BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

March 14, 2006

IN RE:	)	
	)	
UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY CORPORATION INCENTIVE PLAN ACCOUNT (IPA) AUDIT	)	**DOCKET NO. 01-00704**
	)	
PETITION OF UNITED CITIES GAS COMPANY TO AMEND THE PERFORMANCE BASED RATEMAKING MECHANISM RIDER TO ITS TARIFF	)	

INITIAL ORDER OF HEARING OFFICER ON THE MERITS

This matter is before the Hearing Officer, duly appointed by the Directors of the Tennessee Regulatory Authority (the "Authority" or "TRA"), for consideration of certain findings contained in the *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account* filed by the Staff of the Energy and Water Division of the Authority ("Audit Staff")[1] on April 10, 2002, and the *Petition by United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff* filed by United Cities Gas Company, a division of Atmos Energy Corporation ("United Cities" or the "Company"),[2] on August 2, 2002.

[1] The Energy and Water Division is now part of the Utilities Division of the TRA.

[2] The Company is now known as Atmos Energy Corporation. In various filings in this docket, the Company is also referred to as "UCG", "Atmos" or "AEC."

BACKGROUND

PBR Mechanism

The history of the adoption of United Cities' performance-based ratemaking ("PBR") mechanism is fully set forth in Docket No. 97-01364 and is summarized in the *Order on Motions for Summary Judgment* issued in this docket on March 31, 2003. On January 20, 1995, United Cities filed an application proposing that the Tennessee Public Service Commission ("TPSC") review the Company's performance on an ongoing basis, rather than evaluating the Company's performance through a prudency review. United Cities requested that it be allowed to conduct a two-year experiment where its performance in managing and acquiring its gas supply would be measured against pre-defined benchmarks that would act as a surrogate for the market price of gas. After a hearing in which evidence was presented by United Cities and the Consumer Advocate Division of the Office of the Attorney General ("Consumer Advocate"), the TPSC issued an order on May 12, 1995 approving the proposal with modifications. These modifications included requiring the Company to contract with an independent consulting firm to review the PBR mechanism and to have the consultant report to the TPSC annually during the two-year experimental period.

On February 2, 1996, the consultant, Frank H. Creamer of Andersen Consulting, filed his first report recommending certain modifications to the PBR mechanism for the second year. After the report was filed, United Cities and the Consumer Advocate filed testimony and the TPSC conducted a hearing on March 5, 1996. During the hearing, the TPSC took administrative notice of the consultant's report, but did not allow the Consumer Advocate to cross-examine the consultant. On May 3, 1996, the TPSC issued an order modifying the PBR mechanism in accordance with the consultant's report. The Consumer Advocate filed a petition for review in the Tennessee Court of Appeals on June 27, 1996, arguing that it was denied due process when it was not allowed to effectively challenge the consultant's report at the March 5, 1996 hearing. On March 5, 1997, the Court of Appeals vacated the TPSC's May 3, 1996 order, finding that the TPSC had violated the Consumer Advocate's due process rights and remanding the case to the TRA for further proceedings.[3]

The consultant filed his second report on February 28, 1997, which included a recommendation favoring the implementation of a permanent PBR mechanism. On March 31, 1997, United Cities filed a petition requesting that the TRA adopt both reports of the consultant and permanently approve the PBR mechanism. The Consumer Advocate opposed the Company's petition and on May 20, 1997, the Authority convened a contested case in Docket No. 97-01364.

The TRA bifurcated the case and in Phase One decided to consider the issues included in the Court of Appeals' remand, including the consultant's 1996 report and whether the PBR mechanism should continue for a second year. In Phase Two, the Authority decided to consider the issues raised in the Company's petition, including a review of the consultant's 1997 report and whether the PBR mechanism should continue on a permanent basis. A hearing on the Phase One issues was held on March 26 and 27, 1998 and a hearing on Phase Two issues was held on March 27 and 31, 1998.

Final Order on Phase One

The TRA rendered its decisions on the Phase One issues on August 18, 1998 and released the order memorializing those decisions on January 14, 1999.[4] Among its conclusions, the Authority affirmed its statutory power to approve a PBR mechanism, ruled that the mechanism did not violate the TRA's Purchase Gas Adjustment ("PGA") Rule governing natural gas utility

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[3] The TPSC had been dissolved by the Tennessee General Assembly and had been succeeded by the TRA.

[4] *See In re: Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism*, TRA Docket No. 97-01364, *Final Order on Phase One* (January 14, 1999) ("*Final Order on Phase One*").

companies, and held that the TPSC's May 12, 1995 order did not constitute retroactive ratemaking. In addition, the Authority held that the TPSC's May 12, 1995 order approving the two-year experimental period was not invalidated by the fact that the Court of Appeals vacated the TPSC's May 6, 1996 order. The TRA also determined that there was sufficient evidence to show that the PBR mechanism had improved United Cities' performance in purchasing natural gas and had benefited the Company's customers. The Authority determined that the United Cities' contract covering the East-Tennessee-NORA Gas Pipeline ("NORA contract") should be excluded from the Company's PBR plan because the contract predated the existence of the plan. However, the Authority stated that if the NORA contract were renewed or renegotiated, it could be considered for inclusion in the mechanism at that time. The TRA also ordered that the gains and losses under the plan should be calculated on a monthly basis rather than on a transaction basis. The majority of Directors voted to retain the NYMEX index as part of the basket of indices averaged together to determine the benchmark price of natural gas.[5] The existing deadband around the benchmark price was set for the second year at 1% below the level that existed prior to the initiation of the PBR plan. The Authority also declined to accept or adopt the four recommendations the consultant had made for the second year of the experiment, after determining that the recommendations had been rendered moot by the passage of time. United Cities filed a petition for reconsideration of the *Final Order on Phase One*, which was denied by the Authority on February 16, 1999.

[5] Chairman Melvin Malone did not agree with the majority on this issue, opining that United Cities failed to carry the burden in demonstrating that NYMEX was representative of the other indices used in the mechanism. *See Final Order on Phase One*, p. 21, fn. 38 (January 14, 1999).

Final Order on Phase Two

The TRA rendered its decisions on the Phase Two issues on February 16, 1999 and released the order memorializing those decisions on August 16, 1999.[6] Most significantly, the TRA authorized United Cities to permanently operate under the modified PBR mechanism beginning April 1, 1999. In addition, the Company was limited to an earnings cap for incentive gains and losses of $1.25 million during a plan year. The majority of Directors voted to continue the NYMEX index, approved as one of three indices in the basket used to determine the benchmark price of natural gas in the *Final Order on Phase One*.[7] The majority of Directors also ordered that the lower end of the deadband around the benchmark price of 97.7%, which was set under Phase One, was to remain in effect and be adjusted every three years to 1% below the most recent annual audited results of the PBR mechanism.[8] Among other modifications, the five incentive mechanisms of gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost and storage capacity cost were collapsed into two mechanisms – Gas Commodity and Capacity Release Sales.[9]

NORA Contract

On September 26, 2000, United Cities filed *United Cities Gas Company's Petition Regarding Affiliated Transaction and Request for Permission to Include New Agreement Covering East Tennessee NORA Delivery Point* in Docket No. 00-00844. Because the Authority, in its *Final Order on Phase One*, had left the door open for possible inclusion of a new NORA

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6 *See In re· Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism*, TRA Docket No. 97-01364, *Final Order on Phase Two* (August 16, 1999) ("*Final Order on Phase Two*").

7 Chairman Melvin Malone did not agree with the majority on this issue, opining that United Cities failed to carry the burden in demonstrating that NYMEX was representative of the other indices used in the mechanism. *See Final Order on Phase Two*, p. 26, fn. 73 (August 16, 1999).

8 Chairman Melvin Malone dissented on this decision, because the majority ordered the use 1994 data when 1997 data was available. *See In re: Application of United Cities Gas Company to Establish an Experimental Performance-Based Ratemaking Mechanism*, TRA Docket No. 97-01364, *Opinion of Chairman Malone Concurring in Part and Dissenting in Part to the Final Order on Phase Two* (August 16, 1999).

9 The Gas Commodity Cost mechanism is also referred to as the Gas Procurement Incentive mechanism. The Capacity Release Sales mechanism is also referred to as the Capacity Management Incentive mechanism.

contract in the Company's PBR mechanism, United Cities requested approval of the NORA contract it entered into on April 19, 2000, with an effective date of November 1, 2000. The Authority found that the Company had met the criteria for the new NORA contract to be included. Specifically, the TRA found that United Cities renegotiated the new contract as a response to the Incentive Plan, indicating a change in behavior, and that the negotiation process complied with the Affiliate Transaction rules contained in its tariff, since the NORA contract was awarded to its affiliate, Woodward Marketing, LLC.[10]

TRA 2002 Audit of Incentive Plan Account ("IPA")

The Company's IPA filing was received on August 7, 2001 and the Staff of the Energy and Water Division of the Authority ("Audit Staff") completed its audit of the IPA filing on March 22, 2002. On March 28, 2002, the Audit Staff issued its preliminary findings to United Cities and the Company responded on April 5, 2002. On April 10, 2002, the Audit Staff filed its *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account* ("IPA Audit Report"). The IPA Audit Report contained six findings. Finding No. 1 asserted methodology errors in the calculation of the ending balance of the IPA account. According to Audit Staff, United Cities included incentive recoveries for months outside the audit period in its calculations and did not follow its tariff in calculating the monthly balances. These errors led to a miscalculation of the ending balance in United Cities' IPA account resulting in an under-recovery of $35,372. The Company agreed with Finding No. 1. Finding No. 4 asserted an over-recovery of $173 associated with the Capacity Release Incentive Mechanism. United Cities agreed with Finding No. 4.

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[10] *See In re: 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, *Order Granting Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point in Incentive Plan* (November 8, 2001).

Finding No. 6 asserted that the Company kept a reserve margin of 20.5% for the year ended March 31, 2001. Audit Staff found that this level of reserve margin was significantly higher than the presumed level of reasonableness of 7.5% or less in the Company's tariff. However, Audit Staff was "satisfied that the excess reserve is short term and is reasonable considering the options available to the Company at the time purchasing decisions were made."[11] In its Response, United Cities objected to language used by Audit Staff in its discussion of the finding that stated that the Company was "selectively choosing what to include in its Incentive Plan" and that assumed that transportation costs were outside of its Incentive Plan.[12]

Finding Nos. 2, 3, and 5 were disputed by the Company. Finding No. 2 stated that Audit Staff calculated an over-recovery of $526,265 in the Gas Procurement Incentive Mechanism.[13] Audit Staff explained:

> As part of this mechanism, the Company also reported an additional $1,254,424 in "procurement savings," $201,893 resulting from the NORA contract and $1,052,531 resulting from negotiated transportation contracts. United Cities retained 50% of these alleged savings, for a total of $627,212. We disagree that the calculations presented by the Company represent "savings" under the terms of the Incentive Plan. The Company's incentive plan defines savings/(losses) as those total commodity costs that fall outside the deadband. The deadband is a range surrounding the benchmark, within which no sharing takes place. The benchmark is a calculation based on approved market indexes. Any savings to be shared between the Company and the ratepayer must be below "market," as defined by the plan. Therefore, we are recommending audit adjustments to eliminate these "savings" from the Incentive Plan Account (IPA).[14]

After determining that United Cities could not claim savings resulting from the negotiated transportation contracts, the Audit Staff stated further:

> 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

[11] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, p. 23 (April 10, 2002).
[12] *Id.* at 24.
[13] *Id.* at 10.
[14] *Id.* at 5.

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").

The Gas Procurement Incentive Mechanism section of the Company's tariff states that it is the savings associated with its commodity cost of gas that is available for sharing. The commodity cost of gas is compared to a "benchmark." If the total monthly commodity cost of gas falls below 97.7% of the benchmark amount, then the resultant savings will be shared 50/50 with the customers. The benchmark is the mathematical product of the actual purchase quantities and the appropriate price index.

. . .

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 gate purchases.

. . .

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 appropriate proxies. Without a valid benchmark, savings (if any) cannot be quantified.[15]

United Cities provided a Response to Finding No. 2, which was paraphrased in the IPA Audit Report as follows:

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,

[15] *Id.* at 10-11 (footnotes omitted).

