IN THE MISSOURI COURT OF APPEALS
WESTERN DISTRICT

OFFICE OF PUBLIC COUNSEL,	)	
	)	
Appellant,	)	WD74714
	)	
vs.	)	Opinion filed: September 18, 2012
	)	
MISSOURI PUBLIC SERVICE COMMISSION,	)	
	)	
Respondent.	)	

APPEAL FROM THE PUBLIC SERVICE COMMISSION

Before Division Three: Victor C. Howard, Presiding Judge,
Karen King Mitchell, Judge and Cynthia L. Martin, Judge

The Office of Public Counsel (OPC) appeals from the order of the Public Service Commission of the State of Missouri (PSC) approving the 2007-2008 actual cost adjustment rates for Atmos Energy Corporation (Atmos). The PSC rejected the PSC's Staff's proposed disallowance of $308,733 in costs incurred by Atmos under a gas purchase contract with its affiliate, Atmos Energy Marketing (AEM). The OPC claims that the PSC's order is unlawful and unreasonable in that it violates the Affiliate Transaction Rule 4 CSR 240-40.016 and is not supported by competent and substantial evidence. The order of the PSC is affirmed.

Facts

The PSC is responsible for the regulation of public utilities, including natural gas companies, under Chapters 386 and 393, RSMo. The OPC is an agency of the State of Missouri

representing utility consumers in cases before the PSC and on appeal of PSC orders under sections 386.700 and 386.710, RSMo 2000.

Atmos is a public utility operating a natural gas local distribution company (LDC). It provides retail natural gas service to approximately 65,500 residential and business customers in Missouri. In addition to the basic rates that Atmos charges its customers, it can also recover the costs of acquiring the supply of natural gas to serve those customers. These additional charges are recovered through a two-part mechanism known as the Purchased Gas Adjustment/Actual Cost Adjustment (PGA/ACA) process. *See State ex rel. Associated Natural Gas Co. v. Public Serv. Comm'n*, 954 S.W.2d 520, 523 (Mo. App. W.D. 1997)(explaining the PGA/ACA process). The underlying PSC proceeding in this case involved the ACA phase of the process. During this phase, Atmos submits ACA filings, which are meant to correct any discrepancies between the PGA amounts that were prospectively billed to Atmos's customers and the costs Atmos actually incurred in obtaining gas from its suppliers. The PSC examines Atmos's gas purchases to ensure that it charged ratepayers the correct rate and that the utility was prudent with respect to gas purchases.

Atmos holds long-term contracts with various interstate pipelines for natural gas storage and transportation capacity to supply the natural gas requirements to its Missouri service areas. Atmos does not produce natural gas, and it does not buy gas directly from producers. Instead, Atmos contracts with gas marketing companies to purchase the natural gas that then flows through the interstate pipeline using Atmos's pipeline capacity.

Atmos awards contracts to gas marketing companies using a competitive bid process. Under that process, Atmos issues a request for proposal (RFP), and interested suppliers submit

confidential bids with their proposed pricing for the gas supply services. Atmos then awards the contract to the company that offers the best bid for reliable supply at the least cost.

Atmos uses this competitive bid process for each of its eight Missouri service areas. During the 2007-2008 ACA period at issue in this case, Atmos awarded two contracts to its affiliated gas marketing company, Atmos Energy Marketing (AEM), for the Butler and Hannibal/Bowling Green service areas. The contracts for the other service areas were awarded to non-affiliated gas marketing companies. For the 2004-2009 period, Atmos issued forty-eight RFPs for its Missouri gas supply. AEM submitted the successful bid six times. That number is consistent with the number of successful bids submitted by unaffiliated gas marketers.

For the Hannibal/Bowling Green service area, there were two overlapping RFP processes during the 2007-2008 ACA period. In the first RFP process for the period of April 1, 2007 to March 31, 2008, AEM and six other unaffiliated companies submitted bids. AEM submitted the lowest bid of $13,947,511. The next lowest bid of $14,049,424 was a little over $100,000 higher than AEM's bid. The highest bid submitted was $14,541,937 or almost $600,000 higher than AEM's bid. In the second RFP process for the period of April 1, 2008 to March 31, 2009, AEM and three unaffiliated companies submitted bids. AEM submitted the lowest bid of $14,723,472. The next lowest bid submitted was $14,761,471 and was almost $38,000 higher than AEM's bid. The highest bid submitted was $15,069,726 or approximately $346,000 higher than the bid submitted by AEM. The total paid by Atmos to AEM during the 2007-2008 ACA period was a little more than $13.4 million.

