjustment was simplistic because it focused on only one component of the property tax calculation. He reasoned that the combined effect of all of the components, including the proposed reduction to one aspect of the ad valorem tax assessment, might result in an overall increase of the tax rate. For example, Mr. Pous did not take into account the that property valuations might increase that would neutralize the effect of the proposed reduction to one component of the tax calculation . Further, he argued that Mr. Pous grossly overestimated the effect of the reduction. As evidence, Mr. McDonald provided details of the 2007 actual taxes. The tax assessment for 2007, the year after the test year in this case, were assessed at \$15,595,924. This was only \$432,260 less than the assessment included in the cost of service study. He argued that if the adjustment proposed by Mr. Pous had been adopted in the cost of service study the company would have understated its tax liability by \$1,736,774.

The Examiners find that Atmos Mid-Tex has failed to establish that the proposed ad valorem tax expense of \$16,028,184 is reasonable. Although Mr. Pous has clearly overstated the effect of the reduction, the evidence in the record indicates a known and measurable reduction to the property tax assessment that occurred in 2007. That amount, as evidenced by the company's own evidence, was \$432,260. Accordingly, the Examiners recommend a reduction to the ad valorem tax assessment in that amount.

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<sup>261</sup> Atmos Ex. 45, (March 19, 2008 Errata), Schedule F-5, ln. 2.

<sup>262</sup> Dallas Ex. 2, Pous Direct, p. 74, ln. 9 - p. 75, ln. 10.

K. Credit Facility Financing of Customer Payments

a. *Introduction*

The City of Dallas argued that Atmos Mid-Tex should use a portion of its available credit facilities to finance the utility's accounts receivables.

b. *Argument of the Parties*

The City of Dallas proposed that the utility use a portion of the company's billion and a half dollar credit facilities to finance the timing of cash flow associated with the annual minimum level of accounts receivable. As explained by Mr. Pous, accounts receivable represent the amount of money owed to Atmos Mid-Tex at any given point in time. Mr. Pous contended that Atmos has established several credit facilities which would be at a cost much lower than that reflected in the utility's requested cost of equity. Borrowing under one of the credit facilities would be at a substantially reduced interest rate. He estimated that use of the instruments could result in a reduction of \$2,320,064 to the annual revenue requirement.<sup>263</sup>

Atmos Mid-Tex responded that the funds Mr. Pous relied upon for his recommendation are, in reality, unavailable. A portion of those funds are maintained with Fortis Capital by Atmos Energy Marketing, L.L.C., not Atmos Corporation. Atmos is unable to draw upon those funds. Ms. Sherwood testified that Mr. Pous' assessment of the available rates was incorrect. Finally, Atmos Mid-Tex alleges that the proposed adjustment would result in increased costs which would ultimately be incorporated into the cost of service calculation.

c. *Examiners' Recommendation*

The Examiners recommend that no adjustment be made based upon the proposal of the City of Dallas. The evidence established that Atmos Mid-Tex does not have access to those funds and that the proposed activity would result in added expense that would ultimately be included into the cost of service study.

L. Affiliate Status of Atmos Pipeline

Atmos Mid-Tex asserted that Atmos Pipeline was an operating division of Atmos Energy Corporation. In its initial brief the State of Texas argued that Atmos Pipeline was an affiliate of subject to the affiliate transaction standard. The State of Texas failed, however, to establish how

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<sup>263</sup> Dallas Ex. 2, Pous Direct, p. 34, ln 1 - p. 36, ln. 2.

that evidence established that Atmos Pipeline was an “affiliate,” as that term is defined in section 101.003. Namely, there is not evidence in the record that Atmos Pipeline issued “voting securities.”

Furthermore, the State of Texas has not identified which specific transactions would be subject to the scrutiny set out in section 104.055(b). Accordingly, the Examiners find that, Atmos Mid-Tex has established that Atmos Pipeline is an unincorporated division.

## XII. CAPITAL STRUCTURE AND RATE OF RETURN

### A. Introduction

In the determination of a rate structure in this proceeding, the Commission must establish a reasonable rate of return for Atmos Mid-Tex. In setting a gas utility's rates, the regulatory authority shall establish the utility's overall revenues at an amount that will permit the utility an opportunity to earn a reasonable return on the utility's invested capital used and useful in providing service to the public in excess of its reasonable and necessary operating expenses. The regulatory authority may not establish a rate that yields more than a fair return on the adjusted value of the invested capital used and useful in providing service to the public.

As noted by the Austin Court of Appeals in *Railroad Commission of Texas v. Lone Star Gas Company*, to achieve the rate of return that a utility should be allowed to earn, the regulatory agency should consider the cost to the utility of its capital expressed as follows: (1) interest on long-term debt; (2) dividends on preferred stock; and (3) earnings on common stock.<sup>264</sup> As stated by the United States Supreme Court, the annual rate that will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . . The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.<sup>265</sup>

The overall rate of return employs a simple mathematical calculation, using the methodology of the weighted average cost of capital (WACC) which sums the percent return on cost of debt and cost of equity, and thereby represents a weighted cost of debt and return for equity. Regulated

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<sup>264</sup> *Railroad Commission of Texas v. Lone Star Gas Company*, 599 S.W.2d 659 (Tex. App. C Austin 1980).

<sup>265</sup> *Bluefield Water Works and Improvements Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923), see also, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1942).

utilities have various sources of capital with which to finance operating assets: Issuance of common stock and preferred stock, long-term debt, and common equity. Preferred stock and short term debt is sometimes included as a component for a calculation of the combined return. In this case, Atmos has proposed two components: Cost of Debt and Cost of Common Equity.

Identifying the elements of this equation is also a simple task. The cost of debt is typically not at issue as it is based upon known facts. That is, cost of debt is the utility's actual cost of long-term debt, taken from financial instruments, already executed to finance its capital expenditures and operations. The cost of debt, because it is based on known, measurable factors such as the cost of borrowing instruments is easily identified and not the subject debate in this case. Conversely, the cost of common equity is nearly always the subject of debate because it is subjective in nature. Thus, two issues are fundamental to the debate in this case regarding overall return: capital structure and the cost of equity.

## B. Capital Structure

In his direct testimony, Dr. Murry, who testified on behalf of Atmos Mid-Tex, recommended a capital structure of 51.73% long-term debt and 48.27% common equity. He stated that this capital structure is the actual capital structure of Atmos Mid-Tex for the test year, and is consistent with the company's planned capitalization.<sup>266</sup> City of Dallas witness Mr. Copeland did not dispute the use of the company's actual capital structure and also based his arguments on the company's rate of return on this capital structure.<sup>267</sup>

State witness Dr. Miravete however, disputed the proposed capital structure and instead recommended a capital structure of 55.8% debt and 44.2% equity based on the capital structure embodied in a settlement reached with the Tennessee Attorney General in September of 2007. Included also in the debt component of Dr. Miravete's recommendation was a 3.0% provision for short-term debt. Dr. Miravete contended that since Atmos had made use of short-term debt in 9 of 14 previous quarters that short-term debt was in fact, a regular component of Atmos' permanent capital structure and additionally that 3.0% of short-term debt was used in The Tennessee settlement.<sup>268</sup> Dr. Miravete further proposed that if his capital structure recommendation based on the forgoing from the Tennessee settlement were to be rejected, he would recommend at capital structure of 52.4% long-term debt and 47.6% equity based on an average common equity ratio for the period 2002-2006, and extending the method used for arriving at the capital structure as was employed in GUD No. 9670.<sup>269</sup>

The Examiners find that the actual capital structure of the company is appropriate for determining the company's rate of return. The arguments offered by Dr. Miravete would base the employed capital structure on that as determined through the terms of the Tennessee settlement for Atmos, but this position has not been established as a reasonable basis for adopting that capital structure in this proceeding. It is reasonable and consistent with the test year concept to use the

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<sup>266</sup> Atmos Ex 25, Murry Direct, p. 17, ln. 12 – 15, p. 18, ln. 19 - 20.

<sup>267</sup> Dallas Ex. 1, Copeland Direct, p. 31, ln. 17.

<sup>268</sup> State Ex. 3, Miravete Direct, p 4, ln.18 – 23, p. 6, ln. 8 – 26.

<sup>269</sup> State Ex.. 3, Miravete Direct, p 8, ln. 8 – 12.

company's actual capital structure, and Atmos Mid-Tex established that this ratio between long-term debt and common equity is reflective of the current state of operations and financial strategy of the company.

C. Cost of Equity

a. Introduction

In establishing a rate of return under the standard Weighted Average Cost of Capital (WACC) method, the first step lies in determining the appropriate capital structure. Next one must determine the costs of debt and equity. In this proceeding all parties providing a cost of equity estimation agree that the cost of debt is directly measured and agree that a 6.10% cost of debt for Atmos Mid-Tex is reasonable.<sup>270</sup> The essential contested issue the cost of equity.

The cost of equity is not readily measurable, and consequently must be inferred from financial markets. Two primary methods are used to make this inference: (1) the discounted cash flow (DCF), and (2) Capital Asset Pricing Model (CAPM).<sup>271</sup> One component of this analysis was to develop a group of comparable companies to provide a general baseline for identifying appropriate equity returns. The parties also explored general market and economic conditions as a backdrop to place the analysis in context and support their conclusions.

b. Comparable firms.

In the course of performing the DCF and CAPM analyses, baseline equity market data was surveyed from a grouping of allegedly comparable companies. Dr. Murry developed a list of eight companies, which also served as the basis for Mr. Copeland's analysis. The selection criteria for these representative companies used by Dr. Murry were for publicly traded gas utilities engaged in primarily gas distribution operations with a market capitalization of at \$1 billion that pay regular dividends.<sup>272</sup> No selection of comparable companies was employed by Dr. Miravete in his testimony.

c. DCF Analysis, CAPM Analysis, and other Economic Factors

Estimation of the cost of equity was done through two primary equity valuation models: the Discounted Cash Flow (DCF) and Capital Asset Pricing Model. Mr. Copeland also provided results from a third Dividend Discount Model (DDM) method based on the DCF, to supplement the other two methodologies.<sup>273</sup> The DCF is a widely used method to analyze the cost of common equity:

$$K = D/P + g$$

Where: K = cost of common equity

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<sup>270</sup> Atmos Ex. 25, Murry Direct, p. 20, ln. 15 - 16, Dallas 1, Copeland p. 31, ln. 17 - 19.

