

Direct Testimony

of

David Rearden

Policy Program

Energy Division

Illinois Commerce Commission

Reconciliation of Revenues Collected Under Gas Adjustment Charges
With Actual Costs Prudently Incurred

Atmos Energy Corporation

Docket No. 05-0738

March 27, 2007

1 **Q: Please state your name, job title and business address.**

2 **A:** My name is David Rearden and I am a Senior Economist on the Staff of
3 the Illinois Commerce Commission (“Staff”) in the Policy Program. My
4 business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

5 **Q: Please outline your education.**

6 **A:** I have a Ph.D. (1991) in economics (specialties in econometrics and
7 microeconomic theory) from the University of Kansas. I received a
8 Bachelor’s in economics and history from Eastern Illinois University in
9 1982, and studied economics at the Southern Illinois University graduate
10 school from 1982-1984.

11 **Q: Please state your work background.**

12 **A:** Before joining Staff, I was a Manager of Regulatory Policy for Sprint
13 Corporation (“Sprint”) from 1998 until 2001. I wrote and defended
14 testimony before state regulatory commissions, helped develop policy for
15 Sprint, provided analysis and advice for the business units and supported
16 other aspects of Sprint’s external affairs activity.

17 I was a Managing Regulatory Economist at the Kansas Commerce
18 Commission from 1994 until 1997. I wrote and defended testimony on
19 both energy and telecommunications issues. I was promoted to Chief of
20 Rate Design and Managing Telecommunications Economist in 1997. I
21 supervised five employees that analyzed rate design for regulated energy

22 companies in Kansas including purchased gas adjustment (“PGA”)
23 proceedings.

24 I taught economics at the undergraduate and graduate levels at the
25 University of Kansas (1992-1994) and Cleveland State University (1990-
26 1992). Besides introductory and basic intermediate courses, I taught
27 public finance, econometrics and graduate level microeconomics.

28 **Q: Have you filed testimony in Illinois before?**

29 **A:** Yes, I prepared written testimony several times, and I have appeared on
30 the stand for cross examination in Docket Nos. 01-0706 and 01-0707, the
31 2001 fiscal year PGA reconciliations for North Shore Gas Company and
32 Peoples Gas Light and Coke Company, respectively.

33 **Q: Have you appeared or testified before other public utility**
34 **commissions?**

35 **A:** I have filed written testimony or affidavits or appeared before the public
36 utility commission in California, Florida, Georgia, Kansas, Kentucky,
37 Nebraska, New Jersey, New York, Puerto Rico, Vermont and Wisconsin. I
38 have also written comments in several other states.

39 **Q: What is the purpose of your testimony in this proceeding?**

40 **A:** I evaluate the prudence of Atmos Energy Corporation’s (“Atmos”) contract
41 with its marketing affiliate, Atmos Energy Marketing LLC (“Atmos
42 Marketing”). Based on Staff’s opinion that the contract is imprudent, I

43 propose a disallowance to correct for costs that were not prudently
44 incurred.

45 **Q: Please describe the contract.**

46 **A:** Atmos pays a fixed demand charge that grants it the right to nominate a
47 fixed quantity up to 4,700 Dth per day each month. That is, the utility tells
48 Atmos Marketing a fixed amount that it will purchase from Atmos
49 Marketing at a monthly price. For that nominated supply, it pays the
50 *Inside Ferc* TETCO East Texas (“ETX”) first-of-the-month (“FOM”) index
51 price plus 55¢ plus pipeline transportation costs and fuel. There is also a
52 swing component to the contract that permits Atmos to buy gas above the
53 nominated amount. That incremental supply is priced at *Gas Daily’s*
54 TETCO East Louisiana (“ELA”) daily price index. There is a ten day call
55 during the summer months that permits the utility to purchase additional
56 supplies at the ELA daily price. Finally, in return for an additional demand
57 charge, Atmos has a 10-day call during the winter for up to 2,900 Dth per
58 day at the ELA daily price.

