Atmos Energy Corporation Municipal Gas Rate Case

City Council Briefing

September 20, 2006

Purpose

- Advise Council of:
  - Atmos Energy Corporation's Statement of Intent to Change Rates in the Atmos Energy Corp., Mid-Tex Division Gas Utility System
  - Consultant's findings
  - And City Manager's recommendation

Background

- Franchise Ordinance authorizes Atmos Energy Corporation (Atmos) to provide natural gas utility service in Dallas
- Gas Utilities Regulatory Act (GURA) and Franchise Ordinance
  - City has original jurisdiction for distribution rates
  - The Texas Railroad Commission (RRC) has appellate jurisdiction

Background (Continued)

- Gas bill components
  - City Gate Rate usage charge
    - Approved by RRC
    - Cost from producer and transmission company to City limits
    - Includes the cost of gas
    - The Gate Rate typically comprises 70% of residential charges and 80% of commercial charges

Background (Continued)

- Local distribution charges
  - Approved by City
  - Charges for distribution from “City limits” to customers
  - Monthly customer charge
  - Local usage charge

Background (Continued)

- Four billing classes
  - Residential
  - Commercial
    - Businesses and apartments with gas for common use
  - Industrial
    - Contract for a minimum of 125 Mcf per month
    - Service may be interrupted in extreme conditions
  - Transport
    - Fee charged to transport gas between two other parties

Background (Continued)

- Rate setting process
  - On May 31, 2006 Atmos filed its notice of intent to increase gas rates
  - Original period of 35 days to render decision or extend the deadline an additional 90 days (125 days total)

Background (Continued)

- Current Rates
  - Rates currently being charged by Atmos were set by the Railroad Commission of Texas in GUD 9400
    - Rates were set on a system wide basis
  - GUD 9400 is presently on appeal in Travis County District Court
    - The City of Dallas is participating in that appeal

Background (Continued)

- Current Rates also include thee Gas Reliability Infrastructure Program (GRIP) increases
  - GRIP allows interim rate increases based on increases in net investment in plant
  - City denied each of the GRIP adjustments
  - RRC granted the GRIP adjustments on appeal
  - GRIP increases only affect the customer charge

Current Filing

- Atmos has filed this case with the RRC and the 440 incorporated cities in its service area
  - The City has original jurisdiction on the distribution rates within the corporate limits
  - The RRC has original jurisdiction in environs and unincorporated areas and appellate jurisdiction over the city’s rates

Current Filing Continued

- Atmos has requested that the City either deny the rate request or defer jurisdiction to the RRC
  - Atmos has indicated that it will appeal any municipal decision to the RRC in order to maintain system wide rates
  - Other cities have already denied the rates and the rates are on appeal at the RRC (GUD 9670)

Current Filing Continued

- Atmos is seeking an increase in revenues of $60.9 million from all ratepayers
  - Residential Base revenue would increase 24.32%
  - Commercial Base revenue would increase 7.77%
  - Industrial/Transportation Base revenues would decrease 55.94%
  - Service charge rev. would remain unchanged
  - Total Base revenue would increase 16.59%

Current Filing Continued

- Atmos has not provided any Dallas specific data as required by the City Rate Filing Package
- Atmos has indicated they will appeal any City rate order to the RRC so as to obtain uniform statewide rates

Current Filing Continued

- Staff and outside legal counsel have determined that it is appropriate for the City to set rates in this matter
- The City retained Diversified Utility Consultants to review the rate filing and recommend rates to be set by the City

Consultants' Findings

- Diversified Utility Consultants, Inc. (DUCI) issued its report to the City on September 12, 2006 (copy attached)
- DUCI identified several areas of concern with the rate request

Consultants' Findings Continued

- Accumulated Deferred Income taxes (ADIT):
  - ADIT reduce the amount of investment upon which the utility earns a return
  - When Atmos purchased the system from TXU, ADIT was not transferred to Atmos
  - The merger should not have a negative impact on rate payers
  - ADIT must be recaptured to the prior level

Consultants' Findings Continued

- Cash Working Capital (CWC)
  - In the prior case, the company requested a negative CWC
  - RRC ordered a negative CWC over $60 million in GUD 9400
  - Atmos is requesting a positive CWC in this filing
    - Request is based on new and flawed approaches to the calculation

