BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the PGA/ACA Filing of Atmos Energy Corporation for the West Area (Old Butler), West Area (Old Greeley), Southeastern Area (Old SEMO), Southeastern Area (Old Neelyville), Kirksville Area and the Northeastern Area.	)))))))	Case No. GR-2008-0364

INITIAL BRIEF OF THE
OFFICE OF THE PUBLIC COUNSEL

The purpose of this case is to determine the prudency of natural gas commodity rates charged by Atmos Energy Corporation (Atmos) to its Missouri customers between September 1, 2007 and August 31, 2008, which were approved by the Commission "on an interim basis, subject to refund, pending final Commission approval." Now the Commission must decide whether Atmos customers in Missouri paid higher rates for natural gas as a result of unreasonable or imprudent gas purchasing decisions made by Atmos. The evidence of the case demonstrates that Atmos customers in and around the Hannibal area were harmed by unreasonable and imprudent gas purchasing decisions made by Atmos, and that a disallowance is warranted.

1. Background

As in most Actual Cost Adjustment (ACA)/Purchased Gas Adjustment (ACA) cases, the Commission's Staff performs an audit of the local distribution company's (LDC) gas purchases made during the ACA period in question, and makes a recommendation to the Commission regarding whether the rates paid by consumers for natural gas sold during the period were just, reasonable, and prudent. Typically, an ACA case does not result in a contested case, and any disagreement in an ACA review is usually resolved without the need for an evidentiary hearing. In the present case, however, Atmos contests the Commission Staff's recommendation that a small portion of the gas purchases made by Atmos and paid by consumers be disallowed.

This case stands apart from typical ACA cases due to the LDC's unwillingness to provide data that the Commission's Staff needed to perform its audit and analysis. Atmos has been unwilling to provide certain data regarding its subsidiary affiliate despite the Commission's affiliate transaction rules that specifically require the LDC to make available the books and records of its affiliate.[1] Atmos has attempted to make this process difficult for the Commission's Staff by refusing to provide data requested by the Staff, and as a result of Atmos' refusal, this process has been extensively delayed.

Atmos operates in Missouri under an authority granted by the Commission that authorizes Atmos to be the monopoly provider of natural gas in Atmos' service territory. Atmos enjoys the benefits of being the monopoly provider of a necessary service, and in exchange for this authority, Atmos must open its books and records, including those of its affiliate, to review by the Commission, the Commission's Staff, and the Office of the Public Counsel to ensure that rates paid by Atmos' captive customers are just and reasonable. This is often referred to as the "regulatory compact."

Atmos' attempt to withhold the records of its subsidiary affiliate violates this compact and should raise caution flags with the Commission. Atmos has increasingly fought efforts by the Commission's Staff to perform its auditing functions, especially the Commission's department that audits natural gas purchasing.

In the present case, the LDC opposition to opening its records began when Atmos failed to respond to a Staff data request that sought to determine the fair market value of the gas purchased by the affiliate Atmos Energy Marketing (AEM) and sold to Atmos. Specifically, the Staff sought contracts between AEM and its upstream gas suppliers. Atmos' late response to the Staff's data request stated that the requested contracts were not in the possession of Atmos (rather, they were in the possession of subsidiary AEM). The Staff filed a Motion to Compel, and during an oral argument on the motion Atmos argued that the contracts were irrelevant because the gas was purchased through a competitive bidding process. The Commission rejected Atmos' arguments, finding that "the existence of a bidding process does not eliminate the rule's requirement that Atmos not provide a financial advantage to its affiliate, and the mere existence of that bidding process does not necessarily establish the fair market price of the goods and services Atmos obtained from its affiliated marketing company."[2] The Commission ordered Atmos to provide the affiliate documents and concluded that "the Commission promulgated its marketing affiliate transaction rule because dealings between a regulated utility and unregulated affiliated companies can be used to improperly push profits to the unregulated affiliate to the detriment of the captive rate payers of the utility."[3]

Despite the Commission's clear directive that Atmos was to provide access to the records of AEM, the procedure of this case was once again delayed by Atmos' second refusal to provide data, and the Staff was forced to file a second motion to compel Atmos to respond to Staff data requests that again sought information regarding the fair market

