

ATMOS ENERGY CORP
Form 10-Q
May 09, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2006**
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to**

Commission File Number 1-10042

Atmos Energy Corporation

(Exact name of registrant as specified in its charter)

Texas and Virginia
*(State or other jurisdiction of
incorporation or organization)*

75-1743247
*(IRS employer
identification no.)*

**Three Lincoln Centre, Suite 1800
5430 LBJ Freeway, Dallas, Texas**
(Address of principal executive offices)

75240
(Zip code)

(972) 934-9227

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of Accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Number of shares outstanding of each of the issuer's classes of common stock, as of April 28, 2006.

Class

Shares Outstanding

No Par Value

81,151,592

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GLOSSARY OF KEY TERMS

AEH	Atmos Energy Holdings, Inc.
AEM	Atmos Energy Marketing, LLC
AES	Atmos Energy Services, LLC
APB	Accounting Principles Board
APS	Atmos Pipeline and Storage, LLC
Bcf	Billion cubic feet
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
FIN	FASB Interpretation
Fitch	Fitch Ratings, Ltd.
GPSC	Georgia Public Service Commission
GRIP	Gas Reliability Infrastructure Program
KPSC	Kentucky Public Service Commission
LGS	Louisiana Gas Service Company and LGS Natural Gas Company, which were acquired July 1, 2001
LPSC	Louisiana Public Service Commission
Mcf	Thousand cubic feet
MMcf	Million cubic feet
Moody's	Moody's Investors Services, Inc.
MPSC	Mississippi Public Service Commission
NYMEX	New York Mercantile Exchange, Inc.
RRC	Railroad Commission of Texas
RSC	Rate Stabilization Clause
S&P	Standard & Poor's Corporation
SEC	United States Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
TRA	Tennessee Regulatory Authority
TXU Gas	TXU Gas Company, which was acquired on October 1, 2004
WNA	Weather Normalization Adjustment

Table of Contents**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****ATMOS ENERGY CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

	March 31, 2006 (Unaudited)	September 30, 2005
	(In thousands, except share data)	
ASSETS		
Property, plant and equipment	\$ 4,943,329	\$ 4,765,610
Less accumulated depreciation and amortization	1,432,287	1,391,243
Net property, plant and equipment	3,511,042	3,374,367
Current assets		
Cash and cash equivalents	48,899	40,116
Cash held on deposit in margin account	13,537	80,956
Accounts receivable, net	793,019	454,313
Gas stored underground	440,946	450,807
Other current assets	195,412	238,238
Total current assets	1,491,813	1,264,430
Goodwill and intangible assets	737,495	737,787
Deferred charges and other assets	256,701	276,943
	\$ 5,997,051	\$ 5,653,527

CAPITALIZATION AND LIABILITIES

Shareholders' equity		
Common stock, no par value (stated at \$.005 per share); 200,000,000 shares authorized; issued and outstanding:		
March 31, 2006 81,077,197 shares;		
September 30, 2005 80,539,401 shares	\$ 405	\$ 403
Additional paid-in capital	1,447,734	1,426,523
Retained earnings	287,727	178,837
Accumulated other comprehensive loss	(29,575)	(3,341)
Shareholders' equity	1,706,291	1,602,422
Long-term debt	2,181,120	2,183,104
Total capitalization	3,887,411	3,785,526

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Current liabilities		
Accounts payable and accrued liabilities	708,134	461,314
Other current liabilities	380,026	503,368
Short-term debt	262,315	144,809
Current maturities of long-term debt	3,308	3,264
Total current liabilities	1,353,783	1,112,755
Deferred income taxes	287,841	292,207
Regulatory cost of removal obligation	275,209	263,424
Deferred credits and other liabilities	192,807	199,615
	\$ 5,997,051	\$ 5,653,527

See accompanying notes to condensed consolidated financial statements

Table of Contents**ATMOS ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

	Three Months Ended March 31	
	2006	2005
	(Unaudited)	
	(In thousands, except per share data)	
Operating revenues		
Utility segment	\$ 1,447,620	\$ 1,235,377
Natural gas marketing segment	818,629	512,891
Pipeline and storage segment	45,483	45,546
Other nonutility segment	1,595	1,278
Intersegment eliminations	(279,481)	(110,007)
	2,033,846	1,685,085
Purchased gas cost		
Utility segment	1,131,885	912,309
Natural gas marketing segment	774,652	501,731
Pipeline and storage segment	211	4,407
Other nonutility segment		
Intersegment eliminations	(278,305)	(109,256)
	1,628,443	1,309,191
Gross profit	405,403	375,894
Operating expenses		
Operation and maintenance	112,698	103,420
Depreciation and amortization	47,076	45,326
Taxes, other than income	64,796	54,967
Total operating expenses	224,570	203,713
Operating income	180,833	172,181
Miscellaneous (expense) income	(2,439)	958
Interest charges	35,492	33,073
Income before income taxes	142,902	140,066
Income tax expense	54,106	51,564
Net income	\$ 88,796	\$ 88,502
Basic net income per share	\$ 1.10	\$ 1.12
Diluted net income per share	\$ 1.10	\$ 1.11

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Cash dividends per share	\$	0.315	\$	0.310
Weighted average shares outstanding:				
Basic		80,573		79,270
Diluted		81,040		79,760

See accompanying notes to condensed consolidated financial statements

Table of Contents**ATMOS ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

	Six Months Ended March 31	
	2006	2005
	(Unaudited)	
	(In thousands, except per share data)	
Operating revenues		
Utility segment	\$ 2,852,630	\$ 2,149,058
Natural gas marketing segment	1,920,474	1,006,692
Pipeline and storage segment	85,195	89,236
Other nonutility segment	3,087	2,637
Intersegment eliminations	(543,720)	(193,914)
	4,317,666	3,053,709
Purchased gas cost		
Utility segment	2,256,714	1,568,679
Natural gas marketing segment	1,850,178	968,688
Pipeline and storage segment	211	10,628
Other nonutility segment		
Intersegment eliminations	(541,430)	(192,283)
	3,565,673	2,355,712
Gross profit	751,993	697,997
Operating expenses		
Operation and maintenance	220,915	214,197
Depreciation and amortization	90,336	89,323
Taxes, other than income	110,212	93,622
Total operating expenses	421,463	397,142
Operating income	330,530	300,855
Miscellaneous (expense) income	(1,991)	1,343
Interest charges	71,681	65,615
Income before income taxes	256,858	236,583
Income tax expense	97,035	88,482
Net income	\$ 159,823	\$ 148,101
Basic net income per share	\$ 1.99	\$ 1.92
Diluted net income per share	\$ 1.98	\$ 1.90

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Cash dividends per share	\$	0.63	\$	0.62
Weighted average shares outstanding:				
Basic		80,444		77,290
Diluted		80,911		77,769

See accompanying notes to condensed consolidated financial statements

Table of Contents**ATMOS ENERGY CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Six Months Ended March 31	
	2006	2005
	(Unaudited)	
	(In thousands)	
Cash Flows From Operating Activities		
Net income	\$ 159,823	\$ 148,101
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization:		
Charged to depreciation and amortization	90,336	89,323
Charged to other accounts	334	477
Deferred income taxes	58,199	42,605
Other	7,587	3,315
Net assets/liabilities from risk management activities	(24,041)	20,247
Net change in operating assets and liabilities	(143,847)	96,025
Net cash provided by operating activities	148,391	400,093
Cash Flows From Investing Activities		
Capital expenditures	(213,230)	(137,466)
Acquisitions		(1,912,532)
Other, net	(2,842)	(1,957)
Net cash used in investing activities	(216,072)	(2,051,955)
Cash Flows From Financing Activities		
Net increase in short-term debt	117,506	
Net proceeds from issuance of long-term debt		1,385,847
Repayment of long-term debt	(2,162)	(3,849)
Settlement of Treasury lock agreements		(43,770)
Cash dividends paid	(50,933)	(49,211)
Issuance of common stock	12,053	26,025
Net proceeds from equity offering		382,014
Net cash provided by financing activities	76,464	1,697,056
Net increase in cash and cash equivalents	8,783	45,194
Cash and cash equivalents at beginning of period	40,116	201,932
Cash and cash equivalents at end of period	\$ 48,899	\$ 247,126

See accompanying notes to condensed consolidated financial statements

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****March 31, 2006****1. Nature of Business**

Atmos Energy Corporation (Atmos or the Company) and its subsidiaries are engaged primarily in the natural gas utility business as well as other natural gas nonutility businesses. Our natural gas utility business distributes natural gas through sales and transportation arrangements to approximately 3.2 million residential, commercial, public authority and industrial customers throughout our seven regulated natural gas utility divisions, in the service areas described below:

Division	Service Area
Atmos Energy Colorado-Kansas Division	Colorado, Kansas, Missouri ⁽¹⁾
Atmos Energy Kentucky Division	Kentucky
Atmos Energy Louisiana Division	Louisiana
Atmos Energy Mid-States Division	Georgia ⁽¹⁾ , Illinois ⁽¹⁾ , Iowa ⁽¹⁾ , Missouri ⁽¹⁾ , Tennessee, Virginia ⁽¹⁾
Atmos Energy Mid-Tex Division	Texas, including the Dallas/Fort Worth metropolitan area
Atmos Energy Mississippi Division	Mississippi
Atmos Energy West Texas Division	West Texas

⁽¹⁾ Denotes locations where we have more limited service areas.

Our nonutility businesses operate in 22 states and include our natural gas marketing operations, pipeline and storage operations and other nonutility operations. These operations are either organized under or managed by Atmos Energy Holdings, Inc. (AEH), which is wholly-owned by the Company.

Our natural gas marketing operations are managed by Atmos Energy Marketing, LLC (AEM), which is wholly-owned by AEH. AEM provides a variety of natural gas management services to municipalities, natural gas utility systems and industrial natural gas customers, primarily in the southeastern and midwestern states and to our Kentucky, Louisiana and Mid-States utility divisions. These services consist primarily of furnishing natural gas supplies at fixed and market-based prices, contract negotiation and administration, load forecasting, gas storage acquisition and management services, transportation services, peaking sales and balancing services, capacity utilization strategies and gas price hedging through the use of derivative instruments.

Our pipeline and storage business includes the regulated operations of our Atmos Pipeline – Texas Division, a division of Atmos Energy Corporation, and the nonregulated operations of Atmos Pipeline and Storage, LLC (APS), which is wholly-owned by AEH. The Atmos Pipeline – Texas Division transports natural gas to our Atmos Energy Mid-Tex Division and to third parties, as well as manages five underground storage reservoirs in Texas. Through APS, we own or have an interest in underground storage fields in Kentucky and Louisiana. We also use these storage facilities to reduce the need to contract for additional pipeline capacity to meet customer demand during peak periods.

