BEFORE THE TENNESSEE REGULATORY AUTHORITY AT

NASHVILLE, TENNESSEE

July 20, 2001

IN RE:	)	
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PETITION OF UNITED CITIES GAS COMPANY FOR APPROVAL OF A TRANSPORTATION GAS SERVICE AGREEMENT WITH MOUNTAIN HOME ENERGY CENTER, L.L.C.	))))	**DOCKET NO. 01-00138**

ORDER APPROVING TRANSPORTATION GAS SERVICE AGREEMENT

This matter came before the Tennessee Regulatory Authority (the "Authority") at a regularly scheduled Authority Conference held on June 12, 2001, upon the Petition (the "Petition") of United Cities Gas Company ("United Cities" or "UCG") for approval of a transportation gas service agreement (the "Agreement") between United Cities and Mountain Home Energy Center, L.L.C. ("Mountain Home").

UNITED CITIES' PETITION

In the Petition filed on February 8, 2001, United Cities states that the Department of Veterans Affairs (the "VA") began a process in 1997 to select a developer to finance, design, construct, and manage a co-generation energy center that would produce, provide, and sell electricity, steam, and chilled water to the James H. Quillen VA Medical Center (the "VAMC"), East Tennessee State University's James H. Quillen College of Medicine, and, at the developer's option, to other public or private users. According to the Petition, Energy Systems Group ("ESG") was selected as the preferred developer in July 1998. The Petition further states that at the request of the VA, United Cities provided information to ESG regarding past and current billing and rate information for the VA's natural gas usage.

The Petition states that on August 11, 1998, United Cities received a letter from Mr. Jim Adams, president of ESG, stating that consumption of gas by the new co-generation center, in comparison with the historical usage of the VAMC, would at least double overall and would triple in the summer months.[1] Mr. Adams informed United Cities that ESG "would like to purchase this gas through your local distribution system; however, the rate tariffs do not allow acceptable financial performance."[2] Mr. Adams further stated: "If United Cities Gas Company cannot be more flexible, our only alternative is to bypass the city gate and negotiate directly with the pipeline company. This letter is to serve notice of our intent to pursue this option unless your company can be more flexible."[3]

After receiving Mr. Adams's letter, United Cities entered into the Agreement with Mountain Home, an affiliate of ESG formed to operate the co-generation center at the VAMC. Under the Agreement, which becomes effective upon approval by the Authority, United Cities agrees to transport not less than 3,500,000 CCF's per year for a five (5) year term at a rate of $.042 per CCF.[4] The Agreement may be renewed for six (6) consecutive terms for a total of thirty (30) years.

FINDINGS AND CONCLUSIONS

Economic Benefits of the Agreement

The VAMC, a long-time customer of United Cities, currently purchases gas under United Cities' tariff rate of $.0996 per CCF for the first 20,000 CCF's, $.0671 per CCF for the next 480,000 CCF's, and $.0329 per CCF for any amount over 500,000 CCF's. Under the Agreement rate of $.0420 per CCF, United Cities' transportation revenue will increase as the volumes required by the co-generation center increase. United Cities is not requesting a margin recovery with regard to the Agreement. Even at the Agreement's minimum usage of 3,500,000 CCF's at $.0420 per CCF, United Cities' transportation revenue under the Agreement would be greater than United Cities' revenue from the

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[1] Letter from Mr. Jim Adams, President, Energy Systems Group, to Mr. M. Green Faircloth, Business Development Consultant, United Cities Gas Company, August 11, 1998, attached as Exhibit B to United Cities' Petition, Docket No. 01-00138, February 8, 2001.
[2] *Id.*
[3] *Id.*
[4] The term "CCF" means one hundred (100) cubic feet of gas.

VAMC at the current tariff rate.

Furthermore, United Cities will have to make a capital investment to reinforce its distribution system to deliver the additional load resulting from purchases under the Agreement. The resulting expansion of United Cities' system will not only serve ESG's co-generation center at the VAMC, but will also benefit United Cities' other large customers located near the VAMC in Johnson City, Tennessee because it will allow United Cities to provide increased capacity to these other customers. Any per unit margin loss that may result from the lower rate for Mountain Home will not result in a revenue loss that must be borne by other United Cities ratepayers. To the contrary, United Cities' other ratepayers will benefit from increased total margins as the expected volume sold to Mountain Home increases.