<sup>271</sup> Atmos Ex. 25, Murry Direct, p. 30, ln. 19 - 21.

<sup>272</sup> Atmos Ex. 25, Murry Direct, p. 16, ln. 1 - 9.

<sup>273</sup> Dallas Ex.1, Copeland Direct, p. 22, ln. 18 - 21.

D = dividend per share

P = price per share

G = rate of growth of dividends, or, common stock earnings.

The DCF attempts to quantify a market-based value of common equity based on the present value of a stream of returns. While this formula appears relatively straightforward, the variables and assumptions underlying the calculation are subject to interpretation which gives rise to debate.

As in GUD No. 9670, Dr. Murry argued that a DCF analysis should be based upon forecasts instead of historical growth rates and supported this contention with several academic studies.<sup>274</sup> He prepared a DCF analysis of Atmos and also prepared an analysis for his grouping of eight similar utilities. Based upon his analysis, Dr. Murry identified several DCF ranges for cost of equity and he determined that a range of cost of equity between 9.89% and 11.36% for Atmos was reasonable.<sup>275</sup> A summary of his findings is provided in Table 8.1 below.

Table 8.1  
Summary of Findings

	Atmos Energy Corp.		Comparable Co. Avg.	
	Range		Range	
	Low	High	Low	High
52-Week Projected Growth Rates <sup>1</sup>	9.32%	11.36%	7.49%	9.88%
52-Week Earnings Growth Rates <sup>2</sup>	9.09%	10.63%	8.99%	10.00%
Current Projected Growth Rates <sup>3</sup>	10.05%	10.63%	8.01%	9.46%
Current Earnings Growth Rates <sup>4</sup>	9.82%	9.89%	9.51%	9.59%
Suggested Rate Range	9.89%	11.36%		

<sup>274</sup> Atmos Ex. 25, Murry Direct, p. 39, In. 20 – 22.

<sup>275</sup> Atmos Ex. 25, Murry Direct, p. 53, In. 19 – 20.

Requested Rate	11.00%
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In selecting a final DCF range, Dr. Murry uses the higher value of the range of historical growth rates to select the low-end value of his range, and then uses the upper value of EPS growth rate projection to define the upper value of this range. These two ranges represent the highest and lowest values as tabulated in the high range category for the identified DCF values.

Mr. Copeland also applied a DCF analysis.<sup>276</sup> In preparing his DCF analysis, Mr. Copeland used projected growth rate estimates for earnings per share, dividends per share, and book value per share.<sup>277</sup> Applying an average of these projected growth rate indicators Mr. Copeland developed a DCF-derived equity cost rate for Atmos of 7.92%, based on the median value of equity cost rates for the selected companies.<sup>278</sup>

Mr. Copeland further applied a modified version of a DCF analysis, using a Dividend Discount Model, or DDM, to arrive at a cost of equity estimate. Mr. Copeland argued that a DDM analysis could provide a more accurate and reliable estimate of the cost of equity, since it is not dependent upon assumptions of constant dividend growth as in a standard DCF analysis.<sup>279</sup> Applying DDM methodology, Mr. Copeland arrived at a median return on equity estimate for the subject companies of 8.45%.<sup>280</sup>

Mr. Copeland contended that Dr. Murry selectively ignored the results of his DCF analysis based upon dividends growth rates, which were relatively low.<sup>281</sup> Further, Mr. Copeland argued that Dr. Murry focused his analysis primarily on point estimate results for Atmos, which lacked the reliability of using the LDC sample group. Incorporating the dividend growth rate DCF results into the analysis for the sample group Dr. Murry used, changed the Company's proposed DCF ranges to 7.75% to 9.53%.<sup>282</sup>

Dr. Miravete did not apply a DCF analysis. He was critical of Dr. Murry's use of analysts' forecasts in developing his DCF analysis, and contended that the state of capital markets assumed in Dr. Murry's derivations were no longer applicable.<sup>283</sup> Furthermore, he argued that the economic assumptions that Dr. Murry used in developing his interpretation of return on equity estimates were based on economic conditions existing prior to August of 2007, when significant shifts in the financial markets—mirrored through cuts in the Federal Funds rate—began to take place in response

<sup>276</sup> Dallas Ex 1, Copeland Direct, p. 29, ln. 5.

<sup>277</sup> Dallas Ex.1, Copeland Direct, p. 20, ln. 7 – 16.

<sup>278</sup> Dallas Ex.1, Copeland Direct, p. 33, lns. 1 – 4.

<sup>279</sup> Dallas Ex. 1, Copeland Direct, p. 22, ln. 1 – 2.

<sup>280</sup> Dallas Ex. 1, Copeland Direct, p. 24, ln. 17 – 18.

<sup>281</sup> Dallas Ex. 1, Copeland Direct, p. 32, ln. 10 – 23.

<sup>282</sup> Dallas Ex .1, Copeland Direct, p. 32 , ln. 25. p. 33 ln. 1.

<sup>283</sup> State's Ex. 3, Miravete Direct, p. 20, ln. 1 – 12.

to deteriorating credit conditions among financial intermediaries.<sup>284</sup>

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<sup>284</sup> State's Ex. 3, Miravete Direct, p. 18, Ins. 12 – 32, p.19 Ins. 1 – 13.

In response to Dr. Miravete's contention, Dr. Murry asserted that Dr. Miravete had not provided any calculations or empirical evidence to substantiate a counter-position on his DCF analysis.<sup>285</sup> In response to Mr. Copeland's DCF analysis, Dr. Murry argued that Mr. Copeland's conclusions from his analysis was illogical and did not follow from resulting data.<sup>286</sup>

The parties also agreed that the CAPM is a reasonable method for measuring the cost of equity. The CAPM is simply expressed in a formula as:

$$K = R_f + RP$$

Where:        K = the estimated rate of return of the stock  
                  R<sub>f</sub> = risk free rate of interest  
                  RP = risk premium (subject to additional equation).

While the DCF method is a market-based measure of the cost of capital, the CAPM method uses an explicit risk premium component added to a base "risk free" rate and measures the risk premium between a given portfolio and the market in entirety. It then seeks to identifying a cost of capital based on an investor's ability to diversify by combining various securities into an investment portfolio.<sup>287</sup> Dr. Murry stated that the CAPM analysis provided a longer-term perspective than the more volatile DCF analysis, and would generally derive similar cost of capital results for companies in the same industry.<sup>288</sup>

For Atmos Energy, Dr. Murry concluded that the estimated costs of common stock are 11.49% for a size adjusted CAPM, and 12.66%, for a bond yield plus risk premium approach historical asset pricing model. For the comparable companies used by Dr. Murry the results are 12.35% and 12.98%.<sup>289</sup> The DCF analysis and CAPM analysis led Dr. Murry to conclude that a range of 11.00% to 12.00% was reasonable. Accordingly, Dr. Murry recommended that a cost of equity of 11.00% was reasonable.

Mr. Copeland's CAPM analysis produced a cost of equity for the comparable group of 7.78%, and a cost of equity for Atmos of 7.60%. Comparing the results of his DCF analysis and the

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<sup>285</sup> Atmos Ex. 44, Murry Rebuttal, p. 22, ln. 7 – 12.

<sup>286</sup> Atmos Ex. 44, Murry Rebuttal, p. 9, ln. 3 – 16.

<sup>287</sup> Atmos Ex. 25, Murry Direct, p. 45, lns. 5 – 24.

<sup>288</sup> Atmos Ex. 25, Murry Direct, p. 46, lns. 4 – 11.

<sup>289</sup> Atmos Ex. 25, Murry Direct, p. 51, ln. 3 – 5.

CAPM, Mr. Copeland determined that a cost of equity of 9.0% is reasonable. Dr. Miravete did not employ a formal CAPM analysis, but implied its application in his recommended cost of equity. He chose the 10.0% approved return on equity in Atmos' last rate proceeding and reduced this by 100 basis points based on a 100 basis point reduction in the 10-year Treasury bond rate since the time of that decision to conclude that a cost of equity of 9.0 % was reasonable.<sup>290</sup>

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<sup>290</sup> State's Ex. 3, Miravete Direct, p. 26, ln 19 – 23.

The CAPM methodology requires the subjective identification of appropriate risk-free and risk premium elements for the calculation of return on equity, and this issue was contentious in this proceeding. Mr. Copeland devoted considerable discussion referencing academic studies in his direct testimony to argue that the risk premium used by Dr. Murry was overstated and inappropriate in determining a cost of equity for Atmos.<sup>291</sup> It was his position that based on empirical research of risk premium, a risk premium of 3.5% was reasonable for this case.<sup>292</sup> He further contended that Dr. Murry's use of a "size premium" adjustment in determining that CAPM based cost of equity using a Treasury bond risk-free rate was inappropriate since such an adjustment was an older methodology intended for smaller firms that had higher associated investment risks.<sup>293</sup> Dr. Miravete alternatively argued that the risk-free rate employed by Dr. Murry was vague and based on outdated financial market information. Dr. Miravete instead advocated using the ten-year Treasury bond rate as a risk-free rate.<sup>294</sup>

Dr. Murry responded that the ten-year Treasury bond rates are inappropriate for a CAPM analysis because of current distortions in rates caused by a "flight to quality" for investors seeking stable returns in current conditions of financial market uncertainty. Dr. Murry additionally argued that the risk premium he used in his analysis was reasonable and supported by an average Blue Chip forecasted rate of 4.6% extending through the second quarter of 2009.<sup>295</sup>

With reference to Mr. Copeland's testimony, Dr. Murry argued that the risk premium Mr. Copeland used in his CAPM analysis was based on academic studies, but not current market data and was consequently unrealistically low and not supported by market analysts' findings in Value Line for a period of 2003 to present, as he had used.<sup>296</sup> Dr. Murry was also critical of Mr. Copeland's rejection of the necessity of using a size premium in the DCF calculation and countered that its use was reasonable based on the circumstances.<sup>297</sup> Dr. Murry further argued that Mr. Copeland's return on equity recommendations would result in a low After-Tax Interest Coverage (ATIC) ratio for Mid-Tex of 2.3, which would create difficulties for the company in attracting equity

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<sup>291</sup> Dallas Ex. 1, Copeland Direct, p. 33, ln. 5 –11.

