**BEFORE THE TENNESSEE REGULATORY AUTHORITY AT**

**NASHVILLE, TENNESSEE**

November 8, 2001

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| **IN RE:** | ) | |
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| **UNITED CITIES GAS COMPANY'S PETITION REGARDING AFFILIATED TRANSACTION AND REQUEST FOR PERMISSION TO INCLUDE NEW AGREEMENT COVERING EAST TENNESSEE-NORA DELIVERY POINT** | ) ) ) ) ) | **DOCKET NO. 00-00844** |

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**ORDER GRANTING PERMISSION TO INCLUDE NEW AGREEMENT COVERING EAST TENNESSEE-NORA DELIVERY POINT IN INCENTIVE PLAN**

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This matter came before the Tennessee Regulatory Authority (the "Authority") at a regularly scheduled Authority Conference held on June 12, 2001, upon the Petition Regarding Affiliated Transaction and Request for Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point (the "Petition") filed by United Cities Gas Company ("United Cities" or the "Company").

**Background**

On May 12, 1995, the Tennessee Public Service Commission ("TPSC") issued an Order in TPSC Docket No. 95-01134 approving a Performance Based Ratemaking Mechanism Rider ("PBR" or "Incentive Plan") for United Cities for a two-year experimental period. Following the first year of the experimental period, the TPSC held a hearing to review the results. In an Order issued on May 3, 1996, the TPSC approved the plan for a second year, with modifications recommended by an independent consultant's report. The Consumer Advocate Division of the Office of the Attorney General (the "Consumer Advocate") appealed this decision to the

Tennessee Court of Appeals. On March 5, 1997, the Court vacated the TPSC's May 3, 1996 Order and remanded the case to the Authority.[1]

On March 31, 1997, United Cities filed a petition requesting that the Authority adopt the consultant's reports and approve the Incentive Plan on a permanent basis. The Consumer Advocate opposed United Cities' petition. Therefore, on May 20, 1997, the Authority ordered that a contested case be convened to address issues pertaining to the Court's remand of the May 3, 1996 TPSC Order and consider United Cities' petition for a permanent plan. The Authority conducted its Hearings on those issues in two separate phases. In the Phase One Hearing, on March 26 and 27, 1998, the Authority addressed the remand of the TPSC Order, including a review of the consultant's report and consideration of whether the plan should continue for a second year. In the Phase Two Hearing, held on March 27 and 31, 1998, the Authority considered the Company's petition, including the consultant's report for year two, and whether the Incentive Plan should be made permanent.

The Consumer Advocate raised five (5) issues during the Phase One Hearing. As articulated in the Authority's Phase One Order, the third issue related to United Cities' contract covering the East Tennessee-NORA Gas Pipeline ("NORA") supplies: "The NORA contract should be excluded from United Cities' purchases because it predates the plan."[2] The NORA contract is a seven (7)-year contract that was negotiated in 1993 and expired October 31, 2000. During the Hearing, the Consumer Advocate agreed with the Company that the contract was beneficial to Tennessee ratepayers. But the Consumer Advocate maintained that the contract was negotiated prior to implementation of the experimental PBR and did not require a change in

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[1] On June 30, 1996, the TPSC was dissolved by act of the Tennessee Legislature. The Authority was created effective July 1, 1996.

[2] *See Final Order on Phase One*, Authority Docket No. 97-01364 (January 14,1999), p. 19.

the Company's behavior in response to the PBR. The NORA contract was taken into account in the framework of the PBR and, with the transaction by transaction calculation of savings,[3] guaranteed a bonus to the Company for virtually every NORA transaction.

The Authority ordered that the NORA contract be excluded from the Company's PBR calculations after the first year of the experimental plan.[4] However, the Authority stated that:

> "If, upon the expiration of the current contract and if the Company continues to operate under a PBR plan, the contract is renewed or renegotiated, it could be considered for inclusion in the mechanism at that time."[5]

In its Petition, filed on September 26, 2000, United Cities requests permission to include a new NORA contract in its Incentive Plan. The new NORA contract was entered into on April 19, 2000, with an effective date of November 1, 2000.