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 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.

. . .

> 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. 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.
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> 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....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%.[16]

Finding No. 3 of the IPA Audit Report asserted an over-recovery of $100,947 due to the inclusion of transportation costs in calculating the Gas Procurement Incentive Mechanism for the NORA contract. The Audit Staff explained the reason for the finding as follows:

> The NORA contract was initially excluded from United Cities' Incentive Plan in Docket No. 97-01364. The primary reason for the exclusion was that it pre-dated the plan and did not require any additional effort by the Company to generate savings. But the Authority's Phase One Order (January 14, 1999) stated that if, when the contract was renewed or renegotiated, the Company was still operating under its Incentive Plan, the contract could be considered for inclusion. A new NORA contract was entered into on April 19, 2000, with an effective date of November 1, 2000. On September 26, 2000, United Cities filed a petition with the TRA, requesting permission to include the new NORA contract in its Incentive Plan. Since the contract was no longer pre-existing and met the

[16] *Id.* at 11-14.

requirements of the Affiliate Rules contained in the Company's Incentive tariff, the Authority approved the Company's request at its June 12, 2001 Conference.

The Company's calculation of the "savings" related to the NORA contract does not conform to the terms of its Incentive Plan. As discussed in Finding #2 above, the Gas Procurement section of the Company's tariff specifies that the commodity cost for each purchase will be compared to the appropriate benchmark for that purchase. Then the total commodity cost of all purchases for the month will be compared to total benchmark cost. Only the amount of purchases that falls below 97.7% of the benchmark is available for sharing.

The terms of the current NORA contract call for United Cities to pay the appropriate Inside FERC index each month plus a premium for volumes delivered. Through a data request to the Company, Staff has learned that Inside FERC is the commodity price of the NORA gas and the "premium" is the transportation cost for delivery of the gas from the NORA delivery point to the East Tennessee service area.

The Company did not compare the NORA commodity cost with the average of the three indexes for its monthly spot purchases as specified in the tariff. When questioned in a data request, the Company responded that the comparison with the benchmark showed minimal savings and the savings fell within the deadband each month. Therefore, the Company elected to calculate "savings" based on the transportation cost. The calculation is similar to the one for the transportation discounts, addressed in Finding #2. The premium was compared to the maximum tariff rates allowed by FERC. Then 97.7% of the difference was deemed "savings" by the Company to be shared 50/50 with the customer. This type of calculation is not covered under the current Incentive Plan tariff. Additionally, the Company separated out this calculation from the other calculations, so that it led to shared "savings" each month. The tariff is clear that the "total" commodity costs for the month must fall outside the deadband before sharing of savings or losses will occur.[17]

The IPA Audit Report contains a paraphrase of United Cities' response to Finding No. 3 as follows:

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.

[17] *Id.* at 17-18 (footnotes omitted).

> 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.
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> 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.[18]

United Cities further noted that there were no objections raised by either the Audit Staff or any third party concerning the proposed method of calculation set forth in the petition in Docket No. 00-00844. The Company also stated that if the Authority had an issue with the method of calculation, it would have stated so in its order in that docket. United Cities also asserted that the Authority did not provide written notification of any exceptions to the calculations in the quarterly reports within 180 days of the filing of those reports.[19]

Finding No. 5 asserted an under-recovery of $11,271 in the interest calculations. Audit Staff had recalculated the interest on account balance based on its other findings. United Cities disagreed with this finding due to its position in response to Finding Nos. 2 and 3.[20]

Procedural History of Docket No. 01-00704 Prior to Consolidation[21]

Following the filing of the IPA Audit Report, on April 12, 2002, United Cities requested that the Authority set the disagreements over the interpretation of the *Final Order on Phase One*,

[18] *Id.* at 18.
[19] *Id.* at 18-19.
[20] *Id.* at 22.
[21] To simplify the procedural history described in this Order, information concerning various disputes among the parties concerning discovery and witness testimony contained in the record is not recounted.

the *Final Order on Phase Two* and the PBR for an evidentiary hearing in a contested case.[22] On April 15, 2002, the Consumer Advocate filed a *Petition to Intervene*, citing its previous intervention in the Docket No. 97-01364, which involved the approval of the Incentive Plan.[23] At a regularly scheduled Authority Conference held on April 30, 2002, the Directors voted unanimously to convene a contested case, grant the Consumer Advocate's *Petition to Intervene* and appoint General Counsel or his designee as Pre-Hearing Officer to set a procedural schedule to completion.[24] In addition to the Consumer Advocate's participation as a party, Audit Staff were designated as a party and were represented by counsel in this proceeding. On June 5, 2002, United Cities submitted an issues list, which stated the issues as 1) whether United Cities Gas Company's inclusion of its performance based rate making mechanism of the savings resulting from the negotiated transportation discounted contracts is consistent with the Authority's *Final Order on Phase Two*; and 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 on Phase Two* and the Order in Docket No. 00-00844.[25] On June 18, 2002, the Directors appointed a Hearing Officer to preside over the hearing and render a decision on the merits of United Cities' claim.[26]

Following attempts to schedule the matter for a hearing,[27] the Consumer Advocate and Audit Staff filed motions for summary judgment.[28] Following discovery and responses to the motions for summary judgment, oral argument on the motions was heard by the Hearing

[22] *United Cities Gas Company's Motion to Reschedule Consideration of the IPA Audit and to Set an Evidentiary Hearing*, p. 1 (April 12, 2002).
[23] *Petition to Intervene*, p. 2 (April 15, 2002).
[24] *Order Convening a Contested Case Proceeding, Granting Intervention to Consumer Advocate and Appointing a Pre-Hearing Officer* (May 13, 2002).
[25] Issues List Submitted by United Cities Gas Company (June 5, 2002).
[26] *Order Appointing A Hearing Officer* (June 28, 2002).
[27] *Order on Motions for Summary Judgment*, p. 12 (March 31, 2003).
[28] *See Motion for Partial Summary Judgment by the Consumer Advocate & Protection Division of the Office of the Attorney General* (July 17, 2002) and *Motion for Summary Judgment* (July 31, 2002).

Officer[29] on October 24, 2002.[30] Both motions for summary judgment were denied on March 31, 2003.[31]

The *TIF Tariff* in Docket No. 02-00850

As the motions for summary judgment were pending in Docket No. 01-00704, on August 9, 2002, United Cities filed a *Petition by United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff* (the "*TIF Tariff*") in Docket No. 02-00850 to amend its PBR mechanism to incorporate a transportation index factor ("TIF") incentive mechanism for the treatment of transportation costs. In the *TIF Tariff*, United Cities stated that the proposed TIF incentive mechanism

> is designed to encourage the Company to actively negotiate transportation discounts on the Company's pipeline suppliers. The TIF establishes a predefined standard of performance to which the Company's actual discounted transportation costs from the discounted contracts are compared. Effective April 1, 2001, the net incentive savings shall be shared between the Company's customers and the Company based on the amount of the resulting savings as a percent of the actual discounted, renewed and/or renegotiated discounted transportation costs per pipeline contract.[32]

The *TIF Tariff* further described how savings would be shared between the Company and its customers and placed a cap of $1.25 million annually on total incentive savings or costs from all three mechanisms. In addition, the *TIF Tariff* defined "city gates" as where the gas is transferred from the upstream pipeline to the Company's local distribution system and specified that city gate purchases contain bundled commodity, transportation and storage costs. The *TIF Tariff* also provided additional price index descriptions and specified that the location of each commodity purchase must be matched with the proper index's geographic location for comparison purposes. The *TIF Tariff* also expressly included gas deliveries under the existing

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[29] The Hearing Officer at that time was the Authority's General Counsel, J. Richard Collier.

[30] *Order on Motions for Summary Judgment*, p. 12 (March 31, 2003).

[31] *Id.* at 21.

[32] *Petition by United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff*, Exhibit A, 2nd Revised Sheet 45.1 (August 9, 2002).

NORA contract dated November 1, 2000 and future contract renewals, or a negotiated contract with a different vendor, in the PBR mechanism as city gate purchases beginning with the plan year April 1, 2001.

On December 2, 2002, the Consumer Advocate filed a *Petition to Intervene* in Docket No. 02-00850. At the March 3, 2003 Authority Conference, the panel assigned to Docket 02-00850 voted unanimously to convene a contested case, grant the Consumer Advocate's *Petition to Intervene*, and appoint General Counsel or his designee to act as Hearing Officer to hear preliminary matters, to rule on any petitions for intervention and to set a procedural schedule to completion.[33] At the April 12, 2004 Authority Conference, the panel voted unanimously to extend the Hearing Officer's jurisdiction to render an initial decision on the merits of the *TIF Tariff*.[34] Audit Staff filed a *Petition to Intervene* on January 9, 2004, which was granted by the Hearing Officer on January 26, 2004.

<u>Consolidation of Dockets and the Proposed Settlement Agreement</u>

On March 8, 2004, the Company and Audit Staff filed a *Motion to Consolidate and for Approval of Settlement Agreement*, in which they requested that Docket Nos. 01-00704 and 02-00850 be consolidated and that a settlement agreement between Audit Staff and United Cities involving both dockets be approved. On March 26, 2004, the *Consumer Advocate's Motion for Extension of Time to Respond to the Motion to Consolidate and for Approval of Settlement Agreement filed by Atmos Energy Corporation and the Staff of the Tennessee Regulatory Authority* was filed, in which the Consumer Advocate stated it did not object to the consolidation of the dockets but did object to the proposed settlement agreement. The Consumer Advocate requested additional time to respond to the *Motion to Consolidate and for Approval of Settlement*

[33] *Order Suspending Tariff for an Additional Ninety (90) Days, Convening a Contested Case Proceeding, Granting Intervention and Appointing a Pre-Hearing Officer* (April 9, 2003).
[34] *Order Extending Jurisdiction of Hearing Officer* (May 18, 2004).

Agreement. The Hearing Officer granted the motion for consolidation and consolidated both dockets into Docket No. 01-00704. The remainder of the *Motion to Consolidate and for Approval of Settlement Agreement* was held in abeyance pending additional discovery and/or a hearing and a procedural schedule was set.[35] Following discovery, on May 17, 2004, the Consumer Advocate filed the *Consumer Advocate's Objections to the Motion for Approval of Settlement Agreement filed by Atmos Energy Corporation and the Staff of the Tennessee Regulatory Authority.* The Company and Audit Staff filed their responses on May 21, 2004. On May 28, 2004, the Consumer Advocate filed a reply and filed notice of a potential dispute among the parties regarding the nature of the hearing on the Consumer Advocate's objections to the settlement agreement.