Consultants’ Findings Continued

- Atmos Shared Services Division
  - Provides corporate overhead activities including billing to all operating divisions of Atmos Energy
  - The amount of the expense and the allocation to Dallas and the Mid-Tex Division are excessive

Consultants’ Findings Continued

- Other Expense Adjustments
  - Significant adjustments were made in relation to contract expenses, marketing, and uncollectible expenses
  - Numerous smaller adjustments were required to make the level of expenses reasonable and necessary

Consultants' Findings Continued

- Depreciation Expense
  - Atmos requested an increase in net negative salvage
  - Atmos requested over a 100% increase in depreciation rates for the Shared Services Division
  - Such increases are unwarranted and not justified

Consultants' Findings Continued

- Taxes other than income tax
  - Rates as filed do not take into account the impact of recent legislation reducing property taxes
  - Revenue related taxes must be reduced due to the other adjustments to the rate filing

Consultants' Findings Continued

- Rate of Return
  - Company requested a rate of return on equity of 11.75%
  - Consultant recommends a rate of return on equity of 9%

Consultants' Findings Continued

- The combination of the various rate base, return and expense adjustments results in a rate decrease being warranted
- A base rate decrease of approximately 13.8% is warranted based on these adjustments
  - Rates are contained in the following table

Consultants' Findings Continued

DALLAS DISTRIBUTION SYSTEM

COMPARISON OF PRIOR, CURRENT AND PROPOSED

<u>TARIFF RATES FOR RESIDENTIAL CUSTOMERS</u>

	Rates Prior to GUD 9400	Current Rates*	Atmos Energy Requested Rates	Consultant Recommended Rates
Customer Charge	$8.50	$10.09	$13.50	$9.05
Consumption Charge				
First 3 Mcf	$0.6262	$1.2390	$3.5460	$0.5846
Over 3 Mcf	$0.6262	$0.9890	$0.3460	$0.5846

Consultants' Findings Continued

DALLAS DISTRIBUTION SYSTEM

COMPARISON OF PRIOR, CURRENT AND PROPOSED

TARIFF RATES FOR COMMERCIAL CUSTOMERS

	Rates Prior to GUD 9400	Current Rates*	Atmos Energy Requested Rates	Consultant Recommended Rates
Customer Charge	$14.75	$19.18	$30.00	$18.50
Consumption Charge				
First 20 Mcf	$0.6042	$0.7894	$1.2860	$0.5944
Next 10 Mcf	$0.6042	$0.5394	$0.1000	$0.5944
Next 20 Mcf	$0.5079	$0.5394	$0.1000	$0.4997
Next 300 Mcf	$0.5079	$0.2894	$0.1000	$0.4997
Over 350 Mcf	$0.3827	$0.2894	$0.1000	$0.3766

Consultants' Findings Continued

DALLAS DISTRIBUTION SYSTEM

COMPARISON OF PRIOR, CURRENT AND PROPOSED

<u>TARIFF RATES FOR INDUSTRIAL CUSTOMERS</u>

	Rates Prior to GUD 9400	Current Rates*	Atmos Energy Requested Rates	Consultant Recommended Rates
Customer Charge	$200.00	$301.96	$430.00	$285.00
Consumption Charge				
First 1,500 MMBTU	$0.3417	$0.4882	$0.1400	$0.2252
Next 3,500 MMBTU	$0.2948	$0.3382	$0.0350	$0.1942
Next 45,500 MMBTU	$0.2435	$0.1882	$0.0100	$0.1602
Over 50,000 MMBTU	$0.1868	$0.0382	$0.0100	$0.1242

Options Available to City

1. Approve rates requested by Atmos
2. Set rates as recommended by DUCI
3. Set rates at some other level
4. Deny the rate increase (current rates would remain in effect)
5. Take No action (rates as requested would be deemed approved)

City Manager’s Recommendation

- Adopt rates as recommended by Consultant

What’s Next

- September 27, 2006 – Adopt Ordinance setting rates for Atmos
- October 3, 2006 – Deadline to take action on rates or they become approved by operation of law

DUCI

DIVERSIFIED UTILITY CONSULTANTS, INC.
12113 ROXIE DRIVE, SUITE 110, AUSTIN, TX 78729
TELEPHONE (512) 257-2600 FAX (512) 257-2243

