BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

IN RE:	)	
UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION INCENTIVE PLAN ACCOUNT (IPA) AUDIT	))))	**DOCKET NO. 01-00704**

BRIEF IN SUPPORT OF MOTION FOR SUMMARY JUDGMENT

The Tennessee Regulatory Authority (the "Authority" or "TRA") Staff participating as a party in this matter (the "Staff") has filed a motion for summary judgment as to all outstanding issues pursuant to Authority Rule 1220-1-2-.22. The Staff hereby respectfully submits this brief in support of its motion. The Staff is also submitting the affidavits of Pat Murphy and Stephen N. Brown.

PROCEDURAL BACKGROUND

On August 7, 2002, United Cities Gas Company ("United Cities," "UCG," or the "Company") submitted its annual Incentive Plan Account ("IPA") filing to the Authority's Energy and Water Division. On March 28, 2002, after having performed an audit of United Cities' filing, the Energy and Water Division submitted draft audit findings to United Cities, and on April 5, 2002, United Cities submitted its responses to the Energy and Water Division. On April 10, 2002, the Energy and Water Division filed its Compliance Audit Report (the "Report") for approval by the Authority.[1]

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[1] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002.

On April 12, 2002, United Cities filed *United Cities Gas Company's Motion to Reschedule Consideration of the IPA Audit and to Set an Evidentiary Hearing,* in which United Cities stated certain objections to the Report's findings. At an Authority Conference held on April 30, 2002, the Directors voted unanimously to convene a contested case in this matter. The Directors stated that the purpose of the contested case was not to allow the parties to challenge the IPA audit but rather to determine the correct interpretation of the Authority's *Final Order on Phase Two* in Docket No. 97-01364 (the "Phase Two Order").[2]

On June 5, 2002, United Cities submitted its list of issues. The Staff accepts the issues as stated by United Cities and moves for summary judgment as to both. They are:

> 1. Whether United Cities Gas Company's ("United Cities") inclusion in its performance based rate making mechanism (the "PBR") of the savings resulting from the negotiated transportation discounted contracts is consistent with the Authority's Final Order (the "Final Order") on Phase II in Docket No. 97-01364, issued on August 16, 1999.
> 2. How should the savings associated with "avoided costs" resulting from a negotiated gas supply agreement for requirements from the East Tennessee-NORA Gas Pipeline be accounted for in the PBR under the terms of the Final Order and the Order in Docket No. 00-00844.[3]

<u>STANDARD FOR SUMMARY JUDGMENT</u>

Summary judgment is an appropriate method of resolving issues in administrative proceedings, and the standard for determining whether summary judgment should be granted generally follows the standard applied in the courts.[4] Summary judgment should be granted when the moving party demonstrates that there are no genuine issues of material fact and that the moving party is entitled to a judgment as a matter of law.[5] The Authority's Rules specifically

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[2] Transcript of Authority Conference, April 30, 2002, pp. 34-36.
[3] *Issues List Submitted by United Cities Gas Company*, Docket No. 01-00704, June 5, 2002.
[4] *See e.g. Paige v. Cisneros*, 91 F.3d 40, 44 (7th Cir. 1996); *Puerto Rico Aqueduct and Sewer Authority v. United States Environmental Protection Agency*, 35 F.3d 600, 605-06 (1st Cir. 1994); *Contini v. Board of Education of Newark*, 668 A.2d 434, 441-42 (N.J. App. 1995); *Massachusetts Outdoor Advertising Council v. Outdoor Advertising Board*, 405 N.E.2d 151, 156-57 (Mass. App. 1980).
[5] *Bowden v. Memphis Bd. of Educ.*, 29 S.W.3d 462, 464 (Tenn. 2000).

provide for resolution of issues through summary judgment. Authority Rule 1220-1-2-.22 states:

> In any contested case the Authority or the Hearing Officer . . . may determine that there is no genuine issue as to any material fact. In reaching such determination, the Authority or Hearing Officer may, in its discretion, hear and determine all or any part of a case, without hearing oral testimony.

The issues in this case are solely a matter of interpretation of certain orders of the Authority and the Tennessee Public Service Commission ("TPSC"), and a Company tariff. As this brief will demonstrate, there are no genuine issues of material fact requiring additional testimony or an evidentiary hearing. The issues in this proceeding can be determined as a matter of law solely on the basis of certain orders issued in prior Authority and the TPSC dockets, the record in those dockets, the relevant United Cities tariff, and, to a very limited degree, testimony in affidavits attached hereto. A large part of the relevant factual background can be drawn, in fact, from the Authority's and the TPSC's findings in prior orders.

STATEMENT OF FACTS

This matter relates to United Cities' performance-based ratemaking ("PBR") plan, also referred to as an incentive plan, which was originally approved by the TPSC on an experimental basis and later made permanent by the Authority after an extensive Hearing. The TPSC's Order approving United Cities' PBR plan summarizes the Company's original application:

> On January 20, 1995, United Cities filed an application for a performance-based ratemaking proposal, which proposal was composed of five separate mechanisms as described below. United Cities proposed that this initiative have a two-year experimental test period. According to the Company, this proposal would eliminate the need for after-the-fact prudence reviews. United Cities stated that the present method of regulation does not encourage effective risk-taking to improve earnings and lower costs, and that their proposal would benefit both ratepayers and stockholders. The proposed changes were intended to measure the utility's performance against pre-defined benchmarks that are surrogates for the market price of gas. The five proposed changes were:
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> 1. Gas Procurement Incentive Mechanism: Provides a sharing arrangement, allowing the Company to keep 50% of the savings

when gas is purchased below market rates as defined by benchmark indices. The Company would also share 50% of the cost when gas is purchased at 104% of market rates defined by these same indices.

2. Seasonal Pricing Differential Incentive Mechanism: Designed to take advantage of seasonal price arbitrage opportunities by comparing current storage injection commodity price to the futures market price during the winter withdrawal months. The differential is realized by purchasing injection month futures contracts and selling withdrawal month futures contracts, and provides for a 50/50 sharing arrangement on this mechanism.
3. Storage Gas Commodity Mechanism: Similar to the season pricing incentive mechanism described above. It is tied to the storage injection plans of the Company in the same season. The Company may be able to modify their injections to take advantage of any arbitrage opportunities through observation of the futures market. The Company proposed a 50/50 sharing arrangement on this mechanism.
4. Transportation Capacity Cost Incentive Mechanism: Allows United Cities to manage any excess firm transportation capacity on upstream pipelines. The Company can market this excess capacity on a temporary basis until needed, then the Company would propose to share any revenues realized with the customers on a 70/30 basis.
5. Storage Capacity Cost Incentive Mechanism. Similar to the transportation capacity cost incentive mechanism, but relates to gas the Company has in storage. There may be times when United Cities can market any unneeded gas in storage to third parties. The Company has proposed to share any revenues realized with the customers on a 70/30 basis for this mechanism.[6]

The TPSC approved United Cities' Application as described above, with modifications, effective April 1, 1995. The TPSC placed a monthly cap on United Cities' sharing under the PBR plan.[7] The TPSC also modified the plan by imposing a two percent (2%) "reasonableness zone" on the Gas Procurement Mechanism, pursuant to which United Cities "will share in gas costs savings below 98% of market and will also bear a share of the costs in excess of 102% of market."[8] The TPSC ordered that "in Mechanisms 2 through 5 . . . 90% of all gains or losses will

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[6] Untitled Order, TPSC Docket No. 95-01134 (May 12, 1995), pp. 1-3.
[7] *Id.*, p. 6.
[8] *Id.*

go to the consumers while 10% will go to the Company" instead of the 50/50 and 70/30 sharing levels proposed by United Cities.[9]

In the original Application seeking approval of the five (5) mechanisms described in the TPSC's Order, United Cities stated that its proposal was "a comprehensive and integrated restructuring of the five key pieces of the gas purchases of United Cities."[10] United Cities further stated that it proposed "to include all elements of its cost of delivering natural gas to all classes of customers through five (5) mechanisms,"[11] those mechanisms being the same listed in the TPSC's Order. The Application also listed the "INDICES PROPOSED" for use in the PBR plan:

> The proposed indices required by this filing are:
> 1). <u>Inside FERC Gas Market Report</u> – first day of the month
> 2). NYMEX monthly close from the <u>Wall Street Journal</u>
> 3). <u>Natural Gas Intelligence</u> – bid week average
> 4). <u>Gas Daily</u> – first day of the transaction
> The market indices to be filed include:
> 1). <u>Swing Purchases</u>:
> Daily Index = Gas Daily (first day of transaction)
> 2). <u>Spot Purchases</u>:
> Monthly Index = 1/3 NYMEX + 1/3 Natural Gas Intelligence + 1/3 Inside FERC Gas Market Report
> 3). Long Term Purchases:
> Rolling Average 1 or 2 = ** Relevant Index + Adjustment, where:
> ► Adjustment 1 = 3 year rolling average of competitive bids
> ► Adjustment 2 = Avoided transportation costs
> ** (Relevant Index is either the Daily Index or the Monthly Index depending on the contract).[12]

The use of these indices is further explained in Appendix B of the Application, which begins with the statement that "[t]he cost per Dth [decatherm] of each procurement-related transaction, including commodity and demand costs where appropriate, is measured against a

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[9] *Id.*
[10] *Application for Performance-Based Ratemaking Mechanism*, TPSC Docket No. 95-01134, January 20, 1995, p. 2.
[11] *Id.*, p. 4.
[12] *Id.*, pp. 6-7.

predefined benchmark index."[13] The explanation of the Gas Procurement Incentive Mechanism details the "benchmark index formula" for each of the "six possible procurement transactions."[14] Which of these six (6) possibilities applies depends on whether a transaction is spot or swing and whether the transaction is monthly, long term upstream, or long term at the city gate.[15] The explanation for each of the six (6) possible transactions clearly and exclusively involves comparing the price United Cities pays for gas to one of the published market indices proposed for use with the PBR, *Inside FERC Gas Market Report*, NYMEX, *Natural Gas Intelligence*, and *Gas Daily*, or a specific combination of these indices, adjusted for avoided transportation costs where appropriate.[16]

The Direct Testimony of James R. Harrington, a consultant, filed with the Application, states the objectives achieved by the Application:

> a) Sends clear signals through the establishment of benchmark standards
> b) Market-based benchmarks based on the objectivity of actual usage in the market assure prudency of performance
> c) Provides a better measurement of performance by using external criteria rather than, or in addition to, internal criteria based on cost-of-service.[17]

In testimony filed in 1997 in support of United Cities' request to make the PBR plan permanent, Mr. Harrington described each of the market indices:

> *Inside F.E.R.C.'s* Gas Market reports has been reporting in the same format since March 1986. The survey sample comprises more than 350 sources. The sample is composed almost entirely of large and small gas producers, pipeline-affiliated and non-affiliated marketers, distributors and end-users. Prices are reported for actual spot-gas sales agreements, not offers or bids.
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> Intelligence Press, Inc., publishers of *Natural Gas Intelligence* ("NGI") gathers the data used in settling prices via a daily telephone survey of industry representatives. The source base consists of over three hundred participants from all sectors of the natural gas industry and its customers. By obtaining quotes from

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[13] *Id.*, Appendix B, p. 1.
[14] *Id.*
[15] *Id.*
[16] *Id.*, pp. 5-7.
[17] *Direct Testimony of James R. Harrington*, TPSC Docket No. 95-01134, January 20, 1995, p. 6.

a large sampling of producers, marketers, intrastate pipelines, industrial end-users, and utilities, NGI increases the likelihood that the prices appearing in the newsletter more closely approach the true population average in an objective manner.

The NYMEX gas futures index is a major source for discovering the US gas reference price. Market participation by a broad spectrum of the energy industry helps ensure that all available information on supply and demand is incorporated in the price determination process. Gas futures prices are determined by free competition among traders who announce, by open outcry, their desire to buy or sell a certain number of contracts at a certain price. The forces of many pricing factors ensure that futures prices reflect the true market value of the underlying gas commodity and are transparent to the marketplace at large.