At a status conference held on June 2, 2004, the Hearing Officer ruled that the hearing then scheduled for June 8, 2004 would be an evidentiary one with testimony from witnesses.[36] Subsequently, the Consumer Advocate filed the *Consumer Advocate's Renewed Motion to Summarily Deny Motion to Approve Settlement and Alternatively to Treat the Motion as a Motion for Summary Judgment* on June 3, 2004. On June 7, 2004, the Audit Staff filed *Energy and Water Division's Response to Consumer Advocate's Renewed Motion to Approve Settlement and Alternatively to Treat Motion as a Motion for Summary Judgment.* Also on June 7, 2004, the Consumer Advocate filed *The Consumer Advocate's Motion to Set an Evidentiary Hearing on the Merits.*

On June 8, 2004, the Hearing Officer heard arguments on the motions filed since June 2, 2004 and concluded that the proposed settlement agreement could not be approved absent the consent of all parties to that agreement. Because the Consumer Advocate was a party and had

[35] *Order Granting Motion to Consolidate and to Approve Settlement Agreement in Part, Granting Motion for Extension of Time to Respond in Part, and Setting Procedural Schedule* (April 28, 2004).
[36] *See* Transcript of Status Conference, p. 28 (June 2, 2004).

not consented to the proposed settlement, the *Consumer Advocate's Renewed Motion to Summarily Deny Motion to Approve Settlement and Alternatively to Treat the Motion as a Motion for Summary Judgment* was granted to the extent that the *Motion for Approval of Settlement Agreement* could not be approved and therefore must be denied. Further, because the Consumer Advocate had not consented to the proposed settlement agreement, the *Motion to Approve Settlement Agreement* was denied. The Hearing Officer determined that the Consumer Advocate's alternate request to treat the *Motion for Approval of Settlement Agreement* as a motion for summary judgment was rendered moot by the granting of summary denial of that motion and, therefore, it was denied.[37]

On June 16, 2004, Audit Staff filed the *Motion of the Staff of the Energy and Water Division to Set the Petition of United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff for Hearing on the Merits*, in which Audit Staff requested that the *TIF Tariff* be set for a hearing on the merits and the other issues in the docket be held in abeyance. On June 23, 2004, the Consumer Advocate filed *The Consumer Advocate Division's Response to the TRA Staff's Motion to Set Atmos' Petition for Hearing*, requesting that the dockets remain consolidated and that a hearing be set to determine all issues in the interest of judicial economy. At a status conference on June 25, 2004, the Hearing Officer denied the *Motion of the Staff of the Energy and Water Division to Set the Petition of United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff for Hearing on the Merits* and granted *The Consumer Advocate's Motion to Set an Evidentiary Hearing on the Merits* to the extent that a procedural schedule was issued and an

[37] *See Order Granting in Part and Denying in Part Consumer Advocate's Renewed Motion to Summarily Deny Motion to Approve Settlement Agreement and Alternatively to Treat the Motion as a Motion for Summary Judgment and Denying Motion to Approve Settlement Agreement* (August 12, 2004).

evidentiary hearing was set.[38] Following additional discovery, a Notice of Hearing was issued on September 28, 2004.

October 19, 2004 Hearing

The Hearing in this matter was held before the Hearing Officer on October 19, 2004, after the notice was issued on September 28, 2004. Participating in the Hearing were the following parties and their respective counsel:

> **United Cities Gas Company** – Joe A. Conner, Esq. and Misty Smith Kelley, Esq., Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C., 1800 Republic Centre, 633 Chestnut Street, Chattanooga, Tennessee 37450;
>
> **Consumer Advocate and Protection Division** – Russell T. Perkins, Esq. and Timothy C. Phillips, Esq., Consumer Advocate and Protection Division, Office of the Attorney General, 425 Fifth Avenue, North, 3rd Floor, Nashville, Tennessee 37243;
>
> **Audit Staff of Tennessee Regulatory Authority Participating as Party** – Randal L. Gilliam, Esq., 460 James Robertson Parkway, Nashville, Tennessee 37243.

At the Hearing, Counsel for United Cities called John Hack, Director of Gas Supply Planning, Atmos Energy Corporation; Patricia Childers, Vice President of Rates and Regulatory Affairs, Atmos Energy Corporation; and Frank H. Creamer, management consultant and Director, Barrington Associates, Inc., as witnesses. Counsel for Audit Staff called Pat Murphy, Senior Financial Analyst, Tennessee Regulatory Authority, as its witness. The Consumer Advocate called Daniel W. McCormac, Coordinator of Analysts, Consumer Advocate and Protection Division of the Office of Attorney General and Dr. Steve Brown, Economist, Consumer Advocate and Protection Division of the Office of Attorney General as its witnesses. All witnesses were subject to cross examination by the parties and questions from the Hearing Officer and Advisory Staff.

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[38] *See Order Denying Motion of the Staff of the Energy and Water Division to Set the Petition of United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff for Hearing on the Merits and Modifying Procedural Schedule* (August 12, 2004).

United Cities filed its post-hearing brief on November 23, 2004, with the Consumer Advocate and Audit Staff filing their post-hearing briefs on December 13, 2004. United Cities filed a reply brief on January 4, 2005.

POSITIONS OF THE PARTIES[39]

United Cities[40]

United Cities contends that it is entitled to share in the savings from negotiated transportation discounts under the terms of the current PBR mechanism. According to the Company, although discounted transportation contracts did not exist when the PBR mechanism was created and are not specifically addressed in the PBR mechanism or the transportation cost adjuster,[41] the savings from the transportation discounts nevertheless are captured under the current PBR mechanism through the application of the transportation cost adjuster in the Gas Cost Commodity mechanism.[42] The Gas Cost Commodity mechanism measures the Company's performance against a benchmark that consists of three published market indices and the transportation cost adjuster.[43] According to United Cities, the transportation cost adjuster adjusts the commodity-only indices by adding the avoided transportation cost to the basket of indices.[44] The PBR mechanism provides that, for city gate purchases, these indices will be adjusted for the avoided transportation costs that would have been paid if the upstream capacity were purchased

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[39] The Hearing Officer considered the evidence presented, including the testimony and pre-filed testimony of the witnesses, and the post-hearing briefs of the parties, including the references in those briefs to prior filings in support of motions for summary judgment. All arguments made by the parties were considered, except as noted in footnote 40. The positions of the parties are summaries of the major points made by the parties; for the sake of brevity, the summaries are not exhaustive.

[40] In its post-hearing brief, the Company discusses negotiations among the parties in some detail. See *Atmos Energy Corporation's Post-Hearing Brief*, pp. 6-8 (November 23, 2004). The Consumer Advocate urges the Authority to strike or disregard any reference to settlement material. See *Consumer Advocate's Post-Hearing Brief*, pp. 19-20 (December 13, 2004). The Hearing Officer finds that the substance of the settlement negotiations is not in evidence and is irrelevant; therefore, the Hearing Officer has disregarded the substance of the negotiations.

[41] *Atmos Energy Corporation's Reply to Post-Hearing Briefs of the TRA Staff and the Consumer Advocate and Protection Division*, p. 2 (January 4, 2005).

[42] *Atmos Energy Corporation's Post-Hearing Brief*, p. 18 (November 23, 2004).

[43] *Id.*

[44] *Atmos Energy Corporation's Reply to Post-Hearing Briefs of the TRA Staff and the Consumer Advocate and Protection Division*, p. 2 (January 4, 2005)

versus the demand charges actually paid to the supplier.[45] United Cities argues all of its purchases at issue in this docket are "city gate" purchases within the meaning of the PBR mechanism because the term "city gate" refers to any location where the Company's distribution system connects to one of the gas pipelines serving the Tennessee area.[46] The Company concludes that the transportation cost adjuster must be applied in order to make an "apples-to-apples" comparison between the costs the Company pays, which include downstream transportation costs, and the market indices used as the benchmark, which do not include downstream transportation costs.[47] United Cities asserts that allowing the Company to share in the savings from the negotiated transportation discounts, through the application of the transportation cost adjuster, is consistent with the scope and intent of the PBR mechanism.[48]

According to United Cities, the transportation cost adjuster calculates the avoided transportation cost as the difference between the actual price paid and a hypothetical amount that would have been paid if gas were purchased at a point upstream rather than at the city gate.[49] The Company argues that the avoided costs from the transportation discounts should be calculated by comparing the actual cost to the maximum FERC rate, which is the market indicator for downstream transportation costs.[50] United Cities asserts that the maximum FERC rate has historically been used as the benchmark for calculating avoided transportation costs under the NORA contract.[51] In addition, the Company states that the maximum FERC rate is the market-clearing price for the majority of the firm transportation contracts industry-wide and is the basis for the negotiations of any future discounts. Further, the Company argues that the

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[45] *Atmos Energy Corporation's Post-Hearing Brief*, p. 18 (November 23, 2004).
[46] *Id* at 21.
[47] *Id.* at 25.
[48] *Id.* at 27.
[49] *Atmos Energy Corporation's Reply to Post-Hearing Briefs of the TRA Staff and the Consumer Advocate and Protection Division*, p. 3 (January 4, 2005).
[50] *Atmos Energy Corporation's Post-Hearing Brief*, p. 25 (November 23, 2004).
[51] *Id.* at 26.

maximum FERC rate would serve as the benchmark for any prudency review of the Company's purchases. Finally, the Company contends that the maximum FERC rate has been accepted by other state public utility commission reviews of PBR plans as the appropriate benchmark to measure avoided downstream transportation costs.[52]

The Company argues that the IPA Audit Report findings should be barred by the doctrine of estoppel.[53] United Cities outlines its negotiations and what it describes as its "extraordinary efforts" required to obtain the transportation discounts.[54] The Company asserts it would not have undertaken these extraordinary efforts without the motivation of the sharing of the savings under the PBR mechanism.[55]

Several representatives of United Cities met with TRA staff on January 31, 2001.[56] According to United Cities, the purpose of the meeting was to discuss the treatment of the Company's newly negotiated transportation discounts under the PBR mechanism.[57] The Company provided all meeting attendees with a packet of information which listed a breakdown of the savings and demonstrated how the savings would be calculated.[58] At the meeting, United Cities explained that monthly savings would be calculated by subtracting the negotiated rate from the maximum FERC rate for that particular pipeline.[59] Monthly savings would be added together to reach total annual savings, which the Company would be able to share in according to the percentages in the PBR mechanism.[60] According to United Cities, the TRA staff actively participated in the meeting, indicated that they agreed that savings from the negotiated transportation discounts were included within the avoided costs provisions of the PBR

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[52] *Id.*
[53] *Id.* at 16-18
[54] *Id.* at 11-13.
[55] *Id.* at 13.
[56] *Id.*
[57] *Id.*
[58] *Id.* at 14.
[59] *Id.*
[60] *Id.*

mechanism, and accepted the Company's proposed method of calculating and reporting the savings.[61] The Company states that the TRA staff did not give any indication at the meeting that it could not rely on the staff's statements or make any suggestion that United Cities needed to take any further action before proceeding with its proposed reporting and calculations.[62] According to United Cities, the Company relied on these actions and booked as income the savings resulting from the discounted contracts.[63] Thus, the Company argues that the Audit Staff took affirmative action that induced United Cities to act to its detriment.[64] The Company also cites two TRA decisions[65] in audits of gas companies where the Authority declined to make audit findings where the companies had notified the Authority of their intentions, had acted in good faith or had relied on the Authority's tacit approval.[66]

In addition, United Cities asserts that the IPA Audit Report findings should be barred because the TRA staff did not raise timely objections to its quarterly reports made prior to the audit. On March 1, 2001 and May 31, 2001, the Company filed with the Authority quarterly reports in which it calculated and reported the savings from the negotiated transportation discounts.[67] According to United Cities, TRA staff raised no objections, either written or oral, to these quarterly reports.[68] The Company argues that provisions in its tariff require the TRA staff to object to the quarterly reports within 180 days or the Incentive Plan Account is deemed to be in compliance.[69]

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61 *Id.* at 15.
62 *Id.*
63 *Id.* at 18.
64 *Id.*
65 United Cities cites *In re: Audit of Nashville Gas Company's Incentive Plan Account for the Plan Year Ended June 30, 2003*, Docket No. 03-00489 and *In re: Tennessee Regulatory Authority's Audit of Chattanooga Gas Company's Actual Cost Adjustment Filing (ACA) for the Period Ending June 30, 2003*, Docket No. 03-00516.
66 *Atmos Energy Corporation's Reply to Post-Hearing Briefs of the TRA Staff and the Consumer Advocate and Protection Division*, pp. 6-8 (January 4, 2005).
67 *Atmos Energy Corporation's Post-Hearing Brief*, pp. 15-16 (November 23, 2004).
68 *Id.* at 16.
69 *Id.* at 17.