<sup>292</sup> Dallas Ex. 1, Copeland Direct, p. 28, ln. 11.

<sup>293</sup> Dallas Ex. 1, Copeland Direct, p. 33, ln. 14 – 22.

<sup>294</sup> State's Ex. 3, Miravete Direct, p. 27, lns. 8 – 15, 18 - 23.

<sup>295</sup> Atmos Ex. 44, Murry Rebuttal, p. 20, ln. 4 – 7.

<sup>296</sup> Atmos Ex. 44, Murry Rebuttal, p. 10, ln. 15 – 26, p. 11 ln. 1 - 11.

<sup>297</sup> Atmos Ex. 44, Murry Rebuttal, p. 14, ln. 2 – 9.

financing.<sup>298</sup>

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<sup>298</sup> Atmos Ex. 44, Murry Rebuttal, p. 13, Ins. 9 – 17.

In order to consider the results of his DCF and CAPM analysis in perspective, Dr. Murry evaluated economic conditions and concluded that the economy is presently in a period of relatively slow growth, but that additional economic growth could be expected in the third and fourth quarters of this year and return to a normal trend by 2010.<sup>299</sup> Dr. Miravete noted, on the other hand, that economic indicators suggest that capital costs have decreased and that the overall investment risk of gas utilities is below other industries because the level of business risk is low due to the nature of their service. He further added that under such conditions, a utility such as Mid-Tex provides an attractive investment choice.<sup>300</sup>

d. RRM Effects

Dr. Murry noted in his direct testimony that the RRM proposed in this case should reduce business risk for Atmos, and that similar rate provisions were not unusual.<sup>301</sup> He added that investors would be “likely” to lower the cost of capital after the results of the mechanism could be evaluated in practice.<sup>302</sup>

Mr. Copeland also agreed in principle that the RRM would reduce business risk for the company and that an adjustment in return on equity would be appropriate in the event of its adoption. Though he did not attempt to quantify this specifically, it was his position that RRM implementation would warrant a change to the bottom of his recommended 8.0% - 9.0% return on equity range.<sup>303</sup>

Dr. Miravete was also in agreement that the RRM would diminish risk for Atmos, and he further quantified these effects by comparing proposed revenue recoveries under the RRM to past GRIP levels to arrive at a proportionate impact on the company’s return and attendant risk. Based on his analysis, an RRM without a true-up provision would result in a corresponding reduction in return on equity of 75 basis points, with the addition of the true-up measure accounting for an additional 75 basis points in ROE reduction.<sup>304</sup>

D. Examiners’ Recommendation: Cost of Equity and Overall Return.

The Examiners find that it was unreasonable for Dr. Murry to rely exclusively on a DCF analysis of Atmos Energy Corporation in arriving at a DCF range to use in this case. The use of a proxy group of comparable companies has been the methodology previously applied for this utility in a long series of cases before this Commission.<sup>305</sup> While Dr. Murry identified a group of comparable companies to incorporate into his analysis, the DCF results from these companies were not included in range of equity cost values that he used for his recommendation.

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<sup>299</sup> Atmos Ex. 44, Murry Rebuttal, p. 16, Ins. 19 - 22.

<sup>300</sup> State Ext 3, Miravete Direct, p. 10, Ins. 6 – 12, p. 17 Ins. 20 –26.

<sup>301</sup> Atmos Ex. 25, Murry Direct, p. 25, Ins. 11 – 21.

<sup>302</sup> Atmos Ex.25, Murry Direct, p. 25, Ins. 15 – 17.

<sup>303</sup> Dallas Ex. 1, Copeland Direct, p. 31, Ins. 3 – 11.

<sup>304</sup> State Ex. 3, Miravete Direct, p. 28, Ins. 17 – 21.

<sup>305</sup> GUD Nos. 8976, 9145, and 9400.

Referring again back to the DCF results in Table 8.1 shows a range of 9.46% - 10.00% for the comparable companies that Dr. Murry identified. Mr. Copeland also used this same grouping of company data with the inclusion of Dr. Murry's historical dividend growth rates to arrive at a median high and low range of 7.75% - 9.53%.<sup>306</sup>

Dr. Murry's CAPM calculations included a standard CAPM formulation with the addition of a size premium and a CAPM calculation which substituted a high-grade corporate bond yield rate for the risk-free term, and a different risk premium determination. Dr. Murry's CAPM-based estimation for the return on equity was identified to be 11.49% and 12.66% for Atmos.

A bond-yield based CAPM calculation is a subjective procedure. In this proceeding, Dr. Murry used a high-grade corporate bond yield with a risk premium that was not defined by any supporting data. As such, it produced a result which was not relevant for ratemaking, and the Examiners find that its inclusion was not reasonable.

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<sup>306</sup> Dallas Ex. 1, Copeland Direct, p. 32, ln 10 – 25, p. 33 ln. 1.

Dr. Murry's standard CAPM formulation used a risk-free term based on 30-year Treasury bond yields, with a beta-adjusted risk premium of 5.68% derived from the Morningstar investment reporting service.<sup>307</sup> Mr. Copeland had argued that the unadjusted equity risk premium of 7.1% used by Dr. Murry was inappropriate and not supported by the current consensus of academic research in this area. Dr. Murry responded that the risk-free value he employed came from a reputable market research and investment service. However, in rebuttal testimony he cited data using 10-year Treasury bond yields as a risk-free term in order to derive returns on common equity reported by Value Line from a period of 2003 to the present and arrive at a average equity risk premium for the period of 6.9%.<sup>308</sup> Despite this however, Dr. Murry offered no adjustment to his previous CAPM calculation.

As to the risk-free value in the CAPM calculation, the Examiners note that Dr. Murry's use of the 10-year Treasury bond rate in his risk-premium determination cited above is in contradiction to his counter argument to Dr. Miravete, who advocated use of the 10-year Treasury bond rate as a risk-free proxy. The Examiners further note that the 10-year Treasury bond rate has previously been employed in rate cases. The 30-year Treasury bond rate would appear to include a small risk-premium component due to its long-term nature.<sup>309</sup> As such, the use of the 30-year Treasury bond rate would overstate the risk premium in the CAPM derivation, and the Examiners accordingly find this to be unreasonable.

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<sup>307</sup> Atmos Ex. 25, Murry Direct, p. 13, ln. 4.

<sup>308</sup> Atmos Ex. 44, Murry Rebuttal, p. 10, ln. 25 – 26, p. 11, ln. 1 – 2.

<sup>309</sup> In fact, Dr. Miravetty used the 10-year treasury bond, in part because the treasury did not issue 30-year treasury bonds between 2/2002 - 4/2006. State Exhibit 3, Miravete Direct, p. 19, lns. 22 - 24.

Dr. Murry had also included an adjustment for a “size premium” in his CAPM analysis, the need for which Mr. Copeland had challenged in his direct testimony. The Examiners here note that the only evidence in the record suggests that when such a size premium has been applied, it is done so for small companies that are subject to relatively higher levels of investment risk. Dr. Murry cited the use of an electric utility in his rebuttal testimony,<sup>310</sup> however the example company cited has a market capitalization of \$135 million, which is far below Atmos’ reported market capitalization of \$2.52 billion at this time. Atmos Energy has a reported beta coefficient of 0.80 as used in Dr. Murry’s analysis, which is one of the lower reported values among the identified group of comparable companies. Additionally, Atmos pays regular dividends and has a high payout ratio as noted by Dr. Murry in his direct testimony.<sup>311</sup> These clear contraventions to the need to employ a size premium lead the examiners to conclude that its use was unreasonable.

Revisiting the CAPM formula of  $K = R_f + RP$ , based upon Dr. Miravete’s reported 10-year T-bond rate noted in his direct testimony of 3.68% results in a cost of equity of  $3.68 + 5.52 = 9.2\%$ . The Examiners find that Atmos Mid-Tex has not establish that a cost of equity of 11.00% is reasonable. As already noted, the Examiners find that Dr. Murry did not use the results of the comparable group to support his analysis of the applicable DCF range to be applied in this case. The overall range for that group varied from 6.53% to 10.00%.<sup>312</sup> This range encompasses the return on equity recommendations made by the Mr. Copeland and Dr. Miravete. The DCF range may also be further narrowed to the highs identified by Dr. Murry of the 52-week DCF analysis and the high of the current discounted cash flow analysis. That range is 9.59% to 10.00%. The cost of equity recommendation of the City of Dallas and the State is below that range by approximately sixty basis points, however the cost of equity recommendation of Dr. Murry is 100 basis points above that range. In light of the DCF analysis of comparable companies presented by the Company and the City of Dallas, there is no basis for support for a cost of equity so far above that range.

Dr. Murry’s CAPM analysis based on 30-year Treasury bonds as a risk-free value and with an employed size premium resulted in a cost of equity value of 11.49%. The Examiners have here found that the 30-year Treasury bond rate and size premium were inappropriate to this analysis and adjusted the CAPM calculation for reasonable levels of risk, yielding a return on equity value of 9.88%. This value also exceeds the recommendation of the City of Dallas and State, but again reveals a still larger disparity of 111 basis points with the Company’s requested return on equity, and the Examiners find that a reasonable analysis of the evidence does not support the recommendation of Atmos. Further, the flight to quality effect alluded to by Dr. Murry have never been applied at the Commission nor does Dr. Murry posit any specific example wherein it has been applied

An additional consideration impacting the rate of return is in the Rate Review Mechanism (RRM) that Atmos has proposed with their filing in this case. The RRM is relevant to consider in terms of the company’s rate of return, since the intent of this mechanism is to provide regular ongoing review of the company’s rates to ensure it receives its allowed return. The implementation of such a mechanism has the *de facto* effect of reducing the company’s downside revenue risk,

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<sup>310</sup> Atmos Ex. 44, Murry Rebuttal, p. 14, ln. 3 – 5.

<sup>311</sup> Atmos Ex. 25, Murry Direct, p. 29, ln.21.

<sup>312</sup> Atmos Ex. 25, Murry Direct, Schedules DAM – 19 through DAM – 24.

intended as it is, to provide for a constant rate of returns to company operations. This transfer of risk also effectively decouples revenues from business risks that otherwise might normally be expected to impact revenues and returns in the course of the normal business cycle. Such a mechanism obviously influences the rate of return in a profound way as it seeks to ensure constant returns to varying levels of the company's operations, and as such goes beyond the scope of merely providing an "opportunity" to receive a just and fair rate of return, and instead would compel periodic annual review to adjust rates to provide for the allowed return on equity.