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[1] 4 CSR 240-40.016.
[2] *Order Granting Staff's Motion to Compel Atmos to Respond to Data Requests,* Case No. GR-2008-0364, July 15, 2010, p. 4.
[3] *Id.,* p. 5.

value of the gas purchased by AEM. The Staff identified anomalies in certain AEM gas purchasing transactions, and sought additional data regarding these anomalies. Atmos forced an oral argument on the motion to compel and raised the same argument previously rejected by the Commission - that the data sought by the Staff was irrelevant. Once again the Commission rejected Atmos' argument and ordered Atmos to respond to the data requests, concluding that the Staff "must be able to review and evaluate the supply contracts entered into by Atmos' affiliate."[4]

Eventually the parties were able to continue the procedural schedule and an evidentiary hearing was held on March 23-24, 2011 wherein the Commission heard evidence regarding the reasonableness and prudence of Atmos' gas purchasing decisions. That evidence forms the basis for the disallowance recommended by the Staff. Atmos' resistance to discovery, and its attempts to keep the records of its affiliate hidden from regulatory review, increases the need to scrutinize Atmos' gas purchasing practices.

2. Burden of Proof

In a prior PGA/ACA case the Commission explained the burden of proof applicable to ACA cases:

> Section 393.130.1, RSMo Supp. 2006, requires that all charges made or demanded by any gas corporation be just and reasonable. Section 393.150.2 , RSMo 2000, provides that in any hearing involving a rate increase, the gas corporation proposing such rate increase has the burden of proving that the proposed increased rate is just and reasonable. The Commission has also held that the gas corporation has the burden of showing that the gas costs that it proposes to pass on to ratepayers through operation of its PGA tariff are just and reasonable.[5]

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[4] *Order Granting Staff's Motion to Compel Atmos to Respond to Data Requests and Reestablishing Procedural Schedule,* Case No. GR-2008-0364, November 10, 2010, p. 3.

[5] *In the Matter of Missouri Gas Energy's Purchased Gas Adjustment (PGA) Factors to be Audited in Its 2002-2003 Actual Cost Adjustment,* Case No. GR-2003-0330, and *In the Matter of Missouri Gas Energy's Purchased Gas Adjustment Tariff Revisions to be Reviewed in Its 2001-2002 Actual Cost Adjustment,* Case No. GR-2002-348, Report and Order, October 2, 2007, p. 16,

Atmos has the burden of proving to the Commission that its natural gas expenditures were prudently incurred.

It is Atmos' position that there is an initial presumption that its gas expenditures are prudent. However, even if the Commission were to recognize such a presumption, once a party casts a serious doubt on the prudency of such expenditures as the Staff has done in this case, the burden of proof is upon the utility to prove its rates are just and reasonable. The Commission previously stated the following regarding a presumption of prudence:

> However, the presumption does not survive "a showing of inefficiency or improvidence." As the Commission has explained, "utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent . . . However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent.[6]

The Staff's evidence creates a serious doubt regarding the gas purchases made from AEM. The burden of proof is upon Atmos to dispel Staff's doubts and prove that its gas purchasing decisions were prudent and that the purchased gas adjustment rates charged to its customers between September 1, 2007 and August 31, 2008 were just and reasonable.

3. The Prudency Standard

PGA/ACA cases are a function of the Commission's ratemaking authority, including the requirement that all rates charged by a utility be just and reasonable. *Associated Natural Gas Company v. P.S.C., 954 S.W.2d 520 (Mo.App. 1997)*; §393.140

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citing *In the Matter of Tariffs filed by Western Resources, Inc., d/b/a Gas Service, a Western Resources Company, to Reflect Rate Charges to be Reviewed in the Company's 1992-1993 Actual Cost Adjustment*, 3 Mo. P.S.C. 34d 480, 488 (1995).