United Cities contends that is it is entitled to share in the savings from the NORA contract under the terms of the current PBR mechanism.[70] Audit Staff challenged the Company's method used to calculate transportation cost savings resulting from the NORA contract because the NORA purchases were not included in the total commodity purchases for each month, but instead were treated as a separate calculation.[71] Purchases under the NORA contract are bundled transactions containing both commodity and transportation components in the total charges.[72] When United Cities filed its petition in Docket No. 00-00844, it also submitted attachments which it states illustrated the proposed separate calculation of the NORA avoided transportation costs.[73] In the order granting the petition, the Authority stated that its approval was based upon its careful review of the petition and the entire record in the matter.[74] Thus, the Company argues that, because the proposed calculations were part of the record, the Authority approved the method of calculation.[75] According to the Company, the Authority's order was an affirmative act which induced its reasonable reliance to its detriment and, therefore, the Audit Staff is estopped from contradicting the Authority's order.[76] The Company states that the Audit Staff excluded NORA purchases from the IPA Audit Report.[77] Therefore, United Cities asserts that, even if the Authority rules that the NORA purchases cannot be treated as separate transactions, the IPA Audit Report must be amended to include the appropriate calculations for the NORA purchases.[78]

Without waiving the Company's position that transportation savings are included in the current PBR mechanism, United Cities proposed the *TIF Tariff* to be applied to the plan years

[70] *Id.* at 27.
[71] *Id.* at 28.
[72] *Id.*
[73] *Id.* at 29.
[74] *Id.*
[75] *Id.* at 30.
[76] *Id.*
[77] *Id.*
[78] *Id.* at 30-31.

subsequent to the audit period of the IPA Audit Report.[79] According to the Company, the *TIF Tariff* simplifies the PBR calculations by unbundling the transportation cost component of the total delivered cost of gas to the city gate and treating it separately from the commodity costs, allowing transportation costs to be monitored on a pipeline by pipeline basis.[80] The *TIF Tariff* would compare the actual purchase price to the maximum FERC rate to calculate the savings, but would have a three-tiered sharing formula to allocate the monthly transportation savings between the Company and its customers.[81] The Company contends that the *TIF Tariff* will reduce regulatory costs since the Authority will avoid hiring a consultant each year to do a prudency review of its transportation purchases.[82] In addition, United Cities states that the *TIF Tariff* is consistent with the PBR mechanism's intent to ensure that the consumers' cost of gas is based fairly on market-based pricing and that the Company is incented to beat that market price.[83] The *TIF Tariff* also ensures that the Company's gas purchasing activities are focused on reducing the total cost of gas delivered to the city gate, instead of maximizing the benefits of one component of the PBR at the expense of another.[84]

The Company argues that it incurs risk in negotiating transportation discounts by dedicating scarce and limited resources to obtaining them, and to the extent it is unsuccessful in its negotiations, the Company loses the return on that investment.[85] United Cities again cites the extraordinary efforts it undertook to negotiate the discounts as justification of its share of savings, stating that the negotiations with each pipeline lasted anywhere from eight (8) months to one (1) year, and involved many phone calls and meetings.[86] According to the Company, the

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[79] *Id.* at 31.
[80] *Id.* at 33-34.
[81] *Id.* at 32.
[82] *Id* at 34.
[83] *Id.*
[84] *Id.*
[85] *Id.* at 45.
[86] *Id.* at 35.

difficult nature of the negotiations is demonstrated by the fact that it was unsuccessful in obtaining discounts on eleven (11) of the sixteen (16) contracts serving its Tennessee territory.[87]

United Cities argues that the negotiated transportation discounts generate real savings and allowing the Company to share in those savings does not result in higher prices for consumers.[88] According to the Company, the *TIF Tariff* represents a reasonable balancing of risks and rewards.[89] The Company asserts that the crucial component of the PBR is the existence of a standard of performance that reflects each individual and complete marketplace against which the Company's sourcing performance can be determined, rather than whether the transportation marketplace has pricing penalties that are similar to the pricing penalties that exist in the commodity marketplace.[90] United Cities contends that since the transportation marketplace contains only single point-in-time pricing information for a transaction with a population of one, has a price ceiling (the maximum FERC rate) and contains unique contract terms and conditions, the proxy for the transportation marketplace cannot include prices higher than seen in the marketplace or the average of all transactions in the marketplace.[91] Thus, the Company argues the absence of pricing penalties is no reason to deny the *TIF Tariff*.[92]

The Company contends that the *TIF Tariff* is consistent with the TRA's ruling in Docket No. 03-00209,[93] which permitted gas companies to recover the gas costs portion of uncollectible expenses through the PGA rule, and argues that both focus on the overall intent and scope of the

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[87] *Id* at 36.
[88] *Id.* at 44-45.
[89] *Id* at 45.
[90] *Id.* at 46.
[91] *Id.* at 46-47.
[92] *Id.* at 47.
[93] *In re. Petition of Chattanooga Gas Company, Nashville Gas Company, a Division of Piedmont Natural Gas Company, Inc., and United Cities Gas Company, a Division of Atmos Energy Corporation, for a Declaratory Ruling Regarding the Collectibility of the Gas Cost Portion of Uncollectible Accounts Under the Purchased Gas Adjustment (PGA) Rules*, Docket No. 03-00209, *Order Denying Consumer Advocate's Motion for Summary Judgment, Granting, in Part, and Denying, in Part, Petitioners' Motion for Summary Judgment, Denying Petition for a Declaratory Ruling and Modifying Refund Adjustment Formula* (February 9, 2005).

original PBR mechanism.[94] United Cities also states that the *TIF Tariff* should not be denied because of industry events that may cast doubt on the reliability of market indices or because of concerns raised regarding the Company's relationship with its affiliate, Woodward Marketing, LLC.[95]

United Cities argues that implementing the *TIF Tariff* effective April 1, 2001, would not result in impermissible retroactive ratemaking. Rather, the Company asserts that losses and savings would be recouped by United Cities and its customers through adjustments in future rates.[96] According to the Company, 100% of the savings from negotiated transportation costs are immediately passed through directly to the customers through the PGA rule, and the Company then recoups its 50% share of savings annually through a rate increase beginning each October 1 when the Company files its PBR factor true-up.[97] Further, United Cities states that it has not filed audit reports for audit years 2001-2, 2002-3 and 2003-4, and those audit years remain open.[98] Because the *TIF Tariff* will be effective on the first day of the year following the year at issue in the audit, the Company contends that the legal prohibition on retroactive ratemaking places no impediment as to how it will report transportation costs savings when it files its annual reports for those years.[99]

Consumer Advocate

The Consumer Advocate argues that United Cities is not entitled to share in the savings it seeks in this matter.[100] First, the Consumer Advocate contends that the Company's interpretation of the transportation cost adjuster is flawed.[101] The Consumer Advocate asserts that the core of

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94 *Atmos Energy Corporation's Post-Hearing Brief*, pp. 47-48 (November 23, 2004).
95 *Id.* at 48-50.
96 *Id.* at 51.
97 *Id.* at 51-52.
98 *Id.* at 52.
99 *Id.*
100 *Consumer Advocate's Post-Hearing Brief*, p 2 (December 13, 2004).
101 *Id.*

this proceeding is whether the PBR mechanism as interpreted by the Company or the proposed *TIF Tariff* result in a calculation of savings based on the idea that United Cities has delivered to its city gate natural gas at the lowest or best possible cost.[102] According to the Consumer Advocate, United Cities has been unable to establish a measure by which its interpretation of the PBR mechanism or the *TIF Tariff* will actually result in real savings.[103] The Consumer Advocate asserts that the Company has not compared the delivered price at the city gate to a purchase linked to the predefined market indices actually used in the PBR mechanism.[104] According to the Consumer Advocate, these predefined market indices do not include downstream transportation costs from the pipeline receipt point to the city gate.[105] The Consumer Advocate states that there is no similar market index for transportation contracts.[106] The Consumer Advocate explains that the transportation costs are captured by the PBR mechanism in the transportation cost adjuster, which allows for a comparison of two costs: 1) the actual cost AEC pays for the natural gas delivered to its city gate; and 2) the actual cost the Company would have paid if the natural gas was purchased at the Henry Hub and then delivered to the city gate.[107] The Consumer Advocate contends that the transportation cost adjuster addresses "avoided" costs and not "reduced" costs.[108] The Consumer Advocate contends that while the contracts may have resulted in a reduction in rate paid when compared to the maximum FERC rate, no leg or section of travel along the pipeline was eliminated or avoided.[109] According to the Consumer Advocate, it is not a matter of excluding transportation costs, but a matter of adjusting for different costs

[102] *Id.*
[103] *Id.*
[104] *Id.* at 3.
[105] *Id.*
[106] *Id.* at 3-4.
[107] *Id.* at 4.
[108] *Id.*
[109] *Id.* at 5.

related to the difference in receipt points.[110] The Consumer Advocate argues that it is inappropriate to make adjustments to the predefined market indices, but is appropriate to allow for the transportation costs avoided by purchasing the gas at the city gate.[111] According to the Consumer Advocate, there is no need to use the transportation cost adjuster when the commodity is purchased at receipt points with a related predefined market index, such as the Henry Hub.[112] The Consumer Advocate contends that by defining city gate to include every Company purchase that makes it to the city gate, the transportation cost adjuster becomes the rule, rather than the exception.[113]

Further, the Consumer Advocate asserts that the maximum FERC rate does not serve as a proxy for the transportation market.[114] According to the Consumer Advocate, no market index exists for transportation costs and a proxy for the market cannot be found in the maximum FERC rate because the maximum FERC rate is not set by market influences.[115] Rather, the Consumer Advocate contends, the maximum FERC rate is set based on the underlying cost of the company, plus a reasonable return as determined by FERC and is a rate unique to each pipeline.[116] The Consumer Advocate argues that, as an historical rate which is not market sensitive, the maximum FERC rate is a "poor replacement" for widely published market indices, such as those approved in Docket No. 97-01364.[117] If a true market rate exists, the Consumer Advocate asserts it would have to be established by objective market studies and calculation.[118] Moreover, the Consumer Advocate contends that no maximum rate can be part of the PBR, which can properly be implemented only through an index or average reflecting the market as a measure of

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[110] *Id.*
[111] *Id.*
[112] *Id.* at 6.
[113] *Id.*
[114] *Id.* at 12.
[115] *Id.* at 13.
[116] *Id.* at 15-16.
[117] *Id.* at 17.
[118] *Id.*

performance.[119] The Consumer Advocate argues that in Kentucky, where a similar proposal to use the maximum FERC rate as a proxy has been approved, the commission did not find that the Company's proposals in this docket actually benefited ratepayers.[120]

In addition, the Consumer Advocate argues that the TRA should not be estopped from considering the merits of this docket.[121] According to the Consumer Advocate, United Cities has failed to prove the essential elements of estoppel.[122] The Consumer Advocate contends that neither the TRA nor its staff made any promise to United Cities, nor did the Company give up any property or right in exchange for any alleged promise.[123] In addition, the Consumer Advocate states that the contracts were executed before any contact with the TRA or its staff, and the staff did not have any input into the Company's decision to enter into the contracts.[124] The Consumer Advocate contends there is no detrimental reliance because United Cities did not change its position prejudicially, but "simply booked" the profits.[125] According to the Consumer Advocate, the Company has not identified a substantial economic loss that was induced by any alleged promise of the TRA or its staff.[126]

The Consumer Advocate argues that the Company's negotiations were not the cause of the change in market conditions that occurred in 1999.[127] According to the Consumer Advocate, the market changes that occurred in 1999 were more significant than any conduct on the part of any Company employee.[128] Further, the Consumer Advocate asserts that United Cities had to

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[119] *Id.* at 18.
[120] *Id.* at 21-22. *See In the Matter of Modification to Louisville Gas and Electric Company's Gas Supply Clause to Incorporate an Experimental Performance Based Ratemaking Mechanism*, Ky. Public Service Comm'n. Case No. 2001-017, *Order* (October 26, 2001).
[121] *Id.* at 22.
[122] *Id.* at 28.
[123] *Id.* at 23.
[124] *Id.* at 25.
[125] *Id.* at 26.
[126] *Id.* at 27.
[127] *Id.* at 28-32.
[128] *Id.* at 34.

negotiate the contracts anyway.[129] The Consumer Advocate contends that the contracts were settled at a certain amount because of the particular market conditions existing at the time.[130]

The Consumer Advocate argues that the *TIF Tariff* would result in retroactive ratemaking because the proposal makes adjustments to future rates based upon the claimed savings resulting from a rate change in excess of three years before approval.[131] According to the Consumer Advocate, the *TIF Tariff* deals with the question of what rate applies, i.e. rate change, rather than when to collect the rate from customers, i.e. an adjustment in rates.[132] The Consumer Advocate asserts that making a rate change effective to April 1, 2001 would constitute retroactive ratemaking.[133]