That the RRM in practice would carry with it a reduction in business risk is intuitively apparent by its nature; the company's returns on equity will be constant through the ongoing adjustment of rates provided by the RRM regardless of prevailing business conditions. Quantifying the effects of the reduced risk in the appropriate return on equity is another matter. Atmos in this proceeding made no attempt to do so, and indeed Dr. Murry in his testimony had little more than the most rudimentary knowledge of the workings of the Atmos RRM itself. A factor that affected the credibility of his opinion regarding the RRM. Dr. Murry did however, concede that the RRM and similar revenue decoupling mechanisms in effect with other companies could be expected to reduce the concomitant business risk for these companies.

Mr. Copeland also made no direct attempt to quantify the effects of reduced business risk for the company, but implied a reduction of 100 basis points to adjust to the bottom of his recommended range of return on equity would be appropriate. On the other had, Dr. Miravete quantified the reduction for the allowed rate of return on equity with the implementation of the RRM, and determined that a reduction in return on equity of 75 basis points would be reasonable in the event of RRM implementation without the true-up provision.

The Examiners recognize that adjusting return on equity to compensate for the reduced risk to Atmos investors with the RRM is problematic in the absence of more complete financial data. However, to neglect to do so would allow Atmos to receive a return above a fair and reasonable level and thus compels an offsetting adjustment. The macroeconomic forces that underpin current economic conditions were present in the context of the ruling in GUD No. 9670, however, they were not then yet fully realized. That Atmos would require a rate of return on equity that would enable the company to attract capital in a period of diminished returns in bond and equity markets is a contention that has merit, but only insofar as what has been established as reasonable; Atmos in this case has not established that a return on equity in excess of that approved in 9670 is reasonable.

Accordingly, the Examiners find that a return on equity for Atmos Mid-Tex of 10.00% is reasonable, resulting in an overall rate of return of 7.98%. In the event of the implementation of the RRM without the true-up component, the Examiners recommend a return on equity of 9.25% to offset the resultant loss of business risk associated with such a measure to the company as fair and reasonable. This would result in an overall rate of return of 7.62%. These results are summarized in Table 8.2 and Table 8.3 below.

Table 8.2  
Examiner's recommended rate of return

Long Term Debt	51.73%	6.10%	3.16%
Common Equity	48.27%	10.00%	4.83%
Rate of Return			7.98%

Table 8.2.  
Examiner's recommended rate of return for RRM without true-up

Long Term Debt	51.73%	6.10%	3.16%
Common Equity	48.27%	9.25%	4.46%
Rate of Return			7.62%

### XIII. FUNCTIONALIZATION, CLASSIFICATION, AND ALLOCATION

#### A. Introduction

The initial step in setting the rates to be charged by a regulated utility is the determination of the cost of service, that is the total revenues required to cover the utility's cost of operation, including a fair rate of return on its investment. Utilities serve several classes of customers. Accordingly, the cost of the system must be allocated among the various customers. Atmos Mid-Tex has classified the customers served by the utility system into three broad groups: Residential, Commercial, and Industrial & Transportation. In this case, only four issues were raised regarding allocation: (1) Allocation of FERC Accounts 870, 880, and 881; (2) allocation of Allocation of FERC Accounts 885 and 894; (3) allocation of non-standard contract customers, and; (4) the reasonableness of the class cost of service model.

#### B. Allocation of FERC Accounts 870, 880, and 881

##### a. *Introduction*

The State of Texas maintained that Atmos Mid-Tex incorrectly allocated Accounts 870, 880 and 881. These accounts were allocated on the basis of the composite allocation of costs included in FERC Accounts 871 through 879 and FERC Accounts 886 through 893.<sup>313</sup> While FERC Accounts

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<sup>313</sup> CCS Study.

871 through 879 relate to operations, FERC Accounts 886 through 893 relate to the maintenance function.

2. *Argument of the Parties*

Kit Pevoto, who testified on behalf of the State of Texas noted that Accounts 870, 880, and 881, which she alleged were incorrectly allocated, are comprised of costs related to the *operation* function. For example, Account 870 includes the cost of labor and expenses incurred in the general supervision and direction of distribution system operations. FERC Account 880 is comprised of the cost of the distribution maps and records, distribution office expenses, and the cost of labor and materials used and expenses incurred in distribution systems operations not included in other accounts. FERC Account 881 contains rent for property for others used, occupied or operated in connection with the operation of the distribution system. She maintained that based on the cost causation principle, allocation of these accounts should be based on the costs related to both operation and maintenance functions. FERC Account 883 through 893, which formed a partial basis for the allocation factors derived in the allocation calculation are all related to *maintenance* only. Accordingly, she concluded that those accounts should not form a basis of the allocation factors used to calculate the distribution of costs.<sup>314</sup>

Mr. Raab responded on behalf of Atmos Mid-Tex by noting that on a purely theoretical basis it would be appropriate to allocate these expenses as advocated by Ms. Pevoto. He chose the allocation methodology applied here to maintain consistency with GUD No. 9670. He noted that a revision to the allocation methodology as proposed by Ms. Pevoto would result in only a minor change in the allocation to the various customer classes. The overall impact of the allocation is to reduce the Residential class allocation by \$5,625 and to increase the allocation to the Commercial and Industrial and Transport (“I&T”) classes by \$3,997 and \$1,628, respectively. The overall impact on the volumetric rate would be an increase of \$.00001/ccf in the rate of the Commercial class usage charges and an increase of \$.0001/MMBtu in the tail block of the I&T usage charges.<sup>315</sup>

c. *Examiners’ Recommendation*

In GUD No. 9670, Atmos Mid-Tex established that this was a reasonable allocation methodology for these accounts. The proposed change would result in only a minimal change that will generally balance out. Accordingly, the Examiners do not recommend a change in the allocation methodology.

C. Allocation of FERC Accounts 885 and 894

a. *Introduction*

The State of Texas raised a similar argument regarding the allocation of FERC Accounts 885 and 894. These accounts are comprised of accounts related to the *maintenance* function and were

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<sup>314</sup> State Ex. 2, Pevoto Direct, p. 5, ln. 10 - p. 6, ln. 12.

<sup>315</sup> Atmos Ex. 42, Raab Rebuttal, p. 3, ln. 5 - p. 6, ln. 11.

allocated using a composite allocation factor that was derived from maintenance and operations accounts.

b. *Argument of the Parties*

Ms. Pevoto noted that these two accounts were allocated using the same allocation factor that was used to allocate the three FERC accounts discussed above. The allocation factor was derived from a combination of accounts: FERC Accounts 871 through 879, related to *operations*, and FERC Accounts 886 through 893, related to *maintenance*. She argued that accounts 885 and 894 should be allocated based upon an allocation factor that was derived exclusively from accounts related to the maintenance function. Accordingly, accounts related to the operations should not form a basis of the allocation factor.<sup>316</sup> Mr. Raab's response to this issue was the same as the response to the issue raised with regards to the allocation of FERC Accounts 870, 880, and 881. Namely, the change is not consistent with the Commission's Order in GUD No. 9670 and the change is not material and would result in no change to billing rates for Residential customers. Commercial and Industrial customers would experience a minor increase in billing rates.<sup>317</sup>

c. *Examiners' Recommendation*

As in the case of the Accounts discussed in the previous section, the Examiners recommend that the methodology adopted in GUD No. 9670 be maintained. The company established that it was a reasonable methodology in that case and the change would not result in a material change to the customers.

D. Allocation of Non-Standard Contract Customers

a. *Introduction*

In GUD No. 9670 the non-standard contract customers were included in the cost allocation and rate design process. In this case Atmos proposed applying the revenues generated by the non-contract customers as a credit in "other revenues."<sup>318</sup> This results in a reduction of the overall revenue that must be generated from the remaining customers on the system. In GUD No. 9670, the other revenues generated by the non-standard contract customers was \$620,738.<sup>319</sup> In this case, that figure is \$2,027,085.<sup>320</sup> The State of Texas argued that non-standard contract customers should be treated consistent with the treatment in GUD No. 9670.

b. *Argument of the Parties*

Ms. Pevoto argued that the exclusion of these customer from the demand and energy usage calculation in the allocation process distorts the allocation of costs. The exclusion will result in

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<sup>316</sup> State Ex. 2, Peveto, p. 6, ln. 13 - p. 7, ln. 9.

<sup>317</sup> Atmos Ex. 42, Raab Rebuttal, p. 3, ln. 5 - p. 6, ln. 11.

<sup>318</sup> Atmos Ex. 29, Raab Direct, p. 17, lns. 18 - 20.

<sup>319</sup> GUD No. 9670, Final Order, Schedule WP J-2, ln. 3.

<sup>320</sup> March 19<sup>th</sup> Errata, Schedule WP\_J-2.

other customers being allocated the under-recovery of revenues from the non-standard contract customers. She argued that this resulted in a subsidy from the residential, commercial, and standard industrial customers. Accordingly, she asserted that the non-standard contract customers should be included in the cost allocation process to ensure that any under-recovery of cost of service attributable to the non-standard contracts is not paid by the remaining customers.<sup>321</sup>

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<sup>321</sup> State Ex. 2, Pevoto, Direct, p. 7, ln. 10 - p. 8, ln. 13.