Our other nonutility businesses consist primarily of the operations of Atmos Energy Services, LLC (AES) and Atmos Power Systems, Inc., which are each wholly-owned by AEH. Through AES, we provide natural gas management services to our utility operations, other than the Mid-Tex Division. These services include aggregating and purchasing gas supply, arranging transportation and storage logistics and ultimately delivering the gas to our utility service areas at competitive prices in exchange for revenues that are equal to the costs incurred to provide these services. Through Atmos Power Systems, Inc., we construct gas-fired electric peaking power-generating plants and associated facilities and may enter into agreements to either lease or sell these plants.

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ATMOS ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Unaudited Interim Financial Information

In the opinion of management, all material adjustments (consisting of normal recurring accruals) necessary for a fair presentation have been made to the unaudited consolidated interim-period financial statements. These consolidated interim-period financial statements and notes are condensed as permitted by the instructions to Form 10-Q and should be read in conjunction with the audited consolidated financial statements of Atmos Energy Corporation in its Annual Report on Form 10-K for the fiscal year ended September 30, 2005. Because of seasonal and other factors, the results of operations for the three and six-month periods ended March 31, 2006 are not indicative of expected results of operations for the full 2006 fiscal year, which ends September 30, 2006.

Basis of Comparison

Certain prior-period amounts have been reclassified to conform with the current year's presentation.

Significant accounting policies

Our accounting policies are described in Note 2 to our Annual Report on Form 10-K for the year ended September 30, 2005. Except for the Company's adoption of Statement of Financial Accounting Standards (SFAS) 123 (revised), *Share-Based Payment*, discussed below, there were no significant changes to our accounting policies during the six months ended March 31, 2006.

Additionally, during the second quarter of fiscal 2006, we completed our annual goodwill impairment assessment. Based on the assessment performed, our goodwill was not considered to be impaired.

Stock-based compensation plans

Our 1998 Long-Term Incentive Plan provides for the granting of incentive stock options, non-qualified stock options, stock appreciation rights, bonus stock, time-lapse restricted stock, performance-based restricted stock units and stock units to officers and key employees. Non-employee directors are also eligible to receive stock-based compensation under the 1998 Long-Term Incentive Plan. The objectives of this plan include attracting and retaining the best personnel, providing for additional performance incentives and promoting our success by providing employees with the opportunity to acquire our common stock.

On October 1, 2005, the Company adopted SFAS 123 (revised), *Share-Based Payment* (SFAS 123(R)). This standard revises SFAS 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*. Under SFAS 123(R), the Company is required to measure the cost of employee services received in exchange for stock options and similar awards based on the grant-date fair value of the award and recognize this cost in the income statement over the period during which an employee is required to provide service in exchange for the award.

We adopted SFAS 123(R) using the modified prospective method. Under this transition method, stock-based compensation expense for the three and six months ended March 31, 2006 included: (i) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 1, 2005, based on the grant-date

fair value estimated in accordance with the original provisions of SFAS 123; and (ii) compensation expense for all stock-based compensation awards granted subsequent to October 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). We recognize compensation expense on a straight-line basis over the requisite service period of the award. The impact of adoption on total stock-based compensation expense included in our statement of income for the three and six months ended March 31, 2006 was \$0.3 million and \$0.4 million and was recorded as a component of operation and maintenance expense. In accordance with the modified prospective method, financial results for prior periods have not been restated.

Prior to October 1, 2005, we accounted for these plans under the intrinsic-value method described in APB Opinion 25, as permitted by SFAS 123. Under this method, no compensation cost for stock options was recognized

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for stock-option awards granted at or above fair-market value. Awards of restricted stock were valued at the market price of the Company's common stock on the date of grant. The unearned compensation was amortized as a component of operation and maintenance expense over the vesting period of the restricted stock.

Total stock-based compensation expense for the three and six months ended March 31, 2006 was \$0.8 million and \$2.2 million as compared to \$0.7 million and \$1.5 million for the three and six months ended March 31, 2005. Had compensation expense for our stock-based awards been recognized as prescribed by SFAS 123, our net income and earnings per share for the three and six months ended March 31, 2005 would have been impacted as shown in the following table:

	Three Months Ended March 31, 2005	Six Months Ended March 31, 2005
	(In thousands, except per share data)	
Net income as reported	\$ 88,502	\$ 148,101
Restricted stock compensation expense included in income, net of tax	469	962
Total stock-based employee compensation expense determined under fair-value- based method for all awards, net of taxes	(684)	(1,427)
Net income pro forma	\$ 88,287	\$ 147,636
Earnings per share:		
Basic earnings per share as reported	\$ 1.12	\$ 1.92
Basic earnings per share pro forma	\$ 1.11	\$ 1.91
Diluted earnings per share as reported	\$ 1.11	\$ 1.90
Diluted earnings per share pro forma	\$ 1.11	\$ 1.90

Regulatory assets and liabilities

We record certain costs as regulatory assets in accordance with SFAS 71, *Accounting for the Effects of Certain Types of Regulation*, when future recovery through customer rates is considered probable. Regulatory liabilities are recorded when it is probable that revenues will be reduced for amounts that will be credited to customers through the ratemaking process. Substantially all of our regulatory assets are recorded as a component of deferred charges and substantially all of our regulatory liabilities are recorded as a component of deferred credits and other liabilities. Deferred gas costs are recorded either in other current assets or liabilities and the regulatory cost of removal obligation is separately reported.

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Significant regulatory assets and liabilities as of March 31, 2006 and September 30, 2005 included the following:

	March 31, 2006	September 30, 2005
	(In thousands)	
Regulatory assets:		
Merger and integration costs, net	\$ 8,980	\$ 9,150
Deferred gas cost	108,130	38,173
Environmental costs	1,268	1,357
Rate case costs	9,256	11,314
Deferred franchise fees	142	6,710
Other	9,019	9,313
	\$ 136,795	\$ 76,017
Regulatory liabilities:		
Deferred gas costs	\$ 29,258	\$ 134,048
Regulatory cost of removal obligation	286,894	274,989
Deferred income taxes, net	3,185	3,185
Other	7,075	8,084
	\$ 326,412	\$ 420,306

Currently authorized rates do not include a return on certain of our merger and integration costs; however, we recover the amortization of these costs. Merger and integration costs, net, are generally amortized on a straight-line basis over estimated useful lives ranging up to 20 years. Environmental costs have been deferred to be included in future rate filings in accordance with rulings received from various regulatory commissions.

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The following table presents the components of comprehensive income, net of related tax, for the three and six-month periods ended March 31, 2006 and 2005:

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
	(In thousands)			
Net income	\$ 88,796	\$ 88,502	\$ 159,823	\$ 148,101
Unrealized holding gains on investments, net of tax expense of \$294 and \$80 for the three months ended March 31, 2006 and 2005 and of \$542 and \$729 for the six months ended March 31, 2006 and 2005	479	132	884	1,189
Amortization and unrealized losses on interest rate hedging transactions, net of tax expense (benefit) of \$527 and \$527 for the three months ended March 31, 2006 and 2005 and \$1,055 and \$(2,718) for the six months ended March 31, 2006 and 2005	861	861	1,721	(4,435)
Net unrealized gains (losses) on commodity hedging transactions, net of tax expense (benefit) of \$(2,927) and \$7,915 for the three months ended March 31, 2006 and 2005 and \$(17,676) and \$3 for the six months ended March 31, 2006 and 2005	(4,776)	12,913	(28,839)	5
Comprehensive income	\$ 85,360	\$ 102,408	\$ 133,589	\$ 144,860

Accumulated other comprehensive loss, net of tax, as of March 31, 2006 and September 30, 2005 consisted of the following unrealized gains (losses):

	March 31, 2006	September 30, 2005
	(In thousands)	
Accumulated other comprehensive loss:		
Unrealized holding gains on investments	\$ 1,568	\$ 684
Treasury lock agreements	(22,261)	(23,982)
Cash flow hedges	(8,882)	19,957

\$ (29,575) \$ (3,341)

Recent accounting pronouncements

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when the obligation is incurred generally upon acquisition, construction or development and/or through the normal operation of the asset, if the fair value of the liability can be reasonably estimated. A conditional asset retirement obligation is a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Uncertainty about the timing and/or method of settlement is required to be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement

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ATMOS ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

obligation. We will be required to apply the provisions of FIN 47 by September 30, 2006. We are currently evaluating the impact that FIN 47 may have on our financial position, results of operations and cash flows.

In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 (a) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (b) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (d) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and (e) amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired or issued by us after October 1, 2006 and is not expected to have a material impact on our financial position, results of operations and cash flows.

In March 2006, the FASB issued SFAS 156, *Accounting for Servicing Financial Assets*, which amends SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 156 (a) revises guidance on when a servicing asset and servicing liability should be recognized, (b) requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, (c) permits an entity to choose to measure servicing assets and servicing liabilities under the amortization method or fair value measurement method, (d) at initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities for securities which are identified as offsetting the exposure to changes in the fair value of servicing assets or liabilities that the servicer elects to subsequently measure at fair value and (e) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional footnote disclosure. We will be required to apply the provisions of SFAS 156 beginning October 1, 2006 but such application is not expected to have a material impact on our financial position, results of operations and cash flows.

3. Derivative Instruments and Hedging Activities

We conduct risk management activities through both our utility and natural gas marketing segments. We record our derivatives as a component of risk management assets and liabilities, which are classified as current or noncurrent other assets or liabilities based upon the anticipated settlement date of the underlying derivative. Our determination of the fair value of these derivative financial instruments reflects the estimated amounts that we would receive or pay to terminate or close the contracts at the reporting date, taking into account the current unrealized gains and losses on open contracts. In our determination of fair value, we consider various factors, including closing exchange and over-the-counter quotations, time value and volatility factors underlying the contracts. Effective October 1, 2005, the Company changed its mark to market measurement from Inside FERC to Gas Daily to better reflect the prices of our physical commodity. This change did not have a material impact on our financial position on the date of adoption.