59 **Q: Please describe the last three years of the contract.**

60 **A:** Beginning in November 2003, Atmos Marketing (the former Woodward
61 Marketing) entered into annual contracts with its utility affiliate, Atmos.
62 Each contract started in November and continued through the following
63 October. Attachment A outlines the prices, charges and volumes of each
64 of three successive one-year contracts. Note that for the first two

65 contracts, Atmos did not pay more than the TETCO ETX FOM price index
66 for nominated, firm volumes. The last contract uses the same index as
67 the previous two years for purchasing nominated volumes, but it adds a
68 large markup over the index.

69 The first contract did not grant call rights to the utility, but the second
70 contract contained a 10-day call. A “call” is a right to buy at a specified
71 price, called a strike price. A 10-day call grants that right for ten days
72 during some period of time. The call in the second contract permitted the
73 utility to buy supply above the maximum daily quantity at the daily TETCO
74 ELA price for ten days during the entire year. The third contract restricted
75 that right to the summer only, and added a new peaking service available
76 for only ten days during November through March. But the strike price
77 was the same as the second year contract’s ten-day call (daily TETCO
78 ELA).

79 There is only one change in the move from the second to the third contract
80 that reduces gas costs. The maximum daily quantity is lower, which in
81 turn reduces the demand charge. However, the third contract adds 55¢ to
82 the TETCO ETX FOM price. This negates the lower demand charges at
83 very low nominations (at approximately 815 Dth per day). In other words,
84 for nominations greater than 815 Dth per day, the increase in costs from
85 the adder to the FOM index price is greater than the decrease in demand
86 charges. During the 2005 fiscal year, average daily deliveries were

87 slightly below 1,200 Dth per day and nominations averaged nearly 1,150
88 Dth per day.¹ Thus, the new contract is definitely higher priced at any
89 given set of price indexes for the volumes that were nominated.

90 **Q: Has the utility taken actions that have decreased the utility's supply**
91 **options?**

92 **A:** Yes. Atmos relinquished its firm capacity on TETCO.² According to
93 Atmos' response to Staff data request ENG 1.128, it has not held firm
94 capacity since 1996. That action exposed the utility to exploitation by
95 marketers. If the utility controlled its own capacity, it could bid out
96 purchases at the receipt point, nominate to the pipeline itself and balance
97 its own system using its leased and owned assets. Lacking control of its
98 own pipeline capacity, bidders on its RFPs are limited to marketers that
99 have appropriate capacity on TETCO. If the capacity is fully subscribed,
100 there may be few viable bidders available. Other things equal, more
101 bidders are likely to better mitigate prices to utility ratepayers. If the utility
102 leaves its ratepayers vulnerable to a poorly designed bidding process,
103 then its purchasing practices are imprudent when high prices result, even
104 if the bids are assessed properly. That is, the utility cannot deny its
105 imprudence by arguing that it has no other alternatives to high-priced
106 supply. It is vulnerable to high-priced supply because it made a bad

¹ See responses to MHE 5.01, 5.03, 5.04, 7.03, 5.06, 5.07, 5.08, 5.09, 5.10, 5.11, 4.06 and 4.01.

² See response to ENG 1.127: "...the Company does not have transportation capacity under its name with TETCO. The Company has an IT contract directly with TETCO, but receives firm deliveries from the citygate service that was awarded to Atmos Marketing through the competitive bid process. The Company relies on the citygate service to provide firm deliveries to Harrisburg."

107 choice. This contract is imprudent in large part due to the utility's decision
108 to surrender its firm transportation capacity on TETCO. Additionally, it
109 appears that only Atmos Marketing is interested in serving the utility
110 around Harrisburg. That leaves Atmos utility ratepayers not only
111 vulnerable to exploitation by an individual marketer, but, in this instance,
112 also hostage to an affiliated seller that the utility seems willing to
113 cooperate with in ways that are detrimental to ratepayers. I detail
114 examples of such cooperation below when discussing how the contract is
115 implemented.