Finally, the Consumer Advocate argues the importance of risk to incentive-based ratemaking.[134] According to the Consumer Advocate, in initially approving the PBR mechanism, the TPSC relied directly on the assertion that risk-taking was an integral part of the PBR.[135] The Consumer Advocate asserts that performance-based ratemaking is an appropriate alternative when an acceptable level of risk is assumed by the Company and its ratepayers in order that the cost of gas might be lowered.[136] The Consumer Advocate contends that the work of United Cities employees resulted in reductions in gas costs, but there was no risk involved.[137]

Audit Staff

Audit Staff argues that United Cities is not entitled to share in the savings from negotiated transportation discounts under the terms of the current PBR mechanism.[138] Even if

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129 *Id.* at 30.
130 *Id.* at 31.
131 *Id.* at 37, 39.
132 *Id.* at 40.
133 *Id.* at 40.
134 *Id.* at 43.
135 *Id.* at 44.
136 *Id.* at 43.
137 *Id.*
138 *Staff Reply to Atmos Energy Corporation's Post-Hearing Brief*, p. 2 (December 13, 2005).

accepted as true, Audit Staff contends that the Company's extraordinary efforts to negotiate the transportation discounts and the meeting with TRA staff to inform them of the discounts do not entitle United Cities to share in the savings.[139] Audit Staff also asserts that staff did not approve the Company's method of calculating savings and had no power to do so.[140] Audit Staff argues that the doctrine of estoppel does not bar the findings of the IPA Audit Report. The Company could not have acted to its detriment in reliance upon the January 31, 2001 meeting because the transportation discount contracts were executed prior to that meeting and any benefits or burdens to the Company under those contracts would continue regardless of the meeting's outcome.[141]

Audit Staff contends that the savings from the transportation discounts are not "captured" under the current PBR mechanism through the application of the transportation cost adjuster. Further, transportation, as an aspect of the total price of gas, is not included in the PBR mechanism.[142]

According to Audit Staff, United Cities is not entitled to share in the savings from the NORA contract under the terms of the current PBR mechanism. In addition, Audit Staff asserts that there is no need to amend the IPA Audit Report to include the Company's calculations for the NORA purchases because inclusion of the NORA purchases in the calculations results in no savings.[143]

Audit Staff argues that the proposed *TIF Tariff* is just and reasonable and in the best interests of the Company and the consumer. Further, Audit Staff agrees with United Cities that the *TIF Tariff* should be approved effective April 1, 2001.[144]

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139 *Id.*
140 *Id.*
141 *Id.* at 2-3.
142 *Id.* at 3.
143 *Id.*
144 *Id.* at 3-4.

FINDINGS AND CONCLUSIONS

IPA Audit Report

Neither the *Final Order on Phase Two* nor the PBR mechanism tariff captures negotiated transportation discounts. Transportation discounts were not available at the time of the *Final Order on Phase Two* and, therefore, the TRA could not and did not contemplate the appropriate market conditions necessary to consider an appropriate mechanism for savings from transportation discounts in its order. In addition, no transportation costs section exists in the Company's PBR tariff. The sole reference to transportation costs in the Gas Procurement Incentive mechanism is in the context of benchmarking city gate commodity purchases. Both the *Final Order on Phase Two* and the PBR mechanism are very specific as to how shared savings are to be calculated through two specific areas: Gas Commodity Costs and Capacity Release. In addition, the PBR mechanism tariff outlines the use of benchmarks for various types of gas purchases. The absence of similar specificity regarding transportation discounts, and the absence of methodology or benchmarks with which to calculate any such savings, indicates a lack of intent by the Authority to include the discounts in the PBR mechanism.

Nor are transportation discounts captured in the current PBR mechanism through the application of the transportation cost adjuster in the Gas Cost Commodity mechanism. Transportation costs are an aspect of commodity costs. The PBR mechanism distinguishes upstream and city gate purchases. Because a city gate purchase includes a transportation component that is avoided when gas is bought upstream, the price of a city gate purchase is adjusted through the transportation cost adjuster in the Gas Cost Commodity mechanism to create an "apples to apples" comparison of the purchase price and the benchmark market indices. An upstream purchase can be compared directly to the indices. Therefore, the transportation cost adjuster only applies to 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.[145] However, with the exception of the NORA contract purchases, Woodward Marketing, LLC takes delivery at a pipeline receipt point; therefore, no adjustment is needed to make the "apples to apples" comparison. The language of the PBR states that the adjustment made to city gate purchases is for "avoided" costs. Although the Company argues that the negotiated reduction in transportation costs are synonymous with "avoided" costs, the reference to transportation costs in the *Final Order on Phase Two* specifically refers to the distance the gas must be transported from source to city gate when explaining the total cost savings that could be achieved. In addition, the context in which transportation costs appear in the *Final Order on Phase Two* includes references to NORA purchases, which are city gate purchases.

To calculate the avoided transportation costs, the Company used the maximum FERC rate. Unlike other market indices, it is not intended to reflect a market price, but rather sets a legal maximum for transportation rates. The maximum FERC rate is not mentioned in the *Final Order on Phase Two* or in the PBR mechanism tariff. As a result, the maximum FERC rate is not an approved index under the current PBR mechanism. For these reasons, the Hearing Officer concludes that the Company's calculation of the transportation discount savings using the transportation cost adjuster is inconsistent with both the *Final Order on Phase Two* and the PBR mechanism.

Further, the cost savings resulting from the NORA contract were improperly calculated in the Company's IPA filing. The above findings and conclusions regarding the inclusion of savings from discounted transportation contracts apply here as well. In addition, savings related to the NORA contract must be calculated on an aggregate basis and not on an individual basis. Both the *Final Order on Phase One* and the *Final Order on Phase Two* state that any savings are

[145] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, p. 11 (April 10, 2002).

to be calculated on a monthly basis rather than transaction by transaction.[146] The Authority's Order in Docket No. 00-00844, granting permission to include the NORA contract in the IPA, states that "[t]he monthly calculation of profits takes an average of the purchases for the month, so that a 'windfall' situation does not occur for any specific transaction."[147] The subsequent reference in that Order to a "review of the entire record" (including, presumably, a review of the Company's proposed method of calculation) by the Authority does not overrule this confirmation of the approved method in the *Final Order on Phase One* and the *Final Order on Phase Two*. Therefore, the Hearing Officer concludes that the Company's calculation of NORA contract savings does not comply with the PBR mechanism.

According to the IPA Audit Report, in the Company's response to a request to provide an explanation of the calculation of savings pursuant to its tariff, United Cities responded there was "no impact on the lower limit of the commodity deadband each month . . . ."[148] Therefore, the Hearing Officer further concludes that the IPA Audit Report need not be amended to include the appropriate calculations for the NORA purchases because there were no transportation savings.

The findings in the IPA Audit Report are not barred by doctrine of estoppel. 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."[149] The Court further found that "in those Tennessee cases where estoppel was applied, or could have been applied, the public body took affirmative action that clearly induced a private party to act to his or her

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[146] *Final Order on Phase One*, p. 24 (January 14, 1999); *Final Order on Phase Two*, p. 7 (August 16, 1999).

[147] *In re: 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, *Order Granting Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point in Incentive Plan*, p. 5 (November 8, 2001).

[148] *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account*, p. 19 (April 10, 2002).

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

detriment, as distinguished from silence, non-action or acquiescence."[150] In this instance, although the Company may have left the January 31, 2001 meeting with the impression the TRA Staff approved of the Company's proposed reporting and calculations, there is no evidence of any affirmative action on the part of TRA Staff. At most, TRA Staff nodded in acquiescence. Further, the TRA Staff had no authority to contradict the *Final Order on Phase Two*. Nor could any action of the TRA Staff have induced the Company to act with regard to the negotiated transportation discounts, since the contracts were executed before United Cities had contact with the TRA staff. In addition, there is no evidence that United Cities acted to its detriment by negotiating the contracts. Although in certain audit decisions cited by the Company, the TRA has declined to make audit findings where the companies had notified the Authority of their intentions, had acted in good faith or had relied on the Authority's tacit approval, there is no requirement that the Authority do so in the absence of the factors required for estoppel or other legal mandate.

Nor are the findings in the IPA Audit Report barred by Audit Staff's failure to object to the March 1, 2001 and May 31, 2001 quarterly reports within 180 days. Although the language in the tariff itself is somewhat unclear, the *Final Order on Phase Two* directs that the tariff should specify that the incentive plan account contain "similar language, true-up attributes, audit, and filing requirements as the Actual Cost Adjustment clause of the existing Purchase Gas Adjustment rules."[151] The ACA requires a written objection by the TRA within 180 days of the filing of an annual report.[152] Therefore, the intent of the language in the tariff should be interpreted to require an objection within 180 days of the annual report.[153] In addition, a

[150] *Id.*, at 125.
[151] *Final Order on Phase Two*, p. 28 (August 16, 1999).
[152] TRA Rule 1220-4-7-.03(2).
[153] In this instance, however, the Audit Staff and the Company extended the 180 day deadline by mutual consent. *See* Letter from Pat Murphy to Patricia J. Childers (March 5, 2002).

requirement of an audit within 180 days of each quarterly report would create such a burden on the Authority that it is unreasonable to conclude that the Authority would have approved of such a requirement.

As a result, the Hearing Officer concludes that the *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account* should be approved. In addition, the Company should be directed to file its quarterly and annual PBR reports in accordance with this Order so that audits of the PBR mechanism can be conducted for subsequent plan years.

Transportation Index Factor (TIF) Incentive Mechanism

The PBR mechanism can and should be amended from time to time to account for changing market conditions, such as the emergence of a market for transportation discounts. Unfortunately, the record in this docket is not persuasive that the specific methodology proposed by the Company should be approved. For example, the record does not contain sufficient evidence to support the percentage sharing split between the Company and its customers in the proposed *TIF Tariff*. No documentation, including market data, has been provided that shows how the sharing percentages were derived or to indicate their propriety. Nor has the Company provided sufficient support for use of the maximum FERC rate as a benchmark for negotiated discounts. Although used to calculate NORA savings during the experimental PBR, market conditions may have changed since that time and additional information is needed. In addition, the Company's expert witness testified that transportation discounts are now reported to FERC, but not with enough detail to be used as a market proxy.[154] While the reporting may not be detailed enough to use as a proxy, the presence of such reporting indicates that discounts are common enough to, if not rule out the maximum FERC rate as a benchmark, at least cast doubt on the measure and require additional support. Finally, there is an absence of risk for the

[154] Affidavit of Frank H. Creamer, ¶ 19 (October 21, 2002).

Company created by the proposed use of the maximum FERC rate benchmark and the savings sharing structure. Although the Company argues that it incurred risk through dedicating scarce and limited resources to obtaining negotiated transportation discounts, there is no evidence as to what portion of those efforts could also be attributed to standard contract negotiations. There is also insufficient information to quantify costs savings and efficiencies resulting from redirecting the resources used to negotiate the discounts.

The Hearing Officer notes that the original PBR mechanism resulted from extensive testimony and deliberation on market conditions and indices. Similar information is needed before approval of the *TIF Tariff.* As a result, the Hearing Officer concludes the *TIF Tariff* should be denied at this time. However, nothing in this order is intended to preclude the Company from filing a similar tariff in the future with additional supporting documentation. In addition, because the *TIF Tariff* is denied, the Hearing Officer need not reach the issue of whether approval of such an amendment effective April 1, 2001 constitutes retroactive ratemaking.

IT IS THEREFORE ORDERED THAT:

1. The *Compliance Audit Report of United Cities Gas Company's Incentive Plan Account* attached to this Initial Order as Exhibit 1, is approved, adopted and incorporated in this Order as if fully rewritten herein.

2. The *Petition by United Cities Gas Company to Amend the Performance Based Ratemaking Mechanism Rider to Its Tariff* is denied.

3. United Cities Gas Company shall file all outstanding PBR reports consistent with this decision.

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

5. Any part aggrieved by the decision of the Hearing Officer in this matter may file a Petition for Appeal with the Tennessee Regulatory Authority within fifteen (15) days from the date of this Order.

6. In the event this Order is not appealed to the Directors of the Tennessee Regulatory Authority within fifteen (15) days, this Order shall become final and shall be effective from the date of entry. Thereafter, any party aggrieved by the decision of the Hearing Officer may file a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.