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table shows the fair values of our risk management assets and liabilities by segment at March 31, 2006 and September 30, 2005:

	Utility	Natural Gas Marketing (In thousands)	Total
March 31, 2006:			
Assets from risk management activities, current	\$ 13,419	\$ 15,977	\$ 29,396
Assets from risk management activities, noncurrent			
Liabilities from risk management activities, current	(1,067)	(17,530)	(18,597)
Liabilities from risk management activities, noncurrent		(1,861)	(1,861)
Net assets (liabilities)	\$ 12,352	\$ (3,414)	\$ 8,938
September 30, 2005:			
Assets from risk management activities, current	\$ 93,310	\$ 14,603	\$ 107,913
Assets from risk management activities, noncurrent		735	735
Liabilities from risk management activities, current		(61,920)	(61,920)
Liabilities from risk management activities, noncurrent		(15,316)	(15,316)
Net assets (liabilities)	\$ 93,310	\$ (61,898)	\$ 31,412

Utility Hedging Activities

We use a combination of storage, fixed physical contracts and fixed financial contracts to partially insulate us and our customers against gas price volatility during the winter heating season. Because the gains or losses of financial derivatives used in our utility segment ultimately will be recovered through our rates, current period changes in the assets and liabilities from these risk management activities are recorded as a component of deferred gas costs in accordance with SFAS 71, *Accounting for the Effects of Certain Types of Regulation*. Accordingly, there is no earnings impact to our utility segment as a result of the use of financial derivatives. Our utility hedging activities also include the cost of our Treasury lock agreements which are described in further detail below.

Nonutility Hedging Activities

AEM manages its exposure to the risk of natural gas price changes through a combination of storage and financial derivatives, including futures, over-the-counter and exchange-traded options and swap contracts with counterparties. Our financial derivative activities include fair value hedges to offset changes in the fair value of our natural gas inventory and cash flow hedges to offset anticipated purchases and sales of gas in the future. AEM also utilizes basis swaps and other non-hedge derivative instruments to manage its exposure to market volatility.

For the three and six-month periods ended March 31, 2006, the change in the deferred hedging position in accumulated other comprehensive loss was attributable to decreases in future commodity prices relative to the commodity prices stipulated in the derivative contracts, and the recognition for the six months ended March 31, 2006 of \$8.2 million in net deferred hedging gains (\$7.1 million in net deferred hedging losses during the three months ended March 31, 2006) in net income when the derivative contracts matured according to their terms. The net deferred hedging loss associated with open cash flow hedges remains subject to market price fluctuations until the positions are either settled under the terms of the hedge contracts or terminated prior to settlement. Substantially all of the deferred hedging balance as of March 31, 2006 is expected to be recognized in net income in fiscal 2006 along with the corresponding hedged purchases and sales of natural gas.

Under our risk management policies, we seek to match our financial derivative positions to our physical storage positions as well as our expected current and future sales and purchase obligations to maintain no open

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positions at the end of each trading day. The determination of our net open position as of any day, however, requires us to make assumptions as to future circumstances, including the use of gas by our customers in relation to our anticipated storage and market positions. Because the price risk associated with any net open position at the end of each day may increase if the assumptions are not realized, we review these assumptions as part of our daily monitoring activities. We may also be affected by intraday fluctuations of gas prices, since the price of natural gas purchased or sold for future delivery earlier in the day may not be hedged until later in the day. At times, limited net open positions related to our existing and anticipated commitments may occur. At the close of business on March 31, 2006, AEH had a net open position (including existing storage) of 0.3 Bcf.

Treasury Activities

During fiscal 2004, we entered into four Treasury lock agreements to fix the Treasury yield component of the interest cost of financing associated with the anticipated issuance of \$875 million of long-term debt in October 2004. We designated these Treasury lock agreements as cash flow hedges of an anticipated transaction. These Treasury lock agreements were settled in October 2004 with a net \$43.8 million payment to the counterparties. This payment was recorded in accumulated other comprehensive loss and is being recognized as a component of interest expense over a period of five to ten years. During the three and six-month periods ended March 31, 2006, we recognized approximately \$1.4 million and \$2.8 million of this amount as a component of interest expense.

4. Debt***Long-term debt***

Long-term debt at March 31, 2006 and September 30, 2005 consisted of the following:

	March 31, 2006	September 30, 2005
	(In thousands)	
Unsecured floating rate Senior Notes, due October 2007	\$ 300,000	\$ 300,000
Unsecured 4.00% Senior Notes, due 2009	400,000	400,000
Unsecured 7.375% Senior Notes, due 2011	350,000	350,000
Unsecured 10% Notes, due 2011	2,303	2,303
Unsecured 5.125% Senior Notes, due 2013	250,000	250,000
Unsecured 4.95% Senior Notes, due 2014	500,000	500,000
Unsecured 5.95% Senior Notes, due 2034	200,000	200,000
Medium term notes		
Series A, 1995-2, 6.27%, due 2010	10,000	10,000
Series A, 1995-1, 6.67%, due 2025	10,000	10,000
Unsecured 6.75% Debentures, due 2028	150,000	150,000
First Mortgage Bonds		
Series P, 10.43% due 2013	8,750	10,000
Other term notes due in installments through 2013	6,927	7,839

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Total long-term debt	2,187,980	2,190,142
Less:		
Original issue discount on unsecured senior notes and debentures	(3,552)	(3,774)
Current maturities	(3,308)	(3,264)
	\$ 2,181,120	\$ 2,183,104

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ATMOS ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our unsecured floating rate debt bears interest at a rate equal to the three-month LIBOR rate plus 0.375 percent per year. At March 31, 2006, the interest rate on our floating rate debt was 4.975 percent.

Short-term debt

At March 31, 2006 and September 30, 2005, there was \$262.3 million and \$144.8 million outstanding under our commercial paper program and bank credit facilities.

Credit facilities

We maintain both committed and uncommitted credit facilities. Borrowings under our uncommitted credit facilities are made on a when-and-as-needed basis at the discretion of the banks. Our credit capacity and the amount of unused borrowing capacity are affected by the seasonal nature of the natural gas business and our short-term borrowing requirements, which are typically highest during colder winter months. Our working capital needs can vary significantly due to changes in the price of natural gas and the increased gas supplies required to meet customers needs during periods of cold weather.

Committed credit facilities

As of March 31, 2006, we had three short-term committed revolving credit facilities totaling \$918 million. The first facility is a three-year unsecured facility, expiring October 2008, for \$600 million that bears interest at a base rate or at the LIBOR rate plus from 0.40 percent to 1.00 percent, based on the Company's credit ratings, and serves as a backup liquidity facility for our \$600 million commercial paper program. At March 31, 2006, there was \$262.3 million outstanding under our commercial paper program.

We have a second unsecured facility in place which is a 364-day facility expiring November 2006, for \$300 million that bears interest at a base rate or the LIBOR rate plus from 0.40 percent to 1.00 percent, based on the Company's credit ratings. At March 31, 2006, there were no borrowings under this facility.

We have a third unsecured facility in place for \$18 million that bears interest at the Federal Funds rate plus 0.5 percent. This facility expired on March 31, 2006 and was renewed effective April 1, 2006 for one year with no material changes to its terms and pricing. There were no borrowings outstanding under this facility at March 31, 2006.

The availability of funds under our credit facilities is subject to conditions specified in the respective credit agreements, all of which we currently meet. These conditions include our compliance with financial covenants and the continued accuracy of representations and warranties contained in these agreements. We are required by the financial covenants in both our \$600 million three-year credit facility and \$300 million 364-day credit facility to maintain, at the end of each fiscal quarter, a ratio of total debt to total capitalization of no greater than 70 percent. At March 31, 2006, our total-debt-to-total-capitalization ratio, as defined, was 62 percent. In addition, the fees that we pay on unused amounts under both the \$600 million and \$300 million credit facilities are subject to adjustment depending upon our credit ratings.

Uncommitted credit facilities

On November 28, 2005, AEM amended its \$250 million uncommitted demand working capital credit facility to increase the amount of credit available from \$250 million to a maximum of \$580 million. On March 31, 2006, AEM amended and extended this uncommitted demand working capital credit facility to March 31, 2007.

Borrowings under the credit facility can be made either as revolving loans or offshore rate loans. Revolving loan borrowings will bear interest at a floating rate equal to a base rate (defined as the higher of 0.50 percent per annum above the Federal Funds rate or the lender's prime rate) plus 0.25 percent. Offshore rate loan borrowings will bear interest at a floating rate equal to a base rate based upon LIBOR plus an applicable margin, ranging from

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1.25 percent to 1.625 percent per annum, depending on the excess tangible net worth of AEM, as defined in the credit facility. Borrowings drawn down under letters of credit issued by the banks will bear interest at a floating rate equal to the base rate, as defined above, plus an applicable margin, which will range from 1.00 percent to 1.875 percent per annum, depending on the excess tangible net worth of AEM and whether the letters of credit are swap-related standby letters of credit.

AEM is required by the financial covenants in the credit facility to maintain a maximum ratio of total liabilities to tangible net worth of 5 to 1, along with minimum levels of net working capital ranging from \$20 million to \$120 million. Additionally, AEM must maintain a minimum tangible net worth ranging from \$21 million to \$121 million, and must not have a maximum cumulative loss from March 30, 2005 exceeding \$4 million to \$23 million, depending on the total amount of borrowing elected from time to time by AEM. At March 31, 2006, AEM's ratio of total liabilities to tangible net worth, as defined, was 1.21 to 1.

At March 31, 2006, there were no borrowings outstanding under this credit facility. However, at March 31, 2006, AEM letters of credit totaling \$151.8 million had been issued under the facility, which reduced the amount available by a corresponding amount. The amount available under this credit facility is also limited by various covenants, including covenants based on working capital. Under the most restrictive covenant, the amount available to AEM under this credit facility was \$174.2 million at March 31, 2006. This line of credit is collateralized by substantially all of the assets of AEM and is guaranteed by AEH.

The Company also has an unsecured short-term uncommitted credit line for \$25 million that is used for working-capital and letter-of-credit purposes. There were no borrowings under this uncommitted credit facility at March 31, 2006, but letters of credit reduced the amount available by \$4.5 million. This uncommitted line is renewed or renegotiated at least annually with varying terms, and we pay no fee for the availability of the line. Borrowings under this line are made on a when-and-as-available basis at the discretion of the bank.

AEH, the parent company of AEM, has a \$100 million intercompany uncommitted demand credit facility with the Company which bears interest at LIBOR plus 2.75 percent. This facility has been approved by our state regulators through December 31, 2006. At March 31, 2006, \$65.1 million was outstanding under this facility.

In addition, AEM has a \$120 million intercompany uncommitted demand credit facility with AEH for its nonutility business which bears interest at LIBOR plus 2.75 percent. Any outstanding amounts under this facility are subordinated to AEM's \$580 million uncommitted demand credit facility described above. This facility is used to supplement AEM's \$580 million credit facility. At March 31, 2006, \$62 million was outstanding under this facility.