116 **Q: What is bundling or aggregation?**

117 **A:** Bundling is when several types of purchases are aggregated together into
118 a single contract. In this case, there is baseload supply purchased at a
119 first-of-the-month price plus an adder and reservation charges, swing or
120 incremental supply priced at a daily price and a peaking service with an
121 additional reservation charge and priced at a daily price. Further, while
122 the contract does not explicitly state its pricing terms, the marketing firm
123 has apparently arranged to buy excess supplies back at a daily price.

124 **Q. How can bundling raise gas costs?**

125 **A:** Bundling can raise gas costs in two ways. One is through the effect it has
126 on bidders on an RFP. The other effect is how it discourages bidders from
127 even attempting to bid on a contract. It is difficult for the utility to assess
128 the value that each service in a bundle provides to ratepayers without a

129 bidding process for each element or by some other careful study. It may
130 be that breaking the RFP into its components and bidding them out
131 separately leads to lower costs than a bundled contract. Consider the
132 following example. Suppose there are three bidders (A, B and C), and
133 they each have different valuations for the individual services (1, 2 and 3).
134 The valuations that each bidder has for each service (the price that each
135 bidder would bid) are represented by the following matrix.

	A	B	C
1	\$1	\$2	\$3
2	\$3	\$1	\$2
3	\$2	\$3	\$1

136 It is clear that the winning bid from each individual service would be one
137 dollar, for a minimum total cost of three dollars for all three services.
138 However, by bundling the services together and awarding it to only one
139 seller, the minimum total cost from a single supplier becomes six dollars.

140 In addition, aggregating services into one contract discourages bidders
141 that place a high opportunity cost on one aspect of the contract. This
142 might restrict the pool of bidders and/or make the ones that do bid more
143 risk-averse and so cause them to bid higher than they otherwise would,
144 since they may not be able to accurately gauge a given contract element's
145 value.

146 **Q: But the Company put out the contract for bid and it took the lowest**
147 **bidder. Doesn't that shield it from charges of imprudence?**

148 **A:** No. The only bidder was its affiliated marketer. With an unaffiliated
149 marketer, the utility has greater incentive to negotiate a more reasonable
150 result. When the only bidder is affiliated and all costs are borne by the
151 ratepayer, the utility can serve its shareholders' interests by simply
152 passing excessive costs on to ratepayers. In addition, if unaffiliated
153 marketers can be discouraged from bidding, ratepayers' costs are likely to
154 be driven up at ratepayer expense.

155 **Q: Please specify the contract elements that in Staff's opinion are**
156 **imprudent.**

157 **A:** Staff believes that the contract has two features that are imprudent. One,
158 the Company pays a demand charge, fuel and transport, *and* a 55¢ adder
159 above the first-of-the-month index price to nominated volumes. A demand
160 or reservation charge compensates the marketer for granting its customer
161 the right to buy at a certain price. The seller incurs an opportunity cost to
162 make the supply available to the buyer. An adder on the unit price
163 accomplishes the same thing. However, in this contract, not only does the
164 utility pay a demand charge, but it also pays a (large) adder and it is liable
165 for variable transport charges and fuel compensation to the pipeline. The
166 utility is paying twice for the same service, and the sum of all these
167 charges is excessive.

168 Two, there is a peaking service in the contract that provides a 10-day call
169 of 2,900 Dth per day at the ELA daily price during November through
170 March. However, Atmos Marketing also imposes a \$28,234 demand
171 charge for the peaking service. This is also excessive. Atmos is paying
172 around \$5 per Dth of callable supply simply to buy at the daily price.
173 There is no evidence that such a peaking service is worth anything like
174 this amount. Note that in the contract for the previous year the ten-day
175 call was available to the utility at no incremental charge.