**Criteria for Inclusion of the New NORA Contract in the Incentive Plan**

The Authority's Order of January 14, 1999, in Docket No. 97-01364, made a provision for possible inclusion of a new NORA contract in the Incentive Plan. The NORA contract in effect during the Hearings in that docket expired October 31, 2000. The new contract is effective November 1, 2000 for a primary term of two (2) years. It may continue on a month-to-month basis beyond its primary term unless terminated by either party with a sixty (60) day notice.[6] Based on the language in the Authority's January 14, 1999 Order and the language contained in United Cities' tariff,[7] the Company filed the Petition to include the new NORA contract in its PBR calculations.

[3] The original mechanism allowed for calculation of savings based on a transaction by transaction method. The method was changed at the conclusion of the Phase One hearing for year two of the Incentive Plan. *See Final Order on Phase One*, Authority Docket No. 97-01364 (January 14, 1999), p. 29.
[4] *Final Order on Phase One*, Authority Docket No. 97-01364 (January 14, 1999), p. 29.
[5] *Id.*, p. 27.
[6] *See* Petition, Exhibit A.
[7] United Cities "Performance Based Ratemaking Mechanism Rider," Original Sheet No. 45.2, paragraph 2.

The Hearings on Phase One and Phase Two resulted in the following two (2) criteria, which must be met in order for the new NORA contract to be included in the Incentive Plan:

(1) The Company must have renegotiated the new contract as a response to the Incentive Plan, indicating a change in behavior.[8]

(2) If the contract is awarded to an affiliate, the Company must show that the negotiation process complies with the "Affiliate Transaction" rules[9] contained in the Company's tariff.[10]

**Negotiation as a Response to the Incentive Plan**

The Authority's Final Order on Phase One summarizes the Consumer Advocate's concerns over inclusion of the NORA contract in the Incentive Plan as follows:

> "Furthermore, the NORA contract does not require any change in behavior from the Company during the term of the contract. Since the mechanism allowed for calculation of savings and losses on a transaction by transaction basis during the first year, United Cities made a profit on virtually every NORA transaction. In fact, the savings generated amounted to a "windfall" for the Company. Consumer Advocate witness Dr. Stephen Brown testified that approximately 71% of the savings experienced during the first nine months of the plan were directly attributable to the NORA contract. If the NORA contract were not included in the incentive plan, 100 percent of those savings would be passed on [to] the ratepayer."[11]

The Authority finds that the conditions under which the original NORA contract was analyzed by the Consumer Advocate and reviewed by the Authority during the Hearings in Docket No. 97-01364 no longer exist. The original NORA contract was not a product of market forces as is the new contract. United Cities renegotiated the new contract in light of its

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[8] The original NORA contract was excluded from the PBR, because "(1) the NORA contract existed prior to the PBR mechanism, and (2) it required no change in purchasing behavior by the Company." *Final Order on Phase One*, Authority Docket No. 97-01364 (January 14,1999), p. 27.

[9] United Cities "Performance Based Ratemaking Mechanism Rider," Original Sheet No. 45.3, 45.4, and 45.5.

[10] *See Final Order on Phase Two*, Authority Docket No. 97-01364 (August 16, 1999), p. 27: "Prior to any affiliate transactions being included in the computation of savings or losses from this performance-based ratemaking mechanism, said affiliate transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions."

[11] *Final Order on Phase One*, Authority Docket No. 97-01364 (January 14,1999), p. 27.

permanent Incentive Plan. The purpose of the Incentive Plan is to motivate the Company to obtain the lowest possible price for its gas supply in order to maximize the rewards to be shared between the Company and its ratepayers. The monthly calculation of profits takes an average of the purchases for the month, so that a "windfall" situation does not occur for any specific transaction. Significantly, although the Consumer Advocate strongly opposed including the original NORA contract in the PBR, the Consumer Advocate has not intervened in this docket.