Mr. Raab stated that the reason for the departure from the Commission's directive in GUD No. 9670 is based, in part, on the fact that the Commission's decision to allocate the full share of the revenue requirements is that it forces the company to either increase rates to these customers or it forces the company to subsidize these customers at company expense.<sup>322</sup> He explained that these customers have been granted a discount to tariffed prices because if they do not receive the discount, they potentially may meet their energy needs from an alternative source. Furthermore, he ran the cost of service study employing the methodology proposed by Ms. Pevoto and found that the usage charge for residential customers will increase by 20%, the usage charge for commercial customers will increase by 9%, and the tail block charge of the standard contract customers will increase by 93%.<sup>323</sup>

c. *Examiners' Recommendation*

Atmos Mid-Tex has established that the proposed change is just and reasonable. The treatment proposed by Atmos Mid-Tex provides a substantial benefit to all of the customers on the system because it reduces the overall revenue that must be generated from each class. The impact is substantially higher in this case than in GUD No. 9670. As reflected in the calculation of Mr. Raab, the revised treatment would result in an increase to rates. Further, the Examiners find that if the treatment is not revised, Atmos Mid-Tex is left with little incentive to maintain the customers on the system. The customers either have to be charged a non-discounted price or the shareholders of Atmos Mid-Tex would have to subsidize the discount. Finally, during the hearing Mr. Raab specifically noted that the Rate Review Handbook of the Commission contemplates the treatment employed by Atmos Mid-Tex in this case.<sup>324</sup>

E. Operation of the Allocation Model

The City of Dallas contended in its Initial Brief that the cost allocation model does not operate properly. Namely, despite a reduction of the overall revenue requirement, the different classes served by Atmos Mid-Tex experienced varying degrees of changes in rates. The City of Dallas noted that while the revenue requirement was lowered the portion allocated to the residential class actually increased.<sup>325</sup> In its Reply Brief, Atmos Mid-Tex explained that the change observed by the City of Dallas was due to the particular account that was adjusted. The primary difference was due to a decrease in depreciation reserve of services, which increased the net plant (and rate base) associated with services.<sup>326</sup>

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<sup>322</sup> Atmos Ex. 29, Raab Direct, p. 18, lns. 7 - 23.

<sup>323</sup> Atmos Ex. 42, Raab Rebuttal, p. 6, ln. 12 - p. 8, ln. 19.

<sup>324</sup> Tr. Vol. III, pp. 58 - 59.

<sup>325</sup> City of Dallas, Initial Brief, p. 45 - 46.

<sup>326</sup> Reply Brief, Atmos Mid-Tex, p. 30.

The Examiners find that Atmos Mid-Tex has established that the proposed cost of service model is reasonable. The Examiners also note that issues regarding the cost of service model, the class cost of service model, and supporting schedules have been raised by the Examiners in the past. For example, the Examiners raised a complaint in GUD No. 9400 and GUD No. 9670 regarding the complexity of the model and the proprietary nature of the models submitted. In this case, Atmos Mid-Tex has not submitted a model based in whole or in part on proprietary software and the Examiners commend the utility for submitting a model which permits the regulator the ability to trace the impact of the proposed costs and allocations.

#### XIV. RATE DESIGN AND TARIFFS

##### A. Rate Review Mechanism

###### a. Introduction

Atmos Mid-Tex proposed the adoption of a tariff entitled Rate Review Mechanism (RRM). Witnesses for Atmos Mid-Tex asserted that the intent of the proposed tariff was to offer both the utility and the regulators the opportunity to process proposed rate changes with greater efficiency, less litigation, and a lower cost.<sup>327</sup> Mr. Paris also noted that the actual results Atmos Mid-Tex has historically experienced under the current rate setting process never match the decisions actually made by the regulatory authority.<sup>328</sup> The RRM was intended to reduce the expenses associated with traditional rate cases and stabilize revenues.

The RRM is intended to modify the *methodology for calculation rates* and modify the *procedures* for review of a rate request. As set out in the tariff, on March 1<sup>st</sup>, of every year the utility will make an annual filing. The filing will seek an adjustment to the rates. There are two parts to the adjustment. Each part hinges on an analysis of the Evaluation Period. The Evaluation Period is defined as the twelve-month period ending December 31<sup>st</sup>.

The first part of a proposed adjustment is a forward looking rate change based upon the Evaluation period. This part, referred to herein as “Prospective Rates,” resembles the traditional rate setting process based upon test-year data. The true-up procedure, referred to herein simply as the “True-Up,” modifies the prior ratemaking methodology and examines the data from the Evaluation Period to ascertain whether the utility was able to achieve the approved cost of equity. An aspect applicable to both the Prospective Rate calculation and the True-Up calculation is that the methodological principles applicable in the prior rate case are not litigated and applied to each subsequent RRM filing.

###### b. Rate Calculation Methodology: Prospective Rates and True-Up.

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<sup>327</sup> Atmos Ex. No. 32, Paris Rebuttal, p. 9, Ins. 9 - 12.

<sup>328</sup> Atmos Ex. No. 32, Paris Rebuttal, p. 11 Ins. 4 - 7; Atmos Ex. 33, Smith Rebuttal, p. 7, Ins. 21 - 24.

Substantively, the Prospective Rate calculation follows traditional rate setting principles fairly closely. The criticism lodged by the Intervenor regarding the Prospective Rate determination appear to focus on the general procedures outlined below. As already noted above, however, the Prospective Rate process imposed the methodological limitations determined in last contested rate case upon the calculation of prospective rates. Thus, for example, the SSU allocation principles determined in this case, would apply to future RRM filing. From a substantive perspective, the Prospective Rate component of the RRM garnered little criticism. On the other hand, the True-Up procedure included in the RRM was the focus of considerable criticism. That process will be briefly described here.

As noted, the True-Up Procedure modifies the prior ratemaking methodology and examines the data from the Evaluation Period and evaluates the ability of the utility to achieve its cost of equity during the Evaluation Period. If not, and if the regulatory authority approves of the costs that were incurred during the Evaluation Period, an adjustment will be made to rates. The adjustment may result in an increase to rates or a reduction to the rates. In the event that the utility was unable to achieve its approved cost of equity, then an adjustment will be made to recover sufficient revenues to achieve the cost of equity effective during the evaluation period. On the other hand, in the event the utility recovered amounts that resulted in cost of equity in excess of the approved rates, then the rates will be adjusted downward.

For example, Atmos Mid-Tex has recently filed its first RRM with the several of the regulatory authorities which agreed to the RRM. In that filing Atmos Mid-Tex proposed a Prospective Rate increase of \$18,849,477 based upon the cost of service analysis. The True-Up request was \$14,634,080. Thus, the total proposed increase was \$33,483,557. This is also reflected in response to a request by the Examiners. In that request, Atmos Mid-Tex was requested to assume that the RRM was approved in GUD No. 9670. The Examiners requested that the utility provide an example of the RRM filing that would have been made. Atmos Mid-Tex identified a Prospective Rate increase of \$25,425,787, and a True-Up of \$8,862,984.<sup>329</sup>

### c. Rate Review Procedures

As noted above, the RRM creates an annual rate review mechanism. On March 1<sup>st</sup> of each year the utility shall file its request for a rate change. The regulatory authority shall have 120 days to review and attempt to reach agreement with the utility regarding the rates. The rates will become effective on July 15 -- 136 days from March 1. The regulatory authority shall have no less than ninety days to review the filed schedules and work papers in support of that request. Atmos Mid-Tex is required to respond to any request for information within ten business days of the original request. It appears from the language in the RRM that before the end of the review period the

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<sup>329</sup> The parties dispute whether these figures are accurate. The document has been admitted for all purposes. The calculation was requested, however, not for the purpose of proving the veracity of the increase. Rather, the purpose of this document was to provide a concrete illustration of the two parts of the RRM.

regulatory shall issue proposed revisions to the rates and the utility shall have thirty days to respond. If at the end of that period, the utility and the company have not reached an agreement, Atmos Mid-Tex shall have the right to appeal the action of the regulatory authority to the Railroad Commission. If on the other hand the rates are approved, the rates will be effective until July 15<sup>th</sup> of the following year. The period in which the approved rates are effective is referred to as the Rate Effective Period. The period from the date of the annual filing – March 1<sup>st</sup> – until the end of the review and response period is 120 days.

d. Arguments of the Parties.

As suggested above, the focus of the litigation involving this issue was related to the True-Up provisions and the overall process of the RRM. The City of Dallas and the State of Texas opposed the implementation of the RRM. Staff recommended that the RRM, as filed be rejected. Atmos revised the RRM, and as a result Staff offered its support. The issues related to the True-Up procedure will be outlined first followed by an analysis of the procedural issues raised.

i. Position on Methodology: Prospective Rates and True - Up Procedures

(A) City of Dallas and State of Texas

The City of Dallas and the State of Texas argued that the RRM violated basic concepts of utility regulation and Texas law prohibiting retroactive ratemaking.<sup>330</sup> The City of Dallas cited to several cases to underscore the following legal points regarding retroactive ratemaking:

- Fundamental in the utility ratemaking process is the principle, termed the rule against retroactive ratemaking, that utility rates are set for the future and not the past.<sup>331</sup>
- The basic premise underlying the prohibition against retroactive ratemaking is that the setting of utility rates is a legislative function and generally can have only prospective application and cannot be used to recoup losses or gains incurred under prior legal rates.<sup>332</sup>

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<sup>330</sup> Initial Brief; Prehearing Brief, pp. 2 - 7.

<sup>331</sup> *CenterPoint Energy Entex v. Railroad Comm'n of Tex.*, 208 S.W.3rd 608, 622 (Tex. App. — 2006, no pet.); see also, *State v. Public Util. Comm'n of Tex.* 883 S.W.2d 190, 198 - 199 (Tex. 1994); *Railroad Comm'n of Tex. v. Lone Star Gas Co.*, 656 S.W.2d 421, 425 (Tex. 1983).

<sup>332</sup> *Public Util. Comm'n of Tex. v. GTE-Southwest, Inc.*, 901 S.W. 2d 401, 406 (Tex. 1995).

- The rule against retroactive ratemaking prohibits a utility commission from making a retrospective inquiry to determine whether a prior rate was reasonable and imposing a surcharge when rates were too low or a refund when rates were too high.<sup>333</sup>

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<sup>333</sup> *CenterPoint Energy Entex v. Railroad Comm'n of Tex.*, 208 S.W.3rd 608, 622 (Tex. App. — 2006, no pet.)

- Utilities code section 104.110 and 104.151 codify the rule against retroactive ratemaking for gas rates. Rates set by the Commission “constitute the legal rates for the gas utility until changed” in the manner provided by GURA.”<sup>334</sup>
- If, after a hearing, the Commission finds a rate unreasonable, it shall “enter an order establishing the rates the gas utility shall charge or apply for the service in question.”<sup>335</sup>

In summary, it is the opinion of the City of Dallas and the State of Texas that the look back provision of the proposed RRM violates the rule against retroactive ratemaking.