Pasha Publications, Inc. publishers of *Gas Daily* surveys scores of respondences per day and a few hundred during bid week to produce ranges and indices. *Gas Daily* surveys the complete spectrum of the industry, from wellhead to burnertip, to acquire data. The *Gas Daily* price team talks to major producers and all sizes of independents and marketers from the largest national players to the smallest niche players and local distribution companies, regardless of size, power companies, congenerators and end-users.[18]

As directed in the TPSC's May 12, 1995 Order, a consultant, Frank Creamer, prepared a review of United Cities' PBR plan.[19] This review, dated February 28, 1997, discusses each of the five (5) mechanisms. Consistent with the description in the Company's original application, the review shows that "[e]ach gas purchase is assigned to one of six procurement categories."[20] The review states further that "[e]ach of the above gas purchase transactions is then compared in some way to one or more of the [indices] listed below, the first three of which are referred to as market indexes."[21] The listed market indices are *Inside FERC Gas Market Report*, NYMEX,

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[18] *Prepared Direct Testimony of James R. Harrington on Behalf of United Cities Gas Company*, Docket No. 97-01364, August 13, 1997, pp. 21-22.
[19] Untitled Order, TPSC Docket No. 95-01134 (May 12, 1995), p. 6.
[20] *Second Year Review of Experimental Performance-based Ratemaking Mechanism, April 1, 1995 – November 30, 1996*, February 28, 1997, p. 8; see *Application for Performance-Based Ratemaking Mechanism*, TPSC Docket No. 95-01134, January 23, 1995, Appendix B, p. 1. This document was made an exhibit to a deposition of Mr. Creamer taken July 31, 1997. The deposition was admitted into the record, along with the report, during the Phase One Hearing on March 26, 1998. *See* Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, p. 57; Vol. II, March 27, 1998, p. 441. United Cities presented Mr. Creamer as a witness at the March 1998 Hearing in Docket No. 97-01364.
[21] *Second Year Review of Experimental Performance-based Ratemaking Mechanism, April 1, 1995 – November 30, 1996*, February 28, 1997, p. 9.

Natural Gas Intelligence, and *Gas Daily*. The review states:

> In addition, the benchmark may be adjusted depending on whether long-term purchases are upstream or at the city-gate. The two adjustments are:
>
> - Competitive Bid Adjustment for long-term upstream (spot or swing) purchases, using the three-year rolling average of long-term contract premium over spot
> - Avoided Cost Adjustment for long-term city-gate (spot or swing) purchases, using the appropriate pipeline transportation cost.[22]

A table that follows this explanation shows that for long-term spot purchases at the city gate, the benchmark figure equals the Competitive Bid Adjustment plus the Avoided Cost Adjustment, added to the average of the three (3) market indices.[23] This table further indicates that for long-term swing purchases at the city gate, the benchmark equals the Competitive Bid Adjustment plus the Avoided Cost Adjustment, added to the *Gas Daily* Index.[24] The review recommends that the PBR program be made permanent and that it be simplified by "collapsing the five incentive mechanisms into two mechanisms."[25] The review recommends (1) that the Gas Procurement, Seasonal Price Differential, and Storage Gas Commodity mechanisms be collapsed into a single Gas Commodity Cost Mechanism and (2) that the Transportation Capacity Cost and Storage Capacity Cost mechanisms be collapsed into a single Capacity Release Sales mechanism.[26]

On March 31, 1997, United Cities filed a petition for approval of a permanent PBR mechanism. As the result of an appeal which is not relevant to this matter, the Authority considered this petition in two phases. A Hearing on both phases was conducted on March 26, 27, and 31, 1998. The Authority issued its *Final Order on Phase One* (the "Phase One Order") on January 14, 1999, and on April 16, 1999, the Authority issued its *Final Order on Phase Two*,

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[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*, p. 24.
[26] *Id.*

in which the Authority approved continuation of the PBR program on a permanent basis. The Authority ordered:

> The five incentive mechanisms of gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost, and storage capacity cost are collapsed into two mechanisms – Gas Commodity and Capacity Release Sales.[27]

United Cities' PBR Tariff, which shows an issue date of March 16, 1999, and an effective date of April 1, 1999, states that the "Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which the Company's commodity cost of gas is compared."[28] The PBR Tariff further explains the treatment of "Commodity Costs":

> On a monthly basis, the Company will compare its commodity cost of gas to the appropriate benchmark amount. The benchmark amount will be computed by multiplying actual purchase quantities for the month, including quantities purchased for injection into storage, to the appropriate price index. For monthly spot purchases, the price index will be a simple average of the appropriate *Inside FERC Gas Market Report*, *Natural Gas Intelligence*, and NYMEX indexes for that particular month. For swing purchases, the published *Gas Daily* rate for the first business day of gas flow will be used as the index. For long-term purchases, i.e., a term more than one month, these indexes will be adjusted for the Company's rolling three-year average premium paid to ensure long-term supply availability during peak periods. For city gate purchases, these indexes will be adjusted for the avoided transportation costs that would have been paid if the upstream capacity were purchased versus the demand charges actually paid to the supplier.
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> Gas purchases under the Company's existing seven-year Nora supply contract effective November 1, 1993, will be excluded from the incentive mechanism. The Company will continue to recover 100% of the Nora costs through its PGA with no savings or loss potential. If, upon the expiration of the current Nora contract and if the Company continues to operate under the PBRM, the contract is renewed or renegotiated, it will be considered for inclusion in the PBRM at that time.
>
> If the total commodity cost of gas in a month falls within a deadband of 97.7% to 102% of the total of the benchmark amounts, there will be no incentive savings or costs. If the total commodity cost of gas falls outside of the deadband, the amount falling outside of the deadband shall be deemed incentive savings or costs under the mechanism. Such savings or costs will be shared 50/50 between the Company's customers and the Company. At the end of each three-year period,

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[27] *Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999), p. 28.
[28] United Cities Gas Company, T.R.A. No. 1, Performance Based Ratemaking Mechanism Rider, March 16, 1999, 1st Revised Tariff Sheet No. 45.1.

the deadband will be readjusted to 1% below the most recent annual audited results of the incentive plan.[29]

An important feature of the PBR plan as proposed by United Cities and approved by the TPSC and the Authority is that it eliminates the requirement, contained in the Authority's Purchased Gas Adjustment ("PGA") Rules, of an audit of the prudency of United Cities' gas purchases.[30] United Cities submitted testimony arguing for elimination of the prudency audit.[31]

On May 30, 2000, United Cities submitted its audit filing for the first full year of the permanent PBR plan, the period from April 1, 1999 to March 31, 2000. This first audit of the permanent PBR plan was assigned Docket No. 00-00459. The Authority Staff submitted its preliminary audit findings to United Cities on November 1, 2000, the Company submitted its response on December 8, 2000, and the Staff filed its final audit report on January 9, 2001.[32] The Authority approved this report by Order dated March 19, 2001.[33] United Cities' first permanent PBR filing, in Docket No. 00-00459, did not state or claim a separate calculation of savings related to discounted transportation contracts.[34]

United Cities submitted its second PBR filing on August 7, 2001, covering the period from April 1, 2000 to March 31, 2001. The Authority Staff submitted its draft audit findings to United Cities on March 28, 2002, containing six (6) specific audit findings. Finding #2 states that the "Staff calculated an **over-recovery of $526,265** in the Gas Procurement Incentive Mechanism."[35] The audit identifies the cause of this finding of over-recovery:

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[29] *Id.*, Original Sheet No. 45.1-45.2.
[30] Untitled Order, TPSC Docket No. 95-01134 (May 12, 1995), p. 6; United Cities Gas Company, A Division of Atmos Energy Corporation Tariff T.R.A. No. 1, 1st Revised Sheet No. 45.1, March 16, 1999.
[31] *See, e.g., Prepared Direct Testimony of James R. Harrington On Behalf of United Cities Gas Company*, Docket No. 97-01364, August 13, 1997, pp. 14-15.
[32] *Notice of Filing by Energy and Water Division of the Tennessee Regulatory Authority*, Docket No. 00-00459, January 9, 2001.
[33] *See Order Adopting IPA Compliance Audit Report of Authority's Staff*, Docket No. 00-00459 (March 19, 2001).
[34] Affidavit of Pat Murphy, July 31, 2002, p. 2.
[35] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 10.

This finding represents a deviation from the terms of United Cities' Incentive Plan tariff. The $526,265 in savings is 50 percent of what the Company refers to as "Tennessee Negotiated Rate Savings." The savings represent "avoided costs" resulting from negotiated transportation contracts that the Company entered into with various pipelines. These avoided costs are calculated by comparing the transportation rates negotiated in the contract to the maximum pipeline tariff rates approved by the Federal Energy Regulatory Commission ("FERC").[36]

The audit conducted in Docket No. 01-00704 revealed that United Cities had taken advantage of the fact that in its dealings with some of the pipelines from which it purchased gas the Company was able to negotiate a price for transportation service that was lower than the legal maximum rate for transportation service set by the Federal Energy Regulatory Commission, also called the "maximum FERC rate." Such negotiated discounted transportation contracts are for the service of transporting gas and are distinct from the sale of gas as a commodity and also distinct from the pipelines' sale of the reservation of pipeline capacity. United Cities calculated its "savings" with respect to these discounted contracts for transportation service by applying the deadband of 97.7% to 102%, which the Authority approved for commodity purchases, to the maximum FERC rate. United Cities claimed in its audit filing that it was entitled to fifty percent (50%) of the "savings" that resulted when a contract price for transportation services was below 97.7% of the maximum FERC rate.[37]

The Report then reviews the Gas Procurement Incentive Mechanism as stated in United Cities' PBR Tariff. The Report continues:

For each type of purchase, the benchmark is clearly defined. Some purchases allow an adjustment of the indexes; however, nowhere in the tariff is there mention of sharing savings associated with transportation discounts. The only mention of transportation costs is in conjunction with the definition of the appropriate index for city gate purchases. A city gate purchase is one where the Company buys local gas and avoids the full pipeline costs of transporting the gas from the Gulf of Mexico to Tennessee. However, the pipeline purchases that United Cities was able to negotiate lower transportation rates for were not city

[36] *Id.*
[37] Affidavit of Pat Murphy, July 31, 2002, pp. 2-3.

gate purchases.[38]

The Report concludes, regarding this finding:

> Including savings associated with transportation rates in the Incentive Plan would require a revision of the Incentive Plan. If the Company decides to take that approach, a problem would arise in establishing a benchmark with which to compare negotiated rates. The definition of Gas Procurement savings in the current tariff is a discount below "market" prices. The tariff establishes indexes as a proxy for the commodity "market." Since there is no known "market" price for transportation rates (other than the rate paid by United Cities Gas), there is no way to know if the maximum FERC approved tariff rates are the appropriate proxies. Without a valid benchmark, savings (if any) cannot be quantified.[39]

United Cities made two (2) general responses to the Staff's draft report. The first is that Staff represented to United Cities, through its silence after being informed of the Company's intentions, that Staff agreed with United Cities' inclusion of negotiated transportation discounts in its PBR calculation. The second is that the inclusion of such discounts is provided for, either directly or by implication, in the Authority's Phase Two Order.

United Cities refers to a January 31, 2001 meeting between representatives of United Cities and members of the Authority Staff, during which United Cities purportedly "provide[d] notice of its renegotiated transportation contracts that went into effect in November of 2000."[40] United Cities states that "[a]t no time during or immediately following this meeting did Staff indicate that UCG was incorrect in its treatment of these avoided costs as savings under the PBR mechanism."[41]

United Cities further states:

> The quarterly reports for October through December 2000 and January through March 2001 were filed pursuant to the guidelines of the tariff on March 1, 2001 and May 31, 2001, respectively. The Authority failed to provide any written notification to UCG of any exceptions within 180 days of the filing of those

[38] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 11.
[39] *Id.*
[40] *Id.*
[41] *Id.*, p. 12.

reports. Accordingly, pursuant to the tariff (Sheet No. 45.6) UCG's incentive plan account is deemed in compliance with the provisions of the PBR. Accordingly, UCG booked as income its share of benefits earned under the PBR program. This income has been recognized by the Company since November 2000.[42]

United Cities states:

> Even if the Authority determines that the Staff may now raise objections to the previously filed quarterly reports, although no exceptions were made within 180 days of filing those reports, Staff's current conclusion that transportation discounts should not be included in the PBR plan is categorically incorrect.[43]

United Cities' explanation for this assertion is that "[b]oth the initial PBR plan and the permanent PBR plan covered the entire associated commodity cost of purchasing, delivering and storing of gas to the end consumer."[44] United Cities quotes the following passage from the Phase Two Order, stating that in this passage "the Authority specifically identified transportation costs as a component in its definition of the total cost of gas":

> The total cost of gas includes the commodity cost and the transportation cost to move the gas from its source to the city gate. In general, the closer the gas source is to the city gate, the higher the commodity cost, but, since the distance to be moved is less, the transportation cost is less. In contrast, the farther the gas is from the city gate, the cheaper the commodity cost, but the transportation cost to move it a greater distance is more. It is, therefore, possible that the total of commodity and transportation costs for the higher cost gas could be lower than the total cost (commodity plus transportation) for the cheaper gas.[45]

United Cities further states:

> A fundamental requirement of UCG's PBR program is to establish a mechanism that incents proper business decisions and not reward the company at the ratepayers' expense. In order to satisfy this design principle, the PBR program must be all-inclusive, e.g. it must include all the gas purchasing, storage, and transportation activities. Otherwise, if transportation costs had been excluded from the PBR program and treated exclusively as a PGA pass through, the PBR plan would have a material defect due to the potential opportunity to pass on to the ratepayer the relative high transportation cost arrangements that could have been obtained in order to secure relatively lower commodity costs. Under this

[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999), p. 18, n. 46, *quoted in Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 12.

scenario, UCG could earn benefits at the ratepayers' expense under the PBR formula on the commodity portion alone. Clearly, this was not the intent of the Authority in establishing a PBR mechanism and accordingly, the Phase II Order recognized that transportation costs must be included as an integral component of the total commodity cost within the PBR mechanism. Since the PBR plan currently provides for transportation costs, a revision to the plan, as Staff concludes, would not be required.[46]

United Cities concludes:

The negotiated transportation discounts were a direct result of the incentives presented by the PBR. In the final Order on Phase Two the Authority found that the cap should be increased to $1.25 million to provide the Company with the necessary incentives to become more aggressive. Staff met with UCG on two occasions to discuss the treatment of transportation discounts. During those meetings, UCG specifically identified to Staff that "city gate purchases" included both raw commodity costs and transportation costs necessarily incurred for the delivery of the commodity to the city gate.[47] Attached, as Exhibit is an invoice from Woodward Marketing, LLC dated December 29, 2000, which illustrates that the total invoice amount charged to UCG for city gate purchases includes transportation costs.