Debt Covenants

We have other covenants in addition to those described above. Our Series P First Mortgage Bonds contain provisions that allow us to prepay the outstanding balance in whole at any time, after November 2007, subject to a prepayment premium. The First Mortgage Bonds provide for certain cash flow requirements and restrictions on additional indebtedness, sale of assets and payment of dividends. Under the most restrictive of such covenants, cumulative cash dividends paid after December 31, 1985 may not exceed the sum of accumulated net income for periods after December 31, 1985 plus \$9 million. At March 31, 2006 approximately \$266.8 million of retained earnings was unrestricted with respect to the payment of dividends.

We were in compliance with all of our debt covenants as of March 31, 2006. If we do not comply with our debt covenants, we may be required to repay our outstanding balances on demand, provide additional collateral or take other corrective actions. Our two public debt indentures relating to our senior notes and debentures, as well as our \$600 million and \$300 million revolving credit agreements, each contain a default provision that is triggered if outstanding indebtedness arising out of any other credit agreements in amounts ranging from in excess of \$15 million to in excess of \$100 million becomes due by acceleration or is not paid at maturity. In addition, AEM's credit agreement contains a cross-default provision whereby AEM would be in default if it defaults on other

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indebtedness, as defined, by at least \$250 thousand in the aggregate. Additionally, this agreement contains a provision that would limit the amount of credit available if Atmos were downgraded below an S&P rating of BBB and a Moody's rating of Baa2.

Except as described above, we have no triggering events in our debt instruments that are tied to changes in specified credit ratings or stock price, nor have we entered into any transactions that would require us to issue equity, based on our credit rating or other triggering events.

5. Stock-Based Compensation***Stock-Based Compensation Plans***

On August 12, 1998, the Board of Directors approved and adopted the 1998 Long-Term Incentive Plan, which became effective October 1, 1998 after approval by our shareholders. The Long-Term Incentive Plan is a comprehensive, long-term incentive compensation plan providing for discretionary awards of incentive stock options, non-qualified stock options, stock appreciation rights, bonus stock, time-lapse restricted stock, performance-based restricted stock units and stock units to certain employees and non-employee directors of Atmos and its subsidiaries. The objectives of this plan include attracting and retaining the best personnel, providing for additional performance incentives and promoting our success by providing employees with the opportunity to acquire common stock. We are authorized to grant awards for up to a maximum of four million shares of common stock under this plan subject to certain adjustment provisions. As of March 31, 2006, non-qualified stock options, bonus stock, time-lapse restricted stock, performance-based restricted stock units and stock units have been issued under this plan and 1,064,624 shares were available for issuance. The option price of the stock options issued under this plan is equal to the market price of our stock at the date of grant. These stock options expire 10 years from the date of the grant and vest annually over a service period ranging from one to three years.

We used the Black-Scholes pricing model to estimate the fair value of each option granted with the following weighted average assumptions:

Valuation Assumptions⁽¹⁾	Six Months Ended March 31	
	2006	2005
Expected Life (years) ⁽²⁾	7	7
Interest rate ⁽³⁾	4.6%	4.2%
Volatility ⁽⁴⁾	20.3%	21.3%
Dividend yield	4.8%	4.8%

⁽¹⁾ Beginning on the date of adoption of SFAS 123(R), forfeitures are estimated based on historical experience. Prior to the date of adoption, forfeitures were recorded as they occurred.

⁽²⁾ The expected life of stock options is estimated based on historical experience.

- (3) The interest rate is based on the U.S. Treasury constant maturity interest rate whose term is consistent with the expected life of the stock options.
- (4) The volatility is estimated based on historical and current stock data for the Company.

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A summary of option activity as of March 31, 2006, and changes during the six months then ended, is presented below:

	Number of Options	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at September 30, 2005	964,704	\$ 22.20		
Granted	93,196	26.19		
Exercised	(2,166)	20.18		
Forfeited	(166)	21.23		
Outstanding at March 31, 2006	1,055,568	\$ 22.56	5.9	\$ 3,840
Exercisable at March 31, 2006	1,028,794	\$ 22.48	5.8	\$ 3,741

The stock options had a weighted-average fair value per share on the date of grant of \$3.74 and \$3.69 for the six months ended March 31, 2006 and 2005. There were no stock options granted during the three months ended March 31, 2006 and 2005. Net cash proceeds from the exercise of stock options during the six months ended March 31, 2006 and 2005 were less than \$0.1 million and \$9.1 million and during the three months ended March 31, 2006 and 2005 were less than \$0.1 and \$8 million. The associated income tax benefit from stock options exercised during the six months ended March 31, 2006 and 2005 was less than \$0.1 million and \$1 million, and during the three months ended March 31, 2006 and 2005 was less than \$0.1 million and \$0.9 million. The total intrinsic value of options exercised during the six months ended March 31, 2006 and 2005 was less than \$0.1 million and \$1.5 million, and during the three months ended March 31, 2006 and 2005 was less than \$0.1 million and \$1.3 million.

As of March 31, 2006, there was less than \$0.1 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted-average period of 1.7 years.

Restricted Stock Plans

As noted above, the 1998 Long-Term Incentive Plan provides for discretionary awards of time-lapse restricted stock and performance-based restricted stock units to help attract, retain and reward employees and non-employee directors of Atmos and its subsidiaries. Certain of these awards vest based upon the passage of time and other awards vest based upon the passage of time and the achievement of specified performance targets. The associated expense is recognized ratably over the vesting period.

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A summary of the status of the Company's nonvested restricted shares as of March 31, 2006, and changes during the six months then ended, is presented below:

	Number of Restricted Shares	Weighted- Average Grant-Date Fair Value
Nonvested at September 30, 2005	592,490	\$ 25.32
Granted	83,941	26.19
Vested	(76,190)	21.33
Forfeited	(1,428)	25.55
Nonvested at March 31, 2006	598,813	\$ 25.95

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As of March 31, 2006, there was \$8.8 million of total unrecognized compensation cost related to nonvested restricted shares granted under the 1998 Long-Term Incentive Plan. That cost is expected to be recognized over a weighted-average period of 1.7 years. The total fair value of restricted stock vested during the six months ended March 31, 2006 and 2005 was \$1.6 million and \$0.5 million, and during the three months ended March 31, 2006 was \$1.2 million. There were no restricted stock grants that vested during the three months ended March 31, 2005.

6. Earnings Per Share

Basic and diluted earnings per share for the three and six months ended March 31, 2006 and 2005 are calculated as follows:

	For the Three Months Ended March 31		For the Six Months Ended March 31	
	2006	2005	2006	2005
	(In thousands, except per share amounts)			
Net income	\$ 88,796	\$ 88,502	\$ 159,823	\$ 148,101
Denominator for basic income per share weighted average common shares	80,573	79,270	80,444	77,290
Effect of dilutive securities:				
Restricted and other shares	369	335	369	330
Stock options	98	155	98	149
Denominator for diluted income per share weighted average common shares	81,040	79,760	80,911	77,769
Income per share basic	\$ 1.10	\$ 1.12	\$ 1.99	\$ 1.92
Income per share diluted	\$ 1.10	\$ 1.11	\$ 1.98	\$ 1.90

There were no out-of-the-money options excluded from the computation of diluted earnings per share for the three and six months ended March 31, 2006 and 2005 as their exercise price was less than the average market price of the common stock during that period.

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The components of our net periodic pension cost for our pension and other postretirement benefit plans for the three and six months ended March 31, 2006 and 2005 are presented in the following tables. All of these costs are recoverable through our gas utility rates; however, a portion of these costs is capitalized into our utility rate base. The remaining costs are recorded as a component of operation and maintenance expense.

	Three Months Ended March 31			
	Pension Benefits		Other Benefits	
	2006	2005	2006	2005
	(In thousands)			
Components of net periodic pension cost:				
Service cost	\$ 4,117	\$ 3,136	\$ 3,271	\$ 2,478
Interest cost	5,722	6,017	2,210	2,366
Expected return on assets	(6,400)	(6,885)	(547)	(518)
Amortization of transition asset		1	378	378
Amortization of prior service cost	16	(2)	90	96
Amortization of actuarial loss	3,299	1,891	320	151
Net periodic pension cost	\$ 6,754	\$ 4,158	\$ 5,722	\$ 4,951

	Six Months Ended March 31			
	Pension Benefits		Other Benefits	
	2006	2005	2006	2005
	(In thousands)			
Components of net periodic pension cost:				
Service cost	\$ 8,234	\$ 6,272	\$ 6,542	\$ 4,956
Interest cost	11,444	12,034	4,420	4,732
Expected return on assets	(12,800)	(13,770)	(1,094)	(1,036)
Amortization of transition asset		2	756	756
Amortization of prior service cost	32	(4)	180	192
Amortization of actuarial loss	6,598	3,782	640	302
Net periodic pension cost	\$ 13,508	\$ 8,316	\$ 11,444	\$ 9,902

The assumptions used to develop our net periodic pension cost for the three and six months ended March 31, 2006 and 2005 are as follows:

	Pension Benefits		Other Benefits	
	2006	2005	2006	2005
Discount rate	5.00%	6.25%	5.00%	6.25%
Rate of compensation increase	4.00%	4.00%	4.00%	4.00%
Expected return on plan assets	8.50%	8.75%	5.30%	5.30%

The discount rate used to compute the present value of a plan's liabilities generally is based on rates of high-grade corporate bonds with maturities similar to the average period over which the benefits will be paid. During the six months ended March 31, 2006, we did not make a voluntary contribution to our pension plans. However, we contributed \$5.3 million to our other postretirement plans and we expect to contribute approximately \$12 million to these plans during fiscal 2006.

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. Commitments and Contingencies***Litigation and Environmental Matters*

With respect to the specific litigation and environmental-related matters or claims that were disclosed in Note 13 to our annual report on Form 10-K for the year ended September 30, 2005, there were no material changes in the status of such litigation and environmental-related matters or claims during the six months ended March 31, 2006. We continue to believe that the final outcome of such litigation and environmental-related matters or claims will not have a material adverse effect on our financial condition, results of operations or net cash flows.

In addition, we are involved in other litigation and environmental-related matters or claims that arise in the ordinary course of our business. While the ultimate results of such litigation and response actions to such environmental-related matters or claims cannot be predicted with certainty, we believe the final outcome of such litigation and response actions will not have a material adverse effect on our financial condition, results of operations or net cash flows.