In December 2009, the PSC's Staff filed its recommendations regarding Atmos's 2007-2008 ACA filings and raised concerns about Atmos's affiliate transactions, specifically the gas supply agreements between Atmos and AEM for the Butler and Hannibal/Bowling Green service

areas. The Staff explained that it requested underlying supporting documentation for those transactions. Specifically, the Staff sought contracts between AEM and its upstream gas suppliers to determine the true fair market price of the gas. Atmos and AEM provided some but not all of the requested information. Based on the information provided, the Staff initially proposed a disallowance of $349,015 in costs incurred by Atmos under contracts with AEM for the Hannibal/Bowling Green service area.[1] The Staff's proposed disallowance was later adjusted to $308,733. This amount equaled the Staff's calculation of AEM's gross profit on the transactions. The Staff reasoned that because the gas supplies were purchased from an affiliate, the transactions were not arms-length and, thus, did not represent the fair market price of the gas. By removing AEM's profit, it contended, the costs would be brought down to the true fair market price. In response to the proposed disallowance, Atmos claimed that it had used a competitive bid process, and since AEM submitted the lowest bids, AEM's bids determined the fair market price of the gas.

The PSC ultimately decided in favor of Atmos and rejected the Staff's proposed disallowance. In its order, it concluded that the competitive bidding process established the fair market value for the affiliate transactions and that no evidence was presented that the bidding process was unfair or tended to favor the affiliate.

This appeal by the OPC followed.

Standard of Review

On appeal from an order of the PSC, the appellate court must determine whether the order is lawful and reasonable. § 386.510, RSMo Cum. Supp. 2011; *State ex rel. AG Processing,*

[1] The Staff also recommended a disallowance of $13,964 in gas costs for the Butler area but subsequently eliminated this proposed adjustment. It also proposed a disallowance related to a force majeure event on the pipeline that supplied gas to the Hannibal and Butler areas but does not challenge in this appeal the PSC's rejection of this proposed disallowance.

Inc. v. Public Serv. Comm'n, 120 S.W.3d 732, 734 (Mo. banc 2003). An order is lawful if the PSC had the statutory authority to act as it did. *Id.*; *State ex rel. Office of Public Counsel and Mo. Indus. Energy Consumers v. Mo. Public Serv. Comm'n*, 331 S.W.3d 677, 682 (Mo. App. W.D. 2011). "Because the PSC is purely a creature of statute, its powers are limited to those conferred by statute either expressly, or by clear implication as necessary to carry out the powers specifically granted." *Mo. Indus. Energy Consumers*, 331 S.W.3d at 682 (internal quotes and citation omitted). Convenience, expediency, and necessity are not proper matters for consideration in the determination of whether an act of the PSC is authorized by statute. *Id.* The determination of lawfulness is made de novo, without deference to the Commission. *Praxair, Inc. v. Public Serv. Comm'n*, 346 S.W.3d 377, 379 (Mo. App. W.D. 2011). The PSC's ruling is reasonable if it is supported by competent and substantial evidence on the whole record and is not arbitrary capricious, or an abuse of discretion. *Id.* The party seeking to set aside the PSC's order has the burden to prove by clear and satisfactory evidence that the order is unlawful or unreasonable. § 386.430, RSMo 2000; *Mo. Indus. Energy Consumers*, 331 S.W.3d at 682.

Analysis

The OPC claims that the PSC's order is unlawful and unreasonable. Specifically, it contends that the order is unlawful in that it violates the Affiliate Transaction Rule 4 CSR 240-40.016 by failing to ensure that Atmos charged customers the lesser of the fair market price or the fully distributed cost for the gas supply acquired from AEM. The OPC also argues that the order is unreasonable because the finding that Atmos acquired the gas supply from AEM at the lesser of the fair market price or the fully distributed cost is not based on competent and substantial evidence.

"All charges for gas service must be just and reasonable." *Associated Natural Gas*, 954 S.W.2d at 528; § 393.130.1, RSMo Cum. Supp. 2011. To determine whether a utility's costs meet this statutory standard, the PSC employs a "prudence" standard. *State ex rel. Public Counsel v. Public Serv. Comm'n*, 274 S.W.3d 569, 577 (Mo. App. W.D. 2009); *Associated Natural Gas*, 954 S.W.2d at 528. "If a utility's costs satisfy the prudence standard, the utility is entitled to recover those costs from its customers." *Associated Natural Gas*, 954 S.W.2d at 528.