As noted above, UCG also disagrees with the Staff's conclusion that including savings associated with transportation rates would require a revision of the Incentive Plan. Furthermore, UCG disagrees with the conclusion that a problem exists in establishing a benchmark of performance against which to compare the negotiated transportation rates. The absence of published benchmarks providing comparative analysis on discounted transportation rates should not preclude the Staff from including transportation discounts in the PBR mechanism. If transportation costs were treated as a PGA passthrough, as Staff recommends, Staff would still be faced with determining prudency of UCG's decisions. Therefore, the issue of establishing a standard of performance against which to measure UCG's performance exists whether or not transportation costs are included in the PBR program. When transportation contracts are renegotiated, the benefit derived from the new contract is easily quantifiable – it is based on the prior period costs, which in this case were the maximum FERC rates. In calculating the benefit to the ratepayers and UCG, the first contract renewal would be compared to the prior period rate, the undiscounted, published FERC rate. This approach is inward looking, and measures UCG's performance against itself. This approach would be consistent with a prudency audit, if one were to be performed. It should be noted that under the PBR sharing formula, the ratepayer receives the first 2.3% of the discount and one-half of any discount greater than 2.3%.

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[46] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 13.

[47] United Cities in its data response to the TRA staff did not purport to give a full definition of "city gate purchases." At the meetings referenced above with the staff, UCG's position with respect to the total cost of gas at the city gate was specifically set forth and discussed. (Footnote in original.)

Under the PBR program, subsequent renewal periods implicitly contain a 1% improvement factor due to the readjustment of the dead band every three years. Therefore, it is not necessary to adjust the comparative standard of performance and instead, continue to compare all future contracts against the initial rate. In absence of a readjusted dead band, the standard could be trued-up every three to five years, based on prior periods actual costs.

In summary, the savings associated with transportation discounts were provided for in the PBR mechanism, as documented in the Phase II Order and that Staff's current position is contrary to that order. To exclude transportation costs from the PBR mechanism would be a material flaw in the administration of the program.[48]

Finding #3 in the Report is an over-recovery of $100,947 in the Gas Procurement Mechanism.[49] The basis for this finding is that the "Company's calculation of the 'savings' related to the NORA contract does not conform to the terms of its Incentive Plan."[50] The Report finds that United Cities improperly included a separate calculation of savings produced by the transportation component of the contract price in its calculation of savings produced by the Company's East Tennessee-NORA ("NORA") contract, similar to the Company's treatment of discounted transportation contracts in relation to other gas purchases under the PBR plan.[51] Further, the Report found that United Cities had improperly separated the NORA calculation from the calculation for all other contracts, in violation of the terms under which NORA was included in the PBR plan.[52] The Report cites United Cities' response to a Staff data request, in which United Cities states: "Therefore, having no impact on the lower limit of the commodity deadband each month, the separate reporting of Nora seems more straightforward."[53]

United Cities responded as follows:

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[48] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, pp. 13-14.
[49] *Id.*, p. 17.
[50] *Id.*
[51] *Id.*
[52] *Id.*, p. 18.
[53] *Id.*, p. 19. *See* Murphy Exhibit B, United Cities Gas Company Response to Staff Data Request, January 21, 2002, p. 3. (This document contains information marked "Confidential" and is being filed under seal.)

The Company's response to finding #3 is two part. First, it appears that the Staff has chosen to disallow transportation costs on the same basis as set forth in finding #2. Accordingly, UCG adopts its response to finding #2 in regard to savings resulting from avoided transportation costs.

Secondly, the Staff has objected to the method of calculation by the Company of the cost savings resulting from the NORA contract. The method of calculation for the savings associated with the NORA contract have been well documented beginning with the experimental PBR program. Although the NORA contract was subsequently deleted, the method of the calculation nonetheless remained intact as evidenced in Staff's own Table included in their discussion of Finding #2 that noted the type of purchase that the NORA contract falls under, i.e. citygate purchase. It appears that Staff has failed to adjust the commodity portion for the avoided transportation cost when comparing to the indices benchmark.

On or about September 21, 2001, UCG filed a petition requesting permission to include the new NORA contract in the current PBR. TRA Docket No. 00-00844. This petition included attachments which illustrated the inclusion of the avoided cost savings in the PBR calculation. The PBR calculation set forth in the petition is identical to the PBR calculation set forth in the quarterly reports filed thereafter as well as in the annual report.

On November 8, 2001, the Authority entered an order granting permission to include the new NORA contract in the PBR. The Authority held:

> 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.

Order, Docket No. 00-00844.

There were no objections raised by either the Staff or any third party concerning the proposed method of calculation set forth in the petition. Obviously, by the Authority's own language, it carefully reviewed the petition and if it had an issue with the method of calculation, it would have stated so in the order.

As set forth in the Company's response to finding #2, each of the quarterly reports, which include the NORA contract savings in the PBR calculation, are deemed in compliance with the Incentive Plan due to the fact that the Authority did not provide written notification of any exceptions within 180 days of the filing of said reports.[54]

[54] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, pp. 18-19.

ARGUMENT

I. The Authority's Phase Two Order in Docket No. 97-01364 does not provide for Company sharing of "savings" that result from discounted transportation contracts.

A. Neither the Phase Two Order nor United Cities' PBR Tariff provides, directly or by implication, for sharing of "savings" from discounted transportation contracts.

In its response to Finding # 2 in the Report, United Cities has failed to make a persuasive argument that "savings" realized from negotiated discount transportation contracts are included in any sharing mechanism under the Phase Two Order or United Cities' PBR Tariff. The PBR plan, as set forth in the Phase Two Order and the PBR Tariff, does not contain any provision for or even mention discounted transportation contracts. Nor do any of the documents filed by United Cities in support of its applications for approval or extension of the PBR plan. Discounted transportation contracts are not mentioned in the transcript of the Phase One and Two Hearing held on March 26, 27, and 31, 1998. Further, the method United Cities arrived at for calculating the savings from discounted transportation contracts has no reference in any of these places. None of the documents submitted in support of United Cities' applications for a PBR plan and none of the testimony upon which the Authority based its approval of the PBR plan mentions the maximum FERC rate as a benchmark or in any other way.

The terms under which the TPSC and the Authority approved an incentive mechanism for commodity prices provide additional proof that no such incentive mechanism was approved, explicitly or implicitly, for discounted transportation contracts. The Phase Two Order making the PBR plan permanent provides that the PBR program will go forward using two (2) "incentive mechanisms." As set forth in the Phase Two Order, the two (2) mechanisms derive from an original set of five (5) mechanisms created in the initial, experimental phase of the PBR. The Order provides:

The five incentive mechanisms of gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost, and storage capacity cost are collapsed into two mechanisms – Gas Commodity and Capacity Release Sales.[55]

The Order does not include any further mechanism in addition to those listed here. Neither of the two (2) final mechanisms, Gas Commodity and Capacity Release Sales, covers savings resulting from discounted transportation contracts. None of the original five (5) mechanisms covers savings resulting from discounted transportation contracts.

United Cities' PBR Tariff, quoted above, which effectuates the PBR plan, is consistent with this interpretation of the Phase Two Order. It specifies only the two (2) mechanisms. It clearly outlines the use of benchmarks for various types of gas purchase based on indices including NYMEX, *Inside FERC*, *Natural Gas Intelligence*, and *Gas Daily*.[56]

Moreover, the operation of the incentive mechanisms approved in the Phase Two Order demonstrates that the Phase Two Order does not create an accompanying incentive mechanism for discounted transportation contracts. The mechanisms created in the Phase Two Order resulted from a great deal of testimony as well as supporting documentation submitted by United Cities.[57] It is reasonable to conclude that, upon consideration of this testimony and documentary evidence, the Authority carefully crafted the two mechanisms and intended that they be applied in a specific fashion.

The approved mechanism for commodity purchases has certain fundamental aspects. It is clear from the Phase Two Order itself, as well as the TPSC's previous Order establishing the PBR on an experimental basis, that the determination whether and to what extent the Company

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[55] *Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999), p. 28.

[56] United Cities Gas Company, A Division of Atmos Energy Corporation, T.R.A. No. 1, March 16, 1999, 1st Revised Sheet No. 45.1, Original Sheet No. 45.2.

[57] *See, e.g.*, Transcript of Proceedings, Vol. I, March 26, 1998, pp. 59-65, 96-98 (Testimony of Frank Creamer); *Prepared Direct Testimony of James R. Harrington On Behalf of United Cities Gas Company*, August 13, 1997; *United Cities Gas Company Second-Year Review of Experimental Performance-Based Ratemaking Mechanism: April 1, 1995 - November 30, 1996*, February 28, 1997.

was to share in savings in its commodity costs was to have certain key components.

The first component is establishment of a "basket" of indices for the commodity portion.[58] The indices included in this basket are NYMEX, *Inside FERC*, *Natural Gas Intelligence*, and *Gas Daily*.[59] These indices are nationally published surveys of gas commodity prices.[60] They are intended to serve as a "proxy" for the gas market.[61] Each of the indices in the

[58] The testimony of United Cities' witness Frank Creamer is fully consistent with the description of the PBR plan as stated above, and with the Authority's Orders and United Cities' PBR Tariff. It contains no mention of discounted transportation contracts or use of the maximum FERC rate as a benchmark. Mr. Creamer stated:

> To begin with, in 1995, the Tennessee Commission approved a two-year experimental rate mechanism with an objective to streamline regulation and to hold down costs to the consumers. This plan contained five incentive mechanisms that cover virtually all the associated commodity costs by United Cities Gas in the purchasing, delivering, and the storing of gas to the end consumer.
>
> One of these incentive mechanisms, the gas procurement mechanism, relies on a benchmark of performance as defined by the Commission at that time. This benchmark of performance was determined by examining the historical gas procurement costs of the company and in establishing a predefined benchmark of performance, against which United Cities Gas would then be measured against.

Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, p. 59.

> In summary, the performance ratemaking mechanism covered all the associated commodity costs of purchasing, delivering, and storing of gas to the end consumer. Therefore, it addressed the commodity cost of gas, the storage commodity cost of gas, the fixed cost of transporting that gas, as well as the fixed cost associated with the storage of that gas.
>
> And in some ways the mechanism addressed each one of these elements. And there are, against, five basic components of the mechanism, gas procurement, price arbitrage between prices and futures contracts, and those are the "intricies" [sic] and all intricies [sic] on mechanisms.
>
> The other two mechanisms, number 4 and 5, were associated with the transportation capacity release, that is the fixed costs associated with transportation of that gas, as well as, storage capacity release of the program.

Id., p. 61.

> Based on the original order that was attached to – or, excuse me, the rate tariff that was attached to the order, during the first year of the program the effectiveness of United Cities Gas gas purchasing decisions were measured against a basket of widely followed published indices. And these were inside FERC, NYMEX, Natural Gas Intelligence, as well as the Gas Daily.
>
> Additionally these benchmarks could be adjusted depending on what types of purchases were actually conducted, whether they be long term or short term, or if they were purchased upstream or at the city gate.
>
> Each of the purchasing decisions entered into by Untied Cities Gas on a monthly basis were measured against these indexes.

Id., p. 62.

[59] *Id.*

[60] *See* Transcript of Proceedings, Vol. II, March 27, 1998, p. 500 (Testimony of Frank Creamer); *see also Prepared Direct Testimony of James R. Harrington on Behalf of United Cities Gas Company*, Docket No. 97-01364, August 13, 1997, pp. 21-23.