[6] *In the* *Matter of Union Electric Company*, 27 Mo.P.S.C. (N.S.) 183, 193 (1985) (*quoting* *Anaheim, Riverside, etc. v. Federal Energy Regulatory Commission*, 669 F.2d 779, (D.C. Cir. 1981)), cited to by the Commission in its Report and Order in Case No. GR-2009-0355, *In the*

and §393.150 RSMo.[7] In *Midwest Gas Users' Association v. Office of Public Counsel,* 976 S.W.2d 470, 483 (Mo. App. 1998)("*MGUA*"), the Missouri Court of Appeals held that § 393.270.4 RSMo requires Commission rate determinations to be based on all relevant factors. The Court explained that the Commission has the authority to review the prudence of a company's "decision to enter into a particular contract when a less costly alternative is available." *Id.* The Commission does not conduct a prudence review of the PGA before it goes into effect, and the Commission may disallow some or all of the adjustment sought when fuel costs are "unreasonable or the result of imprudent purchases." *Id.*

The gas purchases at issue in this ACA review involve gas transactions between Atmos the regulated entity and AEM the subsidiary affiliate of Atmos. This is not a typical ACA review of arms-length transactions between two unaffiliated entities. Instead, the issues before the Commission involve transactions between a regulated company and its subsidiary affiliate, which are *not* arms-length transactions, and which demand heightened scrutiny by the Commission in its review. Applying the standard set forth by the Court of Appeals in *MGUA*, the Commission must determine whether the gas transactions between Atmos and AEM were unreasonable or the result of imprudent purchases.

The Missouri Supreme Court recognized the potential for abuse caused by the relationship between a regulated utility and its marketing affiliate when the Court reviewed the Commission's affiliate transaction rules following an appeal by Missouri's LDCs. The Court explained that allowing utilities to conduct business with its own

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Matter of Missouri Gas Energy and its Tariff Filing to Implement a General Rate Increase for Natural Gas Service, February 10, 2010, p. 77.

affiliate "gives utilities the opportunity and incentive to shift their non-regulated costs to their regulated operations with the effect of unnecessarily increasing the rates charged to the utilities' customers." The Court went on to conclude that "as long as a [public utility] is engaged in both monopoly and competitive activities, it will have the incentive as well as the ability to 'milk' the rate-of-return regulated monopoly affiliate to subsidize the competitive ventures."[8] This increases the scrutiny the Commission must place on reviews of such transactions, especially in a rate proceeding such as this where all relevant factors must be reviewed. § 393.270.

In determining whether the transactions between Atmos and AEM were imprudent, the Commission's rules provide that gas transactions between a regulated local distribution company and an unregulated marketing affiliate must not provide a financial advantage to the marketing affiliate. 4 CSR 240-40.016. Providing a financial advantage to an affiliate in violation of the Commission's rules is unjust, unreasonable, and imprudent. Commission rule 4 CSR 240-40.016(3)(A) provides:

> (A) A regulated gas corporation shall not provide a financial advantage to an affiliated entity. For the purpose of this rule, a regulated gas corporation shall be deemed to provide a financial advantage to an affiliated entity if –
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> 1. It compensates an affiliated entity for information, assets, goods or services above the lesser of –
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> A. The fair market price; or
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> B. The fully distributed cost to the regulated gas corporation to provide the information, assets, goods or services for itself;

[7] All statutory references are to Missouri Revised 2000 unless otherwise noted.
[8] *State ex rel. Atmos Energy Corp. et al. v. P.S.C.,* 103 S.W.3d 753 (Mo. 2003).

Any gas purchases by Atmos from AEM that were priced above the lesser of the fair market price or the fully distributed cost to the regulated gas corporation is in violation of the rule, and would be subject to disallowance by the Commission in this review.

4. The $308,733 Disallowance

The parties identified two issues: Issue 1: **Were the rates Atmos charged for natural gas during the 2007-2008 ACA period just and reasonable?** Issue 2: **What, if any, ACA adjustments should the Commission order for the 2007-2008 ACA period?** OPC's position is that the rates charged for natural gas during the 2007-2008 ACA were not just and reasonable for customers in the Northeast service area that includes the communities of Hannibal, Palmyra, Canton and Bowling Green (collectively referred to as the "Hannibal"). Due to the unjust and unreasonable rates charged to these consumers during the 2007-2008 ACA, the Commissions should disallow $308,733.

