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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

DAVID M. SOMMERER

ATMOS ENERGY CORPORATION

CASE NO. GR-2009-0417

Jefferson City, Missouri
June, 2011

** **Denotes Highly Confidential Information** **

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DAVID M. SOMMERER

ATMOS ENERGY CORPORATION

CASE NO. GR-2009-0417

Q. Please state your name and business address.

A. David M. Sommerer, P.O. Box 360, Jefferson City, MO. 65102.

Q. By whom are you employed and in what capacity?

A. I am the Manager of the Procurement Analysis Department with the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. In May 1983, I received a Bachelor of Science degree in Business and Administration with a major in Accounting from Southern Illinois University at Carbondale, Illinois. In May 1984, I received a Master of Accountancy degree from the same university. Also, in May 1984, I sat for and passed the Uniform Certified Public Accountants examination. I am currently a licensed CPA in Missouri. Upon graduation, I accepted employment with the Commission.

Q. What has been the nature of your duties while in the employ of the Commission?

A. From 1984 to 1990, I assisted with audits and examinations of the books and records of public utilities operating within the state of Missouri. In 1988, the responsibility for conducting the Actual Cost Adjustment (ACA) audits of natural gas utilities was given to the Accounting Department (now referred to as the Auditing Department). I assumed responsibility for planning and implementing these audits and trained available Staff on the requirements and conduct of the audits. I participated in most of the ACA audits from early 1988 to early 1990. On November 1, 1990, I transferred to the Commission's Energy Department. Until November of 1993, my duties consisted of reviews of various tariff proposals by electric and gas utilities, Purchased Gas Adjustment (PGA) reviews, and tariff reviews as part of a rate case. In November of 1993, I assumed my present duties of managing a newly created department called the Procurement Analysis Department. This Department was created to more fully address the emerging changes in the gas industry especially as they impacted the utilities' recovery of gas costs. My duties have included managing the five member staff, reviewing ACA audits and recommendations, participating in the gas integrated resource planning project, serving on the gas project team, serving on the natural gas commodity price task force, and participating in matters relating to natural gas service in the state of Missouri. In July of 2006, the Federal Issues/Policy Analysis Section was transferred to the Procurement Analysis Department. That group analyzes filings made before the Federal Energy Regulatory Commission (FERC).

Q. What knowledge, skill, experience, training or education do you have in these matters?

A. I have been assigned and testified in many PGA and ACA proceedings. I have reviewed numerous ACA filings and have evaluated the purchasing practices of various Local Gas Distribution Companies (LDC) in Missouri. I have also attended conferences and seminars related to the natural gas futures market and other natural gas issues. In 2011, I assisted in reviewing the National Regulatory Research Institute's paper on

Natural Gas Hedging at the request of Mr. Ken Costello, the paper's author. I have on several occasions provided the Missouri Commission with natural gas supply and hedging overviews.

Q. Have you previously testified before this Commission?

A. Yes. A list of cases and issues in which I have filed testimony is included as Schedule 1 of my testimony.

Q. Did you make an examination and analysis of the books and records of Atmos Energy Corporation (Company or Atmos or LDC) in regard to matters raised in this case?

A. Yes. I have examined all the records provided by Atmos in the context of the issues I am addressing in this case. Since Atmos controls almost all the documentation relevant to this issue, my opinion is subject to the information provided by the Company but it is dependent on the Company to provide all relevant material.

BACKGROUND

Q. Please provided a background for this case.

A. The Procurement Analysis Department (Staff) reviewed Atmos Energy Corporation's 2008-2009 Actual Cost Adjustment (ACA) filings, in Case No. GR-2009-0417, for the former territories of Associated Natural Gas (ANG), (Areas B, K and S), United Cities Gas (Areas P and U) and Greeley Gas (Area G). In the context of this testimony, the term Local Distribution Company or LDC is referring to Atmos Energy Corporation, the regulated utility. Staff's analysis consisted of a review and evaluation of the Company's billed revenues and its natural gas costs for the period of September 1, 2008, to August 31, 2009. A comparison of billed revenue recovery with actual costs will yield either an over-recovery or under-recovery of the ACA costs.

Staff performed an examination of Atmos' gas purchasing practices to determine the prudence of the Company's purchasing decisions. Staff also conducted a hedging review to determine the reasonableness of the Company's hedging plans for this ACA period. Staff conducted a reliability analysis of the Company's estimated peak day requirements and capacity levels to meet those requirements. Staff's Recommendation in Atmos Energy Corporation's 2008-2009 Actual Cost Adjustment was filed December 30, 2010 and is attached as Schedule 2.

