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REC'D TN REGULATORY AUTH.
'02 APR 9 PM 4 02
OFFICE OF THE EXECUTIVE SECRETARY

April 9, 2002

VIA FACSIMILE NO. (615) 741-5015
AND FIRST CLASS U.S. MAIL

Mr. Jon N. Wike
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

Re: United Cities Gas Company Incentive Plan (IPA) Audit; Docket No. 01-00704

Dear Jon:

I spoke with Pat Murphy yesterday concerning the issue of the confidential nature of our response to the Staff's draft audit findings. As I informed Pat, the text of United Cities Gas response to each of the findings may be viewed as "nonconfidential." However, we would request that the exhibits attached to our response remain confidential and be placed in a sealed envelope when presented to the Authority. These exhibits contain proprietary pricing information which should remain confidential.

If you should have any questions concerning anything else in regard to our response, please let me know.

Sincerely,

Joe A. Conner
For the Firm

JAC:ldg
cc: Ms. Patricia Childers, via facsimile
Mr. Mark Martin, via facsimile

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830844-00077 04/09/2002

POSTED 4/10/02

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MEMORANDUM

THIS DOCUMENT CONTAINS CONFIDENTIAL AND PROPRIETARY INFORMATION WHICH IS SUBMITTED SOLELY FOR THE USE OF THE TRA AND ITS AUTHORIZED STAFF AND FOR NO OTHER PURPOSE.

TO: Pat Murphy

FROM: Joe A. Conner

DATE: April 5, 2002

RE: Draft Audit Findings in Docket No. 01-00704

Finding #1 -- Company Response:

UCG agrees with this finding. The Company did not deliberately disregard the method to calculate the ending balance. The Company merely inadvertently failed to bring it forward.

Finding #2 -- Company Response:

UCG respectfully disagrees with Staff Finding #2 that UCG over-recovered under the Gas Procurement Incentive Mechanism. UCG believes that the PBR mechanism, as documented in the Final Order on Phase II in Docket No. 97-01364 ("Phase II Order") provides for savings associated with transportation discounts and that Staff's current position is contrary to that order. Furthermore, UCG believes that Staff's current position is inconsistent with the prior discussion it had with UCG on the treatment of transportation discounts as savings under the PBR mechanism and that Staff had failed to object to UCG's quarterly reports, which reported these transportation discounts as savings, within 180 days of filing as required by the tariff.

In January 2001, UCG requested a meeting with Staff to provide notice of its renegotiated transportation contracts that went into effect in November of 2000. On January 31, 2001, Staff met with UCG to discuss the treatment within the PBR framework of the avoided costs resulting from the renegotiated transportation contracts on the Tennessee Gas pipeline, East Tennessee Natural Gas pipeline, and the Columbia Gulf pipeline. Attached as Exhibit 1 is a copy of the meeting agenda and the summary sheets reflecting how these savings would be treated under the PBR mechanism. UCG discussed in detail with Staff the reporting methods they intended to follow in regard to inclusion of these avoided costs in its quarterly reports. At no time during or immediately following this meeting did Staff indicate that UCG was incorrect in

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its treatment of these avoided costs as savings under the PBR mechanism or in UCG's method of reporting.

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 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.

Even if the Authority determines that the Staff may now raise exceptions 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. Both 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. In the Phase II Order, 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.

Phase II Order, Footnote 46, p.18.

In the Phase II Order, the Authority also adopted the testimony of the company witness, Ron McDowell:

> Further, company witness, Ron McDowell, testified that the operational plans called for delivery at the least cost feasible, taking in consideration United Cities' transportation and storage contracts and other factors. Id.

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

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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 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.

In his 1997 report, Frank Creamer with Andersen Consulting concluded that the plan was designed to cover all associated commodity costs of purchasing, delivering and storing gas to the end consumer, e.g., commodity cost of gas, storage commodity costs of gas, fixed costs of transporting gas, and fixed costs of storing gas. Mr. Creamer's conclusion that the plan was all-inclusive was neither contested nor objected to. Furthermore, Mr. Creamer recommended that all future contract arrangements, including pipeline negotiations, be included in the plan, so as to incent UCG to beat the market on these future activities. If now, transportation costs are to be excluded, as currently recommended by Staff, UCG lacks the incentive to beat the market, and the TRA has no process in place to verify market costs, short of ordering a prudency audit -- the very type of regulatory activity that the PBR was designed to avoid.

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.[1] Attached as Exhibit 2 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

---

[1] UCG 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.

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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%.

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.

Finding #3 -- Company Response:

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.

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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.

Finding #4 -- Company Response:

Company agrees with this finding.

Finding #5 -- Company Response:

Company disagrees with this finding due to the position it has taken in response to findings 2 and 3.

Finding #6 -- Company Response:

It appears that the Staff has agreed with the Company's reserve margin calculation set forth in its annual report of 20.5%. In fact, the Staff acknowledges that the long-term lower costs associated with the new contracts will offset any temporary overlapping reservation fees and that the benefit should continue into the foreseeable future providing a considerable ongoing, lower gas cost to the consumers.

The Company does not appreciate and objects to the Staff's reference in the last paragraph of its discussion that the Company is "selectively choosing what to include in its Incentive Plan." The Staff incorrectly assumes that transportation costs savings are "outside of the plan." The Staff for some reason is mixing apples and oranges with respect to what is included in the PBR and what is outside of the PBR. The Phase II Order specifically deals with the utility's reserve margin. The order provides:

> F. **<u>Whether the TRA should establish a procedure to verify the utility's reserve margin to ensure the utility's level of contract demand is prudent:</u>**
>
> Issue 1(i) deals with whether a procedure should be established to enable the TRA to verify the Company's reserve margin requirements on an annual basis. This issue was addressed in Mr. Creamer's recommendation #10 in his second-year review. The Authority has determined that such a procedure is necessary in order to ensure that the Company is properly managing its firm transportation capacity. Therefore, the Company will be required to submit to the Authority, on an annual basis, documentation to substantiate its reserve margin and the procedure the Company utilized in arriving at the same. This requirement will allow the Authority to ascertain that the Company's level of contract demand is prudent.

Phase II Order, p.24.

Therefore, contrary to the Staff's statement in the third paragraph of its discussion, the Company is not selectively choosing what to include in its Incentive Plan in regard to the reserve margin. To the contrary, the Company has followed to the letter both its tariff as well as the Phase II Order by providing documentation to substantiate its reserve margin and the procedure the Company utilized in arriving at that margin. The Staff has reviewed this documentation and agrees with the Company's position. Accordingly, the Company requests the Staff delete the third paragraph of its discussion in that it is totally inappropriate under the circumstances.

JAC:ldg

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USER NO.:	0257	
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