Jean A. Stone

Jean A. Stone, Hearing Officer

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

'02 APR 10 PM 2 5

April 10, 2002

EXECU...

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

NOTICE OF FILING BY ENERGY AND WATER DIVISION OF THE TENNESSEE REGULATORY AUTHORITY

Pursuant to Tenn Code Ann §§ 65-4-104, 65-4-111 and 65-3-108, the Energy and Water Division of the Tennessee Regulatory Authority (hereafter "Energy and Water") hereby gives notice of its filing of the United Cities Gas Company Incentive Plan Account (hereafter "IPA") Audit Report in this docket and would respectfully state as follows·

1 The present docket was opened by the Authority to hear matters arising out of the audit of United Cities Gas Company's (hereafter the "Company") IPA for the year ended March 31, 2001

2 The Company's IPA filing was received on August 7, 2001, and the Staff completed its audit of same on March 22, 2002

3. On March 28, 2002, the Energy and Water Division issued its preliminary audit findings to the Company, and on April 5, 2002, the Company responded thereto The Audit Report was modified to include the Company's responses.

4 The Audit Report is attached hereto as <u>Exhibit A</u> and is fully incorporated herein by this reference.

EXHIBIT

POSTED 4/11/02

5. The Energy and Water Division hereby files its Report with the Tennessee Regulatory Authority for deposit as a public record and approval of the same

Respectfully Submitted:

Pat Murphy

Pat Murphy
Energy and Water Division
Tennessee Regulatory Authority

CERTIFICATE OF SERVICE

I hereby certify that on this 10th day of April 2002, a true and exact copy of the foregoing has been either hand-delivered or delivered via U S Mail, postage pre-paid, to the following persons

Mr K David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

Ms Patricia J Childers
Manager – Regulatory Affairs
United Cities Gas Company
810 Crescent Centre Dr , Suite 600
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Mr Bob Cline
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1800 Republic Centre
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Pat Murphy

Pat Murphy

COMPLIANCE AUDIT REPORT
OF

UNITED CITIES GAS COMPANY'S
INCENTIVE PLAN ACCOUNT

Docket No 01-00704

PREPARED BY

TENNESSEE REGULATORY AUTHORITY

ENERGY AND WATER DIVISION

APRIL 2002

EXHIBIT A

TENNESSEE REGULATORY AUTHORITY'S
COMPLIANCE AUDIT
of
UNITED CITIES GAS COMPANY'S
INCENTIVE PLAN ACCOUNT

DOCKET NO. 01-00704

TABLE OF CONTENTS

I. INTRODUCTION

The subject of this compliance audit is the Performance Incentive Plan (hereafter "Incentive Plan" or "IPA") of United Cities Gas Company (hereafter "United Cities" or the "Company"), a division of Atmos Energy Corporation. The objective of the audit was to determine whether the balance in the Incentive Plan Account (IPA) as of March 31, 2001 was calculated in conformance with the terms of the Incentive Plan and to verify that the factors utilized in the calculations were supported by appropriate source documentation. The IPA consists of two mechanisms, which are more fully described in Section III below.

The Company filed its annual report of savings/(losses) on August 7, 2001. The Staff granted an extension of the May 31, 2001 filing date, pending the Directors' decision on the Company's petition to include the NORA contract in the Incentive Plan.[1] The following chart summarizes the results of the current period of the Incentive Plan, **as presented in the Company's filing:**

		Year Ended 3/31/01
Total Actual Purchases[2]	$	108,732,299
Total Annual Benchmark[3]	$	110,137,881
Percentage Actual Purchases to Benchmark		98.7%
Total Incentive Savings (Losses) from:		
Gas Procurement	$	1,287,774
Capacity Management		468,864
Total Incentive Savings	$	1,756,638
Incentive Savings(Losses) retained by Ratepayers:		
Gas Procurement	$	643,887
Capacity Management		421,978
Total Incentive Savings to Ratepayers	$	1,065,865
Incentive Savings (Losses) retained by Company:		
Gas Procurement	$	643,887
Capacity Management		46,886
Total Incentive Savings to Company	$	690,773

[1] The matter was considered at the June 12, 2001 Authority Conference. The Order authorizing the inclusion of the NORA contract in the Company's Incentive Plan was issued November 8, 2001 in Docket No. 00-00844.
[2] Includes NORA purchases.
[3] Ibid.

Section IV of this report further describes the actual results of the plan year, including exceptions to the Company's results and the Staff's audit opinion. Section V. describes the Staff's findings in detail.

II. JURISDICTION OF THE TENNESSEE REGULATORY AUTHORITY

Tennessee Code Annotated (hereafter "T.C.A.") gave jurisdiction and control over public utilities to the Tennessee Regulatory Authority. T.C.A. § 65-4-104 states:

> The Authority has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter.

Further, T.C.A. § 65-4-105 grants the same power to the Authority with reference to all public utilities within its jurisdiction as chapters 3 and 5 of Title 65 of the T.C.A. has conferred on the Department of Transportation's oversight of the railroads or the Department of Safety's oversight of transportation companies. By virtue of T.C.A. § 65-3-108, said power includes the right to audit:

> The department is given full power to examine the books and papers of the said companies, and to examine, under oath, the officers, agents, and employees of said companies...to procure the necessary information to intelligently and justly discharge their duties and carry out the provisions of this chapter and chapter 5 of this title.

The Authority's Energy and Water Division is responsible for auditing those companies under the Division's jurisdiction to insure that each company is abiding by the rules and regulations of the TRA. Pat Murphy of the Energy and Water Division conducted this audit.

III. BACKGROUND AND DESCRIPTION OF PERFORMANCE INCENTIVE PLAN

On March 31, 1997, United Cities filed a petition with the Authority, requesting that its experimental Incentive Plan be approved on a permanent basis. After the Consumer Advocate Division intervened, the Authority ordered on May 20, 1997 that a contested case be convened in Docket No. 97-01364. The case was heard in two phases, Phase One on March 26 and 27, 1998 and Phase Two on March 27 and 31, 1998.

The Authority issued its Phase I Order on January 14, 1999 and its Phase II Order on August 16, 1999. The Phase II Order authorized United Cities to continue operating under a modified Incentive Plan. The Incentive Plan automatically rolls over for an additional plan year on each April 1st, beginning April 1, 1999, and continues until the Incentive Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by United Cities to the Authority or (b) modified, amended or terminated by the Authority. The period April 1, 2000 to March 31, 2001 is the second year of the permanent plan and is the subject of this audit.

The Incentive Plan consists of two mechanisms: (1) the Gas Procurement Incentive Mechanism, and (2) the Capacity Management Incentive Mechanism. Under the **Gas Procurement Incentive Mechanism**, United Cities retains 50% of the savings on gas purchased below 97.7% of a pre-determined index. Should the Company purchase gas above 102% of the same pre-determined index, the Company is penalized for 50% of the excess. The computations of savings/(losses) are made on a monthly basis. The lower end of the deadband (the range within which no savings or losses are computed), is to be readjusted at the end of every three-year period based on the most recent audited results. The **Capacity Management Incentive Mechanism** encourages the Company to market off-peak unutilized transportation and storage capacity. The associated savings are shared by the ratepayers and the Company on a 90/10 basis. **Interest** is accrued on the outstanding monthly balance in the Incentive Plan Account using the same computation that is provided for in the Authority's Purchased Gas Adjustment Rule 1220-4-7-.03(vii).[4] The specific details of the Incentive Plan are included in United Cities Performance Based Ratemaking Mechanism Rider, which was issued on March 16, 1999 and was effective on April 1, 1999. A copy of this tariff is attached to the report as **Attachment 1**.

The TRA's Final Order on Phase II also provided that the Company should submit annually to the Authority's Staff the following items:[5]

1. The calculation of the Company's Reserve Margin to ensure that its level of contract demand is prudent.

[4] TRA Final Order on Phase Two, Docket No. 97-01364, August 16, 1999, page 28, paragraph 12. See Attachment 10.

[5] Ibid., page 27, 28, paragraphs 4, 9, and 10

2. Details of the gas supply incentive and rewards program for its non-executive employees who are involved in implementing the incentive plan.
3. Documentation of the Company's compliance with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions.[6]

Staff has determined that United Cities has complied with all three of the above filing requirements:

1. The Company filed its Reserve Margin calculation with its annual filing. Calculations for East Tennessee Natural Gas and Texas Eastern/Columbia Gulf show a 20.5% margin above projected peak day requirements. For Texas Gas, there was no reserve margin as the Company is charged only for capacity actually used. The Company's tariff states that a reserve margin of 7.5% or less will be presumed reasonable.[7] The Staff discusses Reserve Margin in Section V., Finding #6.
2. The Company states that the Incentive and Rewards Program remains the same as that originally submitted to the Authority Staff on June 1, 1999.
3. During the period encompassed in this audit, the Woodward contract in its initial form remained in place. To determine the continued competitiveness of the contract, United Cities issued a Request for Proposal (RFP) on February 7, 2000 to eight major national gas suppliers. Three companies responded with competitive bids. Based on its evaluation of these bids, the Company determined that "the contract price under the Woodward contract is competitive with the prices offered by the other suppliers." Staff agrees with the Company's conclusion. The subject of compliance with affiliate rules regarding the NORA contract was addressed in Docket No. 00-00844.

[6] Attachment 1, TRA No 1, Original Sheet No 45 3, 45.4, and 45.5
[7] Ibid., TRA No. 1, Original Sheet No. 45 5.

IV. ACTUAL PLAN YEAR RESULTS AND AUDIT OPINION

According to the Company's filing, the Incentive Plan generated $1,756,638 in total incentive savings. Of this amount, $1,065,865 benefited the ratepayer and United Cities retained $690,774. Adding the $14,254 in calculated monthly interest due resulted in an unrecovered balance in the account of $705,028. To recover this balance, United Cities implemented a surcharge of $0.00444 per ccf, effective October 1, 2001.

Gas Procurement Incentive Mechanism:

According to the filing, the Company was able to purchase gas at less than the benchmark during all twelve months in the audit period. However, in only two months was United Cities able to participate in the savings generated from the Gas Procurement Incentive Mechanism. This was due to the fact that the total monthly purchases in each of the other months were above the 97.7% lower limit of the deadband (the range within which no savings or penalties are calculated). The Company had no total monthly purchases above the 102% upper limit of the deadband. Total actual purchases for the year averaged 98.7%[8] of the total annual benchmark. Of the $33,350 savings generated, United Cities retained 50% or $16,675. We are in agreement with this portion of the calculation.

The Incentive Plan states that at the end of every three-year period, the lower end of the deadband will be adjusted to 1% below the most recent audited results.[9] The first three-years of the plan ended on March 31, 2002. Therefore, the lower limit of the deadband for the plan year beginning April 1, 2002 is based on the results of this audit. As shown on page 1 of this report, total actual purchases for the year are 98.7% of the total benchmark. Therefore, the **lower limit will remain the same** for the next three-year period, since 1% below 98.7% is **97.7%.**

As part of this mechanism, the Company also reported an additional $1,254,424 in "procurement savings," $201,893 resulting from the NORA contract and $1,052,531 resulting from negotiated transportation contracts. United Cities retained 50% of these alleged savings, for a total of $627,212. We disagree that the calculations presented by the Company represent "savings" under the terms of the Incentive Plan. The Company's incentive plan defines savings/(losses) as those total commodity costs that fall outside the deadband.[10] The deadband is a range surrounding the benchmark, within which no sharing takes place. The benchmark is a calculation based on approved market indexes. Any savings to be shared between the Company and the ratepayer must be below "market," as defined by the plan. Therefore, we are recommending audit adjustments to eliminate these "savings" from the Incentive Plan Account (IPA).[11]

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[8] Including the NORA purchases.

[9] See Attachment 1, TRA No 1, Original Sheet No 45.2.