<u>EXECUTIVE SUMMARY</u>

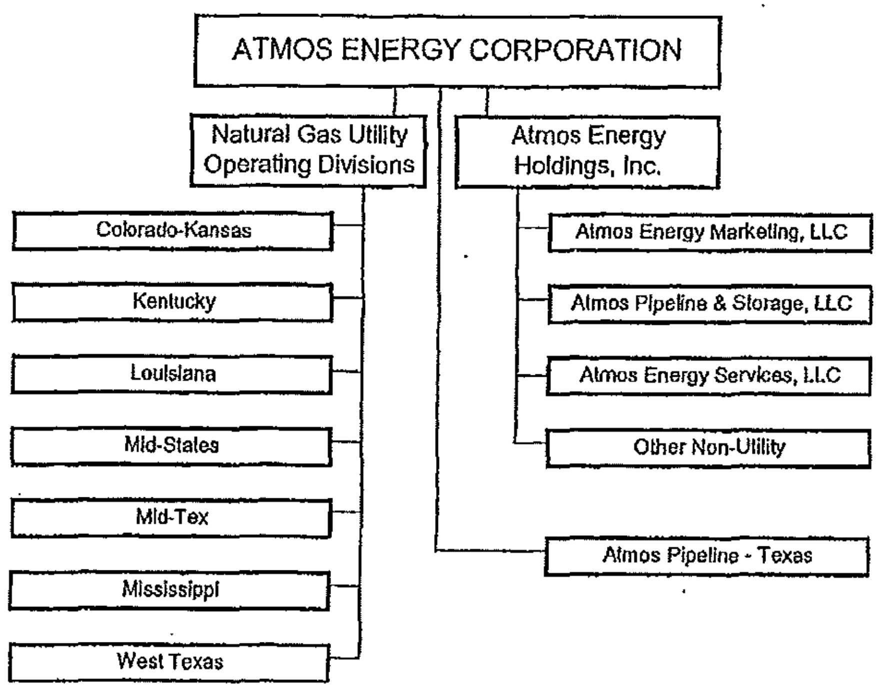
Q. Please provide an executive summary.

A. The issues in this case have been resolved with the exception of Staff's proposed disallowance regarding Atmos' transactions with its affiliated marketing company. Staff proposes an adjustment of ($319,374.48) for the Hannibal area and an adjustment of ($81,852.13) for the Butler area related to the affiliated transactions between Atmos Energy Corporation and Atmos Energy Marketing, LLC (AEM). Affiliate transactions require greater scrutiny because they are not arms-length transactions and because there exists a natural conflict of interest to agree upon terms that result in the 1) greatest overall profit to the consolidated entity versus 2) best overall cost to the utility.

The gas supply transactions that Atmos entered into with its unregulated marketing affiliate, AEM, have raised serious doubts as to their reasonableness and prudency. The Staff has used information supplied by AEM as the basis for the fair market value of the underlying service received from AEM.

Atmos Corporate Structure

Atmos operates in many different state jurisdictions and aggregates its various state operations into larger divisions. The Missouri LDC operations are part of Atmos' Mid-States division and its Colorado-Kansas division. Atmos is the sole owner of Atmos Energy Holdings, Inc. which in turn is sole owner of AEM. Atmos, as the owner, establishes the corporate governance parameters for AEM. See Diagram 1 below, showing the structure. The profits of AEM flow to its parent, Atmos, which has ultimate decision making control over its LDC operations as well as its subordinate affiliates, including AEM.



Atmos' Opportunity and Incentive to Maximize Profits of its Unregulated Operations

Because Atmos may see a fiduciary duty to maximize its profits for its shareholders, including the profits of its unregulated affiliate AEM, there exists a built-in conflict between

Atmos' duty to maximize shareholder profits and its obligation to prudently obtain reasonably priced gas supplies for its regulated LDC operations. In addition, because senior Atmos management controls both sides of the LDC's – affiliate transaction, the Commission's Affiliate Rules provide for a higher level of scrutiny in the evaluation of affiliate transactions. Transactions between Atmos and its unregulated affiliate AEM are governed by the Commission's Affiliate Transaction rules 4 CSR 240-40.015 and 40.016.