176 In short, it appears that the contract is a case of something other than an
177 arms-length transaction, in which the affiliated marketing company
178 appears to be taking advantage of its utility affiliate's ratepayers.

179 **Q: How does Atmos defend the large increase in price from the second**
180 **to third contract?**

181 **A:** In its response to ENG 1.132, it states that, "...the natural gas market and
182 the dynamics of the natural gas market changed as a result of Hurricanes
183 Katrina and Rita. The Company believes that in an extremely volatile
184 market, one cannot assume the same pricing year to year." As noted in
185 Staff Witness Anderson's testimony, the hurricanes explain why the
186 absolute price level went up; however, in order to evaluate this contract,
187 the critical component is the relationship between the price at Henry Hub,
188 off of which most gas is priced, and the TETCO ELA and ETX price
189 indexes. Prices at all locations rose due to the two devastating

190 hurricanes, but the two weather events did not automatically realign prices
191 between locations.³ Put another way, the hurricanes did not change the
192 bases between ETX, ELA and the Henry Hub. And while bases can
193 change from year to year, there is no evidence that such a change
194 actually took place. Atmos has not offered a reasonable explanation for
195 the price increase.

196 **Q: How does Staff calculate its proposed disallowance related to the**
197 **Atmos Marketing contract?**

198 **A:** Staff witness Everson calculates the disallowance for what Staff believes
199 is an imprudent adder. Staff also proposes that the Illinois Commerce
200 Commission (“Commission”) disallow the demand charge for the peaking
201 service. Atmos paid \$28,234 per month for the last two months of 2005
202 for the service. Staff recommends that the Commission disallow \$56,468
203 for 2005 related to the peaking service.

204 **Q: Are there other problems with the execution of the contract?**

205 **A:** Yes. Staff has found three other problems with how Atmos performed
206 under the contract. All three problems highlight concerns that Staff has
207 with the affiliate relationship between Atmos and Atmos Marketing.

208 One, the Company apparently used Atmos Marketing to balance its
209 system supply. Atmos Marketing did this by buying excess supplies when
210 nominations exceeded usage and selling excess supplies when the

³ The price difference between locations is sometimes called “basis.”

211 opposite was true. While the latter function is written in the contract
212 addendum, the former is not. The buybacks are not mentioned in the
213 contract and may be an unauthorized affiliate transaction. Further, the
214 buybacks are transacted at the daily ETX price. The ETX price is typically
215 lower than the ELA price . Thus, the (contractual) incremental purchases
216 by Atmos are at the higher daily price, while the (noncontractual)
217 buybacks are at the lower daily price. In my opinion, this is also imprudent
218 behavior. I calculate a disallowance for the amount that this raised gas
219 costs

220 Two, the contracts specify that the nominations for firm supply at the first-
221 of-the-month price are supposed to be constant for each day in the month.
222 However, Staff observed that that is not the case for several months
223 during 2005. Staff asked the Company in data request MHE 7.10 why
224 nominations changed intra-month during 2005. In response, the Company
225 gave a different explanation for each month that this occurred. The
226 response is appended as Attachment B. Gas costs increased every time
227 that the nominations were changed. I also calculate a disallowance for
228 this imprudent behavior.

229 Further, I note that during October 2005, the nomination was reduced from
230 2,000 Dth per day down to 1,300 Dth per day for just ten days (the 17th
231 through the 26th) . The Company stated that in its response to MHE 7.10
232 that the reason was that "...there was an imbalance due Shipper (AEC) on
233 the pipe." I note several things with respect to this statement. As noted

234 above, the contract between Atmos and Atmos Marketing does not allow
235 for intra-month variations in nominations. Also, the situation was not force
236 majeure: it was up to Atmos Marketing to deal with the imbalance. On top
237 of that, it is very unclear how the change in nominations could have
238 addressed the imbalance. The gas that flowed into the Harrisburg citygate
239 was the gas that ratepayers needed. It is unclear how an imbalance could
240 be addressed unless actual deliveries were altered. But only the
241 nominations were apparently changed. Further, the Shipper is identified
242 as AEC (the utility), but the Company has stated elsewhere that the
243 Company does not have firm capacity on TETCO. Therefore, Atmos
244 cannot be held responsible for any imbalance. Atmos Marketing is
245 balancing the system for Atmos and should be liable for any problems at
246 Harrisburg. Finally, in my opinion this action imprudently raised gas costs
247 to ratepayers.