[61] Transcript of Proceedings, Vol. I, March 26, 1998, p. 98 (Testimony of Frank Creamer).

basket reports an average price paid in a specific period at a specific place, so the basket represents an average of averages.[62] While it is not a perfect reflection of actual market conditions, the basket of indices serves as a rough gauge of such conditions.[63]

As provided in the Phase Two Order, a "deadband" is then applied to the basket figure to determine whether United Cities will share savings with its customers. The Phase Two Order sets the lower limit of the deadband at 97.7%. In the words of Mr. Creamer, the deadband serves as a "zone of reasonableness."[64] If the Company's aggregate price for gas is below 97.7% of the basket of indices, the Company is entitled to share the resulting savings with its customers.[65]

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[62] This is reflected in the Hearing testimony of United Cities' witness James R. Harrington:

> Let me answer that this way, Mr. Williams. I've been involved in probably between 100 and 200 gas contracts in my life that involve establishing the price against these indices that we're talking about here today.
>
> And it is my experience that while it's possible for an individual to over or underestimate when we talk about – and I'm a statistician by training, as you know – when we talk about a sample in excess of 300 in one case and 350 in another case, one or two instances do not make a material impact and did not make a material impact on my arm's length negotiations with regard to these contracts.
>
> I will also state that if, as you suggest, someone is attempting to over or understate to adjust the average, then as you know by reading my testimony how those indices are performed, if it's substantially out of line, those observations are checked. And if they are deemed to be outliers, even upwards or downwards, they're omitted from the index.

Transcript of Proceedings, Vol. II, March 27, 1998, pp. 535-36.

> I think those 300 transactions using the techniques used by these sampling organizations do, in fact, establish a market price.

Id., pp. 536-37.

> And those publications publish the range. One of the indices that we're referring to uses a weighted average to determine the market price. And the other one uses a simple average of all the transactions.

Id., p. 537.

> Prices aren't reported to these indices. The indices seek out a sample through their network.

Id., p. 538.

[63] As Authority witness Hal Novak stated, "the average of the three indexes are a proxy for the market price." Transcript of Proceedings, Docket No. 97-01364, Vol, I, March 26, 1998, p. 259.

[64] Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, p. 130.

[65] *See Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999), p. 27.

The concept behind the basket and the deadband is that they serve as a way of creating and measuring an incentive for the Company to obtain lower prices for gas.[66] The basket and the deadband are essential to putting this concept into operation. If United Cities merely paid the approximate average market price, there would be no evidence that the Company had made any effort to lower its gas costs and there would be no support for a reward to the Company. Likewise, a slight deviation from the approximate average, which is reflected in the basket of indices, would not conclusively indicate any effort or support any reward. It is only when the deviation of the price below the basket of indices becomes statistically significant that a price below that deviation can be said to justify a reward to the Company.

In the Phase Two Order, after much testimony, and careful consideration, the Authority set the lower limit of the deadband at 97.7% and provided that this figure remain in effect for three years. The Authority also determined that the deadband should be further adjusted thereafter.

In summary, the commodity portion of United Cities' PBR plan as approved by the TRA features certain essential elements:

(1) A basket of indices to which prices paid for gas are compared.
(2) The use of nationally published market indices, specifically Inside FERC, NYMEX, Natural Gas Intelligence, and Gas Daily.
(3) The selection of indices based on their use of surveys of actual prices paid in the gas commodity market.
(4) A deadband or zone of reasonableness in which there is no sharing of savings or losses between UCG and its customers.

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[66] *See* Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, pp. 75-76, 86, 180 (Testimony of Frank Creamer), pp. 277, 281 (Testimony of Hal Novak); Vol. II, March 27, 1998, pp. 464-65 (Testimony of Frank Creamer), pp. 509-10, 512, (Testimony of James R. Harrington); Vol. III, March 31, 1998, pp. 572-74 (Testimony of William J. Senter);
Perhaps most significant is the following testimony by Mr. Creamer:

> [A] standard of performance, a benchmark, was established for the company which indicated that purchases between 98 percent and 102 percent of the indices would have been deemed prudent for gas purchase prudency reviews. **To the extent that the company beat that, then that would be evidence that the mechanism has provided the appropriate incentives and provided the appropriate incentives to deliver value to the ratepayer as well as to the company.**

Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, p. 86. (Emphasis provided).

Each of these elements was arrived at after extensive testimony, argument, and deliberation. Moreover, each element serves an important purpose, and each element is indispensable. As explained further below in Part C, the deviation from the Authority's Purchased Gas Adjustment ("PGA") Rule,[67] which the PBR plan represents, cannot be justified without each of these elements in place. Any attempt to extend the application of the PBR plan that does not contain these elements would be contrary to the Authority's Phase II Order.

An examination of United Cities' treatment of the discounted transportation contracts at issue readily demonstrates that such contracts were not and could not have been included in any of the Phase Two mechanisms. The essential features of the PBR mechanism are missing. There was no indicator of an average market price, no index comparable to NYMEX, *Inside FERC*, *Natural Gas Intelligence*, or *Gas Daily*, no "proxy" for the market, for transportation contracts at the time of the Phase Two proceedings. For that matter, there is no such index for transportation service today.[68] It is inconceivable that the Authority would so carefully and explicitly determine and set forth the operation of an incentive mechanism that has as one of its pillars the existence of a market index or set of indices for one portion of the price of gas (the commodity price), and then leave the Company to its own devices as to the application of a supposed mechanism for another portion.

United Cities has made a number of statements that, in isolation, correctly describe some aspect of the PBR plan. United Cities draws erroneous conclusions from these statements, however. The most important of these statements is that transportation, as an aspect of the total price of gas, is included in the PBR plan.[69] This is true, but not in a way that would support

[67] Authority Rule 1220-4-7-.01 *et seq.*

[68] Affidavit of Stephen N. Brown in Support of Motion for Partial Summary Judgment, Docket No. 01-00704, July 17, 2002, p. 3.

[69] Thus, United Cities states that "the Phase II Order recognized that transportation costs must be included as an integral component of the total commodity costs within the PBR mechanism." *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 13.

United Cities' inclusion of transportation contracts in its PBR calculation.

The fact that transportation was mentioned during the Phase Two Hearing does not mean that the Order resulting from that Hearing was intended to encompass discounted transportation contracts as suggested by United Cities. To the contrary, the fact that transportation was discussed exclusively as a factor in determining whether a particular market index served as an accurate reflection of the commodity market demonstrates that discounted transportation contracts were not intended to be included in any incentive mechanism.

Transportation costs **are** an aspect of commodity costs. In establishing the PBR plan, the TPSC and the Authority recognized that disregarding this aspect would create a distortion in the purchasing incentive mechanism. Therefore, the PBR plan, as reflected in United Cities' PBR Tariff, distinguishes between upstream and city gate purchases.[70] Because the price paid by United Cities in a city gate purchase would include a transportation component that is avoided when gas is bought upstream, the price of a city gate purchase is adjusted to reflect the effect of

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[70] There has been some dispute over the meaning of "city gate." Staff's interpretation of this term is consistent with the following Federal regulation which defines "city gate" for use in the Uniform System of Accounts Prescribed for Natural Gas Companies:

> 804 Natural gas city gate purchases
>
> A. This account shall include the cost, at point of receipt by the utility, of natural gas purchased which is received at the entrance to the distribution system of the utility.

Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act, 18 C.F.R. Pt. 201 (2002). Staff's interpretation is: "A city gate purchase is one where the Company buys local gas and avoids the full pipeline costs of transporting the gas from the Gulf of Mexico to Tennessee." *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 11.

United Cities' interpretation of "city gate" has a meaning closer to the point at which the local distribution company takes delivery, which could be at any point on the pipeline, but this interpretation would render the distinction in the PBR Tariff between "city gate" and "upstream" purchases nugatory and would indeed run counter to the entire system of six (6) types of purchases as set forth in United Cities' filings in support of a permanent PBR plan and the TRA's Orders.

United Cities states that during meetings with Staff, "UCG specifically identified to Staff that 'city gate purchases' included both raw commodity costs and transportation costs necessarily incurred for the delivery of the commodity to the city gate." *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 13. Staff would have had no reason to question this statement, which is consistent with Staff's interpretation of "city gate," and thus Staff's silence means nothing. This statement is also consistent with United Cities' elaborate delineation of six (6) possible purchasing variations. This delineation depends on there being a distinction between upstream and city gate. *See United Cities Gas Company Second Year Review of Experimental Performance-Based Ratemaking Mechanism: April 1, 1995 – November 30, 1996*, February 28, 1997, p. 9. United Cities' new interpretation of "city gate" in its responses quoted in the Report is inconsistent with the interpretation of "city gate" in its filings in support of a permanent PBR plan and with the PBR Tariff.

this avoided cost. That simply means that the avoided transportation cost is subtracted from the city gate price in order to make an "apples to apples" comparison with upstream prices possible.

When that adjustment is made, prices that are made comparable in kind can then be compared to the appropriate benchmark. The key feature of this treatment of the effect of transportation costs is that the focus remains on the commodity price. If the commodity price does not contain a transportation charge (because it is an upstream purchase), it can be compared directly to the appropriate indices. If the commodity price does contain a transportation charge (because it is a city gate purchase), it must be adjusted by subtracting the transportation charge before it can be compared to the appropriate indices.[71]

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[71] Viewed in terms of incentives and disincentives, the reason for this adjustment is to provide United Cities with sufficient incentive to make city gate purchases, or at least not to avoid doing so. The avoided cost adjustment allows for the fact that the overall price of gas purchased at the city gate may be lower than the overall price for an upstream purchase. This was made apparent in extensive examination of the NORA contract during the March 1998 Hearing. For example, Dan McCormac of the Consumer Advocate Division of the Office of the Attorney General testified:

> To put things in perspective a minute, the NORA gas is probably the most expensive gas there is. That may surprise somebody, but the reason for that, it's here closer to Tennessee. So if you just look at the price of gas, it's almost meaningless. You have to consider where it is.
> Since it's here close to Tennessee, even through you're paying more for it, it's still cheaper than paying less for it and getting it in Texas and having to pay to move it to Tennessee.
> . . .
> So just because the customers are paying the least cost of gas for the gas commodity itself, doesn't mean that's the best deal for consumers. The gas has to be moved to Tennessee and the consumers have to pay that transportation cost.

Transcript of Proceedings, Docket No. 97-01364, Vol. III, March 31, 1998, pp. 713-14.

Significantly, Mr. McCormac's testimony indicates that he assumed that the PBR sharing mechanism applied only to the commodity cost of gas and did not apply to the transportation cost, which he apparently considered a constant. For example, Mr. McCormac stated:

> The reason for that [the problem of the NYMEX index showing a price for only one location] is the transportation charges. If you're buying gas in Louisiana, it's a little cheaper to get it to Tennessee than it is if you're buying gas in Texas. And the customers are paying 100 percent of those transportation charges.

Transcript of Proceedings, Docket No. 97-01364, Vol. II, March 27, 1998, p. 348.

Mr. McCormac also stated:

> Remember, outside this plan, even if this plan is approved, the customers are paying 100 percent of transportation charges.

Transcript of Proceedings, Docket No. 97-01364, Vol. III, March 31, 1998, p. 714. This statement again suggests that Mr. McCormac, at least, viewed transportation costs as a constant. Staff submits that no one involved in the proceedings in Docket No. 97-01364 viewed transportation costs any differently. If the Authority and the various witnesses had been required to factor in prices for transportation service that were in fact fluctuating because United Cities was in some instances obtaining discounts on transportation service, the discussion of the incentive mechanism would have been very different, and probably much more complex, and so would the Phase Two Order and the PBR Tariff.

The Phase Two Order recognizes the importance for the commodity price of whether a purchase is upstream or city gate. That Order states:

> The total cost of the gas includes the commodity cost and the transportation cost to move the gas from its source to the city gate. In general, the closer the gas source is to the city gate, the higher the commodity cost, but, since the distance moved is less, the transportation cost is less. In contrast, the farther the gas is from the city gate, the cheaper the commodity cost, but the transportation cost to move it a greater distance is more. It is, therefore, possible that the total of commodity and transportation costs for the higher cost gas could be lower than the total costs (commodity plus transportation) for the cheaper gas.[72]

The PBR plan as approved by the TPSC and the Authority, described in the Creamer Report and United Cities' petition for a permanent PBR, and set forth in the PBR Tariff, compensates for this fact by providing that the price for city gate purchases be adjusted by subtracting avoided costs of transportation. This is the only way in which transportation costs were considered in the deliberations leading to approval and extension of the PBR and the only way in which such costs are incorporated into the PBR calculation.[73] In addition, the fact that transportation was in this manner part of the deliberations and approval of the PBR demonstrates that the Authority did not neglect the subject of transportation costs but rather deliberately chose to address this subject solely in the limited fashion just stated.[74]

An adjustment in the commodity price for the transportation costs avoided when gas is bought at the city gate is the full extent of the inclusion of transportation costs in the PBR as

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[72] *Final Order on Phase Two*, Docket No. 97-01364 (August 16, 1999), p. 18, n. 46.