Q. Why are arms-length transactions presumed to show fair market value but affiliate transactions do not?

A. Arms-length transactions are between two separate entities each with their own diverse interests to obtain the best terms for their respective entities. In contrast, the transactions between Atmos and AEM are not "arms-length" transactions. AEM and Atmos share limited resources on access to liquidity and counterparty credit exposures. The same cannot be said for unaffiliated transactions. At a higher management level in Atmos' organizational structure, there is common direction, organization, oversight, and control of both Atmos' LDC operations and the operations of AEM. (See Atmos organizational chart above). Both companies are controlled by a corporate parent that is interested in maximizing the profitability of unregulated operations. In point of fact, a passive approach by the LDC in reacting to cuts imposed by its affiliate supplier can work to the direct benefit of its affiliate and parent company by increasing profitability at the expense of ratepayers. This was illustrated in the last case, GR-2008-0364, where it had become apparent that as long as the LDC's storage was not drawn down to a critical stage, the LDC leveraged its storage to allow its affiliate supplier an extensive amount of leeway in fulfilling its nomination obligations to the LDC and other customers. That same scenario cannot be applied to unaffiliated transactions. For example, the time and quantity of day to day nominations can influence the profitability of affiliated AEM and Atmos transactions. As Staff explained in the previous ACA case, the fact that daily and monthly supplies are priced using different pricing mechanisms creates the possibility for AEM to extract profit from the Missouri LDC by optimizing the difference between the daily and the monthly market. Because of heightened risk exposure and the potential for supply disruptions, an unaffiliated supplier would tend to be risk averse to providing anything less than firm baseload and swing supplies.

<u>**Atmos' Compensation program aligns the interests of its regulated and nonregulated operations**</u>

Q. How are issues of pay structure and executive compensation relevant to this case?

A. The conflict of interest issue is illustrated by the alignment of Atmos and AEM management interests through a common compensation structure as shown from excerpts from Atmos Energy Corporation's 2009 Proxy Statement. As it relates to this testimony, Atmos describes in its Proxy Statement that earnings are a key driver in setting incentive compensation for Atmos executive management and that AEM earnings impact Atmos earnings.

> Annual Incentive Compensation. We believe it is important to provide our named executive officers with a <u>financial incentive</u> to maximize the Company's financial performance each year. Through our Annual Incentive Plan for Management ("Incentive Plan"), we provide our named executive officers, along with other officers, division presidents and other key management employees, an opportunity to earn an annual bonus based upon the Company's actual financial performance each year. The Incentive Plan, which has been designed to comply with Section 162(m) of the Internal Revenue Code, <u>is based on our ability to achieve a target level of earnings per share ("EPS") each year</u>. <u>The EPS performance measurement is the lynchpin of both our annual and long-term compensation programs</u>. The HR Committee believes that <u>EPS is the most appropriate measurement of our financial performance</u>

> both on an annual and long-term basis, as it reflects the growth of both our regulated and nonregulated operations. EPS is also one of the most well-known measurements of overall financial performance, which is commonly used by financial analysts as well as the investing public. The committee believes that utilization of this measurement as the basis for our incentive compensation programs aligns the interests of the participants in the Incentive Plan and the LTIP, including our named executive officers, with the interests of our shareholders (*emphasis added*).
>
> The target EPS goal also took into account earnings expected from our nonregulated operations, including earnings from the provision of natural gas management and marketing services to municipalities, other local gas distribution companies and industrial customers as well as the provision of natural gas transportation and storage services to certain of our natural gas distribution divisions and third parties (*emphasis added*).

The above proxy information indicates, from an auditor's perspective, a risk that affiliate transactions are more likely structured to increase Atmos profits than to provide the utility gas on the best terms available. The fact remains that Atmos management has a strong interest in maximizing the profits of its non-regulated operations that provide gas supply services to its regulated LDC operations. Gas supply audits must rely on the terms from non-affiliated transactions (related to the gas acquired to supply Missouri customers) to determine whether the costs requested to be charged through the ACA process are reasonable and prudent.

The Affiliate Transactions Rule Imposes Requirements That Provide Transparency

Staff's review of transactions between Atmos the LDC and its unregulated affiliate AEM considers whether such transactions provided a financial advantage to the affiliated entity to the detriment of customers of Atmos the LDC. While the Commission's Affiliate Transaction Rule, 4 CSR 240-40.015, Section (2)(A), is not the only basis for determining prudency of transactions, the rule states that a regulated gas corporation shall <u>not</u> provide a financial advantage to an affiliated entity. It further provides how such transactions are to be priced to prevent the passing of a financial advantage to an affiliate. The Rule's pricing standard requires the regulated entity to compensate the affiliate for goods or services at the <u>lesser</u> of the fair market price <u>or</u> the fully distributed cost to the regulated gas corporation to provide the goods or services for itself. In Staff's prudence review of Atmos' (the LDC) fair market value for a particular portfolio of gas supply, the Staff audit determines whether the LDC's fair market value is different than AEM's fair market value. In the event a difference exists, then Staff's audit determines whether any such difference can be justified. Staff found a difference of $401,226.61 between AEM's market value for gas supplied to Missouri and the price ultimately charged to Missouri.