The evidence presented by the Commission's Staff provides the Commission with three alternative disallowance amounts. In the Staff's first and primary disallowance recommendation, the Staff recommends a disallowance of $308,733. OPC agrees with this disallowance because it would allow customers to pay no more than the fair market value of natural gas acquired in an arms-length transaction between a willing buyer and a willing seller, as required by the Commission's rules.[9]

Disallowing $308,733 is consistent with the Commission's affiliate transaction rule, 4 CSR 240.40.016, which establishes that gas purchased by an LDC from its marketing affiliate are to be priced below the lesser of the fair market price or fully distributed cost. The fair market price is defined by Black's Law Dictionary as the price at which a willing buyer and a willing seller would agree upon in an *arms-length* transaction.[10] The evidence demonstrates that the price at which the gas was acquired in an arms-length transaction is the price AEM paid for the gas since the sale of gas from AEM to Atmos, its parent company, is by definition not an arms-length transaction.[11]

The evidence before the Commission demonstrates that Atmos, the largest LDC in the United States,[12] is certainly capable of making natural gas purchases and that Atmos could have acquired the gas supply for itself rather than through AEM.[13] AEM acquired the gas through an arms-length transaction in a competitive market that is also available to Atmos. Atmos' decision to purchase gas through its marketing affiliate AEM, rather than by making the gas purchases itself (and avoiding the AEM profit mark-up) is reason alone to render Atmos' purchasing decisions imprudent. Had Atmos purchased the gas itself, Atmos' customers would not have paid the AEM profits that ultimately benefited Atmos' shareholders. Atmos has not provided a sufficient explanation to overcome the Staff's evidence indicating that Atmos could have acquired the gas supply on its own at similar cost as AEM. As a result of using AEM, Atmos' Hannibal area customers paid $308,733 in gas costs that should be disallowed. In response to Atmos surprising claim that it lacked the expertise to purchase gas, Staff's testimony evidence provides:

> Ms. Buchanan asserts in her discussion that AEM brings to bear some special skills, access to gas markets, and a unique scope of operation not found in Atmos' gas supply department. When viewed in the context of the services AEM actually did perform for its LDC affiliate, Ms. Buchanan's conclusion that the LDC by itself doesn't possess sufficient skills and experience to access the gas markets and to buy gas for its captive ratepayers is not believable. … The LDC knows the amount of its

[9] 4 CSR 240.40.016
[10] Tr. 627.
[11] Ex. 26, Sommerer Direct, p. 6.
[12] Ex. 27HC, Sommerer Rebuttal, p. 2.
[13] Ex. 28HC, Sommerer Surrebuttal, pp. 4-5.

> monthly requirements from the reviews it conducts of its supply requirements. The LDC has the expertise to reasonably estimate baseload supply needs for each month and to estimate the contractual volumes and flexibility it requires from storage injections and withdrawals and swing and daily flowing supply for various months and weather conditions. Thus, the LDC could reasonably acquire the baseload volumes and swing volumes through direct contact with potential bidders or through a more formal RFP process similar to that used to awards its requirements to AEM. Indeed, AEM's knowledge of Atmos' requirements can be no greater than Atmos' own knowledge of its requirements. Smaller LDCs in Missouri order their own gas.[14]

The Staff's evidence also shows that AEM brought in no special capabilities or knowledge to the gas transactions in question, and in fact AEM acquired supply from a provider that was equally available to Atmos for gas purchases.[15] Atmos has not demonstrated that a markup above AEM's cost is just and reasonable.

A $308,733 disallowance may not include any overhead costs that were incurred by AEM in acquiring the gas. The fair market price of the gas purchased by AEM would not include AEM's overhead costs, and therefore, if overhead costs are included in the $308,733 figure, those overhead costs should be subtracted out to reach the proper fair market price of the gas. Unfortunately Atmos did not provide any evidence as to AEM's overhead costs, which Atmos very well could have provided during the evidentiary hearing, but which Atmos chose not to provide.[16] If the Commission concludes that a disallowance is warranted but that overhead costs should be subtracted from the $308,733 figure, the Commission may direct Atmos to provide a late filed exhibit identifying those overhead costs. OPC only asks that the Commission grant the other parties an opportunity to respond to the exhibit accordingly.