[73] By referring to the "savings" generated from discounted transportation contracts as "avoided costs," United Cities has potentially created a muddle. *See Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 12. *See also Issues List Submitted by United Cities Gas Company*, Docket No. 01-00704, June 5, 2002. Because the discounted price negotiated by United Cities in these contracts is lower than the price the Company could pay, the maximum FERC rate, United Cities is indeed, in a sense, avoiding some costs. In the Phase Two Order, the supporting testimony, and the PBR Tariff, the term "avoided costs" refers to the full costs of transportation service, which is avoided when gas is purchased at the city gate. These two very different usages should not be confused.

[74] "Transportation" is of course a term used in connection with the other incentive mechanism, Capacity Release Sales, which refers to transportation capacity. The negotiated discount transportation contracts are distinct from United Cities' release of transportation capacity under the Capacity Release Mechanism of the PBR Tariff. Affidavit of Pat Murphy, July 31, 2002, p. 3. United Cities is not arguing that this other mechanism, Capacity Release Sales, introduces transportation service costs into the PBR mechanism, and Staff will not address that issue.

currently tariffed and approved by the Authority. To this extent, it is true that the PBR plan includes transportation costs, but the PBR plan does not allow for the kind of treatment of transportation costs to which United Cities now claims it is entitled, which involves separating any price United Cities itself pays for the transportation of gas and calculating savings for that price just as United Cities does for a true commodity price.

United Cities' own actions in the course of its PBR program indicate that inclusion of discounted transportation contracts is an afterthought and was not contemplated at the time the plan and the PBR Tariff were approved. The PBR filing currently at issue, covering the period from April 1, 2000 to March 30, 2001, is the first and only such filing in which United Cities has identified a separate figure for transportation savings.[75]

The inconsistency between United Cities' treatment of discounted transportation contracts in its 2000-2001 filing and the PBR Tariff is also evident in the "benchmark" United Cities chose to which the Company compares the transportation discounts. United Cities states in its response to Finding #2: "When transportation contracts are renegotiated, the benefit derived from the new contract is easily quantifiable – it is based on the prior period costs, which in this case were the maximum FERC rates."[76] This is entirely contrary to the PBR plan so painstakingly constructed in the March 1998 Hearing. Mr. Creamer's testimony at that Hearing, which was presented by United Cities, clearly describes a PBR plan that depends on a basket of indices that represent an average of averages of actual market prices.[77]

The maximum FERC rate is not an approved index under the PBR. Nowhere is it mentioned in the Phase Two Order or the PBR Tariff. Moreover, the maximum FERC rate does

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[75] Affidavit of Pat Murphy, July 31, 2002, p. 2.
[76] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 14.
[77] Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, pp. 59-62.

not function in the same way as the indices chosen for the PBR, *Inside FERC*, NYMEX, *Natural Gas Intelligence*, and *Gas Daily*.[78] Where those indices show average actual market prices, the maximum FERC rate, as the name suggests, is a legal maximum rate set by FERC based on a pipeline's costs. It is not intended to reflect a market price but rather to set a legal maximum for transportation rates.[79]

As stated above, each of the elements of the PBR mechanism for commodity purchases has a reason. A benchmark is necessary to provide a measure of purchasing activity in comparison to a real market. The justification for the deviation from the PGA Rule this involves[80] is that the Authority and the TPSC accepted United Cities' policy rationale: to provide an incentive to make purchases below an identifiable market. The deadband indicates the Authority's determination of the level of results attained by United Cities sufficient to show significant effort in response to the plan's monetary incentive and not simple accident. United Cities' arbitrary selection of the maximum FERC rate bypasses this essential determination. It presupposes that the maximum FERC rate serves as a market indicator, when it does not and cannot. Further, United Cities' method assumes that applying the deadband for commodity prices to this figure, the maximum FERC rate, indicates the results sufficient to demonstrate significant effort in response to the monetary incentive, in spite of the fact that the Authority has not made this essential determination with respect to the price United Cities pays for transportation services.[81]

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[78] *See* Affidavit of Stephen N. Brown in Support of Motion for Partial Summary Judgment, Docket No. 01-00704, July 17, 2002, pp. 2-3.
[79] Affidavit of Stephen N. Brown in Support of Motion for Partial Summary Judgment, Docket No. 01-00704, July 26, 2002, p. 2..
[80] See below, Part C.
[81] The Authority would again have to ask whether it is appropriate to reward United Cities for something that, it could be argued, the Company should be doing anyway, obtaining the best possible price for gas. The answer to this question could be very different with regard to a legal maximum rate.

In addition, the statement that the "benefit . . . is easily quantifiable – it is based on the prior period costs" is utterly inconsistent with the workings of the PBR as currently tariffed. The Phase Two Order, the PBR Tariff, and the testimony at the March 1998 Hearing all indicate that the method chosen for the PBR was a comparison to a benchmark based on published market indices, and not a comparison with United Cities' own prior performance. The latter approach was considered, in fact, but it was rejected by United Cities.[82]

B. United Cities' claim of reliance on Staff inaction when informed of United Cities' intention to include "savings" from discounted transportation contracts is unreasonable.

United Cities' claim of reliance on Staff inaction is unreasonable and insufficient to overcome Staff's objections to United Cities' inclusion of savings from discounted transportation contracts in its PBR filing. United Cities cites a meeting that took place in January 2001 during which the Company allegedly informed the Authority Staff of the Company's intent to include discounted transportation contracts in its PBR calculation. United Cities states that "[a]t no time during or immediately following this meeting did Staff indicate that UCG was incorrect in its

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[82] United Cities' adamant opposition to assessing purchases based on past performance is evident in the testimony of James Harrington:

> Benchmark regulation as opposed to price caps or other forms of incentive regulation is preferred in the gas industry since the availability of market data makes this form of regulation possible.

Transcript of Proceedings, Vol. II, Docket No. 97-01364, March 27, 1998, p. 509.

> To paraphrase these Commission decisions in a sentence, by using external benchmarks or indices in advance provides a clearer and objective market and regulatory signal, and by aligning both the ratepayer and shareholder interest through mutual savings, mutual sharing of performance, a behavior change occurs at the utility that enables the company to take effective risks and lower cost and, hence, improve its earnings as it tries to stay competitive in a rapidly evolving gas procurement arena.

Id., pp. 509-10.

> Recent regulatory changes such as FERC Order 636 continue to stress the market as more important in setting prices, and market mechanisms such as PBRs are needed now to sustain market share to retain load factor, and to avoid physical bypass.

Id., p. 510.

> But UCG's past performance was not the market price then and is not the market price now.

> And any plan that uses history as the measure of the market will reward companies that performed poorly and penalize companies like UCG that performed well.

Id., p. 512.

treatment of these avoided costs as savings under the PBR mechanism or in UCG's method of reporting."[83] United Cities has produced no further indication of the Staff's reaction to United Cities' statements during or following this meeting. United Cities has produced no written statement reflecting the Staff's reaction to United Cities' statements. United Cities has only alleged that the Staff was silent when informed of United Cities' intent to include the transportation contracts.

Only one member of the Authority Staff who was present at the January 2001 meeting is currently employed with the Authority and involved with this case. That Staff member, Pat Murphy, is able to recall no written statement or other affirmative statement reflecting Staff's position.[84] Further, no attorney was present with the Authority Staff at the meeting, and United Cities did not seek or obtain a legal opinion as to the propriety of its proposal.[85] The Authority Staff members present at the meeting were without authority to alter or amend an Authority Order or PBR Tariff. Under the circumstances, to the extent that United Cities is claiming that it relied upon the Staff's action or inaction during or following the January 2001 meeting, such reliance was misplaced and cannot be invoked in support of United Cities' interpretation of the Phase Two Order and PBR Tariff.

As to United Cities' argument with regard to Staff's failure to raise objections to United Cities' quarterly reports, Staff's response is already stated well in the Report:

> No obligation exists for Staff to provide written notification of exceptions to the quarterly reports within 180 days. These are interim reports and subject to change. The reports referred to in the tariff that require a written notification are the **annual reports**.[86] The annual report filings are the ones that are audited and

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[83] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 12.

[84] Affidavit of Pat Murphy, July 31, 2002, p. 3. The sole document Ms. Murphy has retained from this meeting is attached to her Affidavit as Murphy Exhibit A. Because this document contains information marked "Confidential," it is being filed under seal.

[85] *Id.*

[86] *See* Attachment 1, TRA No. 1, Original Sheet No. 45.6, Filing with the Authority. (Footnote in original.)

the audit report lists the exceptions to the filing. The 180 days is strictly adhered to during these audits. In the current audit, Staff consented to a delayed filing date by United Cities. The filing was received on August 7, 2001. The 180 days expired on February 3, 2002. The Company requested an extension to March 12, 2002. And Staff requested an additional extension to April 23, 2002.[87]

The Staff's interpretation of the filing requirement is based on the Purchased Gas Adjustment rules.[88] The Company's position that the tariff requires the Staff to audit and comment on the quarterly reports leads to an absurd conclusion. Quarterly reports are filed sixty (60) days following the end of a quarter. Adding another 180 days for Staff review results in an eight (8) months lag after the end of the quarter before the Company would know if its filing was in compliance with the tariff. Staff would be forced to conduct four (4) audits each year. This is simply not reasonable and in no way was contemplated in the formulation of the incentive plan. Further, we are not now, as the Company says, raising exceptions to the previously filed quarterly reports. The exceptions in this report refer to the annual report.[89]

To the extent that United Cities claims that it acted in reliance upon Staff's silence, Staff would state that under the circumstances estoppel should not apply.[90] Under Tennessee law, estoppel against the government is disfavored. In *Bledsoe County v. McReynolds*, the Tennessee Supreme Court stated: "The rule in this State is that the doctrine of estoppel does not apply to the acts of public officials or agencies."[91] The Court further stated that "[p]ublic agencies are not subject to equitable estoppel or estoppel in pais to the same extent as private parties and very exceptional circumstances are required to invoke the doctrine against the State and its governmental subdivisions."[92] The Court in *Bledsoe County* found that "in those Tennessee cases where estoppel was applied, or could have been applied, the public body took affirmative action

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[87] Extension of the 180 days is allowed by mutual consent of the Staff and the Company. See letters of extension attached as Attachment 7. (Footnote in original.)

[88] Final Order on Phase Two (Docket No. 97-01364) page 28 (12) states:
"The tariff should incorporate all the changes as ordered by the Tennessee Regulatory Authority, in addition to specifying that the gains and losses derived from the mechanism are to be accounted for in an incentive plan account with similar language, true-up attributes, **audit, and filing requirements** as the Actual Cost Adjustment clause of the existing Purchased Gas Adjustment rules." [Emphasis added] See Attachment 10. (Footnote in original.)

[89] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, pp. 14-15.

[90] Although United Cities has not mentioned estoppel, Staff addresses this issue because it is, in Staff's view, the only theory available to United Cities with regard to the January 2001 meeting and the quarterly reports.

[91] *Bledsoe County v. McReynolds*, 703 S.W.2d 123, 124 (Tenn. 1985).

[92] *Id.*

that clearly induced a private party to act to his or her detriment, as distinguished from silence, non-action or acquiescence."[93] Because the party claiming estoppel in *Bledsoe County* had "nothing upon which to predicate the essential element of inducement, except silence and inaction," the Court found that there was no estoppel against the government.[94] United Cities has put forward no "inducement" by Staff except silence and inaction. Under these circumstances, estoppel should not apply.

C. The Staff acted properly in applying its interpretation of the Phase Two Order and the PBR Tariff.

United Cities' response to Finding #2 in the Report contains an additional argument to the effect that the lack of a separate mechanism for shared savings with regard to discounted transportation contracts would be such a serious gap in the PBR that the Authority must have meant to establish such a mechanism.[95] In other words, even if the Phase Two Order and the PBR Tariff do not really provide for transportation savings, they should, and the Authority should read such a mechanism into the Phase Two Order and the PBR Tariff.

The Staff's duty when it performs an audit is to apply the Authority's orders and interpret the regulated utilities' approved tariffs as they are and not to speculate about what they should be. The Staff's position in this matter proceeds from this simple mandate. The Staff does not

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[93] *Id.*, at 125.

[94] *Id.*, *accord*, *Carpenter v. State*, 838 S.W.2d 525, 528 (Tenn. 1992); *Elizabethton Housing and Development Agency, Inc. v. Price*, 844 S.W.2d 614, 618 (Tenn. App. 1992).

Even if United Cities were able through the testimony of its representatives present at the January 2001 meeting to establish that the Authority Staff gave advice indicating approval of United Cities' intentions, United Cities would not be justified in relying even upon such advice, stated orally by members of the TRA Staff who lacked the necessary authority to modify United Cities' PBR Tariff. As stated in *Pennzoil Co. v. United States Dept. of Energy*, 680 F.2d 156, 171 (Temp. Emer. Ct. App. 1982), *cert. denied*, 459 U.S. 1190 (1983), "informal advice" by an agency is "to be given little weight, as such, unless [it is] institutional in character." Likewise, in *Vermont Structural Steel v. State Dept. of Taxes*, 569 A.2d 1066, 1070 (Vt. 1989), the Supreme Court of Vermont stated that "reliance on an informal oral opinion as the basis for permanent and far-reaching business and tax planning was unreasonable." In the present matter, United Cities has not even alleged that the Authority Staff gave United Cities an opinion of any kind.