Q. Please explain Staff's review of fair market value in this case.

A. The reason the Staff made the adjustment in this case is that the customers in the Hannibal and Butler areas should not have to pay more than "fair market value" for their gas. In most cases, fair market value is determined by review of an arms-length transaction with an unaffiliated supplier. When the LDC purchases its gas from its affiliate, the audit must apply a higher degree of scrutiny to examine the transaction to determine whether the LDC has conferred advantages or preferences to its affiliate to increase overall corporate profits that would not otherwise be available to an unaffiliated supplier. Moreover, the passing of an advantage or preference to the unregulated affiliate can create a situation where captive ratepayers are paying higher gas costs in order to subsidize shareholder profits. The request-for-proposal (RFP) process that is used to select the lowest bid among a pool of qualified bidders does not set the true fair market price / value of gas supplies that are provided *after* the bid has been let. There are several differences between the hypothetical gas costs that are used to rank bid offers and the ultimate invoiced cost of gas. The RFP relies on forecasted estimated First of Month (FOM) and Gas Daily Average (GDA) prices at index. Gas purchases use actual quantities of FOM baseload and swing. The ratio of nominated baseload to swing supplies can increase affiliate profits. Real price, quantities of gas nominated, the ratio of baseload to swing, and excessive reliance on storage can all work to confer profit advantages to the affiliate. A thorough review of the apples to oranges difference between estimated costs in bid evaluation and the actual costs incurred after the bid is awarded raises the larger question of the soundness of RFP design. This will be discussed later in testimony.

Q. What are the pertinent records that AEM is required to keep and provide to Staff under the requirements of the affiliate transaction rule?

A. The rule states:

> 6) Records of Affiliated Entities.
>
> (A) Each regulated gas corporation shall ensure that its parent and any other affiliated entities maintain books and records that include, at a minimum, the following information regarding affiliate transactions:
>
> 1. Documentation of the costs associated with affiliate transactions that are incurred by the parent or affiliate and charged to the regulated gas corporation;
>
> 2. Documentation of the methods used to allocate and/or share costs between affiliated entities, including other jurisdictions and/or corporate divisions;
>
> 3. Description of costs that are not subject to allocation to affiliate transactions and documentation supporting the nonassignment of these costs to affiliate transactions;

Q. What information did Atmos provide to support its compliance with the rule requirements for gas supply costs with its affiliate.

A. Atmos' position is that its RFP process sets the fair market value for a particular transaction. (Company responses to Data Requests 79 and 80). Staff contends that as part of its prudence review the Staff must inquire into the fair market value of what AEM actually paid for its gas supply and/or transportation because this information is relevant to determining Atmos' fair market value. In the past ACA case, Atmos has contended that fully distributed cost is not directly available because Atmos has no gas supply department capable of negotiating various types of supply with other marketers/producers to create a diversified supply portfolio. This raises a red flag to Staff because there are several key gas procurement functions performed by an LDC. These include but are not limited to financial hedging, peak day planning, acquisition of capacity agreements, nomination of supplies, storage monitoring, weather monitoring, end-use transport monitoring, imbalance tracking, and gas accounting functions. Sometimes Atmos avoids key gas procurement functions by issuing an RFP that includes a total asset management arrangement. In Missouri, the tendency has been for Atmos to bundle its RFP as a full-requirements supply (FOM baseload and swing gas) contract. The asset management agreement is less frequently used in Missouri by Atmos. Atmos RFP design raises the question: If an asset management agreement is designed to optimize the LDC's gas supply, whose obligation is it to optimize full-requirements gas supply deals? The LDC has, in fact, suggested in its RFP materials that it ** ____________ ________________________________ **. The Company from 2004 through 2006 consolidated many of its gas procurement services to another unregulated affiliate,

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Atmos Energy Services (AES). In the past several years, since 2007, Atmos has used its unregulated shared services function called "gas supply & services" on behalf of its LDCs.

The Company has made a management decision to issue formal and specifically structured RFPs in its Kentucky/Mid-States Division, which includes Missouri. Should the Company come forward in its testimony with an explanation of its fully-distributed cost, rather than its contention that fully distributed cost is not directly available, then Staff will address the Company's fully distributed cost in its testimony. The AEM information that Atmos provided to Staff was mainly limited to a spreadsheet that showed AEM's characterization of the revenues and costs associated with the Missouri affiliated gas deals.