(B) Atmos Mid-Tex and Railroad Commission Staff /Staff

In response Atmos and Staff asserted that the RRM is not retroactive rate making. The look back characteristic of the RRM is similar to the purchase gas adjustment clause. The RRM is not limited to one cost, however, but is instead intended to operate for a bundle of costs underlying a utility’s rates, not just gas cost.<sup>336</sup> Atmos also cited to a court of appeals opinion that suggested that a retroactive rate is one that would change the terms of the agreement between the utility and its customers after the fact. Since the terms are set out in the tariff there can be no argument that the proposed RRM is retroactive.<sup>337</sup>

ii. Position on Rate Review Procedures

(A) City of Dallas and State of Texas.

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<sup>334</sup> *Id.*

<sup>335</sup> *Id.* (quoting Util. Code §104.110(a)(1).

<sup>336</sup> Initial Brief, Atmos Mid-Tex, p. 48.

<sup>337</sup> Initial Brief, Atmos Mid-Tex, p. 49, citing to *Southwestern Bell v. Public Util. Comm’n of Texas*, 615 S.W.2d 947 (Tex. Civ App. — Austin 1981, writ ref. n.r.e, 622 S.W.2d 82 (1981).

The City of Dallas and the State of Texas alleged several procedural flaws that either violated requirements of GURA, created ambiguities within the RRM:

*Automatic Adjustment Clause.* Kit Pevoto, in an argument that is somewhat related to the issues discussed in the previous section, alleged that the proposal is akin to an automatic rate setting mechanism.<sup>338</sup>

*Statutory Time Frames.* The City of Dallas and the State of Texas alleged that the RRM procedures violated the statutory time frames set out in section 104.107. That provision provides that the municipalities will have ninety days to review the proposed rate increase from the date the schedules would otherwise go into effect (Effective Date). The same provision provides that the Railroad Commission shall have not longer than 150 days after the date the schedule would otherwise go into effect.

*Notice Provisions.* The City of Dallas and the State of Texas took issue with the notice provisions of the RRM which require that notice be provided by bill insert, rather than publication. The State of Texas alleged the additional point that the notice provision effectively eviscerated the hearing procedure guaranteed by the statute for a protestant. Namely, the State of Texas noted that GURA permitted the use of informal proceedings if the regulatory authority does not receive a complaint before the expiration of forty-five days after notice of the increase is filed. The proposed RRM, however, does not require notice to be provided until forty-five days after the company makes its initial filing, thus, effectively rescinding the statutory requirement that the general public be given an opportunity to complain and trigger the requirement for a formal hearing.

*Rates in Effect on Appeal.* The City of Dallas complained that the RRM allows the proposed rate to go into effect on appeal. A condition, which the City of Dallas alleged, was not contemplated by GURA.

*Municipal Expenses.* The City of Dallas appeared to have argued that the municipal expenses on an appeal were not recoverable pursuant to the provisions of the RRM

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<sup>338</sup> State Ex. 2, Pevoto Direct p. 16, Ins. 5 - 16.

*Expenses included in the rate request.* GURA 104.057(a)(2) and (b) prohibit certain expenses related to charitable or lobbying expenses. The RRM does not include such a limitation. Further, section 104.055(b) requires certain specific findings which are not specifically set out in the RRM with regards to affiliate expenditures.<sup>339</sup>

*Hearing Required.* The State of Texas alleged that GURA required a hearing in every case in which the increase constituted a major change.<sup>340</sup>

*Overall Rate Case Expenses.* The State of Texas alleged that the RRM will not result in a reduction to rate case expenses, in part, because of the uncertainties and ambiguities contained in the RRM. Furthermore, Ms. Pevoto alleged that the annual rate filings would undoubtedly result in increased expenses.<sup>341</sup>

*Diminished ability to review rate requests.* Ms. Pevoto argued that the RRM allowed the revision of rates without the use of a traditional ratemaking process.<sup>342</sup>

(B) Atmos/Staff

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<sup>339</sup> State Ex. 2, Pevoto Direct, p. 19, lns. 13 - 18

<sup>340</sup> State Ex. 2, Pevoto Direct, p. 20, lns. 3 - 5.

<sup>341</sup> State Ex. 2, Pevoto Direct, p. 20, ln. 6, lns. 6 - 22.

<sup>342</sup> State Ex. 2, Pevoto Direct, p. 17, lns. 8 - 14.

*Automatic Adjustment Clause.* Atmos contended that the RRM is not an automatic adjustment clause. The regulatory authority will have the ability to approve, grant in part, or deny any rate changed proposed pursuant to an RRM.<sup>343</sup>

*Statutory Time Frames.* Mr. Smith testified that Atmos Mid-Tex intended to provide sufficient time for review of the RRM filing. He believed that the RRM should minimize the amount of time required to review the rate request because it is intended to limit the issues, such as rate of return that are typically litigated in rate cases.<sup>344</sup>

*Notice Provisions.* Mr. Smith noted that the RRM provides that Atmos Mid-Tex will provide direct mail notice to all affected customers and include all information set forth in GURA 104.102.<sup>345</sup>

*Rates in Effect on Appeal.* Atmos Mid-Tex asserted that the RRM is consistent with the current regulatory structure regarding rates on appeal. Specifically, GURA contemplates the implementation of temporary rates or interim rates.<sup>346</sup>

*Expenses included in the rate request.* Mr. Smith noted that the RRM provides for the exclusion of expenses contemplated by section 104.057 and that the utility would not include expenses prohibited by Texas law.<sup>347</sup>

*Hearing Required.* Mr. Smith noted that nothing in the RRM precluded the regulatory authority from holding a hearing.<sup>348</sup>

*Diminished ability to review rate requests.* Mr. Smith argued that the RRM was intended to adhere to all rate setting requirements under GURA and that the rules and regulations applicable to a regulatory authority's oversight is unaffected by the RRM.<sup>349</sup> He also maintained that Atmos Mid-Tex would provide all of the same cost of service information and schedules that accompany a traditional statement of intent filing. Finally, he noted, in response to the criticism that no testimony would accompany an RRM filing, that there is no statutory requirement that testimony must

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<sup>343</sup> Atmos Ex. 33, Smith Rebuttal, p. 8, Ins. 1 - 17.

<sup>344</sup> Atmos Ex. 33, Smith Rebuttal, p. 13, ln. 1 - 7.

<sup>345</sup> Atmos Ex. 33, Smith Rebuttal, p. 9, ln. 8 & p. 10, ln. 7 - p. 11, ln. 7.

<sup>346</sup> Reply Brief, Atmos p. 6.

<sup>347</sup> Atmos Ex. 33, Smith Rebuttal, p. 8, ln 8 & p. 9, Ins. 1 - 12.

<sup>348</sup> Id.

<sup>349</sup> Atmos Ex. 33, Smith Rebuttal, p. 8, ln. 23 - p. 9, ln. 3.

accompany a request to change rates and that the majority of the municipalities served by Atmos Mid-Tex do not require the filing of testimony.<sup>350</sup>

e. Examiners' Recommendation

2. Introduction

In general the Examiners recognize that the RRM has undergone several permutations which has made evaluation of the proposed tariff challenging. For example, the RRM considered at hearing is not same as the RRM considered at the municipal level. It was revised in rebuttal testimony. Further, it appears to have been revised at the hearing. The Examiners find that the RRM as proposed does not comply with several of the requirements of GURA and that as requested Atmos Mid-Tex has failed to meet its burden of proof. The Examiners find, however, that the proposed RRM may be revised to the address all of the issues raised at the hearing.

ii. Methodology: Prospective Rates and True - Up Procedures

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<sup>350</sup> Atmos Ex. 33, Smith Rebuttal, p. 12, ln. 13 - 17.

The Examiners find that the true-up provisions of the RRM violate the law against retroactive ratemaking. As noted by the City of Dallas and the State of Texas, several provisions of GURA specifically state that rates are to be prospective. Further, Rule 7.245 provides that rates are to be prospective. The case law cited by the parties established that rates are to be prospective – except in limited circumstances. The true-up mechanism is exactly the type of mechanism described by the court in the CenterPoint proceeding: It is a retrospective inquiry to determine whether a prior rate was reasonable and imposing a surcharge when rates were too low or a refund when rates were too high.<sup>351</sup> The fact that it is embodied in a tariff does not cure the retroactive nature of the ratesetting process embodied therein.

There are several statutory provisions that essentially reduce the lag between the time an investment is made and when the utility may adjust rates to begin recovery of expenses related to those investments.<sup>352</sup> Section 104.112 allows a utility to implement a surcharge to recover the cost of relocating a facility to accommodate construction or improvement of a highway, road, street, public way, or other public work on behalf of a federal, State, or political subdivision of the State.<sup>353</sup> Neither provision, however, appears to contemplate a true-up to recover expenses or adjust rates during the period between the date of the investment and the filing of the tariff. That is a specific objective of the true-up provision contemplated by the proposed RRM.

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<sup>351</sup> *CenterPoint Energy Entex v. Railroad Comm'n of Tex.*, 208 S.W.3rd 608, 622 (Tex. App. — 2006, no pet.)

<sup>352</sup> Tex. Util. Code Ann. § 104.301.

<sup>353</sup> Tex. Util. Code Ann. § 104.112.

Atmos and Staff argued that the true-up provision parallels the purchase gas adjustment clause. As noted by the City of Dallas, the State of Texas, and in a prior memorandum issued by the Examiners, it has long been recognized by courts in Texas that the Railroad Commission has the authority to adopt a PGA. The Austin Court of Appeals recognized that the PGA is an automatic escalator mechanism developed by utility regulators to address the rapid fluctuations in the cost of natural gas.<sup>354</sup> As noted by the Court, the clause operates to increase or decrease the revenue of a gas company by the amount of the increased or decreased costs of gas charged the gas companies by suppliers. The allowance of a PGA as an administrative practice has long been permitted and has been judicially recognized and approved in Texas.<sup>355</sup>

Atmos and Staff argued that no evidence is in the record to distinguish the PGA provision from the proposed RRM. On the contrary, the evidence in the record amply illustrates the distinction between the underlying costs associated with the PGA and the total bundle of costs sought to be included in the RRM. Namely, that the volatility of gas costs are outside of the control of the utility. A fact implicit in the opinions of the courts and plainly in evidence in this case. Mr. Smith noted the particular volatility of gas costs in recent years and noted that those changes were due to “national market issues beyond our local control.”<sup>356</sup> Mr. Brock noted that a utility has little or no control over the price swings that are occurring in its natural gas supply. Indeed, he specifically stated that utilities are experiencing record high prices for gas supply with little or no control over the price it must pay for gas supply.<sup>357</sup>

The degree of control, however, exercised by the utility over the costs it seeks to include in the RRM is illustrated by the facts of this case. For example, the decision to grant a raise pursuant to the incentive compensation plan or as part of the merit increase is a matter within the discretion of the utility. The salary levels are a matter within the control of the utility. The decision to purchase additional computer hardware or software is a matter within the discretion of the utility. Thus, the nature of the underlying expense included in the PGA clause is not factually analogous to the costs the utility seeks to include in the RRM.