Purchase Commitments

AEM has commitments to purchase physical quantities of natural gas under contracts indexed to the forward NYMEX strip or fixed price contracts. At March 31, 2006, AEM was committed to purchase 64.2 Bcf within one year, 33.1 Bcf within one to three years and 5.4 Bcf after three years under indexed contracts. AEM is committed to purchase 1.6 Bcf within one year and 0.2 Bcf within one to three years under fixed price contracts with prices ranging from \$6.00 to \$12.00. Purchases under these contracts totaled \$531.8 million and \$345.3 million for the three months ended March 31, 2006 and 2005 and \$1,319.5 million and \$705.4 million for the six months ended March 31, 2006 and 2005.

Our utility operations, other than the Mid-Tex Division, maintain supply contracts with several vendors that generally cover a period of up to one year. Commitments for estimated base gas volumes are established under these contracts on a monthly basis at contractually negotiated prices. Commitments for incremental daily purchases are made as necessary during the month in accordance with the terms of the individual contract.

Our Mid-Tex Division maintains long-term supply contracts to ensure a reliable source of gas for our customers in its service area which obligate it to purchase specified volumes at market prices. The estimated fiscal year commitments under these contracts as of March 31, 2006 are as follows (in thousands):

2006	\$ 136,543
2007	241,031
2008	121,079
2009	12,022
2010	11,263
Thereafter	37,616
	\$ 559,554

Regulatory Matters

In February 2005, the Attorney General of the State of Kentucky filed a complaint at the Kentucky Public Service Commission (KPSC) alleging that our present rates are producing revenues in excess of reasonable levels. We answered the complaint and filed a Motion to Dismiss with the KPSC. On February 2, 2006, the KPSC issued an Order denying our Motion to Dismiss and on March 3, 2006 set a procedural schedule for the case. The Attorney General is currently conducting discovery. A hearing should be scheduled for early 2007. We believe that the Attorney General will not be able to demonstrate that our present rates are in excess of reasonable levels.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In August 2005, we received a show cause order from the City of Dallas, which requires us to provide information that demonstrates good cause for showing that our existing distribution rates charged to customers in the City of Dallas should not be reduced. In addition, during the first quarter of fiscal 2006, approximately 80 other cities in the Mid-Tex Division passed resolutions requesting that we show cause why existing distribution rates are just and reasonable and required a filing by us on a system-wide basis. We filed our response to these orders during the first quarter of fiscal 2006. Discovery has been conducted by the City of Dallas and the other cities. The 80 cities that acted in the first quarter of fiscal year 2006 have begun adopting resolutions requiring a reduction in the Mid-Tex Division's residential and commercial rates. We will be appealing these city actions to the Railroad Commission of Texas (RRC) where we believe that we will be able to demonstrate that our rates are just and reasonable.

In November 2005, we received a notice from the Tennessee Regulatory Authority (TRA) that it was opening an investigation into allegations by the Consumer Advocate Division of the Tennessee Attorney General's Office that we are overcharging customers in parts of Tennessee by approximately \$10 million per year. We have responded to numerous data requests from the TRA Staff. On April 24, 2006, the TRA Staff filed a Report and Recommendation in which it recommended that the TRA convene a contested case procedure for the purpose of establishing a fair and reasonable return. The TRA is scheduled to consider the Staff's recommendation on May 15, 2006. We believe that we are not overcharging our customers, and we intend to participate fully in the investigation.

In January 2006, the Lubbock, Texas City Council passed a resolution requiring Atmos to submit copies of all documentation necessary for the city to review the rates of Atmos West Texas Division to ensure they are just and reasonable. Information was provided to the city on February 28, 2006. We believe that we will be able to ultimately demonstrate to the City of Lubbock that our rates are just and reasonable.

Other

On November 30, 2005, we entered into an agreement with a third party to jointly construct, own and operate a 45-mile large diameter natural gas pipeline in the northern portion of the Dallas/Fort Worth Metroplex (North Side Loop). Under terms of the agreement, we are responsible for contributing no more than \$42.5 million to the construction costs of the pipeline. We are also responsible for 50 percent of the costs of the compression facilities. Approximately 21 miles of the pipeline was placed in service as of March 31, 2006. The remainder of the pipeline and the associated compressors are expected to be placed in service by the end of May 2006. As of March 31, 2006, we had spent \$26.2 million for the North Side Loop project and expect to spend approximately \$23.6 million in the remainder of fiscal 2006 for this project.

During the third quarter of fiscal 2005, we entered into two agreements with third parties to transport natural gas through our Texas intrastate pipeline system beginning in fiscal 2006. To handle the increased volumes for these projects, we will install compression equipment and other pipeline infrastructure. We expect to spend approximately \$32 million in fiscal 2006 for these projects, which are expected to be in service by the end of the fiscal year.

On August 29, 2005, Hurricane Katrina struck the Gulf Coast, inflicting significant damage to our eastern Louisiana operations. The hardest hit areas in our service territory were in Jefferson, St. Tammany, St. Bernard and Plaquemines parishes. In total, approximately 230,000 of our natural gas customers were affected in these areas. Although service has been restored for many of our customers, a significant number of customers will not require gas service for some time because of sustained damages. We cannot predict with certainty how many of these customers will return to these

service areas and over what time period. Additionally, we cannot accurately determine what regulatory actions, if any, may be taken by the regulators with respect to these areas. As of March 31, 2006, we believe adequate provision has been made for any losses that may not be fully recovered through insurance or for which we do not receive rate relief.

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Concentration of Credit Risk**

Credit risk is the risk of financial loss to us if a customer fails to perform its contractual obligations. We engage in transactions for the purchase and sale of products and services with major companies in the energy industry and with industrial, commercial, residential and municipal energy consumers. These transactions principally occur in the southern and midwestern regions of the United States. We believe that this geographic concentration does not contribute significantly to our overall exposure to credit risk. Credit risk associated with trade accounts receivable for the utility segment is mitigated by the large number of individual customers and diversity in our customer base.

Customer diversification also helps mitigate AEM's exposure to credit risk. AEM maintains credit policies with respect to its counterparties that it believes minimizes overall credit risk. Where appropriate, such policies include the evaluation of a prospective counterparty's financial condition, collateral requirements and the use of standardized agreements that facilitate the netting of cash flows associated with a single counterparty. AEM also monitors the financial condition of existing counterparties on an ongoing basis. Customers not meeting minimum standards are required to provide adequate assurance of financial performance.

AEM maintains a provision for credit losses based upon factors surrounding the credit risk of customers, historical trends and other information. We believe, based on our credit policies and our provisions for credit losses, that our financial position, results of operations and cash flows will not be materially affected as a result of nonperformance by any single counterparty.

AEM's estimated credit exposure is monitored in terms of the percentage of its customers that are rated as investment grade versus non-investment grade. Credit exposure is defined as the total of (1) accounts receivable, (2) delivered, but unbilled physical sales and (3) mark-to-market exposure for sales and purchases. Investment grade determinations are set internally by AEM's credit department, but are primarily based on external ratings provided by Moody's Investors Service Inc. (Moody's) and/or Standard & Poor's Corporation (S&P). For non-rated entities, the default rating for municipalities is investment grade, while the default rating for non-guaranteed industrial and commercial customers is non-investment grade. The following table shows the percentages related to the investment ratings as of March 31, 2006 and September 30, 2005.

	March 31, 2006	September 30, 2005
Investment grade	42%	49%
Non-investment grade	58%	51%
Total	100%	100%

The following table presents our derivative counterparty credit exposure by operating segment based upon the unrealized fair value of our derivative contracts that represent assets as of March 31, 2006. Investment grade counterparties have minimum credit ratings of BBB-, assigned by S&P; or Baa3, assigned by Moody's.

Non-investment grade counterparties are composed of counterparties that are below investment grade or that have not been assigned an internal investment grade rating due to the short-term nature of the contracts associated with that counterparty. This category is composed of numerous smaller counterparties, none of which is individually significant.

	Utility Segment⁽¹⁾	March 31, 2006 Natural Gas Marketing Segment (In thousands)	Consolidated
Investment grade counterparties	\$ 13,419	\$ 11,232	\$ 24,651
Non-investment grade counterparties		4,745	4,745
	\$ 13,419	\$ 15,977	\$ 29,396

⁽¹⁾ Counterparty risk for our utility segment is minimized because hedging gains and losses are passed through to our customers.

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ATMOS ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Segment Information

Atmos Energy Corporation and its subsidiaries are engaged primarily in the natural gas utility business as well as certain nonutility businesses. We distribute natural gas through sales and transportation arrangements to approximately 3.2 million residential, commercial, public authority and industrial customers throughout our seven regulated utility divisions, which cover service areas located in 12 states. In addition, we transport natural gas for others through our distribution system.

Through our nonutility businesses we provide natural gas management and marketing services to industrial customers, municipalities and other local distribution companies located in 22 states. Additionally, we provide natural gas transportation and storage services to certain of our utility operations and to third parties.

Our operations are divided into four segments:

the utility segment, which includes our regulated natural gas distribution and related sales operations,

the natural gas marketing segment, which includes a variety of nonregulated natural gas management services,

the pipeline and storage segment, which includes our regulated and nonregulated natural gas transmission and storage services and

the other nonutility segment, which includes all of our other nonregulated nonutility operations.

Our determination of reportable segments considers the strategic operating units under which we manage sales of various products and services to customers in differing regulatory environments. Although our utility segment operations are geographically dispersed, they are reported as a single segment as each utility division has similar economic characteristics. The accounting policies of the segments are the same as those described in the summary of significant accounting policies found in our annual report on Form 10-K for the fiscal year ended September 30, 2005. We evaluate performance based on net income or loss of the respective operating units.