<u>**AEM Documents Are Not Responsive to Staff's Inquiry**</u>

Q. Please discuss what Atmos has provided in the context of the above requirements.

A. Atmos has provided an after-the-fact AEM spreadsheet that aggregates AEM's supplies on the Panhandle Eastern Pipeline (PEPL) system. It also provided 1) transaction confirmations for some of these supplies; and 2) a sample of invoices related to those supplies. Other documents previously provided include a trader validation report and AEM's risk management policy, and a flow chart.

Q. Do you believe these documents are adequate to show that Atmos profits are not being subsidized through the affiliated gas purchases from AEM?

A. No. The AEM spreadsheet is an after-the-fact analysis prepared by AEM at Staff's request. AEM has not shown how the generic PEPL supplies were related to various deals or obligations to serve specific markets. AEM's spreadsheet did show it was **occasionally** using the ** ______________________________

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________________ **. AEM's pricing practice, in part, was responsible for producing some relatively large AEM profits because AEM charged its LDC a higher ** __________ ____ _____ **. These types of practices have the potential of feeding profits to Atmos shareholders at the expense of captive ratepayers. The Rule requires an assessment of all AEM costs associated with or allocated to the transaction. If AEM had provided this information to Staff, which it did not, AEM would be able to demonstrate its overhead costs at the time of the deal and Staff would be able to consider that information in its prudence review. Because AEM did not document its cost allocation methodologies or its pricing/trading, the Staff is unable to consider that information for possible reduction of the proposed disallowance.

<u>How Staff Determined its Proposed Disallowance</u>

Q. Please explain the gas supply at issue in this case.

A. For the 2008-2009 ACA period ending August 2009 Atmos had the following affiliated supply and Asset Management Arrangements (AMA). These agreements were executed between Atmos Energy Corporation (Atmos) and Atmos Energy Marketing, LLC (AEM).

1. The Hannibal/Canton supply-only agreement effective 4-1-08 to 3-31-09.
2. The Rich-Hume AMA effective 4-1-07 to 3-31-09 and 4-1-09 to 3-31-11
3. The Butler system supply-only agreement effective 11-1-07 to 10-31-08.

The Staff's proposed adjustments are for affiliated transactions between Atmos and AEM in the Hannibal area and the Butler area. .

The Hannibal/Canton supply agreement was effective from September 2008 until March 2009 during the ACA period. The Butler supply agreement was effective during the first 2 months of the ACA period. These are supply-only agreements, meaning that AEM provided the entire supply during the effective dates, but did not use Atmos' transportation or storage contracts under any Asset Management Agreements.

Q. What did Staff consider in its review of the gas supply for this ACA period?

A. In addition to the prudence standard, the Staff applied the affiliate transaction costing standards as required by the Commission's Affiliate Transaction Rules. These costing standards require Atmos the LDC to buy services from its affiliate at the lesser of fair market value or the LDC's fully distributed cost (4 CSR 240-40.015, Affiliate Transactions).

Q. How did Staff determine a disallowance in this case?

A. Staff determined the amount of its proposed disallowance based upon AEM workpapers for the fair market value of its own supplies. The Staff further adjusted the AEM assessment of its fair market value to correct for various inconsistencies in the original AEM calculation. These inconsistencies are described in detail in Schedule 3, but they essentially include corrections to AEM's Profit & Loss statement for its failure to include certain December 2008 supplies and its failure to reconcile the AEM spreadsheet sales volumes back to the AEM invoices to the LDC. The Staff supports this disallowance because it brings the costs passed through the ACA to a level that reflects the reasonable fair market value that is based on AEM's costs for whatever types of supply and transportation combinations that AEM has chosen to fulfill its firm sales contract with Atmos the LDC.

Q. Why has the Staff disallowance changed after the ACA recommendation was filed 12/30/10?

A. Staff's recommendation in the 2008-2009 Actual Cost Adjustment Filing, dated December 30, 2010, contained a recommended disallowance of $495,017. A Staff check of the workpapers lowered the recommended disallowance to $491,206.40 because of 1) minor rounding differences, 2) a reduction for December 2008 because of recalculation for missing AEM December 2008 information and 3) a reduction for February 2009 because of reconsideration of cost of gas (used in both baseload supply packages to calculate the WACOG) . This calculation is shown as Revision 1 in the Staff workpapers. Revision 1 was made prior to Staff's receipt of AEM's corrected prices and volume information for December 2008.