September 12, 2006

Mr. Nick Fehrenbach
City Controller's Office, City of Dallas
1500 Marilla Street, 4F North
Dallas, Texas 75201

Re: Dallas Distribution Rates

Dear Mr. Fehrenbach:

In accordance with the City of Dallas' ("City") request, Diversified Utility Consultants, Inc. ("DUCI") has developed base rate distribution tariff charges for the residential, commercial and industrial classes within the Dallas Distribution System. The Dallas Distribution System corresponds to the system previously identified by Atmos Energy Company ("Company") and its predecessors, TXU Gas and Lone Star Gas, prior to Railroad Commission of Texas ("RCT") in Gas Utility Division Docket No. 9400 ("GUD 9400").

The City has historically set local gas distribution base rates based on the specific plant in service and specific costs to operate within the Dallas Distribution System, as well as certain allocated cost. The Dallas Distribution System historically was comprised of the City, Highland Park, University Park, the City of Cockrell Hill, and customers in the surrounding environs.

The City has historically taken its regulatory responsibility very seriously and has reviewed in detail the Company's prior rate requests. The combination of the detailed historical regulatory reviews and the fact that the City represents probably the most dense customer concentration for the Company's Mid-Tex operating division, has historically resulted in customers within the Dallas Distribution System paying some of the lowest rates in the entire Mid-Tex Division. In particular, the density of customers per mile of distribution mains results in a lower per-unit cost for the Company to recover its Dallas Distribution System revenue requirement. Further, the significant density of the Dallas Distribution System should result in the need for fewer employees to serve the same number of customers elsewhere on the Mid-Tex Division because such employees do not need to travel as far to operate and maintain the system.

Unfortunately, in GUD 9400, the RCT adopted the position taken by the Company, and most other cities served by the Company, that a state-wide rate was appropriate. Most other cities, and customers throughout the service territory of the Company, received the benefits that had been previously paid for by the City's customers. In other words, if the City's rates were approximately 25% below the entire Mid-Tex Division average before GUD 9400, and if GUD 9400 did not result in an increase on a statewide basis, rates to customers within the City would increase by 25%. To offset this substantial increase for the City of Dallas, customers in most if not all other cities within the Company's Mid-Tex Division would experience rate decreases.

In GUD 9400, the City submitted testimony based upon the Dallas Distribution System stand-alone revenue requirement. As would be expected, the Dallas Distribution System stand-alone cost of service, prior to any adjustments, resulted in a substantial decrease in revenue requirements compared to the Company's proposed increase.[1] In this case, DUCI started with the relationship developed for Dallas Distribution System stand-alone revenue requirement in GUD 9400 to estimate what the current rate should be to the Dallas Distribution System customer.

Once a set of rates that reflects the continuation of the stand-alone Dallas Distribution System was developed, it was still necessary to develop rates reflective of the new revenue requirement based on the City's current show-cause rate proceeding and the current rate increase request before the City.

DUCI has identified numerous issues that require adjustment in the Company's current filing. These issues include adjustments to operation and maintenance expense, administrative and general expense, depreciation expense, taxes other than income tax, federal income taxes, rate base and the overall level of return requested by the Company.

In the area of rate base, the most significant issue is the recapture of Accumulated Deferred Income Taxes ("ADIT"). ADIT are non-investor supplied capital that serve to reduce the amount of investment upon which the utility earns a return. When Atmos Energy purchased the local distribution system from TXU Gas, it elected to employ an accounting method that resulted in a tax recognition of the sale. The ADIT were lost. Given that the merger should not have had any negative effects on customers, it is necessary to recapture the prior level of ADIT that customers have historically paid. A second significant rate base issue is cash working capital. In the prior rate case, the Company not only filed for a significant negative cash working capital, but the RCT ultimately approved an even greater negative cash working capital, over $60 million. The Company's current case seeks a positive level of cash working capital based on new and flawed approaches to the calculation.

The largest expense adjustment is associated with the Company's Shared Services Division. This division provides the corporate overhead activities including billing to all operating divisions of Atmos Energy. The problem is the amount of the expenses, as well as the allocation of the cost to Dallas and the Mid-Tex Division. Other significant adjustments in the area of expenses are associated with labor, contract expenses, marketing, and uncollectible expenses. There are several other smaller dollar adjustments required to reflect a level of expenses that are reasonable and necessary.