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Income statements for the three and six-month periods ended March 31, 2006 and 2005 by segment are presented in the following tables:

	Three Months Ended March 31, 2006					Consolidated
	Utility	Natural Gas Marketing	and Storage	Pipeline and Other Nonutility	Eliminations	
	(In thousands)					
Operating revenues from external parties	\$ 1,447,376	\$ 564,737	\$ 21,238	\$ 495	\$	\$ 2,033,846
Intersegment revenues	244	253,892	24,245	1,100	(279,481)	
	1,447,620	818,629	45,483	1,595	(279,481)	2,033,846
Purchased gas cost	1,131,885	774,652	211		(278,305)	1,628,443
Gross profit	315,735	43,977	45,272	1,595	(1,176)	405,403
Operating expenses						
Operation and maintenance	94,363	5,821	12,363	1,361	(1,210)	112,698
Depreciation and amortization	41,907	475	4,669	25		47,076
Taxes, other than income	61,701	348	2,654	93		64,796
Total operating expenses	197,971	6,644	19,686	1,479	(1,210)	224,570
Operating income	117,764	37,333	25,586	116	34	180,833
Miscellaneous income (expense)	155	608	132	1,183	(4,517)	(2,439)
Interest charges	30,303	1,997	6,621	1,054	(4,483)	35,492
Income before income taxes	87,616	35,944	19,097	245		142,902
Income tax expense	32,988	14,012	7,010	96		54,106
Net income	\$ 54,628	\$ 21,932	\$ 12,087	\$ 149	\$	\$ 88,796
Capital expenditures	\$ 83,749	\$ 235	\$ 26,781	\$	\$	\$ 110,765

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Three Months Ended March 31, 2005					Consolidated
	Pipeline					
	Utility	Natural Gas Marketing	and Storage	Other Nonutility	Eliminations	
	(In thousands)					
Operating revenues from external parties	\$ 1,235,092	\$ 429,598	\$ 19,827	\$ 568	\$	\$ 1,685,085
Intersegment revenues	285	83,293	25,719	710	(110,007)	
	1,235,377	512,891	45,546	1,278	(110,007)	1,685,085
Purchased gas cost	912,309	501,731	4,407		(109,256)	1,309,191
Gross profit	323,068	11,160	41,139	1,278	(751)	375,894
Operating expenses						
Operation and maintenance	86,469	4,016	12,843	893	(801)	103,420
Depreciation and amortization	41,181	474	3,642	29		45,326
Taxes, other than income	52,220	261	2,398	88		54,967
Total operating expenses	179,870	4,751	18,883	1,010	(801)	203,713
Operating income	143,198	6,409	22,256	268	50	172,181
Miscellaneous income	1,974	201	292	616	(2,125)	958
Interest charges	28,062	679	6,228	179	(2,075)	33,073
Income before income taxes	117,110	5,931	16,320	705		140,066
Income tax expense	43,459	2,140	5,682	283		51,564
Net income	\$ 73,651	\$ 3,791	\$ 10,638	\$ 422	\$	\$ 88,502
Capital expenditures	\$ 63,129	\$ 228	\$ 6,908	\$	\$	\$ 70,265

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Six Months Ended March 31, 2006					
	Utility	Natural Gas Marketing	Pipeline and Storage	Other Nonutility	Eliminations	Consolidated
	(In thousands)					
Operating revenues from external parties	\$ 2,852,182	\$ 1,425,350	\$ 39,119	\$ 1,015	\$	\$ 4,317,666
Intersegment revenues	448	495,124	46,076	2,072	(543,720)	
	2,852,630	1,920,474	85,195	3,087	(543,720)	4,317,666
Purchased gas cost	2,256,714	1,850,178	211		(541,430)	3,565,673
Gross profit	595,916	70,296	84,984	3,087	(2,290)	751,993
Operating expenses						
Operation and maintenance	187,129	10,173	23,361	2,626	(2,374)	220,915
Depreciation and amortization	80,171	945	9,171	49		90,336
Taxes, other than income	104,603	591	4,814	204		110,212
Total operating expenses	371,903	11,709	37,346	2,879	(2,374)	421,463
Operating income	224,013	58,587	47,638	208	84	330,530
Miscellaneous income (expense)	2,992	1,198	1,537	1,844	(9,562)	(1,991)
Interest charges	61,891	4,859	12,594	1,815	(9,478)	71,681
Income before income taxes	165,114	54,926	36,581	237		256,858
Income tax expense	62,073	21,542	13,327	93		97,035
Net income	\$ 103,041	\$ 33,384	\$ 23,254	\$ 144	\$	\$ 159,823
Capital expenditures	\$ 156,164	\$ 567	\$ 56,499	\$	\$	\$ 213,230

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Six Months Ended March 31, 2005****Pipeline
and
Storage
Other
Nonutility
Eliminations
(In thousands)**

	Utility	Natural Gas Marketing	Pipeline and Storage (In thousands)	Other Nonutility	Eliminations	Consolidated
Operating revenues from external parties	\$ 2,148,498	\$ 862,508	\$ 41,579	\$ 1,124	\$	\$ 3,053,709
Intersegment revenues	560	144,184	47,657	1,513	(193,914)	
	2,149,058	1,006,692	89,236	2,637	(193,914)	3,053,709
Purchased gas cost	1,568,679	968,688	10,628		(192,283)	2,355,712
Gross profit	580,379	38,004	78,608	2,637	(1,631)	697,997
Operating expenses						
Operation and maintenance	183,022	7,462	23,504	1,940	(1,731)	214,197
Depreciation and amortization	80,232	978	8,055	58		89,323
Taxes, other than income	88,840	170	4,446	166		93,622
Total operating expenses	352,094	8,610	36,005	2,164	(1,731)	397,142
Operating income	228,285	29,394	42,603	473	100	300,855
Miscellaneous income	2,946	447	607	1,209	(3,866)	1,343
Interest charges	55,321	1,080	12,399	581	(3,766)	65,615
Income before income taxes	175,910	28,761	30,811	1,101		236,583
Income tax expense	65,236	11,708	11,089	449		88,482
Net income	\$ 110,674	\$ 17,053	\$ 19,722	\$ 652	\$	\$ 148,101
Capital expenditures	\$ 129,056	\$ 367	\$ 8,043	\$	\$	\$ 137,466

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Balance sheet information at March 31, 2006 and September 30, 2005 by segment is presented in the following tables:

	March 31, 2006				Eliminations	Consolidated
	Utility	Natural Gas Marketing	Pipeline and Storage	Other Nonutility		
(In thousands)						
ASSETS						
Property, plant and equipment, net	\$ 3,015,227	\$ 7,203	\$ 487,264	\$ 1,348	\$	\$ 3,511,042
Investment in subsidiaries	259,284	(2,086)			(257,198)	
Current assets						
Cash and cash equivalents	26,849	21,532		518		48,899
Cash held on deposit in margin account		13,537				13,537
Assets from risk management activities	13,419	21,392	4,317		(9,732)	29,396
Other current assets	1,014,883	420,241	44,985	66,200	(146,328)	1,399,981
Intercompany receivables	534,920			26,534	(561,454)	
Total current assets	1,590,071	476,702	49,302	93,252	(717,514)	1,491,813
Intangible assets		3,215				3,215
Goodwill	566,800	24,282	143,198			734,280
Noncurrent assets from risk management activities						
Deferred charges and other assets	231,699	1,372	5,296	18,334		256,701
	\$ 5,663,081	\$ 510,688	\$ 685,060	\$ 112,934	\$ (974,712)	\$ 5,997,051
CAPITALIZATION AND LIABILITIES						
Shareholders equity	\$ 1,706,291	\$ 139,625	\$ 86,425	\$ 33,234	\$ (259,284)	\$ 1,706,291
Long-term debt	2,176,251			4,869		2,181,120
Total capitalization	3,882,542	139,625	86,425	38,103	(259,284)	3,887,411
Current liabilities						
Current maturities of long-term debt	1,250			2,058		3,308
Short-term debt	262,315	62,000		65,105	(127,105)	262,315

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Liabilities from risk management activities	1,067	21,847	5,421		(9,738)	18,597
Other current liabilities	779,514	251,596	55,584		(17,131)	1,069,563
Intercompany payables		44,801	516,653		(561,454)	
Total current liabilities	1,044,146	380,244	577,658	67,163	(715,428)	1,353,783
Deferred income taxes	280,746	(11,282)	16,352	2,025		287,841
Noncurrent liabilities from risk management activities		1,861				1,861
Regulatory cost of removal obligation	275,209					275,209
Deferred credits and other liabilities	180,438	240	4,625	5,643		190,946
	\$ 5,663,081	\$ 510,688	\$ 685,060	\$ 112,934	\$ (974,712)	\$ 5,997,051

Table of Contents**ATMOS ENERGY CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	September 30, 2005					
	Utility	Natural Gas Marketing	Pipeline and Storage	Other Nonutility	Eliminations	Consolidated
	(In thousands)					
ASSETS						
Property, plant and equipment, net	\$ 2,926,096	\$ 7,278	\$ 439,574	\$ 1,419	\$	\$ 3,374,367
Investment in subsidiaries	231,342	(1,896)			(229,446)	
Current assets						
Cash and cash equivalents	10,663	28,949		504		40,116
Cash held on deposit in margin account	4,170	76,786				80,956
Assets from risk management activities	93,310	39,528	1,739		(26,664)	107,913
Other current assets	666,081	421,777	36,208	63,820	(152,441)	1,035,445
Intercompany receivables	505,728			20,133	(525,861)	
Total current assets	1,279,952	567,040	37,947	84,457	(704,966)	1,264,430
Intangible assets		3,507				3,507
Goodwill	566,800	24,282	143,198			734,280
Noncurrent assets from risk management activities		2,073	1,338		(2,676)	735
Deferred charges and other assets	249,179	1,461	5,737	19,831		276,208
	\$ 5,253,369	\$ 603,745	\$ 627,794	\$ 105,707	\$ (937,088)	\$ 5,653,527
CAPITALIZATION AND LIABILITIES						
Shareholders equity	\$ 1,602,422	\$ 144,827	\$ 53,426	\$ 33,089	\$ (231,342)	\$ 1,602,422
Long-term debt	2,177,279			5,825		2,183,104
Total capitalization	3,779,701	144,827	53,426	38,914	(231,342)	3,785,526
Current liabilities						
Current maturities of long-term debt	1,250			2,014		3,264
Short-term debt	144,809	60,000		51,320	(111,320)	144,809
Liabilities from risk management activities		63,936	25,038		(27,054)	61,920
Other current liabilities	623,300	217,777	95,557	4,963	(38,835)	902,762
Intercompany payables		87,968	437,893		(525,861)	

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Total current liabilities	769,359	429,681	558,488	58,297	(703,070)	1,112,755
Deferred income taxes	268,108	12,369	9,563	2,167		292,207
Noncurrent liabilities from risk management activities		16,654	1,338		(2,676)	15,316
Regulatory cost of removal obligation	263,424					263,424
Deferred credits and other liabilities	172,777	214	4,979	6,329		184,299
	\$ 5,253,369	\$ 603,745	\$ 627,794	\$ 105,707	\$ (937,088)	\$ 5,653,527

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Atmos Energy Corporation

We have reviewed the condensed consolidated balance sheet of Atmos Energy Corporation as of March 31, 2006, and the related condensed consolidated statements of income for the three-month and six-month periods ended March 31, 2006 and 2005, and the condensed consolidated statements of cash flows for the six-month periods ended March 31, 2006 and 2005. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Atmos Energy Corporation as of September 30, 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended, not presented herein, and in our report dated November 16, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of September 30, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Ernst & Young LLP

Dallas, Texas
May 2, 2006

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

The following discussion should be read in conjunction with the condensed consolidated financial statements in this Quarterly Report on Form 10-Q and Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended September 30, 2005.