Staff revised its recommendation by using a different methodology of allocating the AEM supply purchases to cover the Atmos purchases for each month. In Staff's revision the AEM baseload gas purchases are assigned to serve the LDC's baseload purchases and the AEM daily gas purchases are assigned to serve the LDC's swing purchases. In instances where there are not enough daily purchases to serve the LDC's swing volume requirements, the remainder was priced at baseload prices because the AEM baseload volumes were sufficient to cover the remaining balance for the volumes supplied to the LDC. This revised methodology *lowers* the recommended disallowance to $434,314.81. This calculation is shown as Revision 2 in the Staff workpapers and was made prior to Staff's receipt of AEM's corrected prices and volume information for December 2008.

Revision 3 in the Staff workpapers updates Revision 2 for the AEM supplemental price and volume information for December 2008, received by Staff 4/29/11. It lowers the recommended disallowance to $401,226.61.

Staff workpapers are included as Schedule 3.

Q. During the traditional ACA process in Missouri, does the Company file testimony accompanying its initial ACA filing?

A. No. The vast majority of issues that could be raised in an ACA do not rise to the level of requiring a hearing, and many ACA dockets close without the need for a procedural schedule. Only when there is a serious disagreement regarding an adjustment to the ACA balance is a procedural schedule set by the Commission.

In the process of making its ACA recommendation, the Staff has raised the question of the prudency and the reasonableness of Atmos' gas supply transactions with its unregulated affiliate AEM. At the time the Company filed its ACA and the Staff subsequently filed its recommendation, the Company had not provided any information that demonstrates that AEM brought any special skills or value-added capability to Atmos LDC gas purchasing. Atmos, the largest LDC in the United States, is capable of making natural gas purchases and could have acquired the gas supply for itself rather than through AEM. Atmos has not demonstrated that a markup above AEM's cost is just and reasonable.

Q. Why is there no disallowance, as in the last case, related to the prudency of Atmos decisions regarding supply cuts?

A. The Staff is still concerned about Atmos' follow-up with its supplier when the supplier fails to perform. ** ____ ________________________________ **. However, after examining the duration and materiality of those cuts, the Staff is not proposing a disallowance related to supply nominations and cuts in this case. Had the weather been different, had the LDC deviated from its Gas Supply Plan Procedure, or had there been pipeline ruptures, the resulting supply and the impact to the LDC may have been different. That fact that Staff is not proposing a prudence adjustment related to supply cuts in this case does not cause Staff's concerns to go away.

<u>Staff Questions the Value of AEM's Supply Services</u>

Q. What factors other than cost does Staff consider in evaluating the value of the gas supply provided by the affiliate?

A. Staff's recommend adjustment is based on the information provided by AEM. The chief reason why Staff has inquired into the fair market value of the gas supplies that AEM provided to Atmos (the LDC) is that it is possible for AEM to use high risk interruptible or spot gas, in addition to interruptible transportation, or other risk-taking measures to fulfill its firm service obligation with Atmos the LDC.

Q. Why do you make this distinction?

A. The fair market value for <u>firm</u> gas supplies is higher than the market value for interruptible or spot gas supplies with interruptible transportation. Firm gas supplies and firm transportation represent the highest quality and most dependable level of service that can be provided to captive ratepayers. If an affiliated gas supplier assembles a patchwork of interruptible spot gas and transportation and then sells it to the utility under its "firm" contract obligation, then captive ratepayers would not be getting the level of service and reliability that they are paying for - truly firm gas service. A further technique that may be available to an affiliated marketer that is not available to unaffiliated suppliers is the use of a "credit sleeve". A "credit sleeve" describes a situation where a supplier that would not qualify for the LDC's credit requirements is approved for the affiliate marketer's portfolio. The marketer may not pass the risk or rewards of dealing with that self-same counterparty, allowing the Company to leverage supplier risk and create a "value play". The Staff is not alleging that a type of "credit sleeve" has taken place in this instance, but offers this explanation to illustrate one of many practices that make Staff's scrutiny of the affiliated marketing company's fair market value relevant to its prudence analysis.

Further serious doubt regarding the prudence of the transactions between Atmos and AEM is raised by AEM's P&L spreadsheet because it shows AEM's fair market value for gas supply was much <u>less</u> than what it charged its regulated parent Atmos. This raises the question: Why can't Atmos LDC buy the same gas supplies at the same pricing from the same suppliers that AEM buys from in a competitive market at "arms length"?

Q. Is this the same affiliate issue as in Case No.GR-2008-0364?

A. Yes. The supply contracts with the affiliate started in the GR-2008-0364 case and continue in this case.

<u>Atmos Gas Supplier and RFP Process</u>

Q. Did Atmos use an RFP process to obtain this supply?

A. Yes. Atmos issued a Request For Proposal (RFP) for its gas supply needs for the Actual Cost period under review. Atmos awarded contracts to its affiliate Atmos Energy Marketing (AEM) in the Missouri service areas.