"A utility's costs are presumed to be prudently incurred." *Id.* (internal quotes and citation omitted). The presumption does not, however, survive a showing of inefficiency or improvidence. *Id.* If some other participant in the proceeding alleges that the utility has been imprudent in some manner, that participant has the burden of creating a serious doubt as to the prudence of an expenditure. *Public Counsel*, 274 S.W.3d at 577; *Associated Natural Gas*, 954 S.W.2d at 528. If that is accomplished, the utility then has the burden of dispelling those doubts and proving the questioned expenditure was in fact prudent. *Id.* The prudence test should not be based upon hindsight but upon reasonableness:

> The [utility's] conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the [utility] had to solve its problem prospectively rather than in reliance on hindsight. In effect, [the PSC's] responsibility is to determine how reasonable people would have performed the tasks that confronted the [utility].

Associated Natural Gas, 954 S.W.2d at 529 (internal quotes and citation omitted). The prudence standard applies to affiliate transactions. *Public Counsel*, 274 S.W.3d at 577.

The PSC's enactment of the Affiliate Transaction Rules was a reaction to the emergence of a profit-producing scheme among public utilities, in which utilities abandoned their traditional monopoly structure and expanded into non-regulated areas. *State ex rel. Atmos Energy Corp. v. Public Serv. Comm'n*, 103 S.W.3d 753, 763-64 (Mo. banc 2003). This expansion gave 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. *Id.* at 764. "To counter this trend, the new rules…prohibit utilities from providing an advantage to their affiliates to the detriment of rate-paying customers." *Id.*

The Affiliate Transaction Rules at issue in this case establish regulatory standards surrounding regulated gas utilities' dealings with their affiliated companies. 4 CSR 240-40.015; 4 CSR 240-40.016. 4 CSR 240-40.016 specifically sets forth standards of conduct for regulated gas utilities engaged in marketing affiliate transactions. The Affiliate Transaction Rules prohibit a regulated gas corporation from providing a financial advantage to an affiliate. Specifically:

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

4 CSR 240-40.016(3)(A). This provision of the Affiliate Transaction Rules is known as the asymmetrical pricing standard. *Atmos Energy Corp.*, 103 S.W.3d at 762. "Fully distributed cost" (FDC) is defined in the rules as:

> a methodology that examines all costs of an enterprise in relation to all the goods and services that are produced. FDC requires recognition of all costs incurred directly or indirectly used to produce a good or service. Costs are assigned either through a direct or allocated approach. Costs that cannot be directly assigned or indirectly allocated (e.g., general and administrative) must also be included in the FDC calculation through a general allocation.

4 CSR 240-40.016(1)(F). In its order of rulemaking, the PSC explained its rationale for the asymmetrical pricing standard:

> FDC [fully distributed cost] assures that all costs are accounted and recovered and FMP [fair market price], in conjunction with FDC, assures that the regulated utilities obtain the best prices or lowest costs possible whether buying or selling or producing goods or services. Asymmetrical pricing assures that the pricing standard is always applied to the favor of regulated utility's customers.

25 *Missouri Register* 64 (January 3, 2000).

The Affiliate Transaction Rules also provide evidentiary standards for affiliate transactions to assure compliance with the asymmetrical pricing standard. A regulated gas corporation must obtain competitive bids when it purchases goods or services from an affiliate or demonstrate why competitive bids were unnecessary or inappropriate. 4 CSR 240-40.016(4)(A). In addition, in transactions that involve either the purchase or receipt of goods or services by a regulated gas utility from an affiliate, the utility shall document both the fair market price of such goods or services and the fully distributed cost to the utility to produce the goods or services for itself. 4 CSR 240-40.016(4)(B).

Finally, the Affiliate Transaction Rules include recording keeping requirements:

> (C) [E]ach regulated gas corporation shall maintain the following information regarding affiliate transactions on a calendar year basis:
>
> > 1. Records identifying the basis used (e.g., fair market price, fully distributed cost, etc.) to record all affiliate transactions; and
> >
> > 2. Books of accounts and supporting records in sufficient detail to permit verification of compliance with this rule.

4 CSR 240-40.016(5)(C).

Although Atmos purchased its gas supply for its Hannibal/Bowling Green service area from its affiliate AEM, the PSC properly presumed that Atmos was prudent in the purchase until the Staff or OPC presented evidence that raised a serious doubt concerning the prudence of its expenditures. *Public Counsel*, 274 S.W.3d at 578; *Associated Natural Gas*, 954 S.W.2d at 528. The Staff and the OPC failed to raise a serious doubt about the prudence of the transactions.