248 Three, for the final two months of 2005, Atmos Marketing began splitting
249 its Harrisburg nominations between two sets of meters that it terms
250 Harrisburg and Galatia. In other words, Atmos Marketing separately
251 tracked nominations and deliveries for Harrisburg and Galatia rather than
252 aggregate them as would seem to be specified in the contract. In my
253 opinion, this also imprudently raised gas costs because the buyback price
254 is lower than the incremental sales price. If one location brought in more
255 than nominated on a given day, Atmos bought the excess supply at the
256 TETCO ELA (higher) price. However, if nominations were greater than

257 supply at the other location, it was resold back to Atmos Marketing, but at
258 the TETCO ETX (lower) price. But the locations should be aggregated, so
259 the excess at one location should offset the deficit at the other—thus
260 Atmos should buy less at the higher price and resell less at the lower
261 price. If the same index is used for incremental sales and buybacks,
262 splitting nominations between the two locations does not affect gas costs.

263 **Q: What do the three execution problems say about the relationship**
264 **between the utility and its marketing affiliate?**

265 **A:** It appears that the relationship between the utility and the marketing
266 affiliate is at less than arm's length. The utility seems to be all too willing
267 to accommodate Atmos Marketing by altering its nominations and
268 agreeing to balancing methods that seem to favor Atmos Marketing. Also,
269 the disaggregated nominations are not in the contract and imprudently
270 raise costs given the disparity between the incremental sale price and the
271 buyback price.

272 **Q: Do you recommend a disallowance for these behaviors?**

273 **A:** Yes. I recommend a disallowance of \$87,808.13 for the three factors I
274 discuss above. I provide Schedule 3.01 that calculates the recommended
275 disallowances for each month during 2005. Note that all three problems
276 are interrelated. Changing the daily nominations alters the incremental
277 sales and buybacks. Similarly, aggregating Harrisburg and Galatia in
278 November and December 2005 affects those variables as well. Thus, the

279 recommended disallowances are calculated all together. The overarching
280 principle is that I recommend that the difference in price between the two
281 TETCO daily prices be disallowed from Atmos' gas costs. While there
282 may be other reasonable approaches available, this one has the distinct
283 advantage of being known and measurable, it appropriately compensates
284 ratepayers for the additional costs caused by Atmos for entering into
285 affiliate transactions without authorization and makes the balancing costs
286 symmetrical between being long and being short.

287 **Q: Please summarize your testimony.**

288 **A:** I look at the prudence of the contract between Atmos Marketing and
289 Atmos for supply to the Harrisburg area. In my opinion, this contract is
290 imprudently expensive. I explain what the sources of the excessive
291 charges are and explain why they are excessive. Staff witness Everson
292 calculates the value for the adder to nominated volumes. I recommend
293 that the Commission disallow the demand charges for the peaking service
294 as imprudent. For the two months that it was in effect, the proposed
295 disallowance is \$56,468. Finally, I recommend that a further \$87,108.13
296 be disallowed related to the performance of Atmos under the contract.

297 **Q: Does this complete your prepared direct testimony?**

298 **A:** Yes.