Q. Please discuss the Atmos RFP process.

A. At the outset, I reemphasize that an RFP bid-letting process alone does not set the fair market value/price of supplies. The RFP process may assist in a determination of the fair market value, but it is not dispositive. The RFP evaluations use hypothetical volumes, forecasted index prices, and assumptions about ratios of swing to baseload gas. An evaluation of RFP bid responses does not represent the actual gas costs that appear on invoices. Furthermore, based on Staff's evaluation of the reduced number of conforming bidders that have responded to the Hannibal/Bowling Green RFP over several past RFP periods, the Staff has serious concerns over the purported robustness of Atmos' RFP process and Atmos' business model that calls for whole-requirements (combined FOM baseload and daily priced swing gas) bidding.

Q. Please explain.

A. In recent RFP periods the number of ** ______________________________ ___ **. This is an indication that the RFP process may not be as robust as alleged. Possible reasons for this include:

A) ** ____
____
____
____
____
____
____
__________________________________ **.

B) ** ____
________ ____
____ **.

C) Illinois experience is similar to the Missouri experience –Illinois has voiced concerns over RFP design and has also experienced lengthy contested ACA /affiliate transactions proceedings.

D) ** ____
____
____
___________________________ **.

Q. You previously mentioned the firmness of the supply; do you have other concerns here?

A. Yes. As discussed in the previous case, ** ________________________ ____ **. This practice is not consistent with an LDC's expectation of acquiring and locking in some baseload supply in advance of winter and providing supply and pricing stability to ratepayers during the coldest months of the winter. Staff's examination of some of the underlying

AEM/AEC contracts revealed further causes of concern for reliability of supply: 1) the contract's service level was left blank instead of indicating firm, 2) the contract's delivery point required a haven delivery but in reality used a constrained downstream secondary point, and 3) the contract did not include nomination deadlines.

Q. Are there any other issues regarding how Atmos chooses its gas supply and the implications of those decisions on fair market value?

A. A major policy issue related to Atmos' RFP process and the determination of fair market value is the question of how AEM's choice of gas suppliers and types of supply, and the risks inherent in those types of supply, may impact the prices ultimately paid by Atmos' customers. These matters raise serious questions during Staff's prudence review of the LDC's gas supply decisions in its transaction with its affiliate AEM. For example, are the AEM suppliers the same suppliers that lost the bid in the original Atmos RFP process? If the AEM suppliers are different than the suppliers bidding into the Atmos RFP process, then why don't the AEM suppliers respond to Atmos' RFPs? Staff's prudence review of Atmos' gas supply decisions is thwarted and incomplete without answers to these questions.

To further explain the reasons behind Staff's concerns, consider the following example: Assume that suppliers A, B, and C, are simply not bidding into Atmos' RFP, but they routinely supply AEM. In examining Atmos' purchases for prudence, Staff can not overlook the fact that Atmos' LDC gas supply department and AEM brokers are soliciting the same gas suppliers and the same transportation markets. AEM profits on buying gas more cheaply than it sells it. AEM's profits go to Atmos' shareholders. In turn, Atmos (the LDC) passes its gas costs to the ratepayer. Staff's prudence review is driven by its concern that Atmos and AEM are dealing fairly and transparently in a manner that assures 1) Missouri's captive ratepayers are paying the lowest reasonable total cost for firm gas supplies, 2) Atmos has obtained the lowest reasonable cost for firm gas supplies for its consumers, and 3) that ratepayers are receiving the reliability of the firm gas supplies and firm transportation that they are paying for.

Atmos RFP Process in Other States

Q. Are you aware of whether Atmos conducts affiliated transactions with AEM in other states?

A. Yes. In addition the Staff has monitored recent Atmos' transactions with AEM in the states of Kentucky, Tennessee, Georgia, Kansas, Virginia, and Illinois where Atmos provides regulated gas service.

SUMMARY

Q Why does Staff consider an adjustment to the invoiced cost of gas necessary in this case?

A. As previously discussed, the disallowance is necessary due to the unavailability of detailed AEM records/procedures of how AEM allocates the costs associated with its supplies. In addition there is no AEM evaluation of the economics of the deal. Staff considers this unusual because publicly available statements from Atmos indicate that AEM monitors risk and maintains a flat trading book and does not engage with speculative trading. My understanding of the practice of keeping a "flat book" is that the marketer attempts to match its exposure to price increases and decreases by closely matching the volume and price risk of its purchases (supply) with the volume and price risk of its sales (markets).