In accordance with the asymmetrical pricing standard, Atmos was required to compensate AEM for gas marketing services at the lower of the fair market price or the fully distributed cost of providing that service. 4 CSR 240-40.016(3)(A). The OPC argues that Atmos failed to follow the Affiliate Transaction Rules when it did not determine its fully distributed cost to supply the gas for itself and that the PSC unlawfully determined that Atmos's fully distributed cost was greater than the fair market price. The PSC found that Atmos's fully distributed cost of providing gas marketing services through its own employees would be higher than the market price for those services from gas marketing companies as established by a competitive bidding process. The PSC explained:

> Atmos uses the services of independent gas marketing companies to purchase its natural gas because it does not have the in-house expertise needed to perform the gas marketing services provided by those companies.
>
> If it were to undertake its own gas marketing services using its own, in-house employees, Atmos would need to hire or train additional personnel at a substantial cost and develop processes already used by independent gas marketers to secure gas supplies and transport gas through the interstate gas pipeline system.
>
> In-house gas marketing employees would still need to negotiate and contract for the purchase and transport of natural gas supplies. The price of gas and the cost to transport that gas would still be determined by market forces, just as those prices are determined by market forces when they are purchased by independent marketing companies.
>
> Most importantly, Atmos is a natural gas distribution company. Its core competency is in the distribution of natural gas to its customers. It is able to most efficiently provide service to its customers by focusing on that core competency while leaving gas marketing services to gas marketing companies that specialize in providing that service.[2]

The PSC's findings were supported by the testimony of Rebecca Buchanan, an Atmos regional gas supply manager. Regardless, neither the Staff nor the OPC challenged, in the proceedings below, Atmos's decision to purchase its gas supplies through gas marketing companies rather

[2] The footnotes were omitted.

than by using in-house gas marketing experts. They did not suggest that the fully distributed cost to Atmos was lower than the fair market price, and the Staff did not seek to disallow any of Atmos's gas costs based on a fully distributed costs argument. In fact, Staff witness David Sommerer, who is the manager of the PSC's procurement analysis department and reviewed Atmos's ACA filings, testified that the Staff was not concerned in this case with the fully distributed cost for Atmos to provide gas marketing services for itself:

> This is not a producer here, so you're looking at sort of a wholesale cost and clearly the fully distributed cost includes direct and indirect cost that might be allocated pursuant to general and administrative.
>
> The Company's [Atmos's] testimony is that—well, you've got a wholesale price. If you layer in or you load indirect cost and administrative costs, almost by definition, you're looking at something higher than the fair market value price.
>
> So you know, we inquired into what the Company's view of fully distributed cost and *for purposes of this case—and I won't say this universally, but for purposes of this case—I understand that argument and to me the Staff's position is not a concern about fully distributed cost being less than the fair market value price*.

(emphasis added). Rather, the Staff and the OPC's focus in this case was on the fair market price of the gas marketing services provided by AEM.

The OPC argues that the PSC unlawfully concluded that the transactions between Atmos and AEM established the fair market price because such transactions were not conducted at arm's length. The parties agree that the fair market value of a good or service is "[t]he price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's-length transaction." BLACK'S LAW DICTIONARY 1691 (9th ed. 2009). Arm's length transactions are defined as "dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." BLACK'S LAW DICTIONARY 123 (9th ed. 2009).

The PSC found that the fair market value of the transactions was established in this case by the competitive bidding process Atmos used to obtain its Missouri gas supply. Specifically, the PSC found:

> Staff and [OPC]'s position ignores the existence of the bidding process in establishing the fair market value for the transaction. If AEM had not submitted a bid, or if it had not submitted the lowest bid, there would be no question that the bidding process established the fair market value of the transaction. Indeed, Staff did not propose any disallowance related to the contracts for Missouri gas supply in which an unaffiliated gas marketing company submitted the lowest and best bid and agreed that the bidding process would establish fair market value for those transactions.
>
> Assuming the bidding process was fair and open, and no party has presented evidence to establish a serious doubt about the fairness of the bidding process, that bidding process established the fair market value for the affiliate transactions, just as it did for the transactions with non-affiliated gas marketing companies. Because of the bidding process, Atmos, and ultimately its ratepayers, will pay no more for the services of the affiliated gas marketing company than they would have to obtain the same services from an unaffiliated gas marketing company. In effect, it is the non-affiliated gas marketing companies bidding in the open market that establish the fair market value for the bids won by AEM as much as they do for the bids won by non-affiliated bidders. Absent some showing of insider-dealing to favor an affiliate in the bidding process or some showing of facts that cast doubt on the bidding process itself, there is no need for Staff to search behind the bidding process to try to establish an independent fair market value for the affiliate transactions, if any such determination were possible.