The Petition states that in the early fall of 1999, United Cities addressed the need to replace gas supplies expiring October 31, 2000 under the original (1993) NORA contract. The original agreement covered requirements for its NORA/Dickerson No. 1 Delivery Point on the NORA/East Tennessee Natural Gas Pipeline. As the Petition states, only two companies currently hold pipeline capacity on the NORA/East Tennessee Pipeline: Equitable Energy ("Equitable"), the supplier under the original contract, and Woodward Marketing, LLC ("Woodward" or "WMLLC"), an affiliate of United Cities. Therefore, the Company obtained bid proposals from these two companies.

The Authority finds that United Cities negotiated the new NORA contract as a response to the Incentive Plan. Equitable responded to the Company by letter dated September 23, 1999. Two of the options proposed were based on Market Index plus premium. The indexes were NYMEX and Inside FERC, two of the indexes used in the Company's benchmark calculation. Likewise, by memo dated August 26, 1999, Woodward proposed a rate of Inside FERC plus premium. Both proposals contained rates tied to market indexes, showing a response to the Company's Incentive Plan.

**Compliance with the Affiliate Transaction Rules**

Since Woodward is one of two suppliers with capacity on the NORA/East Tennessee Natural Gas Pipeline, and is also an affiliate of United Cities, the Company's decision on a supplier must conform to the "Affiliate Rules" outlined in the Company's tariff.[12] Of the seventeen (17) guidelines or rules contained in United Cities tariff, numbers 4, 10, 11, and 12 are relevant to the Petition.

Affiliate Rule No. 4 states that "[t]he Company may not give its marketing affiliate preference over nonaffiliated companies in natural gas supply procurement activities."[13] In the context of its Incentive Plan, the Company lacks the motivation to afford preference to its affiliate. The Incentive Plan rewards the Company with higher profits, to be shared between the Company and its ratepayers, when the Company obtains the lowest price possible for its gas supply. In the absence of an Incentive Plan, the Company might give unfair advantage to its affiliate by purchasing gas from the affiliate, regardless of whether the price is higher than the price offered by other suppliers. Since gas costs are a pass-through for the Company, with the ratepayers reimbursing one hundred percent (100%) of the gas costs, purchase through an affiliate could have the effect of shifting profits to the unregulated entity. The Incentive Plan, however, makes this strategy unlikely as it penalizes the Company for high gas supply costs.

Affiliate Rule No. 10 requires the Company to obtain competitive bids when purchasing from an Affiliate or show why bids were "neither necessary nor appropriate." According to the Company, the Company requested that Woodward submit a written proposal for a new NORA contract, which Woodward did on August 26, 1999. On September 23, 1999, United Cities requested a competing proposal from Equitable. Equitable faxed a letter of proposal to United

[12] United Cities "Performance Based Ratemaking Mechanism Rider," Original Sheet No. 45.3, 45.4, and 45.5.
[13] *Id.*

Cities the same day. The decision to award the contract to Woodward was based on the fact that Woodward's proposed premium was less than Equitable's proposed premium. Each company used Inside FERC plus premium as the basis of its proposed price.[14] Price information filed by the Company shows that the Company's selection of Woodward over Equitable results in substantial savings to the Company's ratepayers.

Affiliate Rule No. 11 requires the Company's marketing employees and the affiliate's marketing employees to function independently of each other. Affiliate Rule No. 12 requires that the books and records of the two entities be maintained separately from each other. In its response to an Authority data request dated November 21, 2000, as part of the Company's last Incentive Plan Audit, the Company submitted to the Authority the names and location of the employees of each entity, as well as the office locations and the location of the books and records of each. Based on a review of this information, the Authority finds no evidence of sharing of information or employees.