The Examiners note that unlike the PGA another automatic adjustment clause implemented by regulatory authorities is the WNA. In Texas, unlike the PGA, the WNA has not been judicially recognized, or specifically addressed in GURA. The WNA is intended to address changes in the weather -- an issue entirely outside of the control of the utility. Further, as the WNA does not result in an increase in revenues it appears that it is consistent with the intent of the legislature when it enacted legislation to limit the filing of a statement of intent to “increases.”

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<sup>354</sup> See, *Southern Union Gas Company v. Railroad Commission of Texas*, 692 S.W.2d 137, 193 (Tex. App. — 1985) (“Southern Union Gas”).

<sup>355</sup> See, *Southern Union Gas* at 193, citing to *San Antonio Ind., S.D. v. City of San Antonio*, 550 S.W.2d 262 (Tex. 1976); *Railroad Comm’n of Texas v. City of Fort Worth*, 576 S.W.2d 899 (Tex. Civ. App. 1979, writ ref’d n.r.e); *Railroad Comm’n of Texas v. High Plains Natural Gas Company.*, 613 S.W.2d 46 (Tex. Civ. App. 1981), aff’d, 628 S.W.2d 753 (Tex. 1981).

<sup>356</sup> Atmos Ex. 33, Smith Direct, p. 18, lns. 8 - 10.

<sup>357</sup> Staff Ex. 1, Brock Direct, p. 11, ln. 17 - p. 12, ln. 6.

Regarding the issues related to the true-up provisions of the RRM, the Examiners conclude that removal of these provisions would address the concerns raised by the intervenors. As to the other issues, the Examiners recommend that changes be made to conform the RRM to the statute.

iii. Rate Review Procedures

*Automatic Adjustment Clause.* The complaints raised in this context appear to relate to the issues raised in the context of the true-up provisions. Removal of the true-up provision would address this issue. Nevertheless, the Examiners find that unlike the PGA, the proposed RRM does not provide an automatic adjustment to rates subject to later review. Instead, the proposed true-up provision of the RRM allows the utility to look back and *request* an adjustment to rates based upon expenses incurred and investments made after the last rate case.

*Statutory Time Frames.* The Examiners find that from a technical perspective the proposed time frames appear to conflict with the statutory language in GURA. The language of the RRM may simply be adjusted to address the concerns raised by the intervenors. By including language that changes the “proposed effective date” and recognizes the ability of the regulatory authority to suspend rates, this issue is addressed. The Examiners note, however, that the period of consideration will not change: March 1<sup>st</sup> to July 15<sup>th</sup>.

*Notice Provisions.* The notice provisions may be amended to comply with GURA.

*Rates in Effect on Appeal.* The Examiners find that the current regulatory structure permits rates to go into effect on appeal. The Examiners recommend that the language of the RRM be amended to parallel the requirement of GURA section 121.155.

*Municipal Expenses.* The expense provisions of GURA do not appear to be affected by the RRM and the Examiners do not recommend any changes related to those provisions in the RRM.

*Expenses included in the rate request.* The Examiners recommend that the RRM be amended to specifically reference the relevant provisions.

With those changes, the Examiners recommend approval of the RRM. The RRM may accomplish the goal of streamlining the ratemaking process and, by providing an annual adjustment of rates it will improve the ability of the utility to recover the approved cost of equity.

B. Recovery of Gas Cost Portion of Uncollectible through GCR.

a. *Introduction*

Atmos Mid-Tex proposed to recover uncollectible gas cost through the utility’s gas cost recovery mechanism, Rider GCR. The proposal would shift the costs of recovering those expenses, approximately \$7,330,519, from the cost of service to the GCR.

b. *Argument of the Parties*

Mr. Smith contended that the proposal is consistent with the Commission's rule on gas cost recovery, 16 Tex. Admin. Code § 7.5519(a) which contemplates the ability of a gas utility to recover all of its gas costs. He also noted that it is consistent with the Commission's decision in GUD No. 9539. He also pointed out that Atmos Mid-Tex is currently allowed recovery of the gas cost portion of bad debt in Tennessee, Virginia, Kansas and the environs of the service are in Amarillo. Mr. Smith noted that in GUD No. 9670, the Examiners recommended denial of the same request because the West Texas Division did not file the report required by GUD No. 9539 until directed by the Gas Services Division Audit Staff. Mr. Smith asserted that no further issues have been raised and Atmos Energy has not missed any further deadlines.<sup>358</sup>

Mr. Pous argued that, consistent with the Commission's determination in GUD No. 9670, the request should be denied. He asserted that the proposed treatment could result in a double recovery. Furthermore, Mr. Pous argued that the proposed recovery of the gas cost portion of uncollectible gas costs would eliminate an incentive to minimize uncollectible expense.<sup>359</sup> In response, Mr. Smith reiterated the points made on direct and argued that the utility's process of tracking and reporting uncollectible gas cost expense ensures that double recovery will not occur. Further, he presented evidence to substantiate the claim that Atmos Energy aggressively pursues the collection of uncollectible expenses. Evidence was provided to illustrate that the recovery of uncollectible gas costs has actually improved since the approval of the recovery mechanism there.<sup>360</sup> Mr. Brock, who testified on behalf of Staff, expressed support of the mechanism and the reporting requirements set out in the proposed GCR tariff.

c. *Examiners' Recommendation*

The Examiners find that Atmos Mid-Tex has established that the recovery of the gas cost portion of uncollectible expenses through the PGA is reasonable. The gas cost recovery rule appears to contemplate the ability of a utility to recover all of its gas costs. Specifically, the Texas gas cost recovery rule provides that a gas utility "may include a purchased gas adjustment clause in its rates to provide for the flow-through of **part or all of its gas costs** above or below the cost of gas contained in its rates . . .".<sup>361</sup> This provision would appear to suggest that the intent of the rule is that the utility be allowed, if it chooses to employ a PGA formula, to recover all of its gas costs through that PGA formula. To the extent that the utility can identify unrecovered gas costs, then the utility should be able to recover those costs through an adjustment to the formula. In promulgating the rule, the Commission noted several of the reasons for its adoption. Among those, the Commission stated that gas "utilities under the regulation of the Railroad Commission of Texas need

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<sup>358</sup> Atmos Ex. 32, Paris, Direct p. 19, ln. 20 - p. 21, ln. 13, Atmos Ex. 33, Smith Direct, 13, ln. 13 - p. 20, ln.

<sup>359</sup> Dallas Ex. 2, Pous Direct, p. 71, ln. 1 - 12.

<sup>360</sup> Atmos Ex. 33, Smith Rebuttal, p. 24, ln. 4 - p. 28, ln. 10.

<sup>361</sup> 16 TEX. ADMIN. CODE 7.5519(a) (emphasis added).

to be allowed to recover their costs. . . .”<sup>362</sup> The Examiners recommend approval of the proposal to include the recovery of the gas cost portion in the proposed GCR.

C. Examiners’ Modification to the GCR.

As noted in the previous section, the Examiners generally recommend approval of the proposed GCR. After reviewing the GCR the Examiners recommend the following six adjustments:

- The Examiners recommend that the clause in the second and third paragraphs be modified to include the term “gas” in the following clause: “and the quantities will be adjusted as necessary to recover actual **gas** costs.”
- The Examiners recommend that the formula for GCRF be modified to remove the Adjustment (ADJ). Instead the adjustments should be stated separately to facilitate audit of the bills, and books and records.

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<sup>362</sup> 4 TEX. REG. 4546

- The Examiners recommend that the definition of Estimated Gas Cost Factor (EGCF) be clarified by the addition of a sentence that states the limit of lost and unaccounted for gas. This is consistent with the recommendation made by Staff.<sup>363</sup>
- The Examiners recommend that the interest to be employed in the definition of the reconciliation factor (RF) be clearly stated by the inclusion of the following sentences: “The interest rate to be used is the annual interest rate published by the PUC every December. The interest rate for 2008 is 4.69%.”
- The Examiners recommend that the reference to NARUC be revised in the definition of Actual Gas Cost Incurred.
- Finally, the Examiners have inserted the allocation factors that are generated by the Class Cost of Service Study in the Pipeline service allocation chart on page 2 of the tariff.

The Examiners recommend that the proposed GCR tariff be approved with these additional changes.