Pricing and Volumes for Harrisburg Contracts, November 2003 through October 2006

ICC Staff Exhibit 3.0
Attachment A

Pricing						
Term	MDQ	Demand charges	Nominated Vols	Incremental Vols	Calls	Peaking Service
November 2003 through October 2004	1850 Dth	\$11,470 or \$6.20/Dth	IF TETCO ETX FOM plus transport and fuel	GD TETCO ELA plus transport and fuel	NO CALL	N/A
November 2004 through October 2005	8300 Dth	\$33,670 (1) or \$4.06/Dth	IF TETCO ETX FOM plus transport and fuel for 1st 4700 Dth	GD TETCO ELA plus transport and fuel for next 4700 Dth Inc'l volumes	10 day call for volumes over 4700 Dth at GD TETCO ELA plus transport and fuel	N/A
November 2005 through October 2006	4700 Dth	\$19,066 or \$4.06/Dth	IF TETCO ETX FOM plus 55¢ plus transport and fuel for 1st 4700 Dth	GD TETCO ELA plus transport and fuel for next 4700 Dth Inc'l volumes	10 day call SUMMER ONLY for volumes over 4700 Dth at GD TETCO ELA plus transport and fuel	10-day call (2900 Dth per day) during November through March, the strike price is GD TETCO ELA plus transport and fuel w/ a monthly demand charge of \$28,234 during November through March

Notes

(1) \$33,670 = 1850 x \$6.20 + 2850 x \$4.00 + 3600 x \$3.00

IF TETCO ETX FOM stands for Inside Ferc's first-of-the-month price index on the TETCO pipeline at the East Texas delivery/receipt point.

GD TETCO ELA stands for Gas Daily's daily price index on the TETCO pipeline at the East Louisiana delivery/receipt point.

GD TETCO ETX stands for Gas Daily's daily price index on the TETCO pipeline at the East Texas delivery/receipt point.

ATMOS ENERGY CORPORATION
ILLINOIS COMMERCE COMMISSION
DOCKET NO. 05-0738
DATA REQUEST NO. MHE 7.10

MHE 7.10 In reference to the spreadsheet provided in response to Staff data request MHE 5.03, please provide an explanation of the change in nomination from 500 on February 13, 2005 to 0 on February 14 and 15 and back to 500 on February 16, 2005. Provide a similar explanation for any other such changes in other months to base load nominations during 2005.

Response: February 2005: The FOM base load nom was 500/dth per day. According to the Operator Allocation Daily Detail from TETCO, the actual allocation quantity for days 1, 14 and 15 were zero. The 500/dth for each of these days should have been reflected as a buy back but it appears that AEM failed to include any respective costs in the invoice.

July 2005: The FOM base load nom was 1,000/dth per day. Working closely with our Gas Control Department it was brought to my attention that we had a problem with the meter at the Ellis storage facility and we were not able to inject as planned; therefore causing an excess volume on the pipe. Effective July 26th, we cut both Harrisburg and Galatia to 1 dth/day and depleted the 2,122 dth variance on the pipe.

October 2005: The FOM base load nom was 2,000/dth per day. On October 17th, we received notice from our Gas Control Department that there was an imbalance due Shipper (AEC) on the pipe. The nom was cut to 1,300/dth per day from October 17th through October 26th in order to deplete the variance on the pipe. This was accomplished and the 2,000/dth per day FOM nom was continued through the end of the month.

December 2005: The FOM base load nom was 1,370/dth per day. There were nom changes on 12/7, 12/8, 12/9 and 12/13 through the end of the month. These changes were due to colder weather and a need for additional supply.

Submitted by: Deborah Sparkman
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Proposed Atmos Marketing Disallowances ICC Staff Exhibit 3.0
Schedule 3.01

Month	Proposed Disallowance
January 2005	\$ 900.81
February 2005	\$ 830.91
March 2005	\$ 1,049.94
April 2005	\$ 723.64
May 2005	\$ 584.92
June 2005	\$ 183.32
July 2005	\$ 1,546.54
August 2005	\$ 456.41
September 2005	\$ 4,551.52
October 2005	\$ 24,558.66
November 2005	\$ 3,034.72
December 2005	\$ 49,386.73
Total	\$ 87,808.13