[95] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 13.

dispute that there is some merit in the contention that where, as in the discounted transportation contracts, United Cities is able to produce savings in the overall cost of gas, that should result in rewards both to United Cities and its consumers. What the Staff disputes is simply the notion that the PBR as currently approved and tariffed contains any provision for sharing the savings resulting from discounted transportation contracts. The Staff views this as a policy issue of the same level of magnitude the original PBR and, therefore, as a question for the Directors of the Authority. Therefore, the Staff reemphasizes the statement in the Report that United Cities should have requested a tariff revision before proceeding with its intentions to record savings derived from discounted transportation contracts in its PBR calculations.[96]

The Staff is bound by statute to avoid unauthorized extensions of the PBR plan. The Authority derives its ratemaking authority from statute.[97] The relevant statute provides that rates shall be "just and reasonable."[98] This statutory directive is traditionally carried out through a rate review or rate case, in which a utility's rates are set after analysis of the utility's investment and its expenses. The PGA rule is a refinement of this process that acknowledges the effect of fluctuations in gas commodity prices on a utility's expenses.[99] The PGA rule allows rates more accurately to reflect current, or near current, actual costs.[100]

The PBR is a further deviation from the PGA, and thus from traditional ratemaking. The PBR rewards a utility for achieving meaningful savings in its gas costs. In creating a PBR, the Authority must overcome, to some extent, the objection that it is rewarding the utility for doing

[96] *Id.*, p. 16.
[97] Tenn. Code Ann. § 65-5-201.
[98] Tenn. Code Ann. §§ 65-5-201, 65-5-203.
[99] Authority Rule 1220-4-7-.02(1).
[100] *Id.*

what it should be doing anyway, operating its business at the lowest possible cost.[101]

Because the PBR is such a significant deviation from traditional ratemaking, and thus such an extension of the Authority's statutory authority, the Authority's orders creating the PBR should be strictly construed. This has been the approach of the Authority Staff, whose charge it is to audit the Company's PBR filings. It should not be presumed that the Authority left it to the utility to determine that a type of activity not even contemplated in the Order should nevertheless be allowed to operate, to produce sharing for the Company, by some far-fetched, inaccurate analogy to the mechanism created in the Order.

On the contrary, until the Authority determines otherwise, under the PGA the savings realized by the Company on transportation contracts belong, in their entirety, to the Company's customers. The burden should be on the Company to demonstrate that the savings it achieves through discounted transportation contracts can be measured in a meaningful way so as to make a savings mechanism acceptable.

II. United Cities is not permitted to calculate shared savings that result from the NORA contract separately from other transactions under the PBR plan.

As United Cities indicates in its response to Finding #3, quoted in the Report, that finding actually involves two (2) issues. The first issue applies to the NORA contract the same question that has been raised for all other gas purchases with regard to the inclusion of "savings" from discounted transportation contracts. The Staff's argument on this issue, as stated above in Part I, applies equally to the corresponding aspect of the NORA contract and is incorporated herein by

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[101] *See* Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, pp. 275-76 (Testimony of Hal Novak):

> Q. Shouldn't regulated companies perform their best anyway?
> A. Absolutely. They should – there's a prudent standard here. What we chose to do was break out of that mold in 1995 with just an ideology that a company should perform in a prudent manner. We felt that the company could even do better that that if there were proper incentives put in the proper place.

Id., p. 277.

reference. In this part, the Staff addresses the separate issue of whether United Cities is entitled to calculate any savings related to the NORA contract separately from all other contracts.

United Cities' original request for approval of the PBR included United Cities' NORA contract, which already existed at the time of the request for approval.[102] As a result of objections by the Consumer Advocate, the NORA contract was excluded on the grounds that it was not negotiated in response to the PBR.[103] The Phase One Order states:

> The NORA contract should be excluded from United Cities' PBR plan as proposed by the Consumer Advocate because the contract predated the existence of said plan.[104]

As the Phase One Order explained:

> [T[he NORA cont[r]act 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.[105]

The Phase One Order modified the PBR plan by ordering that "gains and losses under the plan should be calculated on a monthly basis rather than on a transaction basis."[106] The Phase One Order also stated:

> 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.[107]

In a Petition filed on September 26, 2000, United Cities requested permission to include a new NORA contract in its PBR plan. United Cities based its request on the provision in the

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[102] Transcript of Proceedings, Docket No. 97-01364, Vol. I, March 26, 1998, p. 79 (Testimony of Frank Creamer).
[103] *Final Order on Phase One*, Docket No. 97-01364 (January 14, 1999), pp. 26-27, 29.
[104] *Id..*, p. 29.
[105] *Id.*, p. 27.
[106] *Id.*, p. 29. This provision negates any argument United Cities makes with regard to NORA on the basis of its filings in TPSC Docket No. 95-01134 or Authority Docket No. 97-01365. Such filings may have shown the NORA contract as a separate calculation, but that method was allowed in the experimental phase of the PBR plan. The Phase One Order terminated separate calculation for all contracts.
[107] *Id.*, p. 27.

Phase One Order quoted above. The request stated:

> Pursuant to the language in the Authority's Order, which is cited above, United Cities requests permission to include the new contract covering the NORA/East Tennessee Gas Pipeline supplies in its PBR plan.[108]

The Authority approved this request in an Order dated November 8, 2001 in Docket No. 00-00844. This Order states that "the Authority approved United Cities' request to include transactions under the new NORA contract in its Incentive Plan."[109] The ordering clause states:

> 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.[110]

The Staff's interpretation of the current status of the NORA contract in the PBR plan is that this contract is now to be treated as any other contract. The savings associated with the NORA contract are to be calculated on an aggregate basis and not on an individual basis. This is consistent with the provision in the Phase One Order that all purchases are to be treated on a monthly rather than on a transaction-by-transaction basis. United Cities' PBR Tariff currently states only that the NORA contract is excluded from the PBR plan,[111] although this provision has obviously been superseded by the November 8, 2001 Order. United Cities has sought no revision of its PBR Tariff to provide for separate treatment of the NORA contract.

Nevertheless, United Cities in its 2000-2001 audit filings has attempted to treat the NORA contract as if it were subject to a separate PBR plan. The reason for this action is simple expediency, as explained in a Company response to a TRA Staff data request. There the Company clearly admits that the only reason for a separate NORA calculation was that including

[108] *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, September 26, 2000, pp. 4-5.

[109] *Order Granting Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point in Incentive Plan*, Docket No. 00-00844 (November 8, 2001), p. 9.

[110] *Id.*

[111] United Cities Gas Company, A Division of Atmos Energy Corporation, T.R.A. No. 1, Original Sheet No. 45.2, March 16, 1999.

NORA with the other contracts produced no savings.[112] As support for this position, United Cities cites an exhibit submitted with its Petition in Docket No. 00-00844, which purportedly shows NORA being calculated separately. United Cities claims that this calculation somehow became part of the Authority's approval of the request to include NORA. United Cities states: "There were no objections raised by either the Staff or any third party concerning the proposed method of calculation set forth in the petition."[113]

To begin with, United Cities overlooks the fact that the "proposed method of calculation" was not "set forth in the petition," but was rather contained, if anywhere, in exhibits attached to the Petition. The Authority did not refer to this exhibit, approve this exhibit, or incorporate the exhibit in its Order. The Authority merely approved United Cities' request to "include the Company's new agreement covering the East Tennessee-NORA delivery point in its Performance Based Ratemaking Mechanism Rider."[114]

It was reasonable for Staff to conclude that when the Authority approved inclusion of the NORA contract in the PBR plan, the NORA contract should be treated the same as any other contract involved in the PBR plan. To conclude otherwise would have been to some extent to rewrite the Phase One Order, which specifically provides that all contracts are to be calculated on an aggregate basis rather than on an individual basis. Allowing United Cities' proposed practice would permit gaming of the PBR plan with respect to the NORA contract, as has already been demonstrated in the Company's attempt to treat it as a separate calculation. United Cities should not be allowed to choose how it will handle the NORA contract based solely on which way the results happen to fall.

[112] *See* Murphy Exhibit B, attached to Affidavit of Pat Murphy, July 31, 2002. (Filed under seal.)
[113] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, Docket No. 01-00704, April 10, 2002, p. 18.
[114] *Order Granting Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point in Incentive Plan*, Docket No. 00-00844 (November 8, 2001), p. 9.

CONCLUSION

For the reasons stated above, the Hearing Officer should find as a matter of law that United Cities' objections to Findings #2 and #3 in the Report are without merit. The Staff requests further that the Hearing Officer refer this matter to the Authority's Directors for consideration of the Report.

Respectfully submitted,

Jon Wike

Jon Wike
Tennessee B.P.R. #018281
Counsel for Authority Staff
Participating as a Party

Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505
615-741-3191

BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

IN RE:	)	
	)	
UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION INCENTIVE PLAN ACCOUNT (IPA) AUDIT	)))	**DOCKET NO. 01-00704**

STATE OF TENNESSEE)
COUNTY OF DAVIDSON)

AFFIDAVIT OF PAT MURPHY

I, Pat Murphy, being duly sworn, do hereby depose and state as follows:

1. My name is Pat Murphy, and I am employed as a Senior Financial Analyst by the Tennessee Regulatory Authority, 460 James Robertson Parkway, Nashville, Tennessee 37243. I have worked for the Authority since 1996. From 1991 to 1996, I was employed by the Authority's predecessor, the Tennessee Public Service Commission.

2. I received a B.A. degree in Mathematics from Southern Adventist University in Collegedale, Tennessee in 1967. Between 1988 and 1990 I completed twenty-seven (27) credit hours in Accounting at Belmont University in Nashville, Tennessee.

3. I have been a Certified Public Accountant in Tennessee since 1992.

4. My duties at the Authority include performing audits of the natural gas utilities regulated by the Authority. In addition to incentive plan account audits, these audits include Actual Cost Adjustment audits of six (6) gas companies, weather normalization audits of three (3) gas companies, and compliance audits as needed on all regulated energy and water companies. On all such audits, I have conducted the entire audit from start to finish, including

analysis of information submitted by companies and preparation of a final audit reported submitted to the Authority for approval.

5. I have conduct five (5) incentive plan account audits:

Nashville Gas Company (3)
Docket 99-00207 (period ended 6/30/99)
Docket 00-00759 (period ended 6/30/00)
Docket 01-00776 (period ended 6/30/01)

United Cities Gas Company (2)
Docket 00-00459 (period ended 3/30/00)
Docket 01-00704 (period ended 3/30/01)

6. I conducted the audit which is the subject of this proceeding and prepared the audit report. I have full knowledge of the information contained in the audit report. I also conducted the previous incentive plan account audit for United Cities Gas Company, in Docket No. 00-00459. United Cities' responses to my preliminary audit findings, which United Cities submitted on April 5, 2002, are quoted verbatim in the audit report.

7. United Cities' first permanent PBR filing, in Docket No. 00-00459, did not state or claim a separate calculation of savings related to discounted transportation contracts. The current IPA filing is the first and only time in which United Cities claimed shared savings for discounted transportation contracts. The previous United Cities IPA filing did not contain a separate line for savings from discounted transportation contracts or any other indication that United Cities was attempting to include such contracts in its performance-based ratemaking calculation. The discounted transportation contracts for which United Cities is claiming it is entitled to shared savings are contracts for gas transportation service. Transportation service is entirely separate and distinct from United Cities' gas commodity purchases.

8. The audit conducted in Docket No. 01-00704 revealed that United Cities had taken advantage of the fact that in its dealings with some of the pipelines from which it purchased gas the Company was able to negotiate a price for transportation service that was

lower than the legal maximum rate for transportation service set by the Federal Energy Regulatory Commission, also called the "maximum FERC rate." Such negotiated discounted transportation contracts are for the service of transporting gas and are distinct from the sale of gas as a commodity and also distinct from United Cities' release of transportation capacity under the Capacity Release Mechanism of the PBR Tariff. United Cities calculated its "savings" with respect to these discounted contracts for transportation service by applying the deadband of 97.7% to 102%, which the Authority approved for commodity purchases, to the maximum FERC rate. United Cities claimed in its audit filing that it was entitled to fifty percent (50%) of the "savings" that resulted when a contract price for transportation services was below 97.7% of the maximum FERC rate.