The Company's request for depreciation expense is also excessive. The Company has requested an increase in net negative salvage, which is unjustified.[2] In addition the Company requested a

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[1] Schedule (DJL-17) in GUD 9400 identified a $14.4 million annual reduction in rates to Dallas Distribution System customers if statewide rates had not been filed.

[2] Net negative salvage represents a situation where cost of removal exceeds gross salvage when plant is retired.

significant increase in depreciation rates for its Shared Service division. The request represents an increase of over 100% compared to existing depreciation rates. Such increases are unwarranted.

In the area of Taxes Other Than Income Taxes, the company fails to recognize the impact of the recently passed Texas legislation reducing property taxes. In addition, other revenue related taxes decline in association with the previously noted reduction to revenue requirements attributable to both expenses and rate base being reduced.

The final area of adjustment is the Company's requested rate of return. The Company has requested a 11.75% return on equity. Alternatively, a 9% return on equity is more appropriate. There are also concerns associated with the Company's capital structure and the creation of phantom return through other activities.

The combination of the various rate base, return and expense adjustments results in a rate decrease being warranted at this time. In fact, a base rate decrease of approximately 13.8% is warranted, based on the above noted adjustments.

A rate decrease is both logical and consistent with the claimed benefits associated with the recent purchase of the system. In addition, Atmos Energy is now the largest local distribution company in the nation. This should result in a lower per-unit cost to provide the corporate overhead services that are required to efficiently operate a local gas distribution company. In other words, customers should receive the benefits of economies of scale, rather than being subjected to inappropriate charges and requests in what appears to be the Company's attempt to recover the premium it paid for TXU Gas. While the Company has not directly asked for an acquisition adjustment, [3] many of its other requests that are overreaching appear to be made in an attempt to compensate for such overpayment.

The combination of unreasonable requested expenses, overstated investment, excessive levels of return, and maintaining a Dallas Distribution System and its corresponding rate benefits, along with the 13.8% rate reduction recommended in association with the current rate filing, results in rates for the Residential, Commercial and Industrial classes as set forth on Attachment 1. The recommended rates represent an approximate 25%, 11%, and 33% reduction for the Residential, Commercial, and Industrial customer classes, respectively from existing base rates. In addition, the net change for the entire Dallas Distribution System is a slight increase compared to the rates in effect prior to GUD 9400.

If you have any questions regarding this matter, please do not hesitate to contact DUCI. We are prepared to discuss the information contained within this letter report with the City as requested.

Sincerely,

Jacob Pous

[3] An acquisition is an adjustment to recover the amount paid in excess of book value from customers.

DALLAS DISTRIBUTION SYSTEM
COMPARISON OF PRIOR, CURRENT AND PROPOSED
TARIFF RATES FOR VARIOUS CUSTOMER CLASSES

	Rates Prior To GUD 9400	Current Rates*	Proposed Rate
Residential			
Customer Charge	$8.50	$10.09	$9.05
Consumption Charge			
First 3 Mcf	$0.6262	$1.2390	$0.5846
Over 3 Mcf	$0.6262	$0.9890	$0.5846
Commercial			
Customer Charge	$14.75	$19.18	$18.50
Consumption Charge			
First 20 Mcf	$0.6042	$0.7894	$0.5944
Next 10 Mcf	$0.6042	$0.5394	$0.5944
Next 20 Mcf	$0.5079	$0.5394	$0.4997
Next 300 Mcf	$0.5079	$0.2894	$0.4997
Over 350 Mcf	$0.3827	$0.2894	$0.3766
Industrial & Transportation			
Customer Charge	$200.00	$301.96	$285.00
Consumption Charge			
First 1,500 MMBTU	$0.3417	$0.4882	$0.2252
Next 3,500 MMBTU	$0.2948	$0.3382	$0.1942
Next 45,500 MMBTU	$0.2435	$0.1882	$0.1602
Over 50,000 MMBTU	$0.1868	$0.0382	$0.1242

NOTE: Consumption blocks have been added as necessary to permit comparison to the current rate structure billed to customers.

* Rates taken from Schedule J of GUD 9767 and reflect the impact of GRIP filings.