[14] Ex. 28HC, Sommerer Surrebuttal, pp. 4-5.
[15] *Id.*
[16] Ex. 28HC, Sommerer Surrebuttal, pp. 8-9.

Evidence in the case suggests that the reason AEM was able to undercut other gas marketer bids by a substantial margin was because the gas sold by AEM to Atmos was interruptible and not firm as required by the RFP.[17] This is "the same as giving a financial advantage to the affiliate" which is specifically prohibited by 4 CSR 240-40.016 of the Commission's affiliate transaction rules. The base North American Energy Standards Board (NAESB) agreement does not specify firm or interruptible gas, and allows for either.[18] The Transaction Confirmation between Atmos and AEM does not specify that the gas would be firm rather than interruptible, and would on its fact allow interruptible gas despite the fact that other transaction confirmations entered into between Atmos and AEM specify firm supplies.[19] AEM's ability to offer a bid on the RFP that was much lower than all other conforming bids could be a result of AEM bidding with interruptible gas supplies.[20] This evidence is corroborated by the fact that Atmos has not explained or attempted to explain or offer evidence showing how AEM was able to acquire natural gas at prices that were significantly less than the prices obtained by the other gas marketers.[21] If AEM provided gas supplies that were interruptible, the fair market price of those gas supplies would be less than the fair market price for gas acquired by AEM that was firm, further justifying the $308,733 disallowance.[22] Records of the costs incurred by Atmos and AEM were required to be maintained by Atmos per 4 CSR 240-40.016(6).[23] Yet once again, Atmos chose not to provide any records from

[17] Tr. 734; Ex. 28HC, Sommerer Surrebuttal, p. 6.
[18] Tr. 407; Ex. 27HC, Sommerer Rebuttal, Schedule 5.
[19] Ex. 12HC.
[20] Tr. 734.
[21] Tr. 725.
[22] Tr. 721-722.
[23] *See also* Tr. 729.

AEM that would demonstrate that the gas AEM provided to Atmos was in fact firm gas. Atmos failed to satisfy its burden.

Allowing Atmos to profit from the sale of natural gas puts the entire PGA process in question because it violates the understanding that LDCs do not profit from the gas commodity charges paid by consumers. There is no question that AEM's profits benefit Atmos' shareholders since AEM is a subsidiary of Atmos and shareholders invest in Atmos, not AEM.[24] Disallowing $308,733 for Hannibal area customers will ensure the integrity of the PGA/ACA process is maintained. For these reasons, OPC urges the Commission to conclude that $308,733 should be disallowed for the 2007-2008 ACA.

5. The Scenario 1 and Scenario 2 Disallowances

The Staff also recommends alternative prudency disallowances should the Commission conclude that it will not make the $308,733 disallowance. These scenarios were recommended to disallow imprudently incurred gas costs caused by Atmos' decision not to nominate sufficient first-of-the-month baseload supply, and by Atmos' decision to help its affiliate by allowing additional reductions to its nominations.[25]

Under these scenarios, Atmos' imprudent decisions began on November 20, 2007, when Mr. Mike Walker, Atmos' gas supply specialist, made Atmos' December first-of-the-month nominations earlier than when Atmos normally makes its baseload nominations.[26] These nominations were made eleven (11) days before the first-of-the-month. At the time of Atmos' nominations, Atmos' storage was already below Atmos' plan, yet with no reasonable basis, Atmos chose not to follow its plan and instead made a baseload nomination that was twenty-five percent (25%) below a nomination number that

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[24] Ex. 26HC, Sommerer Direct, p. 4.
[25] Tr. 621.

was *already adjusted downward* twenty percent (20%) because of warmer than normal weather per Atmos' gas purchasing plan.[27]

The twenty-five percent (25%) under-nomination was highly unusual, as testified to by Ms. Buchanan, Manager of Regional Gas Supply, when asked by Commissioner Jarrett if the December 2007 nominations were "the only time in the history of Atmos that they went above or below the 20 percent" adjustment called for in Atmos' plan.[28] Ms. Buchanan could not identify any other instance where Atmos went above or below the allowed 20% adjustment, and simply testified that she "would be surprised if it was the only time."[29] Atmos' imprudent nomination decision resulted in Atmos' needing to make additional gas purchases, which increased the cost of gas to Atmos' customers.[30]

Atmos claims it nominated a low amount of gas based on an analysis of past usage history, however, Mr. Walker testified that the average normal baseload requirement and the twenty percent (20%) warmer weather adjustment already factored past usage history into account,[31] and therefore, the additional downward adjustment was unnecessary, and ultimately harmful.

Atmos' imprudent decisions continued when Atmos was notified on November 21, 2007, that a pipeline rupture had occurred upstream from Atmos' receipt point, yet Atmos made no attempt to increase its nominations. The excuse provided by Atmos for this shortfall was that its gas supply specialist, Mr. Mike Walker, was away on vacation between November 20, 2007 and November 26, 2007, and was "expected to watch some

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[26] Tr. 448.
[27] Tr. 548.
[28] Tr. 428.
[29] *Id.*
[30] Ex. 28HC, Sommerer Surrebuttal, pp. 1-2.
[31] Tr. 562.

football" during that time.[32] These excuses are simply unacceptable to the Atmos customers forced to pay the increased gas costs that resulted from Atmos' imprudence. The Atmos employee filling in for Mr. Walker in his absence should have increased Atmos' nominations. That person, however, could have been Ms. Rebecca Buchanan, who was very new to the position and new to acquiring gas supply.[33]

Atmos was also imprudent in not effectively monitoring its gas supply issues remotely, which Mr. Walker testified is possible,[34] and which could have averted the under-nomination problem by giving Atmos time to increase its nominations on the morning of Monday, November 26, 2007. Given the crucial nature of providing gas during the winter heating season; given the 5-day deadline for nominations; given the fact that Atmos purposely nominated an amount that was significantly below the warm weather adjustment; and given the fact that Atmos had made its nominations earlier than normal - it would be prudent for an LDC in such a situation to use its remote monitoring abilities to monitor and protect the gas heating needs of the thousands of customers relying on Atmos to make prudent decisions.

Atmos' imprudent decisions continued on November 26, 2007, five days before the first-of-the-month, when Atmos made absolutely no attempt to increase its nominations despite being notified that a pipeline rupture had occurred upstream from Atmos' receipt point at Haven.[35] In addition, Atmos should have been aware of its low storage balances. With this information, a prudent LDC would have attempted to increase their nominations to protect their customers from insufficient firm gas supplies,

[32] Tr. 571.
[33] Ex. 1, Buchanan Direct, p. 2; Tr. 580.
[34] Tr. 560.
[35] Tr. 582.

and the resulting higher gas prices that would likely occur when Atmos was forced to purchase more gas from its affiliate AEM to make up for the under nominations.[36] Nothing prohibited Atmos from requesting an increase to its nominations, and a prudent LDC would have requested an increase in nominations up to the pipeline's deadline, which is different than the supplier's deadline.[37] The evidence of the case shows that Atmos' baseload nominations were not cut by AEM,[38] which suggests Atmos was not prevented from acquiring additional baseload gas.

Atmos decisions were also imprudent in that Atmos agreed to allow its nominations to be curtailed by up to thirty-one percent (31%), which Atmos' witness Ms. Buchanan admitted "seems large."[39] Despite Atmos' claim that this curtailment was the result of the Haven outage, the evidence in the case shows that the outage caused only a small percentage of the gas supplies to be curtailed when compared to the greater volume that AEM was ultimately unable to provide Atmos.[40]

The decisions made by Atmos that lead to the Staff's recommendation for disallowances of $52,572 or $85,577 were the result of imprudent nominations, and imprudent decisions to lessen those nominations, which resulted in Atmos' need to acquire additional gas at an increased cost.

6. Conclusion

OPC urges the Commission to disallow $308,733 for the reasons argued herein, or in the alternative, recognize the imprudence of Atmos' actions and make a disallowance according to Staff's Scenario 1 or Scenario 2.

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[36] Tr. 621.
[37] Tr. 621.
[38] Tr. 713; Ex. 28HC, Sommerer Surrebuttal, p. 12.
[39] Ex. 10HC; Tr. 373.

Respectfully submitted,

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I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record this 13th day of May 2011.

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[40] Ex. 28HC, Sommerer Surrebuttal, pp. 6-7.