D. Conservation & Energy Efficiency (CEE) Tariff

a. Introduction

Atmos has requested the approval of a new tariff rider, Rider CEE, in conjunction with the proposed Rider RRM. The program created by the Rider CEE would implement a conservation program through a voucher program that would provide free energy saving materials and supplies to eligible customers. Customers eligible for the program would receive up to \$200 fo items such as caulking, weather-stripping, sheathing, water heater blankets and other energy savings devices such as clock-thermostats from approved suppliers or retailers. Eligibility would be limited to customers who qualify for heating bill assistance through LIHEAP agencies and all agencies that distribute Atmos “Share the Warmth” funds would be eligible to participate in the program as would all

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<sup>363</sup> Staff, Ex. 1, p. 15, ln. 18 - p. 16, ln. 20.

primary account holders over the age of 65. Funding for the program will be provided by the Atmos Mid-Tex and ratepayers, each contributing \$1,000,000 annually to the program.<sup>364</sup>

b. Argument of the Parties

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<sup>364</sup> Atmos Ex. 26, Smith Direct, p. 25, Ins. 1 - 20

The State opposed the approval of the Rider CEE because that tariff was a conceptual summary of the proposal and did not contain details of the conservation and energy efficiency program. Mr. Pevoto argued that the documentation hardly evidenced a strong commitment to demand side management. Further, she noted that the amount proposed to be funded by Atmos Mid-Tex is not as high as the amount suggested by the Examiners in GUD No. 9670.<sup>365</sup> The City of Dallas in its Initial Brief argued that while the CEE is a laudable social goal, it was not well defined or thought out. Further, the social goals sought to be attained by the CEE are not really ratemaking issues. Finally, the City of Dallas noted that the allocation factors used to allocate the cost impose almost the entire cost of the program on the residential customer class – 91.52%.<sup>366</sup> Staff generally supported the program. Mr. Brock indicated that the only reservation was that the cost to administer the program might be considered excessive. To that end, Staff requested that Atmos Mid-Tex be required to file an annual report that provides details of the cost to administer the program.<sup>367</sup>

c. Examiners' Recommendation

The Examiners recommend that the proposed program be approved in conjunction with the RRM. After considering the arguments of the parties the Examiners recommend two adjustments to the proposal. First, as recommended by Staff, Atmos Mid-Tex should file an annual report that provides details of the cost to administer the program with details of the amounts paid out of the program for energy conservation assistance. Second, the Examiners recommend that the allocation of the costs be modified to more evenly distribute the cost of the program among the users of the system. The proposed allocation would impose 91.52% of the costs of the portion contributed by ratepayers on the residential customers. Ultimately, however, conservation benefits the entire system. Further, the RRM process, which is intended to operate in tandem with the CEE will impact the entire system as well. Accordingly, the Examiners recommend that the allocation of the costs be based upon throughput which would distribute the costs as follows: 45.15% to the Residential Class, 29.20% to the Commercial Class, and 25.66% to the Industrial and Transportation Class. Finally, the Examiners note that if the program is rejected, an adjustment must be made to the cost of service to the removal of expenses associated with funding the CEE.

E. Weather Normalization Adjustment.

a. *Introduction*

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<sup>365</sup> State Ex. 2, Pevoto Direct, p. 21, Ins. 1 - 10.

<sup>366</sup> City of Dallas, Initial Brief, pp. 44 - 45.

<sup>367</sup> Staff Ex. 1, p. 13, ln. 18 - p. 15, ln. 16.

In GUD No. 9670, the Commission approved, as part of an agreement entered into by all of the parties to that proceeding, a Weather Normalization Adjustment tariff. In this case Atmos Mid-Tex proposed the modification of the WNA. Specifically, the utility seeks to include the adoption of a mechanism that would incorporate multiple regional weather stations to calculate the WNA as opposed to the use of a single weather station. Further, Atmos Mid-Tex seeks to exclude non-weather sensitive commercial customers from the operation of the WNA.<sup>368</sup>

b. *Argument of the Parties*

Atmos Mid-Tex maintained that the use of multiple weather stations will result in the use of more representative weather data for customers since weather stations in closer proximity to the customers actual location will be used in the calculation.<sup>369</sup> The City of Dallas opposed the adjustment because it would result in two identical customers, in the same rate class taking the same amount of gas in any given period, receiving different bills. Mr. Pous asserted that was contrary to the Commission's policy and the utility's position that statewide rates should apply.<sup>370</sup> The State of Texas also asserted that Atmos Mid-Tex failed to meet its burden of proof on this issue. The State of Texas asserted that while the evidence established that the weather was warmer than normal for the City of Dallas, Atmos Mid-Tex collected 11.1 million dollars from its residential and commercial customers during the test year. The State of Texas concluded, therefore, that the WNA was operating contrary to its intended purpose.<sup>371</sup>

Staff of the Railroad Commission indicated its support for the proposed modification to the WNA. In particular Staff supported the change from a single station in Dallas to five regional stations. Mr. Brock noted that customers served in central Texas experience different weather patterns from what might be considered normal in the Dallas Metroplex or near the Panhandle of Texas.<sup>372</sup>

c. *Examiners' Recommendation*

The Examiners recommend approval of the proposed WNA. Atmos Mid-Tex has established that the proposed changes are reasonable. In response to the contentions raised by the State of Texas, the utility has established that the evidence cited included areas that were outside of the Texas service area. Areas that did not include a WNA.

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<sup>368</sup> Atmos Ex. 26, Smith Direct, p. 11, ln. 20 - p. 13, ln. 13.

<sup>369</sup> Atmos Ex. 26, Smith Direct, p. 12, ln. 18 - p. 13, ln. 4.

<sup>370</sup> Dallas Ex. , Pous Direct, p. 88, ln. 25 - p. 88, ln. 3.

<sup>371</sup> State of Texas, Intial Brief, pp. 22 - 23.

<sup>372</sup> Staff Exhibit 2, Brock Direct, p. 7, ln 3 - p. 11, ln. 4.

## F. Class Base Revenue Spread

The State of Texas offered testimony generally approving of the class base revenue spread. As asserted by Ms. Pevoto, the class base revenue spread is reasonable because it does not result in an increase for any class of more than 1.5 times the system percentage increase. Ms. Pevoto cautioned that any change made to the base revenues should not result in a percentage increase for any class that is greater than 1.5 times the system percentage increase.<sup>373</sup> In rebuttal testimony filed by Atmos Mid-Tex, Mr. Raab appeared to be perplexed by the testimony of the State of Texas which he considered to be somewhat contradictory on this point. Mr. Raab also pointed out that while he was pleased with Ms. Pevoto's ultimate conclusion, he considered the limitation selected by Ms. Pevoto arbitrary. The Examiners find the analysis in the in the testimony offered by the State of Texas to be somewhat contradictory. Further, the Examiners find that there is no testimony or evidence in the record to enable an evaluation of the proposed spread. Finally, the Examiners consider that if the proposed econometric model that allocates costs is based upon reasoned principles of cost causation, an arbitrary limitation appears to be unreasonable.

## G. Customer Charge

a. *Introduction*

Atmos Mid-Tex proposed the increase of the customer charge for all classes of customer. The customer charge for the residential customer will increase from \$10.69 to \$14.00; the customer charge for commercial customers will increase from \$20.28 to \$25.00, and; the customer charge for industrial and transportation customers will increase from \$344.75 to \$500.00.<sup>374</sup> Ms. Pevoto opposed the proposed increase to the customer charge for commercial and industrial and transportation customers.

b. *Argument of the Parties*

The State of Texas noted that the proposed change resulted in an increase of 23% for Commercial customers and 45% for industrial and transportation customers. Ms. Pevoto averred that the proposed increase was excessive and will unfairly impact those who consume relatively small quantities of gas. She stated that the customer charge should remain at current levels.<sup>375</sup> In his direct testimony Mr. Raab indicated that the proposed customer charges were less than the fixed costs suggested by the class cost of service study he prepared.<sup>376</sup> In its Initial Brief, Atmos Mid-Tex

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<sup>373</sup> State Ex. 2, Pevoto Direct, p.8, ln. 14 - p. 9, ln. 16.

<sup>374</sup> March 19<sup>th</sup> Errata, Schedule WP\_J-3.2.

<sup>375</sup> State Ex. 2, Pevoto Direct, p. 10, ln 7 - p. 11, ln. 21.

<sup>376</sup> Atmos Ex. 29, Raab Direct, p. 22, ln. 15 - 22.

indicated that the State of Texas provided no rational basis for the reduced customer charge.<sup>377</sup> In a Statement of Position and in its Initial Brief the Industrial Gas Users indicated their support for the proposed tariffs and customer charge.

c. *Examiners' Recommendation*

The Examiners recommend approval of the proposed customer charges. The proposal is rationally supported by the evidence provided in support of the company's class cost of service study. Although the proposed increase may result in a higher impact on small use customers, no evidence was provided upon which to base an alternative customer charge. On the other hand, substantial evidence was provided that the current level was inadequate and an increase was appropriate.

H. Declining Block Rate Structure

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<sup>377</sup> Initial Brief, Atmos Mid-Tex, p. 40.

The State of Texas opposed the block rate structure applicable to the industrial and transportation customers proposed by Atmos Mid-Tex. Ms. Pevoto noted that the first noted that the proposed rates increase the first two blocks by about 5%. The remaining block rate decreased. She argued that the change in the rate structure will result in different impact on different customers and change the intra-class cost allocation. The result is that a customer who used a relatively small volume of gas would experience a larger increase in its bill than one who uses large volume of gas in the class. She recommended that the Commission reject the proposed rate structure as the bases for the change was not adequately explained. IGU responded to the issues raised by noting that the declining rate structure proposed by Atmos Mid-Tex recognized the company's effort to re-balance its rate structure for the industrial and transportation class to collect more of its fixed costs of service through an increased fixed monthly charge and less through the volumetric component.<sup>378</sup> Atmos Mid-Tex has established that the proposed block rate structure is reasonable and the Examiners recommend approval.

#### I. Electronic Filing

Atmos has proposed the implementation of an electronic filing system in future proceedings. Staff recommended certain changes to the proposal. Specifically, Staff recommended that the utility file all future filings on a readable CD disk with several qualifications. For those filings that either require a date stamp for verification of filing or required by statute, Staff would recommend the utility file an original hard copy with four (4) copies in the form of readable CD disks. If the utility requires a date stamped copy for verification of filing, an original first page may be supplied and and date stamped for the utility accompanying the CD disks. Compliance filings may be field by CD disk with the Gas Services Division Director. All electronic filings should include a hard copy cover page.<sup>379</sup> Atmos Mid-Tex agreed to the proposed modifications.<sup>380</sup> The Examiners recommend that the Commission approve the request with the changes outlined by Staff of the Railroad Commission.

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<sup>378</sup> IGU Initial Brief, p. 5.

<sup>379</sup> Staff Ex. 2, Brock Direct, p. 18, lns. 1 - 11.

<sup>380</sup> Atmos Ex. 33, Smith Direct, p. 38.

XV. CONCLUSION

Atmos Mid-Tex requested a total base revenue requirement of \$409,942,043, which would result in a base revenue increase of \$46,910,156. For the reasons discussed in the preceding sections of this Proposal for Decision, the Examiners recommend that the Commission approve a total base revenue requirement of \$375,736,557 which will result in a base revenue increase of \$12,704,670.

Respectfully submitted,

Gene Montes  
Hearings Examiner  
Office of General Counsel

Rose Ruiz	Frank Tomicek
Technical Examiners	Technical Examiners
Gas Services Division	Gas Services Division

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