The Possibility of Bypass by ESG

In Authority Docket No. 97-00262, *In re: Petition of Chattanooga Gas Company for Approval of Large Customer Contract Under Experimental Rule with Archer Daniels Midland Co.*, the Authority applied four (4) criteria for approval of a discounted long-term gas transportation service contract for the purpose of avoiding system bypass. The Authority derived these criteria from an Experimental Rule approved for Chattanooga Gas Company, pursuant to which "the Authority must find that; customer bypass is imminent; such bypass would be uneconomic; the contract rates and terms are not unduly preferential or unduly discriminatory; and that the contract rates are the highest that could be negotiated."[5]

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[5] *Order Disapproving Special Contract Under the Large Customer Contracts Tariff*, Authority Docket No. 97-00262 (March 17, 1998), p. 5. The Authority also set forth specific guidelines for determining whether bypass is imminent:

> The Authority finds that CGC does not have to demonstrate that either one of its Large Customers or Harbert have actually begun construction of a bypass pipeline in order to demonstrate "imminence" under the Experimental Rule. The Authority finds that CGC may produce detailed and credible studies to support its position. The Authority also finds that a company may also have performed one or more of the following acts in addition to, or in combination with, another factor such as: determining a definite and feasible route; obtaining quoted prices for components of the bypass system such as rights-of-way and easements, construction, facilities costs, and determined legal requirements that can be reasonably met. When submitted these factors are viewed on their own merits, case by case.

Id., p. 8.

In this instance, there is strong evidence of "imminence" of bypass given the volume of gas ESG requires, ESG's proximity to the pipeline, and ESG's expertise through its parent company, Citizens Gas Company. United Cities submitted with its Petition the letter sent to it by Mr. Adams, stating ESG's intention to bypass if rates are not adjusted. After filing the Petition, United Cities submitted a letter from Mountain Home's Federal Operations Manager, which explains Mountain Home's analysis of the feasibility, both financially and legally, of bypass. That letter states that the Tennessee Pipleline is only 1.5 miles from Mountain Home "and could easily be connected to our facility."[6] While United Cities produced no additional specific evidence that demonstrates that ESG has taken any of the other steps that would indicate bypass is imminent, United Cities does face the definite threat of bypass unless it agrees to a lower rate than its tariff rate.

As for the other criteria, bypass by ESG would mean the loss to United Cities of a large-volume customer, the VAMC, and would deprive United Cities of the margin associated with service to this customer. Therefore, should bypass occur, the result would certainly be uneconomic. The Agreement's rates and terms are not unduly preferential or unduly discriminatory. In addition, the record in this matter contains evidence that United Cities obtained the highest rate that could be negotiated.[7]

Conclusion

After careful review of the Petition, and of the entire record in this matter, the Authority determined that approval of United Cities' Agreement with Mountain Home is consistent with the Authority's previous orders regarding special contracts and shall be approved. The Authority finds it particularly significant that United Cities is not seeking any recovery of lost margin in relation to the

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[6] Letter from Ms. Julie F. Payne, Federal Operations Manager, Mountain Home, to Mr. Joe Conner, Counsel for United Cities, March 27, 2001, submitted in response to Authority Data Request No. 1, Item No. 6, April 30, 2001. The letter further states that Mountain Home estimated that it would make up the cost of connecting to the Tennessee Pipeline within five (5) years, but notes that "[w]hile paying the proposed Transportation Rate is still more expensive than installing a bypass, we realize the value added by United Cities Gas makes up some of that difference."

[7] In response to an Authority data request, United Cities stated that "[t]he lowest rate needed to protect current margin was $0.0377/Ccf, but UCG was able to negotiate a rate of $.0.042/Ccf. With the rate of $0.042/Ccf the increase in margin goes to $39,335.94 per year." See Exhibit B, Supplemental Response to Question #7, Data Request No. 1 Mountain Home Energy Center, LLC, Docket No. 01-00138, March 5, 2001.

Agreement and that, even if Mountain Home only purchases the minimum amount under the Agreement, United Cities' ratepayers will still benefit from the Agreement.

IT IS THEREFORE ORDERED THAT:

1. The Petition of United Cities Gas Company for approval of a transportation gas service agreement with Mountain Home Energy Center, L.L.C. 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