[10] Ibid

[11] The NORA contract is discussed in Staff Finding #3, page 17. The negotiated transportation contracts are discussed in Staff Finding #2, page 10

Capacity Management Incentive Mechanism:

According to the Company's calculations, the Capacity Management Incentive Mechanism generated a total of $468,864 in savings. Under the terms of the Incentive Plan, United Cities is entitled to retain 10%, or $46,886, of the total savings under this mechanism, and 90%, or $421,978, benefits the ratepayer. During our review, we discovered that total savings were actually $467,130. Therefore, the Company is entitled to retain $46,713. We are recommending an audit adjustment of $173.[12]

Audit Opinion:

The Staff's audit resulted in 6 findings. The net effect is that the Company is **over-collecting $580,742** from the ratepayers. The corrected balance in the Incentive Plan Account as of March 31, 2001 should be **$124,286**. The difference between the Company's filing and the Staff's audit results should be adjusted to the Company's Incentive Plan Account beginning balance in the next plan year, so that the beginning balance agrees to these audit results. See Section V. for details of these findings.

In addition to the findings referenced in the paragraphs above, the Company made other procedural errors in the calculation of its ending balance to be surcharged from the ratepayer.[13] Also, the Company's Reserve Margin calculation shows a reserve percentage significantly above the percentage deemed prudent under the terms of its Incentive Plan tariff.[14]

Based on our review, we conclude that the Company's filing **contains material errors**. As a result, we must report that, for the plan year under review, the Company's calculations **are not in conformance** with the terms of its Incentive Plan. We recommend that United Cities take the following steps to correct its future filings.

1. The Company should immediately correct its beginning balance for April 1, 2001, the beginning of the current plan year, to reflect the Staff's audit adjustments.
2. The Company should revise its calculations for the current plan year to eliminate the alleged savings generated from negotiated transportation contracts and the alleged savings generated from the NORA calculation of avoided transportation costs.
3. The Company should revise its method for calculating interest to be in conformance with its tariff and the PGA Rule.
4. The Company should terminate the customer surcharge implemented on October 1, 2001.
5. The Company should continue the use of 97.7% as the lower limit of the deadband for incentive calculations during the period April 1, 2002 to March 31, 2005.

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12 See Staff Finding #4, page 21.

13 These deficiencies are described in the discussion of Staff Finding #1, page 8

14 Refer to Staff Finding #6, page 23, for a discussion of this finding.

V. IPA AUDIT FINDINGS

As outlined in Section IV. above, the result of the Staff's audit was a **net overrecovery of $580,742**. The Staff corrected balance in the IPA account at March 31, 2001 and the correct amount to surcharge customers is **$124,286**. A summary of the IPA account as filed by the Company and as adjusted by the Staff is shown below, followed by a detail of each finding.[15]

SUMMARY OF THE IPA ACCOUNT:

Incentive Plan Account	Company Filing	Staff Audit Results	Difference **(Findings)**
Beginning Balance at 4/1/00	$ 0	$272,859	$ 272,859
Plus Gas Procurement Savings	643,888	16,675	-627,213
Plus Capacity Release Savings	46,886	46,713	-173
Minus Customer Surcharges	0	237,487	237,487
Plus Interest	14,254	25,526	11,272
Ending Balance at 3/31/01	$705,028	$124,286	$-580,742

SUMMARY OF FINDINGS:

				See page
FINDING #1	Calculation of Ending Balance	$ 35,372	Under-recovery	8
FINDING #2	Gas Procurement Mechanism	-526,265	Over-recovery	10
FINDING #3	Gas Procurement Mechanism	-100,947	Over-recovery	17
FINDING #4	Capacity Release Mechanism	-173	Over-recovery	21
FINDING #5	Interest on Account Balance	11,271	Under-recovery	22
FINDING #6	Reserve Margin	0	No effect	23
	Net Result	**$-580,742**	**Over-recovery**	

[15] See Attachment 3 for Staff's schedule showing the calculation of the corrected ending balance

FINDING #1:

Exception

The Staff discovered methodology errors in the calculation of the ending balance for the IPA account. United Cities included incentive recoveries for months outside the current audit period in its calculations. Also, the Company did not follow its tariff in calculating the monthly balances, including the calculation of interest.

Discussion

The Company's filing for April 1999 through March 2000 (the first year of the Incentive Plan) showed Incentive savings, including interest, of $303,805. Audit adjustments of $30,946 reduced this amount to **$272,859**. There were no recoveries to net with the savings, as this was the first year of the Company's Incentive Plan. The Company began surcharging $0.00191 per ccf on customer bills beginning with the October 2000 billing.

The Company's tariff is very specific as to the method for tracking the Incentive savings and recoveries. The section Determination of Shared Savings[16] states that a separate Incentive Plan Account (IPA) shall be set up to record the monthly savings or losses. The amount collected from or refunded to customers each month will be credited or debited to the IPA as appropriate. Interest will be calculated on the monthly balance using the same method used in the Company's Actual Cost Adjustment (ACA) account.

United Cities did not follow this method to calculate its ending balance at March 31, 2001. The Company submitted three (3) exhibits with the filing showing its calculation of the balance to be surcharged to customers and its calculation of interest due from the customers.[17] Attachment 5 calculated a residual balance at August 2001 of $-1,428 (over-recovery). The schedule begins with the Company's unadjusted balance at March 31, 2000. Collections are then subtracted from this balance monthly from October 2000 through July 2001 to arrive at a residual balance to start the next plan year (April 2000 – March 2001). The period of April 2001 through July 2001 is outside the current period being reported. Therefore, those recoveries should not be part of the current audit period calculations.

Attachment 6 incorporated the results of Attachment 5. The audit adjustment from the last audit is netted with the residual balance calculated on Attachment 5 to arrive at an adjusted beginning balance of $-32,374 at April 1, 2000.[18] This beginning balance is used to calculate the interest due each month. Two things are incorrect on this

16 See Attachment 1, TRA No. 1, Original Sheet No. 45.6

17 The filed exhibits are attached to this report as Attachment 4, Attachment 5, and Attachment 6. Since the entire annual filing was stamped "Confidential" by the Company, Staff notified United Cities that the schedules would be attached as exhibits to the Staff's audit report, as there was no proprietary information on them United Cities made no objection.

18 $-1,428 - $30,946 = $-32,374

schedule One, the beginning balance should not include recoveries The beginning balance should be $272,859[19] Two, the recoveries (surcharges) should be credited to the IPA each month to arrive at an ending balance on which to calculate the interest

Attachment 4 then summarizes the Company's calculation of its ending balance On this schedule, the Company adds the Gas Procurement Savings, the Capacity Management Savings and the interest on monthly balances to arrive at an ending balance of $705,028 That balance is divided by the prior 12-month sales to determine the surcharge rate increment of $0 00444 per ccf This schedule ignores the beginning balance as determined by the Company Based on the Company's method, the beginning balance of $-32,374 should have also been added, thereby reducing the ending balance by this amount

Attachment 2 is a Staff schedule showing the correct method for calculating the beginning balance, the monthly interest, and the ending balance[20] The Staff's audit adjustment for this combination of errors is **a positive $35,372**[21]

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

[19] UCG's balance of $303 805 at March 31, 2000 less the Staff's audit adjustment of $30,946
[20] Note that the Staff is using the Company's reported calculated savings
[21] Staff's Ending Balance with Interest less the Company's reported Ending Balance less the difference due to interest ($764,503 - $705,028 - $24,102 = $35,372)

FINDING #2:

Exception

The Staff calculated an **over-recovery of $526,265** in the Gas Procurement Incentive Mechanism.

Discussion

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[22] negotiated in the contract to the maximum pipeline tariff rates approved by the Federal Energy Regulatory Commission ("FERC").[23]

The Gas Procurement Incentive Mechanism[24] section of the Company's tariff states that it is the savings associated with its commodity cost of gas that is available for sharing. The commodity cost of gas is compared to a "benchmark." If the total monthly commodity cost of gas falls below 97.7% of the benchmark amount, then the resultant savings will be shared 50/50 with the customers. The benchmark is the mathematical product of the actual purchase quantities and the appropriate price index. The appropriate price index is defined in the tariff as follows:

Type of Purchase	**Index**[25]
Monthly Spot Purchase	Simple average of the appropriate *Inside FERC Gas Marketing Report*, *Natural Gas Intelligence*, and *NYMEX* for that particular month.
Swing Purchase	*Gas Daily* rate for the first day of gas flow.
Long-term Purchase	Indexes will be adjusted for the Company's rolling three-year average premium paid to ensure long-term supply availability during peak periods.
City gate purchase	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

22 The Company has broken these costs down into demand, storage deliverability, space, and commodity components.
23 The Company is using the FERC max tariff rates as a benchmark against which to compare its cost.
24 See Attachment 1, TRA No 1, 1st Revised Sheet No. 45.1 and Original Sheet No. 45.2.
25 See Attachment 1, TRA No 1, Original Sheet No 45 2.

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.[26] However, the pipeline purchases that United Cities was able to negotiate lower transportation rates for were not city gate purchases

In addition to calculating transportation "savings" (as discussed above), the Company also calculated the commodity savings associated with the same purchases as per the terms of its tariff As described in Section IV of this report, United Cities' gas purchases fell below the benchmark every month in the period However, in only two months did the total monthly purchases fall below 97 7% of the benchmark, allowing the Company to share in the savings

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 appropriate proxies Without a valid benchmark, savings (if any) cannot be quantified.

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[27] is a copy of the meeting agenda and the summary

[26] This definition of a "city gate" purchase was offered by the Company in a data response
[27] United Cities Exhibits 1 and 2 are filed under confidentuality seal

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 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 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.[27] 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

[27] 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.

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%.

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.

Staff Response

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**.[28] The annual report filings are the ones that are audited and 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.[29]

The Staff's interpretation of the filing requirement is based on the Purchased Gas Adjustment rules.[30] The Company's position that the tariff requires the Staff to audit and

[28] See Attachment 1, TRA No. 1, Original Sheet No 45 6, Filing with the Authority

[29] Extension of the 180 days is allowed by mutual consent of the Staff and the Company. See letters of extension attached as Attachment 7

[30] Final Order on Phase Two (Docket No 97-01364) page 28 (12) states:

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.

Regarding the meeting that took place in January 2001, as United Cities should be aware, the Authority is not bound by anything that is said **or not said** by any person during a meeting between a company and the Authority Staff. This was an informational meeting only.

The Company quotes Footnote 46 from the Phase Two Order defining the "total" cost of gas. The footnote makes it clear that the total cost includes a <u>commodity</u> piece and a <u>transportation</u> piece. It is true that transportation cost is a function of the location of the gas source, but that fact is irrelevant to the discussion of this finding. Transportation costs were simply not considered at the time United Cities' incentive plan was formulated. At the origination of the plan, no one anticipated savings derived by negotiating transportation rates. Therefore, the Authority did not address transportation rates during the Hearings on the Incentive Plan.

The Company further states that all purchasing activities were anticipated by the plan and that the Phase Two Order "recognized that transportation costs must be included as an integral component of the total commodity cost within the PBR mechanism."[31] Upon careful reading of the Order, Staff fails to arrive at the same conclusion. In summary, Staff's position is that transportation costs were irrelevant at the time the Incentive Plan was crafted. These costs are excluded by <u>omission from the plan itself</u>, not arbitrarily excluded by Staff's interpretation of the plan. Staff has been consistent in the administration of the tariff.

The Phase Two Order contemplates evaluating United Cities' performance compared to an external index. Both the incentive plan hearings and the resulting Order stressed the importance of an <u>external benchmark</u> to measure against. A major flaw in the Company's efforts to include alleged transportation savings in the current plan is the lack of an external benchmark. United Cities has suggested the FERC approved maximum tariff rates as a surrogate for market. So called "savings" and "losses" then hinge on actions taken by the FERC, not by United Cities itself. However, the best indicator of "market" is the price agreed upon between a willing buyer and a willing

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"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

[31] Quoted from UCG's response.

seller. In the case of its transportation contracts, this would be the price United Cities and its supplier agreed upon. United Cities has also suggested measuring its performance against United Cities' own past performance. As Staff stated before, including this type of transaction in the plan would require a revision of the plan itself. Based on the information available today, Staff would recommend continued exclusion of transportation negotiated discounts, because there is no "market" test to evaluate the results.

FINDING #3:

Exception

The Staff calculated an **over-recovery of $100,947** in the Gas Procurement Incentive Mechanism.