Cautionary Statement for the Purposes of the Safe Harbor under the Private Securities Litigation Reform Act of 1995

The statements contained in this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact included in this Report are forward-looking statements made in good faith by the Company and are intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act of 1995. When used in this Report, or any other of the Company's documents or oral presentations, the words anticipate, believe, expect, estimate, forecast, goal, intend, objective, plan, strategy or similar words are intended to identify forward-looking statements. Such forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the statements relating to the Company's strategy, operations, markets, services, rates, recovery of costs, availability of gas supply and other factors. These risks and uncertainties include the following: adverse weather conditions, such as warmer than normal weather in the Company's gas utility service territories or colder than normal weather that could adversely affect our natural gas marketing activities; regulatory trends and decisions, including deregulation initiatives and the impact of rate proceedings before various state regulatory commissions; market risks beyond our control affecting our risk management activities including market liquidity, commodity price volatility and counterparty creditworthiness; national, regional and local economic conditions; the Company's ability to continue to access the capital markets; the effects of inflation and changes in the availability and prices of natural gas, including the volatility of natural gas prices; increased competition from energy suppliers and alternative forms of energy; risks relating to the acquisition of the TXU Gas operations, including without limitation, the Company's increased indebtedness resulting from the acquisition of the TXU Gas operations; the impact of recent natural disasters on our operations, especially Hurricane Katrina; and other uncertainties, which may be discussed herein, all of which are difficult to predict and many of which are beyond the control of the Company. A more detailed discussion of these risks and uncertainties may be found in the Company's Form 10-K for the year ended September 30, 2005. Accordingly, while the Company believes these forward-looking statements to be reasonable, there can be no assurance that they will approximate actual experience or that the expectations derived from them will be realized. Further, the Company undertakes no obligation to update or revise any of its forward-looking statements whether as a result of new information, future events or otherwise.

OVERVIEW

Atmos Energy Corporation and its subsidiaries are engaged primarily in the natural gas utility business as well as certain nonutility businesses. We distribute natural gas through sales and transportation arrangements to approximately 3.2 million residential, commercial, public authority and industrial customers throughout our seven regulated utility divisions, which cover service areas located in 12 states. In addition, we transport natural gas for others through our distribution system.

Through our nonutility businesses we provide natural gas management, transportation, storage and marketing services to industrial customers, municipalities and other local distribution companies located in 22 states. Additionally, we provide natural gas transportation and storage services to certain of our utility operations and to third parties.

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Our operations are divided into four segments:

the utility segment, which includes our regulated natural gas distribution and related sales operations,

the natural gas marketing segment, which includes a variety of nonregulated natural gas management services,

the pipeline and storage segment, which includes our regulated and nonregulated natural gas transmission and storage services and

the other nonutility segment, which includes all of our other nonregulated nonutility operations.

The following summarizes the results of our operations for the six months ended March 31, 2006:

Our utility segment net income decreased by \$7.6 million during the six months ended March 31, 2006. The decrease reflects the impact of weather, as adjusted for jurisdictions with weather-normalized rates, that was one percent warmer than the prior-year period and 12 percent warmer than normal, coupled with higher operating expenses.

Our natural gas marketing segment net income increased \$16.3 million during the six months ended March 31, 2006 compared with the six months ended March 31, 2005. The increase in natural gas marketing net income primarily reflects our ability to capture higher margins in a volatile natural gas market. These increases were partially offset by an unfavorable unrealized margin variance and an increase in interest charges resulting from increased short-term borrowings to fund working capital needs.

Our pipeline and storage segment net income increased \$3.5 million during the six months ended March 31, 2006 compared with the six months ended March 31, 2005, primarily reflecting Atmos Pipeline & Storage LLC's ability to capture more favorable arbitrage spreads in connection with its asset management contracts coupled with increased throughput on the Atmos Pipeline Texas system and higher transportation and related services margins.

Our total-debt-to-capitalization ratio at March 31, 2006 was 58.9 percent compared with 59.3 percent at September 30, 2005 reflecting the impact of current-year net income partially offset by an increase in short-term debt borrowings to fund working capital needs.

For the six months ended March 31, 2006, we generated \$148.4 million in operating cash flow compared with \$400.1 million for the six months ended March 31, 2005, reflecting the adverse impact of high natural gas costs on our working capital.

Capital expenditures increased to \$213.2 million in the six months ended March 31, 2006 from \$137.5 million in the prior-year period primarily reflecting increased capital spending for various pipeline expansion projects in our Atmos Pipeline Texas Division.

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

Our condensed consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States. Preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures of contingent assets and liabilities. We based our estimates on historical experience and various other assumptions that we believe to

be reasonable under the circumstances. On an ongoing basis, we evaluate our estimates, including those related to risk management and trading activities, allowance for doubtful accounts, legal and environmental accruals, insurance accruals, pension and postretirement obligations, deferred income taxes and the valuation of goodwill, indefinite-lived intangible assets and other long-lived assets. Actual results may differ from such estimates.

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Our critical accounting policies used in the preparation of our consolidated financial statements are described in our Annual Report on Form 10-K for the year ended September 30, 2005 and include the following:

Regulation

Revenue Recognition

Allowance for Doubtful Accounts

Derivatives and Hedging Activities

Impairment Assessments

Pension and Other Postretirement Plans

Our critical accounting policies are reviewed by the Audit Committee on a quarterly basis. There have been no significant changes to these critical accounting policies during the six months ended March 31, 2006.

RESULTS OF OPERATIONS

The following table presents our financial highlights for the three-month and six-month periods ended March 31, 2006 and 2005:

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
	(In thousands, unless otherwise noted)			
Operating revenues	\$ 2,033,846	\$ 1,685,085	\$ 4,317,666	\$ 3,053,709
Gross profit	405,403	375,894	751,993	697,997
Operating expenses	224,570	203,713	421,463	397,142
Operating income	180,833	172,181	330,530	300,855
Miscellaneous income (expense)	(2,439)	958	(1,991)	1,343
Interest charges	35,492	33,073	71,681	65,615
Income before income taxes	142,902	140,066	256,858	236,583
Income tax expense	54,106	51,564	97,035	88,482
Net income	\$ 88,796	\$ 88,502	\$ 159,823	\$ 148,101
Utility sales volumes MMcf	111,721	128,195	206,909	219,152
Utility transportation volumes MMcf	31,152	31,904	61,754	59,882
Total utility throughput MMcf	142,873	160,099	268,663	279,034
Natural gas marketing sales volumes MMcf	69,450	66,644	140,946	126,940
Pipeline transportation volumes MMcf	83,428	84,208	173,041	156,961

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Heating degree days ⁽¹⁾					
Actual (weighted average)	1,330	1,422	2,387	2,415	
Percent of normal	84%	90%	88%	89%	
Consolidated utility average transportation revenue per Mcf	\$ 0.61	\$ 0.53	\$ 0.56	\$ 0.55	
Consolidated utility average cost of gas per Mcf sold	\$ 10.13	\$ 7.12	\$ 10.91	\$ 7.16	

(1) Adjusted for service areas that have weather-normalized operations.

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The following table shows our operating income by segment for the three-month and six-month periods ended March 31, 2006 and 2005. The presentation of our utility operating income is included for financial reporting purposes and may not be appropriate for ratemaking purposes.

	Three Months Ended March 31			
	2006	2005	2006	2005
Operating	Heating Degree	Heating Degree	Operating	Heating Degree
Income	Days	Days	Income	Days
	Percent of		Percent of	
	Normal⁽¹⁾		Normal⁽¹⁾	
(In thousands, except degree day information)				
Colorado-Kansas	\$ 14,650	100%	\$ 16,248	97%
Kentucky	9,055	100%	10,758	100%
Louisiana	8,596	70%	16,250	74%
Mid-States	24,895	93%	24,705	95%
Mid-Tex	29,455	68%	41,022	82%
Mississippi	16,752	100%	18,509	100%
West Texas	13,539	100%	15,302	99%
Other	822		404	
Utility segment	117,764	84%	143,198	90%
Natural gas marketing segment	37,333		6,409	
Pipeline and storage segment	25,586		22,256	
Other nonutility segment and other	150		318	
Consolidated operating income	\$ 180,833	84%	\$ 172,181	90%

	Six Months Ended March 31			
	2006	2005	2006	2005
Operating	Heating Degree	Heating Degree	Operating	Heating Degree
Income	Days	Days	Income	Days
	Percent of		Percent of	
	Normal⁽¹⁾		Normal⁽¹⁾	
(In thousands, except degree day information)				
Colorado-Kansas	\$ 23,260	100%	\$ 24,483	98%
Kentucky	15,247	100%	16,603	98%
Louisiana	16,487	80%	22,583	78%
Mid-States	39,193	96%	35,843	93%
Mid-Tex	80,242	74%	79,570	80%
Mississippi	26,745	101%	27,116	95%
West Texas	19,670	100%	21,088	100%
Other	3,169		999	

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Utility segment	224,013	88%	228,285	89%
Natural gas marketing segment	58,587		29,394	
Pipeline and storage segment	47,638		42,603	
Other nonutility segment and other	292		573	
Consolidated operating income	\$ 330,530	88%	\$ 300,855	89%

(1) Adjusted for service areas that have weather-normalized operations.

Table of Contents***Three Months Ended March 31, 2006 compared with Three Months Ended March 31, 2005******Utility segment***

Our utility segment has historically contributed 65 to 85 percent of our consolidated net income. The primary factors that impact the results of our utility operations are seasonal weather patterns, competitive factors in the energy industry and economic conditions in our service areas. Natural gas sales to residential, commercial and public authority customers are affected by winter heating season requirements. This generally results in higher operating revenues and net income during the period from October through March of each year and lower operating revenues and either lower net income or net losses during the period from April through September of each year. Accordingly, our second fiscal quarter has historically been our most critical earnings quarter with an average of approximately 67 percent of our consolidated net income having been earned in the second quarter during the three most recently completed fiscal years. Additionally, we typically experience higher levels of accounts receivable, accounts payable, gas stored underground and short-term debt balances during the winter heating season due to the seasonal nature of our revenues and the need to purchase and store gas to support these operations. Utility sales to industrial customers are much less weather sensitive. Utility sales to agricultural customers, which typically use natural gas to power irrigation pumps during the period from March through September, are primarily affected by rainfall amounts and the price of natural gas.