By awarding the new NORA contract to Woodward, United Cities has entered into an agreement similar to the original contract with Woodward. The Company's original contract with Woodward provided that Woodward would be the supplier for the Company's gas requirements[15] as well as the agent for the Company's capacity on the East Tennessee system. In the new NORA contract, Woodward assumes the remainder of the Company's gas requirement, so that Woodward is now the sole supplier to the Company.

The original Woodward Contract was scrutinized in great detail during Phase Two of the

[14] In responses to Authority data requests dated March 13, 2001, the Company stated that the "Index plus premium" reflects the total delivered cost to the NORA/Dickenson East Tennessee Pipeline interconnect. East Tennessee Pipeline demand and commodity charges are applicable from the pipeline interconnect to the city gate for both bidders. The Company also stated that the Inside FERC index referred to in both bids is the same index.

[15] This contract excluded the NORA supply, although Woodward managed the NORA contract.

Incentive Plan Hearings in Docket No. 97-01364. The Consumer Advocate made many allegations regarding the appropriateness of including this contract between United Cities and its affiliate in the PBR. Among these allegations were the following:

1. The contract was not a direct response to the PBR mechanism, but was anticipated when Woodward Marketing and UCG Energy Company formed a non-regulated gas marketing company in 1986.[16]
2. The Consumer Advocate did not have the necessary information to fully analyze the contract.[17]
3. The TRA did not have the "full picture" of the contract because Woodward did not bill United Cities according to its cost and source of supply.[18]

Each of these concerns was addressed during the Phase Two Hearing. In its Final Order on Phase Two, the Authority concluded the following:

> Based upon the record, the Authority concludes that the contract price is good, if not exceptional, and that the contract benefits Tennessee consumers, as well as United Cities.
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> . . .
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> The evidentiary record of the Phase Two proceeding demonstrates that the gas sales contract with WMLLC was not anticipated at the time WMLLC was formed and was initiated by United Cities after the experimental PBR plan had been approved in Tennessee. The record further demonstrates that WMLLC has invoiced United Cities according to the provisions of the contract.[19]

Therefore, the Authority concludes that the fact that Woodward is now the sole supplier should not block approval of United Cities' Petition, provided that United Cities abides by the Affiliate Guidelines contained in its tariff. The current contract was entered into under different circumstances than the original contract. Based on the above chronology of events in the negotiation process of the new NORA contract, and the information provided by the Company,

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[16] *Final Order on Phase Two*, Authority Docket No. 97-01364 (August 16, 1999), p. 11.
[17] *Id.*, p. 14.
[18] *Id.*, p. 15.
[19] *Id.*, p. 20.

the Authority concludes that United Cities management demonstrated conformance to the requirements of the Affiliate Rules in its tariff.[20]

Upon a careful review of the Petition, and of the entire record in this matter, the Authority approved United Cities' request to include transactions under the new NORA contract in its Incentive Plan.

**IT IS THEREFORE ORDERED THAT:**

1. The Petition of United Cities Gas Company for permission to include the Company's new agreement covering the East Tennessee-NORA delivery point in its Performance Based Ratemaking Mechanism Rider is approved; and

2. Any party aggrieved with the Authority's decision in this matter may file a Petition for Reconsideration with the Authority within fifteen (15) days from the date of this Order.

Sara Kyle, Chairman

H. Lynn Greer, Jr., Director

Melvin J. Malone, Director

ATTEST:

K. David Waddell, Executive Secretary

[20] There has been a change in Woodward's relationship to Atmos Energy Corporation ("Atmos"), the parent company of United Cities. On August 8, 2000, Atmos announced that it would acquire the remaining 55 percent of Woodward Marketing LLC. In a letter dated December 12, 2000, United Cities informed the Authority that: "The affiliate relationship between Atmos/United Cities and Woodward will be no different once Atmos begins 100% ownership. Atmos/Woodward will have to abide by the TRA's standards as it does under the current 45% ownership. All transactions with Woodward will be bid out or justified as to why it could not be bid out, as the Company does today." According to an April 2, 2001 press release, the acquisition was completed on April 1, 2001.