BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

March 22, 2002

IN RE:	)	
	)	
PETITION OF UNITED CITIES GAS COMPANY FOR EXPEDITED APPROVAL OF AUTHORITY TO PURCHASE FUTURES CONTRACTS FOR THE WINTER HEATING SEASONS OF 2001-02 ON AN EXPERIMENTAL BASIS	)	**DOCKET NO. 01-00510**

ORDER ACCEPTING WITHDRAWAL OF PETITION

On June 12, 2001, United Cities Gas Company ("United Cities" or the "Company") filed a *Petition for Expedited Approval of Authority to Purchase Futures Contracts for the Winter Heating Season of 2001-02 on an Experimental Basis* (the "*Petition*"). This matter came before the Tennessee Regulatory Authority ("Authority" or "TRA") at a regularly scheduled Authority Conference held on July 10, 2001 upon the July 2, 2001 filing of *United Cities Gas Company's Notice of Withdrawal of Petition* (the "*Withdrawal*").

<u>United Cities' *Petition*</u>

The *Petition* proposes a remedy to what United Cities terms a "huge increase in gas prices experienced in 2000," which "was attributable to supply shortages resulting from less natural gas exploration and development than was necessary to meet the increase in demand."[1] The *Petition* notes:

> While higher prices will promote increased investment in exploration and development of new gas sources, which over time will help hold down prices to consumers, it is not anticipated that these market responses will occur rapidly enough to prevent near term price spikes such as those experienced in December of 2000.[2]

The *Petition* then explains that the Company's Performance Based Ratemaking ("PBR") plan is inadequate to address price spikes such as those that occurred in 2000:

> Under the current PBR, which was approved by the TRA by orders issued on January 14, 1999 (Phase I) and August 16, 1999 (Phase II), UCG receives an incentive for out performing the market in acquisition of gas supplies. By the same token, UCG is penalized if its acquisition of gas supplies results in a price above the pre-defined market benchmark.
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> Since the adoption of the PBR, UCG has successfully out performed the market resulting in consumers benefiting from lower than market prices. UCG executes an annual contract with a gas supplier to acquire gas at a designated cost below the market benchmark. While this method of contracting has benefited consumers, there is only a limited built-in hedge through summer storage against price spikes such as those experienced in December of 2000.[3]

United Cities then states its proposed remedy:

> In an effort to address the potential for a repeat of the dramatic price increases experienced in 2000, UCG is proposing that up to 50% of the expected gas purchases net of storage for the winter heating season should be confirmed in advance through the acquisition of futures contracts. UCG is not proposing to benefit from any gain resulting from a profit on the futures contracts in the event winter market prices exceed the futures contracts previously acquired. Instead, UCG is proposing that any difference between the futures contract price and the market benchmark during the winter heating season be reflected in UCG's 191 deferred gas cost account.[4]

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[1] *Petition*, p. 1.
[2] *Id.*
[3] *Id.*, p. 2.
[4] *Id.*

The *Petition* concludes:

> In order to take advantage of the potential for stabilized gas cost during the winter heating season 2001-02, it would be necessary for UCG to act swiftly to lock in futures contracts while the market prices remain at or below $5.00 per MMBtus. Accordingly, UCG is requesting that the TRA act on an expedited basis to consider this petition.[5]

Data Requests and Related Filings

The Authority Staff submitted data requests to the Company on June 13 and June 15, 2001. On June 19, 2001, the Consumer Advocate and Protection Division of the Office of Attorney General (the "Consumer Advocate") filed a *Petition for Approval to Obtain Data Requests from United Cities Gas Company,* in which the Consumer Advocate requested Authority approval, pursuant to Tenn. Code Ann. § 65-4-118(c)(2)(A), of data requests to the Company. The Consumer Advocate also submitted both its proposed data requests and the answers to those requests, already provided by United Cities.

On June 26, 2001, the Consumer Advocate filed a document entitled *Attorney General's Notice*, in which the Consumer Advocate "notifie[d] the Tennessee Regulatory Authority that the Attorney General is not prepared at this time to intervene in this matter."[6] The Consumer Advocate further stated that it was "still reviewing" United Cities' responses to its data requests, which United Cities provided on June 25, 2001. The Consumer Advocate went on to state:

> The natural gas prices during the winter of 2001 caused significant hardship to Tennessee consumers. It is important that the gas utilities and the TRA consider measures which may mitigate the impact of similar

[5] *Id.*, p. 3.
[6] *Attorney General's Notice*, p. 1.

future price climbs. However, it is also important that the extremity of the winter of 2001 be kept in perspective.

The pilot concept presented by UCG in the present docket merits consideration. Certainly the Attorney General does not object to an expedited review of the petition. However, the matter may not be ripe for review. The fact that this is an experimental program, which will be subjected to review should UCG make a similar proposal next year, mitigates in favor of preceding [sic] at such a pace. In the practical sense there seems to be no need for such urgency. For the years 1996 through 2000 gas futures prices either steadily declined or remained level for the months of June and July. According to the data, there is no need to proceed with approval of this matter prior to thorough review. This matter would more appropriately considered [sic] at the July 10, 2001 TRA Conference.

Even if the petition is reviewed now or in the future, two (2) potential problems should be strongly considered with UCG's petition. First, by refusing to include the futures purchase within the Performance Based Ratemaking, UCG places all the risk of this program on the consumers. UCG should share the risk with consumers. This will encourage UCG toward more sound decisions with respect to futures purchases. Second, and as corollary to the first, the TRA might consider a cap on the futures prices authorized under the program. While the UCG petition mentions that they would like to purchase below $5.00 per MMBtus there is no firm commitment from UCG toward making this a cap.[7]

Discussion of United Cities' *Petition* at the June 26, 2001 Authority Conference

At the June 26, 2001 Authority Conference, the Authority's Directors heard statements from the Company, the Consumer Advocate, and Authority Staff. The Company was represented by its counsel, Mr. Joe Conner, and by Mr. John Hack, director of gas supply planning for Atmos Energy, the parent company of United Cities. The Consumer Advocate was represented by Mr. Tim Phillips, Assistant Attorney General. The Authority Staff was represented by Mr. Dan McCormac, Chief of the Authority's Energy and Water Division.

[7] *Id.*, pp. 1-2.

Mr. Conner stated that the Company's current PBR plan provides for sharing between the Company and its customers of both loss and gain resulting from differences between the price the Company pays for gas and the market price. Mr. Conner stated, however, that the PBR is not set up for the purchase of futures contracts, which are the focus of the Company's proposal in its *Petition*. Mr. Conner stated that the *Petition* was the Company's attempt to "implement . . . a price stabilization mechanism and more of an insurance policy for the consumer."[8]

Mr. Hack stated that "if the market does run up like it did last year, [the proposal] would provide a tremendous savings for customers and stabilize prices."[9] Notwithstanding Mr. Conner's previous comments, Mr. Hack conceded that the Company could do what it was proposing in its *Petition* through its current PBR mechanism. Mr. Hack stated:

> But the concern we have as far as doing it within the PBR, if we fix that portion of gas and, say, the market goes from 4.20 in January and goes to 3.50, then we would have an exposure there of that through the PBR that would be risk that the company would not want to take.
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> In addition to that, if we did go through the PBR and we were, say, on the right side of the market and say we had a savings under this, then our proposal is to provide total savings to the end user so that it does stabilize prices. Otherwise, we would be keeping a portion of that savings through the PBR mechanism.[10]

In response to the Directors' concerns that the Company was only willing to share in gains or losses with its customers when there was little risk of loss, Mr. Hack

[8] Transcript of Authority Conference, June 26, 2001, p. 14.
[9] *Id.*, p. 16.
[10] *Id.*, pp. 16-17. Upon further questioning, Mr. Hack stated that although the PBR contains language regarding the use of futures contracts to hedge, manage, or reduce gas costs, the Company has not used and would not use a futures contract under the PBR. *Id.*, p. 47. Mr. Conner later qualified this statement by adding that the Company does make extensive use of storage, which is one type of price-stabilizing mechanism. *Id.*, p. 54.

stated:

> The PBR was established at times that the market did not have the volatility that it has today. Staying with the market price, we could – we would still be meeting that market price, but we wanted to additionally try to stabilize the price. We're trying to look at this as looking at last winter and if you had a repeat of that. Then the customer would be better off with this stabilized price.
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> If the market for some reason did take a downturn and we were out of the market by a dollar, then that's the risk that we're concerned that's really something that we can't identify.[11]

Mr. Hack did not, however, believe that the TRA should review the PBR mechanism at the present time.[12]

Director Greer expressed concern over the Company's unwillingness to incur the risk associated with futures contracts. Director Greer stated that "[i]f the Company is not willing to take [this risk], I'm having a hard time understanding why the consumer should take it."[13]

Director Malone stated that the Company was to be commended for looking for ways to address the problem of high prices and price instability. Director Malone questioned, however, whether an additional mechanism was necessary when the Company already has a mechanism, the PBR, which would allow it to purchase futures contracts, particularly since it appears that the Company has always realized a gain under the PBR.[14]

Chairman Kyle summed up the Company's proposal and its relation to the existing PBR mechanism:

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[11] *Id.*, p. 23.

[12] *Id.*, p. 25. Mr. Conner added that adjustment of the deadband in the PBR would not adequately address the price spikes experienced in 2000-2001. *Id.*, p. 55.

[13] *Id.*, p. 20.

[14] *Id.*, pp. 26-27.

> We know that the stated purpose of this petition is to stabilize gas costs for consumers during the winter heating season 2001-2001. But you already have this authority to use futures markets to stabilize gas costs under your current PBR mechanism. It's just that in this petition you request 100 percent of the costs or benefits that are caused by such purchases to flow to consumers rather than absorbing 50 percent of the cost or benefit.[15]

Mr. Hack stated that the Company has PBRs in two other states but does not have PBRs in eight states. He stated that the Company has received the assurance of most of the non-PBR states that they will not "second guess" the Company if it purchases gas futures at a reasonable price and the price of gas later falls below the futures price. In other words, the state would not find such a purchase to be imprudent merely because the futures price turned out to be higher than the eventual market price.[16]

Mr. Hack added:

> So we're viewing this the same way with the PBR state. The problem with the PBR state is the fact that we do have the benchmark and trying to stabilize the prices is really not addressed in the PBR per se on just a price stabilization. We're not saying that the price we buy will necessarily be the lowest price, but it will be a reasonably stable price. That's the reason we feel that we need to [proceed] formally in the PBR states to get the approval of the commission.[17]

On behalf of the Consumer Advocate, Mr. Phillips stated that the "real problem with this filing is that it's not included in the PBR," and he expressed concern that "[t]he entire risk is shifted to the consumers."[18] Mr. Phillips further stated, however, that the Company's effort to address high gas costs and cost volatility was "significant"

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[15] *Id.*, p. 56.
[16] *Id.*, p. 27.
[17] *Id.*, pp. 27-28.
[18] *Id.*, p. 48.

and "a step in the right direction."[19] "At the same time," Mr. Phillips stated, "I think it is much better if this matter was centered on or placed under the PBR."[20] Mr. Phillips pointed out that the Company, not the consumer, is responsible for making gas purchases, and he stated, "I think if the company has some risk involved, their decisions are going to be more prudent."[21] Mr. Phillips added that information that would indicate whether the Company had acted reasonably in its gas purchases would not be available until the late spring of 2002.[22]

Director Malone noted that "[t]he very nature of a futures contract is that you may or may not be correct, but the result does not always indicate whether or not it was prudent."[23] Mr. Phillips responded that when the Company is not willing to accept some of the risk involved, there is a question "whether or not it is an actual prudent decision-making process."[24] Mr. Phillips added that he believed that the Company's filing was not ripe for a decision by the Authority, and that although the Consumer Advocate had not decided whether to intervene, it was prepared to act in an expedited fashion.[25] Mr. Phillips noted that while the price problems of 2000-2001 could at some point be repeated, gas supply has increased since that time.[26]

Mr. McCormac stated that the trend in gas production is upward and storage levels are above the five-year average, but noted that "[n]obody can predict the winter

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[19] *Id.*
[20] *Id.*
[21] *Id.*, p. 49.
[22] *Id.*, p. 50.
[23] *Id.*
[24] *Id.*, p. 52.
[25] *Id.*, p. 53.
[26] *Id.*, pp. 58-59.

weather."[27] Mr. McCormac added that although the market is driven by speculation and ultimately unpredictable, "the market trend is down on price."[28]

At the conclusion of the discussion, the Directors agreed to defer consideration of United Cities' *Petition* until the July 10, 2001 Authority Conference.

United Cities' *Withdrawal*

On July 2, 2001, the Company filed its *Withdrawal*, in which it gave the Authority notice of its intent to withdraw the *Petition* and requested that the Authority close this matter. United Cities' *Withdrawal* came before the Directors at the Authority Conference held on July 10, 2001. The Directors noted that United Cities' withdrawal of its *Petition* did not lessen the Company's responsibility to take all reasonable and prudent measures to secure gas at the lowest possible price. The Directors expressed support for the Company's efforts to act in its customers' interest. However, the Directors noted the differences between the Company's proposal and its PBR plan, particularly the fact that the PBR plan provides for the Company to share any gains and losses from gas purchases whereas under the proposal the customers would absorb one hundred percent (100%) of any gains or losses. Further, the Directors observed that the Company's proposal would require its customers to pay what is essentially an insurance premium that is necessary to minimize market price volatility.

The Directors reminded the Company that hedging and other financial instruments are already specifically mentioned in the Company's tariff as part of the gas procurement mechanism. Finally, the Directors proposed that the Authority host a

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[27] *Id.*, p. 60.
[28] *Id.*

workshop in which the gas companies would share their strategies and experience in gas purchasing and explore any viable alternatives to help consumers and shareholders.[29]

The Directors then unanimously accepted United Cities' withdrawal of its *Petition*.

IT IS THEREFORE ORDERED THAT:

United Cities Gas Company's withdrawal of its *Petition for Expedited Approval of Authority to Purchase Futures Contracts for the Winter Heating Season of 2001-02 on an Experimental Basis* is accepted.

Sara Kyle, Chairman

H. Lynn Greer, Jr., Director

Melvin J. Malone, Director

ATTEST:

K. David Waddell, Executive Secretary

[29] On July 25, 2001, the Authority hosted a Workshop on Managing Natural Gas Price Volatility. The Workshop featured a presentation on hedging by Mr. Bruce Henning, Director, Regulatory and Market Analysis, Energy and Environmental Analysis, Inc. Representatives of United Cities Gas Company, Nashville Gas Company, Chattanooga Gas Company, the Consumer Advocate, and the Authority were in attendance and participated in a discussion of price volatility, hedging, and gas purchases.