In addition, Atmos has provided no compelling reason why AEM is able to buy cheaper supplies than its LDC gas purchasing function. The main reason Atmos claims that its affiliate AEM can buy cheaper supplies is because of its marketer expertise. The Company's argument seems to be that the LDC does not have the expertise to buy gas directly from suppliers – a business model chosen and implemented by Atmos. This is inconsistent with Atmos' declaration that it is the largest natural-gas-only distributor in the United States. It is inconsistent with the fact that in evaluating the design and operation of its boilerplate RFP, Atmos must have expertise to evaluate and deal directly with the same suppliers that are serving its affiliate AEM.

In summary, the proposed disallowance results from the Company's own failure to fully comply with the record-keeping requirements of the Affiliate Rules and its inability to explain the reasonableness of its affiliate transaction.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Atmos Energy Corporation's	)	
Purchased Gas Adjustment	)	File No. GR-2009-0417
	)	
	)	

AFFIDAVIT OF DAVID M. SOMMERER

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David M. Sommerer, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 22 pages to be presented in the above case; that the answers in the foregoing Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

David M. Sommerer

David M. Sommerer

Subscribed and sworn to before me this 2nd day of June, 2011.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public

CASES WHERE TESTIMONY WAS FILED

DAVID M. SOMMERER

COMPANY	CASE NO.	ISSUES
Atmos Energy Corporation	GR-2008-0364	Affiliated Transactions
Missouri Gas Energy	GR-2009-0355	PGA tariff
Laclede Gas Company	GT-2009-0026	Tariff Proposal, ACA Process
Missouri Gas Utility	GR-2008-0060	Carrying Costs
Laclede Gas Company	GR-2007-0208	Gas Supply Incentive Plan, Off-system Sales, Capacity Release
Laclede Gas Company	GR-2005-0284	Off-System Sales/GSIP
Laclede Gas Company	GR-2004-0273	Demand Charges
AmerenUE	EO-2004-0108	Transfer of Gas Services
Aquila, Inc.	EF-2003-0465	PGA Process, Deferred Gas Cost
Missouri Gas Energy	GM-2003-0238	Pipeline Discounts, Gas Supply
Laclede Gas Company	GT-2003-0117	Low-Income Program
Laclede Gas Company	GR-2002-356	Inventory, Off-System Sales
Laclede Gas Company	GR-2001-629	Inventory, Off-System Sales
Laclede Gas Company	GR-2001-387	ACA Price Stabilization
Missouri Gas Energy	GR-2001-382	ACA Hedging/Capacity Release
Laclede Gas Company	GT-2001-329	Incentive Plan
Laclede Gas Company	GO-2000-394	Price Stabilization
Laclede Gas Company	GT-99-303	Incentive Plan
Laclede Gas Company	GC-99-121	Complaint PGA
Laclede Gas Company	GR-98-297	ACA Gas Cost
Laclede Gas Company	GO-98-484	Price Stabilization
Laclede Gas Company	GR-98-374	PGA Clause

COMPANY	CASE NO.	ISSUES
Missouri Gas Energy	GC-98-335	Complaint Gas Costs
United Cities Gas Company	GO-97-410	PGA Clause
Missouri Gas Energy	GO-97-409	PGA Clause
Missouri Gas Energy	GR-96-450	ACA Gas Costs
Missouri Public Service	GA-95-216	Cost of Gas
Missouri Gas Energy	GO-94-318	Incentive Plan
Western Resources Inc.	GR-93-240	PGA tariff, Billing Adjustments
Union Electric Company	GR-93-106	ACA Gas Costs
United Cities Gas Company	GR-93-47	PGA tariff, Billing Adjustments
Laclede Gas Company	GR-92-165	PGA tariff
United Cities Gas Company	GR-91-249	PGA tariff
United Cities Gas Company	GR-90-233	PGA tariff
Associated Natural Gas Company	GR-90-152	Payroll
KPL Gas Service Company	GR-90-50	Service Line Replacement
KPL Gas Service Company	GR-90-16	ACA Gas Costs
KPL Gas Service Company	GR-89-48	ACA Gas Costs
Great River Gas Company	GM-87-65	Lease Application
Grand River Mutual Tel. Company	TR-87-25	Plant, Revenues
Empire District Electric Company	WR-86-151	Revenues
Associated Natural Gas Company	GR-86-86	Revenues, Gas Cost
Grand River Mutual Telephone	TR-85-242	Cash Working Capital
Great River Gas Company	GR-85-136	Payroll, Working Capital
Missouri-American Water Company	WR-85-16	Payroll

SCHEDULE 2

HAS BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

SCHEDULE 3

HAS BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY