BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Atmos Energy Corporation's	)	
2008-2009 Purchased Gas Adjustment and	)	**Case No. GR-2009-0417**
Actual Cost Adjustment.	)	

STAFF'S REPLY BRIEF

Respectfully submitted,

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I. <u>Introduction</u>

In the *Report And Order* of the Atmos '07 - '08 ACA case involving an affiliate transaction with Atmos Energy Marketing, LLC ("AEM") the Commission concluded in its decision "Fair market price is set by the market…"[1] That did not happen in this case. As Staff pointed out in its Initial Brief and demonstrates again below, Atmos failed to establish a fair market price for gas supplies from its affiliate AEM in the Hannibal and Butler service areas. Furthermore, the bidding/award and contracting process <u>should</u> be equitable for all bidders. It was not. Atmos accepted only one bid – a bid from AEM – to set the fair market price of gas through the cheaper and less reliable secondary receipt point. By doing so, Atmos Energy Corporation's ("Atmos") reliance on <u>non-comparable bids</u> violates the Commission's decision: "As simple as it sounds, fair market price is established by the fair market composed of willing buyers and sellers."[2] Relying on one bid does <u>not</u> set a fair market price.

MO statute section 393.130.1 requires that "All charges for gas service must be just and reasonable." The Staff contends that *Atmos should recover in rates no more than the costs it has supported.* It is not just and reasonable for captive ratepayers to pay costs that Atmos cannot support.

Moreover, as discussed below, Atmos' dual contracting standards passed a profit opportunity to its affiliate AEM that was not made available to third party suppliers. Such a preference is clearly shown in a side-by-side comparison of the transaction confirmations of AEM and Atmos' non-affiliate suppliers. Preferential treatment is prohibited under the Commission's Marketing Affiliate rules.

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[1] GR-2008-0364, *Report And Order*, p 27.
[2] GR-2008-0364, *Report And Order*, p 26.

Because Atmos engaged in less than arms-length transactions with its affiliate, the Staff addresses the prudence standard applied in ACA rate cases and how the affiliate rules are applied within that standard.

II. Prudence Standard

In its initial brief, Atmos argues the standard for review of arms-length transactions is the same as for affiliate transactions. Below Staff will demonstrate this to be inaccurate. To determine whether a utility's costs meet this statutory requirement, the Commission employs a "prudence" standard. It is the governing legal standard in this case.

The "prudence" standard is set out in Associated Natural Gas Company v. Public Service Commission of Missouri, a 1997 Western District Court of Appeals case (954 SW2d 520, 528-529)(hereinafter "ANG").

The ANG court defines the "Prudence Standard" saying that there is a presumption a utility has been prudent until there is a showing of inefficiency or imprudence:

> "A utility's costs are presumed to be prudently incurred…. However the presumption does not survive a showing of inefficiency or improvidence.
>
> 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.
>
> The test of prudence should not be based upon hindsight, but upon a reasonableness standard: The company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the task that confronted the company."

Though the Commission follows a "prudence" standard, this case is further complicated by Atmos having chosen to buy gas supplies for its Hannibal and Butler areas from its unregulated affiliate AEM. When transactions are not at arms-length, the Commission's Affiliate Transaction rules apply. As the Supreme Court recognized, the Commission adopted its Affiliate Transaction rules to protect ratepayers from improper cross-subsidization. State ex rel. Atmos Energy Corp. v. Public Service Comm', 103 S.W.3d 753 (Mo.Sup.Ct. en banc 2003).

The asymmetrical pricing provision of the Commission's Marketing Affiliate Rule 4 CSR 240.016(3)(A) requires Atmos to compensate its affiliate at the lower of the fair market price or the fully distributed cost to Atmos for the provision of gas supplies. Atmos witness Rebecca Buchanan testified the company had not calculated its fully distributed costs at the time it had made its agreements with AEM.[3] This heightened Staff's scrutiny of fair market price.

The Commission itself has recognized that Staff's prudence review does not stop at the bidding process:

> "…[T]he 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 affiliate company."[4]

"Throughout the United States it is recognized that a public utility's dealings with affiliates require thorough investigation and close scrutiny by a public utility commission."[5] Therefore, Staff's prudence review of Atmos' purchasing decisions and practices with its

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[3] Tr Vol 2, p 99 ln 12 – p 100 ln 22.

[4] *Order Granting Staff's Motion to Compel Atmos to Respond to Data Requests*, Case No. GR-2008-0364, July 15, 2010, p 4.

[5] Turpen v. Oklahoma Corp. Comm., 769 P.2d 1309, 1320 (OK. Sup.Ct. 1988) citing United States v. Western Elec. Co., Inc. 392 F.Supp.836,853 [D.D.C. 1984] See also Smith v. Illinois Bell Teleph. Co., 282 U.S. 133, 157, 51 S.Ct. 65, 72, 75 L.Ed. 255, 267 [1930]; General Tel. Co. of Upstate N.Y. v. Lundy, 17 N.Y.2d 373, 271 N.Y.S.2d 216, 222-23, 218 N.E.2d 274, 278-279 [1966]; New England T.&T. Company v. Dept. of Pub. Util., 371Mass. 67, 354 N.E.2d 860868-869 [1976]; Washington Water Power v. Idaho Public Util., 101 Idaho 567, 617 P.2d 1242, 1247-1248, 16 A.L.R.4th 435 [1980]; Pacific Telephone and Telegraph Co. v. Flagg, 189 Or. 370, 220 P.2d 522, 529-530 [1950] and Town of New Shoreham v R.I. Pub. Util. Com'n., 464 A.2d 730, 733 [R.I. 1983].

affiliate AEM must necessarily address whether Atmos paid its affiliate a fair market price for the gas supply as a result of Atmos' bid award and contracting process.

III. In its Initial Brief in this case, Atmos makes a flawed argument on Burden of Proof, and not only misconstrues the decision of Missouri's Western District Court of Appeals in State ex rel. Public Counsel v. Public Service Commission[6], but also fails to overcome the serious doubts raised by Staff on the reasonableness of its gas costs.

Doubts are raised in affiliate transactions because one common management controls both sides of the transaction. In the context of the prudence review of this case, the Staff has raised more than a serious doubt concerning the reasonableness of Atmos' gas commodity purchase costs paid to its affiliate, AEM. In this regard, Staff has met the ANG standard that puts the burden of proving the reasonableness of the utility's purchase costs back on the utility.

Atmos incorrectly interprets the Court's decision regarding the prudence standards for arms-length transactions and less than arms-length transactions in the appeal by Public Counsel and the Attorney General of the Commission's report and order in Union Electric Company's (UE) 2006 general rate case.

In *Public Counsel v. Public Service Commission* (the "*UE* case") the Public Counsel and the Attorney General challenged, among other things and in relevant part, the prudency of UE having purchased two combustion turbine generators (CTGs) at its affiliates' cost.

Contrary to Atmos' argument here, the *UE* case does not hold that affiliate and non-affiliate transactions enjoy the same presumption of prudence under the ANG standard discussed above. The Missouri Supreme Court recognized the difference between affiliate

[6] 274 S.W.3d 569, 577 (Mo.App.2009)

transactions and arms-length transactions when it identified the dangers inherent in affiliate transactions.[7]

Further, the *UE* case does not help Atmos because the facts in *UE* are easily distinguished from the facts of this case.

In the *UE* case, the Commission valued the CTGs *at the price that UE had paid its affiliate*.[8] In doing so, the Commission relied on record evidence which supported the affiliate's costs of the CTGs *without markup* as reasonable costs to UE. In UE's underlying rate case, the Commission rejected arguments from Public Counsel and the Attorney General asserting that the market for CTGs had weakened and that the fair market price for UE's CTGs should be some lesser amount than the amount UE's affiliate paid for the CTGs.

The *UE* Court held the Commission did not err in making findings of fact that valued UE's purchased turbines differently than Public Counsel's comparable turbines. The UE Kinmundy plant turbine purchased by UE was valued *differently* because it burned *either* oil or natural gas, whereas Public Counsel's comparable turbines at Audrain, Goose Creek and Raccoon Creek burned *only* natural gas. Furthermore, the UE Pinckneyville turbine units had a lower heat rating constituting a significant improvement in efficiency than Public Counsel's comparable turbines. The Commission's order relied on these factors to show that both UE's Kinmundy and Pinckney units had a higher market value than the features of the turbines that Public Counsel relied on at the Audrain, Goose Creek and Raccoon Creek plants. This difference is significant. The Commission accepted as reasonable that *UE paid only its*

[7] The Missouri Supreme Court's affirmation of the Commission's affiliate rules found that when a traditional regulated monopoly expands into non-regulated areas, that "…expansion 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…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 its competitive ventures." State ex rel. Atmos Energy Corp. v. Public Service Comm', 103 S.W. 3d 753, 764 (Mo. Sup. Ct. enbanc 2003).
[8] State ex rel . Public Counsel v. Public Service Commission, 274 S.W.3d 569, 578 (Mo.App.2009)

affiliate's costs – the <u>*same*</u> *position Staff and Public Counsel*[9] *have taken with Atmos in its gas purchases from its affiliate AEM.*

Staff contends that Atmos ratepayers should pay <u>ONLY</u> the affiliate AEM's actual costs, plus AEM's reported overhead expenses in the GR-2009-0417 case. Staff asserts the abundant record evidence demonstrates that Atmos, *because of its flawed RFP bid award process and lax contracting standards with its affiliate AEM*, failed to set a fair market price for comparable gas supplies.[10] Staff's proposed disallowance is just and reasonable because the ratepayers should pay only a fair market price. The fair market price in this case is what AEM paid for gas, plus AEM's overhead expenses related to acquiring its gas supplies – *the same result arrived at by the UE Court*.

The *UE* case supports Staff's contention that Atmos cannot use a cheaper, less reliable secondary receipt point to set a fair market price for gas delivered through a more valuable, more reliable primary receipt point. Simply put, the gas "product" is valued differently. Record evidence discussed at length in Staff's Initial Brief proves they are different products, like "apples and oranges." Comparing "apples to oranges" in this context does not set a fair market price for either. *Thus, Atmos' use of* <u>*one*</u> *bid (AEM) at the secondary point cannot set the fair market price of gas delivered to the secondary point by comparing that one bid to two bids through the primary receipt point.*

[9] See Initial Brief Of The Office Of The Public Counsel p 7. "*The only fair market price supported by the record evidence before the Commission is the price paid by AEM, offset for overhead, which results in a disallowance of $337,226.*"

[10] See Staff' Initial Brief, pp 28-30, Sect. VI. <u>**Atmos' RFP has failed to establish a Fair Market Price for the Hannibal area and Butler Gas Supplies Purchased from AEM as required under the Commission's Affiliate Rules**</u> [internal cites to record omitted]

IV. <u>**Atmos has not overcome the serious doubts raised by Staff and has not met its burden of demonstrating the reasonableness of the gas costs it paid its affiliate AEM**</u>

As discussed above and at length in Staff's Initial Brief, Atmos' RFP process did not set a fair market price for gas through the cheaper, less reliable secondary receipt point. Staff has shown the record evidence proves, contrary to Atmos' requirements of its non-affiliate bidders[11], Atmos failed to specify enforceable contractual rights to firm gas supplies in its supply contracts with AEM, thus passing to AEM an opportunity to use cheaper, higher risk less than firm gas.[12]

Atmos' non-affiliate contracts expressly required firm baseload and firm swing gas - giving Atmos enforceable rights to firm supply. Atmos' lax treatment of its AEM contracts gave AEM the flexibility to arrange its supply portfolio with higher risk, cheaper gas. Atmos' non-affiliate contracts did not make that flexibility available to its non-affiliate suppliers. Thus, AEM could easily use its supply flexibility to underbid non-affiliate suppliers that did not have that same flexibility. Atmos' dual contracting standards violate the standards provision of the Commission's Marketing Affiliate Rule 4 CSR 240-40.016(3)(B) requiring "…*the regulated gas corporation shall conduct its business in such a way as not to provide any preferential service, information or treatment to an affiliated entity over another party at any time.*"

[11] See Staff's Initial Brief, pp 33-34, Sect. VIII. **Atmos' contracts with its Non-affiliate Suppliers, both Before and After AEM, locked in specific Firm Baseload and Swing Gas amounts providing Atmos with enforceable rights to Firm supply** [internal cites to record omitted]

[12] See Staff's Initial Brief, pp 31-32, Sect. VII. <u>**Atmos failed to lock-in contractural rights to Firm Baseload and Swing gas in its supply contracts with AEM, passing an opportunity to AEM to bid cheaper less-than-firm gas supplies**</u> [internal cites to record omitted]

Therefore, the Commission should approve Staff's proposed disallowances of $337,226 in GR-2009-0417.[13] Ratepayers should pay only the gas costs that Atmos has supported, *which is no more than AEM's cost of gas supplies and AEM's reported overhead expenses.*

V. <u>Atmos' RFP created a Hobson's choice that restricted non-affiliate bids to the more valuable primary receipt point at Haven and passed a profit-play opportunity to AEM to bid gas through the riskier lower cost secondary receipt point.</u>

Atmos' RFP requirements insisted on "firm", "firm and warranted" gas deliveries "without fail", creating a Hobson's choice for non-affiliate suppliers compelling non-affiliates to bid gas supplies at the more valuable and most reliable primary receipt point at Haven, assuring Atmos would receive the highest level of firm gas supplies as requested in the RFP.

In contrast, AEM was not faced with this Hobson's choice and only Atmos' affiliate AEM interpreted the provision in the RFP allowing deliveries to cheaper, less reliable secondary receipt points as a reasonable bid alternative that would meet Atmos' strenuous insistence on firm gas supplies. Non-affiliate suppliers bid the most reliable, higher cost delivery into the primary point to meet Atmos' insistence on "firm" gas. AEM did not. AEM monetized the higher risk of an opportunity *not available to non-affiliates*. Said another way, AEM made a value-play on risk and passed its increased profits from the deal to Atmos' shareholders.[14]

Furthermore, Atmos' failure to lock-in enforceable rights to firm supply in its supply contracts with its affiliate AEM gave AEM an opportunity for it to provide less-than-firm

[13] In GR-2008-0364, the '07-'08 ACA period, Atmos had two RFP supply agreements with its affiliate AEM for Hannibal area. In the first RFP in that case, RFP 1, Atmos compared its one AEM bid through the secondary receipt point to four bids through the primary receipt point of Haven (a total of 5 conforming bids). In the second RFP (RFP 2) in GR-2008-0364 for Hannibal area, Atmos compared its one AEM bid through the secondary point to two bids through the primary receipt point (a total of 3 conforming bids). This RFP supply agreement runs into the '08-'09 ACA in GR-2009-0417 and becomes the first supply agreement of that ACA and it gives rise to the $337,000 disallowance in that case. See Staff's Initial Brief pp 22 – 23 [internal cites to record omitted].

[14] Staff's concern is <u>NOT</u> about profit. Staff's concern is that the RFP language insisting on "Firm" gas created the value-play for <u>only</u> AEM. AEM, unlike the two non-affiliate suppliers, did <u>NOT</u> bid the requested primary point at Haven and did <u>NOT</u> bid the same gas product and service level. Hence, the "apples to oranges" bid comparison.

supplies. That incentive was not available to non-affiliate suppliers because they were contractually obligated (in their transaction confirmations, the "supply contracts") to provide firm baseload and firm swing gas.

VI. **Atmos has not supported its fair market price of gas supplies upon which it based its cost of its gas supplies from AEM and passed through to customers.**

Atmos was content setting a fair market price with only one bid from AEM through the cheaper secondary point. Atmos, with full knowledge of the value difference between the points, did not re-open bidding at the secondary point. *We will never know how low prices would have been bid because we have no other bids at the secondary point on which to compare AEM's bid.* Moreover, Atmos did nothing to attract more bidders to the Hannibal area. The failure of Atmos' RFP to attract bidders is amplified by the fact that Atmos' 2nd RFP supply agreement in the '08-'09 ACA *attracted only one (1) bid from a pool of 60 qualified suppliers*. That bidder was a non-affiliate supplier that Atmos contractually required to provide firm baseload and firm swing gas, which Atmos did not require from its affiliate AEM.

The Commission should reject Atmos' contention that it set a fair market price by relying on only AEM's bid at the cheaper secondary receipt point. The bidding process was not robust and did not generate a fair market price at the secondary point. In addition, the contracting standards with AEM were lax because Atmos failed to specify any enforceable rights to firm supply, thus passing an opportunity to AEM that was not made available to non-affiliate suppliers. Therefore, Atmos should recover in rates only the cost of AEM's gas supplies and AEM's reported overhead expenses.

VII. <u>**The Commission should order the $337,226 adjustment so that ratepayers pay no more than the costs that Atmos has supported in the record evidence of this case.**</u>

Staff's proposed $337,226 disallowance is a just and reasonable result because it is derived from information provided by Atmos in the record evidence.

Furthermore, Atmos' argument that it would be harmed by the $337,226 disallowance must fail because the disallowance <u>does not deny</u> Atmos its actual cost of AEM's gas supplies *and* reported overhead expenses of its affiliate. The $337,226 disallowance does <u>not</u> harm Atmos. Contrary to Atmos' belief, the true harm falls on ratepayers that have already paid Atmos' unsupported costs that Atmos paid its affiliate AEM.

Atmos' cost of gas supplies is a pass through cost to customers. It is not reasonable or just to require customers to pay gas costs *that are not supported by the utility because the utility failed to set a fair market price.* Requiring ratepayers to pay costs to Atmos that Atmos cannot support is imprudent on its face. The $337,226 adjustment collects in rates only the just and reasonable and prudently incurred costs that Atmos has supported in the record evidence of this case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 14th day of November, 2011.

/s/ Robert S. Berlin