9. United Cities states that a meeting took place between representatives of United Cities and members of the Authority Staff in January 2001. Although I do not recall specific details of that meeting, I am able to state with certainty that I attended that meeting, along with Mike Horne, who was at that time Chief of the Authority's Energy and Water Division. I do not recall any other members of the Staff being present. To the best of my knowledge, no Authority attorney was present at the meeting. I have no reason to dispute that United Cities' PBR plan was a topic of discussion. I am aware of no written opinion or other statement generated by the Authority in response to statements made by United Cities at that meeting. I can recall no oral representation by members of the Authority Staff made at that meeting to the effect that United Cities' PBR tariff allows United Cities to claim purported savings generated from discounted transportation contracts in United Cities' calculation of savings to be shared with its customers. The only document I have retained associated with that meeting is a copy of the meeting agenda submitted by United Cities, on which I made several handwritten notes. A copy of this document is attached hereto as Murphy Exhibit A.

10. On December 20, 2001, the Authority's Energy and Water Division submitted a data request to United Cities. United Cities' response to this data request, dated January 21, 2002, is attached hereto as Murphy Exhibit B.

FURTHER AFFIANT SAYETH NOT.

Pat Murphy

Pat Murphy

Subscribed and sworn to before me this 31 day of July, 2002.

Lynda Lu Perrin

Notary Public

My Commission Expires: May 28, 2006

IN THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	**DOCKET NO. 01-00704**
	)	
UNITED CITIES GAS COMPANY, a	)	
Division of AMOS ENERGY	)	
CORPORATION INCENTIVE PLAN	)	
ACCOUNT (IPA) AUDIT	)	

AFFIDAVIT OF STEPHEN N. BROWN IN SUPPORT OF MOTION FOR PARTIAL SUMMARY JUDGMENT

I, Stephen N. Brown, being duly sworn, depose and say:

1. I am an economist in the Consumer Advocate and Protection Division, Office of the Attorney General and have held this position since 1995. In that capacity, I review utility filings and information relating to rates and rate changes and follow the economic conditions that affect the companies. Also, I assess and evaluate facts for the Consumer Advocate and Protection Division and other entities within the Office of the Attorney General.

2. From 1986 to 1995 I was employed by the Iowa Utilities Board as Chief of the Bureau of Energy Efficiency, Auditing and Research, and Utility Specialist and State Liaison Officer to the U.S. Nuclear Regulatory Commission. From 1984 to 1986, I worked for Houston Lighting & Power as Supervisor of Rate Design. From 1982 to 1984, I worked for Arizona Electric Power Cooperative as a Rate Analyst. From 1979 to 1982, I worked for Tri-State Generation and Transmission Association as Power Requirements Supervisor and Rate Specialist. From 1979 through 2002, my work spanned many issues including cost of service studies, rate design issues, telecommunications issues and matters related to the disposal of

nuclear waste.

3. I have an M.S. in Regulatory Economics from the University of Wyoming, an M.S. and Ph.D. from the University of Denver, and a B. A. from Colorado State University.

4. In particular, I am giving my opinion on the "maximum FERC rates" referred to by UCG in its response to the Staff's audit findings. The "maximum FERC rates" are transportation rates set separately for each pipeline by the Federal Energy Regulatory Commission (FERC). This rate is included in the pipeline's tariff. The maximum FERC rate is based on the pipeline's costs and has no basis other than cost. The maximum FERC is not a market-based rate.

Stephen N. Brown

STEPHEN N. BROWN
Senior Economist
Office of the Attorney General
Consumer Advocate and Protection Division
P.O. Box 20207
Nashville, Tennessee 37202
(615) 741-3132

Dated: July 26, 2002

Sworn and subscribed before
me this 26th day of July, 2002

Janice J. Tomlinson
NOTARY PUBLIC

My commission expires: 1/25/2003

BEFORE THE TENNESSEE PUBLIC SERVICE COMMISSION
Nashville, Tennessee
May 12, 1995

IN RE: APPLICATION OF UNITED CITIES GAS COMPANY TO ESTABLISH AN EXPERIMENTAL PERFORMANCE-BASED RATEMAKING MECHANISM

DOCKET 95-01134

This matter came on to be heard on March 7, 1995 upon the application of United Cities Gas Company (United Cities or Company) to implement an experimental performance-based ratemaking mechanism. At the hearing the following appearances were entered:

FOR UNITED CITIES GAS COMPANY

Jack M. Irion
Bomar, Shofner, Irion & Rambo
P. O. Box 129
Shelbyville, TN 37160

FOR THE CONSUMER ADVOCATE DIVISION

L. Vincent Williams
404 James Robertson Parkway #1504
Nashville, TN 37219

FOR THE COMMISSION

Jeanne Moran
460 James Robertson Parkway
Nashville, TN 37243-0505

The following is a summary of events in this docket: On January 20, 1995, United Cities filed an application for a performance-based ratemaking proposal, which proposal was composed of five separate mechanisms as described below. United Cities proposed that this initiative have a two-year experimental test period. According to the Company, this proposal would eliminate the need for after-the-fact prudence reviews. United Cities stated that the present method of regulation does not encourage effective risk-taking to improve earnings and lower costs, and that their proposal would benefit both ratepayers and stockholders. The proposed changes were intended to measure the utility's performance against pre-defined benchmarks that are surrogates for the market price of gas. The five proposed changes were:

1. Gas Procurement Incentive Mechanism: Provides a sharing arrangement, allowing the Company to keep 50% of the savings when gas is purchased below market rates as defined by benchmark indices. The Company would also share 50% of the cost when gas is purchased at 104% of market rates defined by these same indices.

2. Seasonal Pricing Differential Incentive Mechanism: Designed to take advantage of seasonal price arbitrage opportunities by comparing current storage injection commodity price to the futures market price during the winter withdrawal months. The differential is realized by purchasing injection month futures contracts and selling withdrawal month futures contracts, and provides for a 50/50 sharing of any gains realized.

3. Storage Gas Commodity Mechanism: Similar to the season pricing incentive mechanism described above. It is tied to the storage injection plans of the Company in the same season. The Company may be able to modify their injections to take advantage of any arbitrage opportunities through observation of the futures market. The Company proposed a 50/50 sharing arrangement on this mechanism.

4. Transportation Capacity Cost Incentive Mechanism: Allows United Cities to manage any excess firm transportation capacity on upstream pipelines. The Company can market this excess capacity on a temporary basis until needed, then the Company would propose to share any revenues realized with the customers on a 70/30 basis.

5. Storage Capacity Cost Incentive Mechanism. Similar to the transportation capacity cost incentive mechanism, but relates to gas the Company has in storage. There may be times when United Cities can market any unneeded gas in storage to third parties. The Company has proposed to share any revenues realized with the customers on a 70/30 basis for this mechanism.

The Consumer Advocate Division of the Office of the Attorney General sought permission to intervene in this matter on February 1, 1995. Permission was granted by the Commission on February 10, 1995. On February 17, the Consumer Advocate filed for an extension of time to file testimony. On February 23, the Commission extended the date for prefiled testimony to February 27, 1995. On that date, the Consumer Advocate filed the testimony of Dan McCormac. This testimony put forth the Consumer Advocate's view that all of the mechanisms proposed were flawed but offered no alternatives. On March 3, 1995, United Cities filed rebuttal testimony.

On March 6, 1995, the Consumer Advocate Division filed a Motion to Dismiss. On March 7, 1995, the scheduled hearing was held in the Hearing Room on the Ground floor of the Tennessee Public Service Commission. All parties presented their cases before the Commission. Prefiled testimony was received in evidence and was cross examined.

On March 14, 1995, the Consumer Advocate filed Surrebuttal Testimony of Stephen Brown, Economist. On March 16, 1996, the Consumer Advocate filed a Summation and Argument that United

Cities did not meet its burden of proof in this case, and that the application should, therefore, be dismissed. Also on March 16, United Cities filed a Brief in Reply to the Motions by the Consumer Advocate. Finally, on March 17, 1995, United Cities filed a letter with the Commission objecting to the proffered testimony of Stephen Brown as untimely and not subject to cross examination.

On March 28, 1995, the Commission announced its decision at its regularly scheduled Commission Conference. The Commission did not address the issue of the admissibility of the testimony of Stephen Brown, since it was not necessary to the outcome of this matter. Likewise, the Commission did not discuss the Consumer Advocate's Motion to Dismiss since it is implicitly overruled by the Commission's action on the original application.

The Commission expressed the view that the changes that are occurring in the natural gas industry are creating a situation where the Commission should begin to look to incentive programs and more streamlined regulation to improve efficiency and hold down costs to consumers. The Commission, therefore, determined that it would approve United Cities' proposal in principle, but that it would modify and condition the program so as to better balance the benefits between consumers and the Company.

The unanimously approved motion provided that United Cities should be limited to a maximum of $25,000 per month on gains or losses for all of the approved PGA mechanisms. The Gas

Procurement Mechanism would be modified to include a 2% reasonableness zone that applies to both sides of the market. The Company will share in gas costs savings below 98% of market and will also bear a share of the costs in excess of 102% of market. In Mechanisms 2 through 5 (see above) 90% of all gains or losses will go to the consumers while 10% will go to the Company.

The Company will also contract with an independent consulting firm to review this mechanism and report to the Commission annually during this experimental two-year period. This review will not be an audit or a substitute for the current prudence review, which will no longer be necessary, but will be for the purpose of informing the Commission if the proper incentives are in place and what, if any, further modifications should be made to the program. The Commission will review this matter in one (1) year and consider any proposed adjustment filed by the parties. Proposed adjustments shall be filed not less than thirty (30) nor more than sixty (60) days before the anniversary date of the program which shall be April 1. The Commission will again review this matter in two (2) years to consider any further adjustments and whether this program should be permanent.

IT IS THEREFORE ORDERED:

1. That United Cities' experimental performance-based ratemaking mechanism as filed and described in its application and testimony is approved, as modified herein, effective April 1,

1995. Applicable tariffs are hereby approved subject to such changes as may be required to meet the modifications described hereinabove.

2. That United Cities should be limited to a maximum of $25,000 per month on gains or losses for all of the approved PGA mechanisms.

3. That the Gas Procurement Mechanism will include a 2% reasonableness zone that applies to both sides of market. The Company will share in gas costs savings below 98% of market and will also bear a share of the costs in excess of 102% of market.

4. That in Mechanisms 2 through 5 (see above) 90% of all gains or losses will go to the consumers while 10% will go to the Company.

5. That an independent consultant be engaged to review this mechanism and report to the Commission annually for the next two years, under the guidlines set forth hereinabove.

6. That this docket will be reviewed annually by the Commission for the next two years to determine whether the mechanism is operating as intended and if any adjustments need to be made.

7. That United Cities is relieved of any responsibility for prudence reviews or their cost during the term of this experimental program, subject to any further orders of the Commission.

8. That any party aggrieved with the Commission's decision in this matter may file a Petition for Reconsideration with the

Commission within ten (10) days from and after the date of this Order.

9. That any party aggrieved with the Commission's decision in this matter has the right of judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Division, within sixty (60) days from and after the date of this Order.

CHAIRMAN

COMMISSIONER

COMMISSIONER

ATTEST:

EXECUTIVE DIRECTOR

95-1134

LAW OFFICES
BOMAR, SHOFNER, IRION & RAMBO
104 DEPOT ST.
SHELBYVILLE, TENNESSEE 37160

JAMES L. BOMAR, JR.
JOHN C. SHOFNER
JACK M. IRION
ANDREW C. RAMBO
JOHN D. TEMPLETON

REPLY TO:
P.O. BOX 129
TELEPHONE 615-684-6213
FACSIMILE 615-684-6227

January 19, 1995

RECD TN. PUBLIC SERVICE COMM.
JAN 20 AM 11: 22
OFFICE OF THE EXECUTIVE DIRECTOR

via Federal Express

Mr. Paul Allen
Executive Director
Tennessee Public Service Commission
460 James Robertson Parkway
Nashville, TN 37243-0505

In Re: Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism
Docket No.

Dear Paul:

Enclosed is the original and six (6) copies of an Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism. I would appreciate your date-stamping one of the copies and returning it to me in the enclosed envelope. Our check for the necessary filing fee is enclosed.

I am attaching to the original Application a sealed envelope containing Exhibits MTT No. 1-10. These Exhibits contain confidential and proprietary information, and we would request that they be kept under seal pending any contrary Order by the Commission. I am also enclosing a proposed Order with respect to such confidentiality. I would appreciate this Order being submitted to the Commission (or Chairman if that is appropriate) as soon as possible.

I wish to note that regardless of our request for confidential treatment of these Exhibits, and the requested Order, we have, by copies of this letter, submitted copies of these Exhibits to the Utility Rate Division and also to the Consumer Advocate Division. United Cities has already had informal discussions with the Staff and CAD regarding this Application, and they have been previously provided materials similar to those for which confidentiality is sought.

DO NOT FILE

In addition to the Utility Rate Staff and CAD I have served this Application on the Commissioners and additional Staff members listed below.

If there are any questions, please give me a call. We appreciate your help and consideration.

Sincerely yours,

BOMAR, SHOFNER, IRION & RAMBO

Jack M. Irion

Jack M. Irion

JMI:jcw

Enclosures

copy to: Chairman Bissell
Commissioner Hewlett
Commissioner Kyle
Roger Knight
Dr. Chris Klein
Hal Novak
Jeanne Moran
Vince Williams
Archie Hickerson
Dan McCormac
Brent Bustin
Mark G. Thessin
Richard K. Wrench
Patricia D. Jackson
James G. Sager
James R. Harrington

BEFORE THE
TENNESSEE PUBLIC SERVICE COMMISSION
NASHVILLE, TENNESSEE

Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism	))))))	**Docket No.** 95-1134

APPLICATION FOR PERFORMANCE-BASED RATEMAKING MECHANISM

United Cities Gas Company (United Cities), files herewith, pursuant to Tennessee Code Annotated, Section 65-2-102, an Application to establish an experimental Performance-Based Ratemaking Mechanism. In support of said Application, United Cities presents the following information:

I.

The full name and address of the Petitioner is as follows:

United Cities Gas Company
5300 Maryland Way
Brentwood, TN 37027

II.

The names and addresses of all persons to whom correspondence, petitions, interventions and other communications relative to this Application should be mailed are as follows:

Mark G. Thessin
Vice President - Regulatory Affairs
United Cities Gas Company
5300 Maryland Way
Brentwood, TN 37027

Richard K. Wrench
Director - Regulatory Affairs
United Cities Gas Company
5300 Maryland Way
Brentwood, TN 37027

Jack M. Irion
Bomar, Shofner, Irion & Rambo
104 Depot Street
P.O. Box 129
Shelbyville, TN 37160

III.

United Cities is a corporation duly organized under the laws of the Commonwealth of Virginia and the State of Illinois and having its principal office in the city of Brentwood, Tennessee. It is a public utility company providing natural gas service at retail to the cities and communities of Union City, Columbia, Spring Hill, Franklin, Murfreesboro, Nolensville, Alcoa, Morristown, Greeneville, Elizabethton, Jonesboro, Kingsport, Johnson City and Bristol, Tennessee; various municipalities in the states of Illinois, Georgia, South Carolina, Virginia, Missouri, Iowa and Kansas.

IV.

United Cities Gas Company (United Cities) respectfully applies to the Tennessee Public Service Commission (Commission) to establish an experimental two-year Performance-Based Ratemaking Mechanism for United Cities. This performance-based mechanism, which is a natural continuation of the evolution of competitive energy markets that has occurred in Tennessee, would base risk and rewards to United Cities on how United Cities' gas purchasing performance measures against the market. The proposal would reward United Cities if it competes well against the market, thereby providing greater relative benefits to its customers, and place United Cities' earnings at risk if it competes ineffectively or poorly.

United Cities' proposal is a comprehensive and integrated restructuring of the five key pieces of the gas purchases of United Cities. United Cities is submitting testimony in support of this Application with specific implementing tariff language.

V.

BACKGROUND

The natural gas industry has been moving toward a market oriented structure with the issuance of FERC Orders 436 and 636. Customers, basically large commercial and industrial, have an opportunity to purchase and arrange for delivery of natural gas to the local distribution company (LDC) city gate and subsequently to the inlet side of the meter. These purchases may be made independently of the LDC on a competitive price basis.

Many services available from the pipeline are now subject to unbundling. For those customers who are not large enough or lack the expertise to do their own procurement, the LDC continues to perform this function. They are core customers and these core customers rely on the LDC to perform these services.

The LDC has an obligation to serve these core customers. It has a requirement to provide a reliable supply available when the customer requires. As indicated in past gas prudency audits, to date United Cities has an exemplary record in performing these services. Accordingly, market forces should have an impact on utility and regulatory decision making with the benefits being shared between the customers and the LDC. Existing regulation does not encourage the LDC to take risks that might benefit customers because it currently does not reward the LDC for any benefits arising from taking such risks. A sharing of benefits can serve as an excellent substitute for the existing regulatory review process related to the Purchased Gas Adjustment (TPSC Rule 1220-4-1-.12). Therefore, United Cities proposes an experimental two-year performance-based regulation of its highest single cost, natural gas, with performance and the market becoming the benchmark of the prudence of the LDC purchasing practices.

This proposal is designed to do the following:

- Lower regulatory costs
- Provide up-front regulatory oversight enabling the elimination of after-the-fact prudency reviews for gas costs

- Promote successful cost management
- Develop an environment to enhance United Cities' competitive position in the energy industry
- Benefit each customer group in Tennessee

In addition to lower regulatory costs, this proposal is designed to promote these other regulatory objectives:

- To send clear signals to United Cities by establishing benchmark standards
- To achieve improvement in performance measurement by using external criteria (benchmarks) instead of or in addition to internal criteria (i.e. cost-of-service)
- To implement market-based benchmarks from actual usage therefore ensuring prudency

VI.

THE PERFORMANCE-BASED RATEMAKING MECHANISMS

United Cities proposes to include all elements of its cost of delivering natural gas to all classes of customers through five (5) mechanisms as follows:

1). Gas Procurement Incentive Mechanism

2). Seasonal Pricing Differential Incentive Mechanism

3). Storage Gas Commodity Mechanism

4). Transportation Capacity Cost Incentive Mechanism

5). Storage Capacity Cost Incentive Mechanism

The basis of these five mechanisms is to provide an "incentive rate" which is a regulatory mechanism that indexes the utility's profits to how effectively it performs, for all customer groups and independent of individual rate schedules. It will allow United Cities to benefit from good business decisions and risk taking while being penalized for bad business decisions.

1. GAS PROCUREMENT INCENTIVE MECHANISM

Purpose
Manage gas procurement on a least cost basis

Overview
- United Cities is required to buy below prevailing market price to benefit from the incentive
- United Cities is penalized if purchases exceed market price plus a reasonableness zone
- Reasonableness zone is necessary because of core requirements for weather, reliability

Sharing
Yes, 50/50 for this and other commodity mechanisms

2. SEASONAL PRICING DIFFERENTIAL INCENTIVE MECHANISM

Purpose
Take advantage of the seasonal price arbitrage opportunities

Overview
- Tied to winter purchases for winter consumption
- Compares current injection prices plus storage commodity costs to the futures market price during the winter withdrawal months
- The differential can be realized by purchasing injection month futures contracts and selling withdrawal month futures contracts

Sharing
Yes, 50/50 for commodity mechanism

3. STORAGE GAS COMMODITY MECHANISM

Purpose
To manage the cost of gas in leased and owned storage fields

Overview
- Tied to storage injection plans
- Able to modify storage injections when futures market price provides price arbitrage opportunities and necessary storage injection/withdraw flexibility exists.

Sharing
Yes, 50/50 for commodity mechanism

4. TRANSPORTATION CAPACITY COST INCENTIVE MECHANISM

Purpose
Manage firm transportation capacity on upstream pipelines

Objectives
- Capture maximum value for the idle transportation capacity

- Incentive to aggressively and creatively market transportation capacity

Sharing
Yes, 70/30 ratepayer/shareholder for this and other capacity mechanisms

5. STORAGE CAPACITY COST INCENTIVE MECHANISM

Purpose
Manage firm storage capacity

Objective
- Capture maximum value for the idle storage capacity
- Incentive to aggressively and creatively market storage capacity

Sharing
Yes, 70/30 ratepayer/shareholder for capacity mechanism

United Cities is proposing to implement these five mechanisms through a Performance-Based Ratemaking Mechanism Rider as shown in Appendix A. The plan would be initiated as an experimental program, effective April 1, 1995, with the gas cost mechanism information available to the Commission as frequently as monthly. The detail formula for each of the five proposed mechanisms is shown in Appendix B.

The Company has met informally on several occasions with the Consumer Advocate Division and the Commission's Staff to discuss this proposal and receive any input of comments from those parties.

VI

INDICES PROPOSED

The proposed indices required by this filing are:

1). **Inside FERC Gas Market Report - first day of the month**

2). **NYMEX monthly close from the Wall Street Journal**

3). **Natural Gas Intelligence - bid week average**

4). **Gas Daily - first day of the transaction**

The market indices to be filed include:

1). **Swing Purchases:**
Daily Index = Gas Daily (first day of transaction)

2). **Spot Purchases:**

Monthly Index = 1/3 NYMEX + 1/3 Natural Gas Intelligence + 1/3 Inside FERC Gas Market Report

3). <u>Long Term Purchases:</u>

Rolling Average 1 or 2 = ** Relevant Index + Adjustment, where:

- **Adjustment 1 = 3 year rolling average of competitive bids**
- **Adjustment 2 = Avoided transportation costs**

****(Relevant Index is either the Daily Index or the Monthly Index depending on the contract).**

VII

PROPOSED RIDERS

Attached as Appendix A are the proposed riders:

Tennessee P.S.C. No. 1, Revised Sheet No. 45.1
Capacity Assignment Credit Rider

Tennessee P.S.C. No. 1, Original Sheet No. 46
Performance-Based Ratemaking Mechanism Rider

VIII

REQUEST FOR APPROVAL

WHEREFORE, United Cities asks this Commission to find that the proposed transaction is in the public interest, to grant authorization under Tennessee Code Annotated, Section 65-2-102, as amended, of its Performance-Based Ratemaking Mechanism Rider.

UNITED CITIES GAS COMPANY

Dated: January 19th, 1995

By Jack M. Irion
Its Attorneys

Bomar, Shofner, Irion & Rambo
104 Depot Street
P.O. Box 129
Shelbyville, TN 37160
(615)684-6213

STATE OF TENNESSEE)
)
COUNTY OF WILLIAMSON)

Richard K. Wrench being first duly sworn, on oath deposes and says that he is Director-Regulatory Affairs of United Cities Gas Company; that as such he is authorized to make this affidavit; that he is familiar with the contents of the foregoing Application; and that the same is true to the best of his knowledge, information and belief.

Richard K. Wrench

Richard K. Wrench

Subscribed and sworn to
before me this 18th day
of January, 1995

Teresa Morris

Notary Public

My commission expires

1/27/96

UNITED CITIES GAS COMPANY

APPENDIX A

DOCKET NO. ______________

CAPACITY ASSIGNMENT CREDIT RIDER

Applicability

The intent of this Rider is to allow the Company during certain periods to enter into contractual agreements with others to temporarily assign or release non-pipeline capacity held by the Company, excluding the Company's Barnsley storage field. Such facilities shall include capacity associated with LNG/LP air facilities. The specific terms of such assignment and/or release shall be set forth in a contract between the Company and the assignee/lessee. Contracts with customers within the Company's service territories shall be filed with and approved by the Commission.

Determination of Capacity Assignment Credit

Revenues related to commodity costs, fuel and related surcharges shall be a credit to the Deferred Gas Cost Account. Revenues related to any fixed demand costs, related surcharges and any additional administrative charges levied by the Company and/or its subsidiary shall be shared between the Company's customers and the Company on a 70%/30% basis.

Filing With the Commission

The determination period of any revenues to be credited to the Deferred Gas Cost Account shall correspond with the Company's Reconciliation Year which ends June 30 each year. Supporting documentation of these transactions shall be maintained by the Company and made available to the Commission upon request.

PERFORMANCE-BASED RATEMAKING MECHANISM RIDER

Applicability

The performance-based ratemaking mechanism rider replaces on an experimental two year basis the current reasonableness review of the utility's gas purchasing activities overseen by the Public Service Commission. This new mechanism is designed to encourage the utility to maximize its gas purchasing activities at minimum costs consistent with efficient operations and service reliability, and will provide for a shared savings or cost between the utility's shareholders and ratepayers.

Overview of Structure

The performance-based ratemaking mechanism consists of five parts.

Gas Procurement Incentive Mechanism
Seasonal Pricing Mechanism
Storage Gas Commodity Mechanism
Transportation Capacity Cost Incentive Mechanism
Storage Capacity Cost Incentive Mechanism

Determination of Shared Savings

The calculations, recording of data and determination of the various elements with respect to the five mechanisms shall be accomplished in accordance with formulas approved by the Commission in Docket ________. Monthly data will be recorded no later than 60 days after the last calendar day of each month. The results of the monthly calculations shall be recorded in the Company's Deferred Gas Cost Account as a debit entry in the event of shared savings or a credit entry in the event of shared costs. Such shared savings or shared costs shall be reflected in the Company's ACA (factors DACA or CACA of the Company's PGA Rider).

Filing With The Commission

The Company will file calculations of shared savings and shared costs quarterly with the Commission not later than 60 days after the end of the quarter or more frequently if required by Commission Order in Docket ___________.

Periodic Review

Because of the experimental nature of the Performance-based Ratemaking Mechanism, it is anticipated that the indices utilized, and the composition of the utility's purchased gas portfolio may change. The Company shall, within 30 days of identifying a change to a significant component of the mechanism, alert the Commission staff to the change.

UNITED CITIES GAS COMPANY

APPENDIX B

DOCKET NO. ________________