Changes in the cost of gas impact revenue but do not directly affect our gross profit from utility operations because the fluctuations in gas prices are passed through to our customers. Accordingly, we believe gross profit margin is a better indicator of our financial performance than revenues. However, higher gas costs may cause customers to conserve, or, in the case of industrial customers, to use alternative energy sources. Higher gas costs may also adversely impact our accounts receivable collections, resulting in higher bad debt expense.

The effects of weather that is above or below normal are partially offset through weather normalization adjustments, or WNA, in certain of our service areas. WNA allows us to increase the base rate portion of customers' bills when weather is warmer than normal and decrease the base rate when weather is colder than normal. As of March 31, 2006, WNA covered approximately 1.1 million customer meters in the following service areas for the following periods.

Georgia	October	May
Kansas	October	May
Kentucky	November	April
Mississippi	November	April
Tennessee	November	April
Amarillo, Texas	October	May
West Texas	October	May
Lubbock, Texas	October	May
Virginia	January	December

Our Mid-Tex Division does not have WNA. However, its operations benefit from a rate structure that combines a monthly customer charge with a declining block rate schedule to partially mitigate the impact of warmer-than-normal weather on revenue. The combination of the monthly customer charge and the customer billing under the first block of the declining block rate schedule provides for the recovery of most of our fixed costs for such operations under most weather conditions. However, this rate structure is not as beneficial during periods where weather is significantly warmer than normal.

Operating income

Utility gross profit margin decreased \$7.4 million to \$315.7 million for the three months ended March 31, 2006 from \$323.1 million for the three months ended March 31, 2005. Total throughput for our utility business was 142.9 billion cubic feet (Bcf) during the current-year period compared to 160.1 Bcf in the prior-year period.

The decrease in utility gross profit margin and throughput primarily reflects weather, as adjusted for jurisdictions with weather-normalized rates, that was six percent warmer than the prior-year quarter and 16 percent

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warmer than normal. Weather in our Mid-Tex and Louisiana divisions, where we currently do not have weather-normalized rates, was approximately 30 percent warmer than normal during the quarter. During the three months ended March 31, 2006, our Mid-Tex and Louisiana divisions were 17 and four percent warmer than the prior-year quarter. The impact of warmer weather resulted in a \$14.7 million reduction in gross profit margin compared with the prior-year quarter. Additionally, our Louisiana division experienced a \$1.4 million reduction in gross profit margin during the current-year quarter due to the impact of Hurricane Katrina compared with the prior-year quarter. These decreases were partially offset by a \$2.9 million increase arising from the Company's fiscal 2004 and fiscal 2005 filings under Texas's Gas Reliability Infrastructure Program (GRIP).

Operating expenses, which include operation and maintenance expense, provision for doubtful accounts, depreciation and amortization expense and taxes other than income taxes, increased to \$198 million for the three months ended March 31, 2006 from \$179.9 million for the three months ended March 31, 2005. The increase reflects a \$9.5 million increase in taxes, primarily related to franchise fees and state gross receipts taxes, both of which are calculated as a percentage of revenue, which are paid by our customers as a component of their monthly bills. Although these amounts are included as a component of revenue in accordance with our tariffs, timing differences between when these amounts are billed to our customers and when we recognize the associated expense may affect net income favorably or unfavorably on a temporary basis. However, there is no permanent effect on net income.

Operation and maintenance expense, excluding the provision for doubtful accounts, increased \$3 million primarily due to higher employee costs associated with increased headcount to fill positions that were previously outsourced to a third party and increased pension and postretirement costs resulting from changes in the assumptions used to determine our fiscal 2006 costs. These increases were partially offset by lower third-party costs associated with formerly outsourced administrative and meter reading functions that were in-sourced during the first quarter of fiscal 2006.

The provision for doubtful accounts increased \$4.9 million to \$7.1 million for the three months ended March 31, 2006. The increase was primarily attributable to increased collection risk associated with higher natural gas prices. In the utility segment, the average cost of natural gas for the three months ended March 31, 2006 was \$10.13 per thousand cubic feet (Mcf), compared with \$7.12 per Mcf for the three months ended March 31, 2005.

As a result of the aforementioned factors, our utility segment operating income for the three months ended March 31, 2006 decreased to \$117.8 million from \$143.2 million for the three months ended March 31, 2005.

Interest charges

Interest charges allocated to the utility segment for the three months ended March 31, 2006 increased to \$30.3 million from \$28.1 million for the three months ended March 31, 2005. The increase was attributable to higher average outstanding short-term debt balances to fund natural gas purchases at significantly higher prices coupled with a 200 basis point increase in the interest rate on our \$300 million unsecured floating rate Senior Notes due 2007 due to an increase in the three-month LIBOR rate. These increases were partially offset by \$1.2 million of interest savings arising from the early payoff of \$72.5 million of our First Mortgage Bonds in June 2005.

Miscellaneous income

Miscellaneous income for the three months ended March 31, 2006 decreased to \$0.2 million compared to \$2 million for the three months ended March 31, 2005. The \$1.8 million decrease was primarily due to a \$3.3 million charge recorded during the quarter associated with an adverse regulatory ruling in our Mid-States Division related to the calculation of a performance-based rate mechanism in Tennessee. Under the performance-based rate program, we and our customers jointly share in any actual gas cost savings achieved when compared to pre-determined benchmarks.

Natural gas marketing segment

Our natural gas marketing segment aggregates and purchases gas supply, arranges transportation and/or storage logistics and ultimately delivers gas to our customers at competitive prices. To facilitate this process, we

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utilize proprietary and customer-owned transportation and storage assets to provide the various services our customers request, including furnishing natural gas supplies at fixed and market-based prices, contract negotiation and administration, load forecasting, gas storage acquisition and management services, transportation services, peaking sales and balancing services, capacity utilization strategies and gas price hedging through the use of derivative products. As a result, our revenues arise from the types of commercial transactions we have structured with our customers and include the value we extract by optimizing the storage and transportation capacity we own or control as well as revenues for services we deliver.

To optimize the storage and transportation capacity we own or control, we participate in transactions in which we combine the natural gas commodity and transportation costs to minimize our costs incurred to serve our customers by identifying the lowest cost alternative within the natural gas supplies, transportation and markets to which we have access. Additionally, we engage in natural gas storage transactions in which we seek to find and profit from the pricing differences that occur over time. We purchase physical natural gas and then sell financial contracts at advantageous prices to lock in a gross profit margin. Through the use of transportation and storage services and derivative contracts, we are able to capture gross profit margin through the arbitrage of pricing differences in various locations and by recognizing pricing differences that occur over time.

Operating income

Gross profit margin for our natural gas marketing segment consists primarily of storage activities, which are comprised of the optimization of our managed proprietary and third party storage and transportation assets and marketing activities, which represent the utilization of proprietary and customer-owned transportation and storage assets to provide the various services our customers request.

Our natural gas marketing segment's gross profit margin for the three months ended March 31, 2006 and 2005 is summarized as follows:

	Three Months Ended March 31	
	2006	2005
	(In thousands, except physical position)	
Storage Activities		
Realized margin	\$ 10,611	\$ 14,669
Unrealized margin	2,741	(20,545)
Total Storage Activities	13,352	(5,876)
Marketing Activities		
Realized margin	21,005	17,236
Unrealized margin	9,620	(200)
Total Marketing Activities	30,625	17,036
Gross profit	\$ 43,977	\$ 11,160
Net physical position (Bcf)	23.6	12.5

Our natural gas marketing segment's gross profit margin was \$44 million for the three months ended March 31, 2006 compared to gross profit of \$11.2 million for the three months ended March 31, 2005. Gross profit margin from our natural gas marketing segment for the three months ended March 31, 2006 included an unrealized gain of \$12.4 million compared with an unrealized loss of \$20.7 million in the prior-year period. Natural gas marketing sales volumes were 82.4 Bcf during the three months ended March 31, 2006 compared with 74.8 Bcf for the prior-year period. Excluding intersegment sales volumes, natural gas marketing sales volumes were 69.5 Bcf during the current-year period compared with 66.6 Bcf in the prior-year period. The increase in consolidated natural gas marketing sales volumes primarily was attributable to successfully executed marketing strategies into new market areas.

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Our storage activities generated \$13.4 million in gross profit margin for the three months ended March 31, 2006 compared to incurring a loss of \$5.9 million for the three months ended March 31, 2005. Our marketing activities generated \$30.6 million for the three months ended March 31, 2006 compared with \$17 million for the three months ended March 31, 2005. Higher realized marketing activities attributable to successfully capturing increased margins in certain market areas that experienced higher market volatility were offset by lower realized storage activities due to warmer weather during the current-year quarter, which resulted in fewer withdrawal opportunities than the prior-year quarter.

The \$32.8 million increase in our natural gas marketing gross profit margin was primarily due to favorable movement during the three months ended March 31, 2006 in the forward natural gas prices used to value the financial hedges designated against our physical inventory and our fixed-price forward contracts. These results in our storage operations were magnified by an 11.1 Bcf increase in our net physical position at March 31, 2006 compared to the prior-year quarter. We have elected to exclude this forward/spot differential from our hedge effectiveness assessment. Subsequent to the hurricanes, which occurred in the fall of 2005, the forward/spot differential has been volatile and may continue to cause material volatility in our unrealized margin. However, the economic gross profit we have captured in the original transactions will remain essentially unchanged.

Operating expenses, which include operation and maintenance expense, provision for doubtful accounts, depreciation and amortization expense and taxes other than income taxes, increased to \$6.6 million for the three months ended March 31, 2006 from \$4.8 million for the three months ended March 31, 2005. The increase in operating expense primarily was attributable to an increase in personnel costs due to increased headcount and an increase in regulatory compliance costs.

The increase in gross profit margin, partially offset by higher operating expenses, resulted in an increase in our natural gas marketing segment operating income to \$37.3 million for the three months ended March 31, 2006 compared with operating income of \$6.4 million for the three months ended March 31, 2005.

Interest charges

Interest charges allocated to the natural gas marketing segment for the three months ended March 31, 2006 increased to \$2 million from \$0.7 million for the three months ended March 31, 2005. The increase was attributable to higher average outstanding debt balances to fund natural gas purchases at significantly higher prices.

Pipeline and storage segment

Our pipeline and storage segment consists of the regulated pipeline and storage operations of the Atmos Pipeline Texas Division and the nonregulated pipeline and storage operations of Atmos Pipeline and Storage, LLC. The Atmos Pipeline Texas Division transpo