An open market composed of willing buyers and willing sellers who are not related or on close terms establishes the fair market price of a good or service. In this case, the competitive bid process undertaken by Atmos, that included non-affiliates, produced the fair market price for gas marketing services in its eight Missouri service areas. For the 2007-2008 ACA period, Atmos received bids from its affiliate AEM and non-affiliate gas marketing companies. AEM submitted the lowest bid for two of the service areas. The contracts for the other services areas in Missouri were awarded to non-affiliate gas marketing companies. Mr. Sommerer testified that the bidding process established the fair market price for those transactions, and the Staff did not

propose any disallowances related to the unaffiliated gas marketers that submitted the lowest and best bids in the other service areas.

For the Hannibal/Bowling Green area, the bid prices of unaffiliated gas marketers during the first RFP ranged from $14,049,424 to $14,541,937. AEM's bid fell below that range at $13,947,511, a little over $100,000 to almost $600,000 lower than the bids of the unaffiliated gas marketers. During the second RFP process, the bid prices of unaffiliated gas marketers ranged from $14,761,471 to $15,069,726. AEM's bid again fell below that range at $14,723,472, almost $38,000 to approximately $346,000 lower than the unaffiliated gas marketers' bids. Mr. Sommerer agreed that AEM submitted the lowest and best bids for the Hannibal/Bowling Green service area and confirmed that the Staff was not asserting that Atmos was imprudent in accepting the lowest bid. He also stated that a concern would have been raised if Atmos had accepted a higher bid from one of the unaffiliated gas marketers instead of the lowest bid from AEM. Because of the competitive bidding process, which is required by 4 CSR 240-40.016(4)(A), Atmos paid less for gas marketing services provided by AEM than it would have paid for the same services provided by a non-affiliate company for its Hannibal/Bowling Green service area. Nothing in the record indicated that Amos tended to favor its affiliate in the bidding process. And the Staff and the OPC did not raise a serious doubt about the fairness of the bidding process.

The OPC argues that the fair market price of the gas acquired from AEM should have been based on AEM's cost of acquiring the gas from its upstream suppliers. Indeed, the Staff's proposed disallowance equaled the gross profit AEM earned on the transactions with Atmos suggesting that it was imprudent for AEM to profit on services it provided to Atmos. This court recently reviewed the similar issue of whether an unregulated affiliate of an electric company

was required to sell its services to its regulated affiliate utility at its cost without earning a profit. *See Public Counsel*, 274 S.W.3d at 582. This court agreed with the PSC's conclusion that the utility had no power or obligation to change its unregulated affiliate's decision to stop selling power to it at cost and instead seek much greater profits by selling on the newly available market. *Id.* Indeed, forcing the unregulated affiliate's board to lose out on profits by selling its electricity to the utility at cost instead of selling it on the open market likely would have resulted in the board violating its fiduciary duty to manage the corporate business solely in accord with the corporation's interest. *Id.* In this case, the OPC cites no cases holding that a utility acts imprudently in transacting business with its affiliate simply because the affiliate earns a profit on the transaction. Indeed, restricting an affiliate's ability to earn a profit could ultimately deprive a utility of the best price where the affiliate, which otherwise would have submitted the lowest bid, decides not to sell to the utility. As a regulated utility, Atmos certainly had an obligation to obtain natural gas for its Hannibal/Bowling Green service area at the lowest prudent cost. It also had an obligation to engage in fair dealing with its affiliate. It did so by buying the gas from AEM, who offered the best bid for reliable supply at the least cost to the benefit of the ratepayers.

The OPC also argues that AEM garnered a financial advantage from Atmos through the affiliate transactions because AEM was allowed to supply Atmos with "interruptible" gas supplies, which are a less reliable and less expensive supply source than "firm" or "guaranteed gas supplies. The OPC, however, did not raise this issue in its application for rehearing, and it will not be addressed here. Section 386.500.2, RSMo 2000, requires an application for rehearing before the PSC to "set forth specifically the ground or grounds on which the applicant considers said order or decision to be unlawful, unjust or unreasonable." The applicant will waive any

grounds omitted from the rehearing application. *State ex rel. Office of Public Counsel v. Public Serv. Comm'n*, 236 S.W.3d 632, 636 (Mo. banc 2007); § 386.500.2 ("The applicant shall not in any court urge or rely on any ground not so set forth in its application for rehearing.").

The PSC properly ensured that Atmos charged customers the lesser of the fair market price or the fully distributed cost for the gas supply acquired from AEM. The transactions between Atmos and AEM were in compliance with the Affiliate Transaction Rules. Furthermore, the PSC's conclusions were supported by competent and substantial evidence on the whole record.

The order of the PSC is affirmed.

VICTOR C. HOWARD, JUDGE

All concur.