Discussion

The NORA contract[32] was initially excluded from United Cities' Incentive Plan in Docket No. 97-01364. The primary reason for the exclusion was that it pre-dated the plan and did not require any additional effort by the Company to generate savings. But the Authority's Phase One Order (January 14,1999)[33] stated that if, when the contract was renewed or renegotiated, the Company was still operating under its Incentive Plan, the contract could be considered for inclusion. A new NORA contract was entered into on April 19, 2000, with an effective date of November 1, 2000. On September 26, 2000, United Cities filed a petition with the TRA[34], requesting permission to include the new NORA contract in its Incentive Plan. Since the contract was no longer pre-existing and met the requirements of the Affiliate Rules contained in the Company's Incentive tariff, the Authority approved the Company's request at its June 12, 2001 Conference.

The Company's calculation of the "savings" related to the NORA contract does not conform to the terms of its Incentive Plan. As discussed in Finding #2 above, the Gas Procurement section of the Company's tariff specifies that the commodity cost for each purchase will be compared to the appropriate benchmark for that purchase. Then the **total** commodity cost of all purchases for the month will be compared to **total** benchmark cost. Only the amount of purchases that falls below 97.7% of the benchmark is available for sharing.

The terms of the current NORA contract call for United Cities to pay the appropriate Inside FERC index each month plus a premium for volumes delivered. Through a data request to the Company, Staff has learned that Inside FERC is the commodity price of the NORA gas and the "premium" is the transportation cost for delivery of the gas from the NORA delivery point to the East Tennessee service area.

The Company did not compare the NORA commodity cost with the average of the three indexes[35] for its monthly spot purchases as specified in the tariff. When questioned in a data request, the Company responded that the comparison with the benchmark showed minimal savings and the savings fell within the deadband[36] each month. Therefore, the Company elected to calculate "savings" based on the transportation cost. The calculation is similar to the one for the transportation discounts,

[32] The NORA contract covers gas supply from the East Tennessee-NORA Gas Pipeline
[33] Page 27 and 29.
[34] Docket No 00-00844. The Company's petition is attached as Attachment 8.
[35] See Chart located in the discussion of Finding #2
[36] The range of 97 7% to 102% of the benchmark, within which no sharing takes place.

addressed in Finding #2. The premium was compared to the maximum tariff rates allowed by FERC. Then 97.7% of the difference was deemed "savings" by the Company to be shared 50/50 with the customer. This type of calculation is not covered under the current Incentive Plan tariff. Additionally, the Company separated out this calculation from the other calculations, so that it led to shared "savings" each month. The tariff is clear that the "total" commodity costs for the month must fall outside the deadband before sharing of savings or losses will occur.

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. 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.

Staff Response

The Company puts forth four (4) arguments to support its calculations of NORA "savings." The first argument is its response to Finding #2 in regard to avoided transportation costs. Refer to Staff's response in Finding #2.

The second argument is that NORA gas is a "citygate" purchase. As such, Staff's Table (found in the discussion of Finding #2) points out that the indexes for citygate purchases "will be adjusted for avoided transportation costs that would have been paid if the upstream capacity were purchased versus the demand charges actually paid to the supplier." In a Staff data request, we asked the Company two questions concerning NORA purchases. One, why the NORA "savings" were calculated separately from the other commodity purchases for the month. Two, provide an explanation of the NORA calculation of "savings" in terms of its tariff. In its response, United Cities stated that, when compared to the "benchmark price" (the simple average of Inside FERC, NGI, and NYMEX), the difference was minimal and within the deadband each month. "Therefore, having no impact on the lower limit of the commodity deadband each month, the separated reporting of Nora seems more straightforward."[37] In other words, the Company was not able to produce savings using the calculation provided for in the tariff. The Company then calculated "savings" from avoided transportation costs, using FERC tariff rates as a benchmark.

The Company states that "Staff has failed to adjust the commodity portion for the avoided transportation cost when comparing to the indices benchmark." We take exception to this attempted transfer of responsibility. We asked the Company on more than one occasion to supply us with its calculation of NORA savings under the terms of the plan, adjusting the indexes for the avoided transportation cost (if appropriate). The final request was made in writing.[38] The Company failed to respond to these requests. Therefore, we must conclude that either (1) the adjustment to indexes was inappropriate, or (2) the adjustment produced no "savings" for the Company under this scenario.

The third argument is that the "avoided transportation" calculation was attached as an exhibit to United Cities' petition to include the new NORA contract in the incentive plan. United Cities, in its petition, requested "permission to include the new contract covering the NORA/East Tennessee Gas Pipeline supplies in its PBR plan."[39] In its November 8, 2001 Order in Docket No. 00-00844, the Authority granted the Company's request. UCG is arguing that when it approved the petition, the TRA approved the

[37] Quoted from the Company's response, dated January 21, 2002.

[38] See copy of email request, attached as Attachment 9

[39] Company petition (received September 26, 2000, in Docket No 00-00844), page 4 and 5. See Attachment 8

calculation in their attachment, even though this calculation is inconsistent with the relief sought in the petition and with the Order. Staff disagrees with this position.

The fourth argument is that the Authority Staff did not provide a written notification to the Company of exceptions to the quarterly reports. Refer to our response to this argument in Finding #2.

Staff raised another point in its discussion of this finding that the Company did not respond to. "Gains and losses under the plan will be calculated on a monthly basis rather than on a transaction basis."[40] This is additional evidence that the Authority did not contemplate a separate avoided transportation cost calculation in its deliberation of the Company's incentive plan. Side calculations, such as the ones made for NORA purchases, cannot be combined with the commodity calculations for other purchases to arrive at a total gain or loss for the month. The Company has already admitted in a data response that including NORA in the total commodity calculation did not produce savings for the month. The only way the Company could calculate "savings" under the NORA contract was to separate out the calculation and take its share of the alleged savings on a "transaction by transaction" basis. This is a direct violation of its tariff.

[40] Final Order on Phase Two, Docket No. 97-01364, page 7 (12). See Attachment 10

FINDING #4:

Exception

The Staff calculated an **over-recovery of $173** in the Capacity Release Incentive Mechanism.

Discussion

Following the filing of the annual IPA report, the Company submitted a corrected schedule for the calculation of Capacity Release savings. The corrected schedule contained minor changes due either to corrected invoices or a deviation from the 69.5% Tennessee/Virginia ratio. The total difference was $1,734 in capacity release savings. United Cities share was $173.

Company Response

Company agrees with this finding.

FINDING #5:

Exception

The Staff calculated an **under-recovery of $11,271** in the interest calculation.

Discussion

The Staff recalculated the interest on account balance based on the above findings, resulting in an under-recovery. See Attachment 3.

Company Response

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

FINDING #6:

Exception

The Company's Reserve Margin calculation showed a reserve of 20.5% for this audit period.

Discussion

Reserve margin is a reserve of natural gas in excess of a Company's projected peak day requirement. A Company is allowed a reasonable level of reserve, and can recover the cost of this reserve supply from ratepayers through the PGA mechanism. United Cities' Incentive tariff defines what its reasonable level is in the section entitled Reserve Margin.[41] As a matter of prudence, the reasonable level of reserve margin for United Cities is 7.5% or less. For the 2000-2001 period, the Company reports that its reserve margin is 20.5%, significantly higher than the presumed level of reasonableness stated in the tariff.

In order for United Cities to recover these excess gas costs from the ratepayers through the PGA, it must show that they are necessary to meet customer requirements. With this in mind, Staff requested additional information from the Company to substantiate the need for this level of reserve. After several discussions with Gas Supply personnel, we are satisfied that the excess reserve is short term and is reasonable considering the options available to the Company at the time purchasing decisions were made. The Company had a window of opportunity to transfer transportation contract demand from a higher cost pipeline to a lower cost pipeline. Contracts with the higher cost pipeline would be expiring November 2001. However, the new contract with the lower cost pipeline began November 2000, leading to a temporary overlap of capacity. The Company states that the opportunity would have been lost had they waited until the current contracts expired before negotiating the new contracts. The long term lower cost associated with the new contracts should offset the extra cost of a temporary duplication of supply, and the benefits should continue into the foreseeable future, providing considerable ongoing lower gas costs.

It became apparent to Staff during this audit that the Company is selectively choosing what to include in its Incentive Plan. United Cities included transportation cost savings, which are outside the plan, but did not include excess gas costs above the presumed reasonable level as losses to be shared. These excess gas costs were flowed through the PGA for 100% recovery.

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

[41] See Attachment 1, TRA No 1, Original Sheet No. 45.5 and 45 6.

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. **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:**
>
> > 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.

Staff Response

Staff stands by the statements made in the last paragraph of the discussion To clarify the point Staff is making, Staff agrees that the Company was correct in not including the excess costs as losses within the plan The Company was able to support its decisions to the Staff's satisfaction Neither the excess gas costs <u>nor</u> the transportation discount calculations should be in the plan Staff is being consistent in its administration of the tariff

ATTACHMENT 1

UNITED CITIES GAS COMPANY, A DIVISION OF
ATMOS ENERGY CORPORATION

T. \. No. 1
1st Revised Sheet No. 45.1
Cancelling Original Sheet No. 45.1

PERFORMANCE BASED RATEMAKING MECHANISM RIDER

Applicability

The Performance-Based Ratemaking Mechanism (the PBRM) replaces the reasonableness or prudence review of the Company's gas purchasing activities overseen by the Tennessee Regulatory Authority (the Authority) in accordance with Rule 1220-4-7-.05, Audit of Prudence of Gas Purchases. This PBRM 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 costs between the utility's customers and shareholders. Each plan year will begin April 1. The annual provisions and filings herein will apply to this annual period. The PBRM will continue until it is either (a) terminated at the end of a plan year by not less than 90 days notice by the Company to the Authority or (b) modified, amended or terminated by the Authority.

Overview of Structure

The Performance-Based Ratemaking Mechanism consists of two parts:

Gas Procurement Incentive Mechanism
Capacity Management Incentive Mechanism

The Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which the Company's commodity cost of gas is compared. It also addresses the use of financial instruments or private contracts in managing gas costs. The net incentive savings or costs will be shared between the Company's customers and the Company on a 50% / 50% basis.

The Capacity Management Incentive Mechanism is designed to encourage the Company to actively market off-peak unutilized transportation and storage capacity on upstream pipelines in the secondary market. The net incentive benefits will be shared between the Company's customers and the Company on a 90% / 10% basis.

The Company is subject to a cap on overall incentive savings or costs on both mechanisms of $1.25 million annually.

Gas Procurement Incentive Mechanism

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, by the appropriate price index. For monthly spot

Issued by: Thomas R. Blose, Jr. President
Date Issued: March 16, 1999

Effective Date: April 1, 1999

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.

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

Financial Instruments or Other Private Contracts:

To the extent the Company uses futures contracts, financial derivative products, storage swap arrangements, or other private agreements to hedge, manage or reduce gas costs, any savings or costs will flow through the commodity cost component of the Gas Procurement Incentive Mechanism.

Capacity Management Incentive Mechanism

To the extent the Company is able to release daily transportation or daily storage capacity, the associated savings will be shared by the Company's customers and the Company on a 90/10 basis. The sharing percentages shall be determined based on the actual demand costs incurred by the Company (exclusive of credits for capacity release) for transportation and storage capacity during the plan year, as such costs may be adjusted due to refunds or surcharges from pipeline and storage suppliers. Any incentive savings or costs resulting from adjustments to the sharing percentages caused by refunds or surcharges shall be recorded in the current Incentive Plan Account (IPA).

Affiliate Transactions

The following guidelines present the minimum conditions deemed necessary to ensure that affiliate transactions between the Company and its affiliate(s) do not result in a competitive advantage over others providing similar services. These guidelines will remain in effect as long as the Company is operating under a performance based ratemaking plan. We note that these guidelines may fail to anticipate certain specific methods by which such advantages may be conferred by the Company on its marketing affiliates. All parties should be aware that to the extent such instances arise in the future, they will be judged according to this stated intent.

Definitions:

Terms used in these guidelines have the following meanings:

1. Affiliate, when used in reference to any person in this standard, means another person who controls, is controlled by, or is under common control with, the first person.

2. Control (including the terms "controlling", "controlled by", and "under common control with"), as used in this standard, includes, but is not limited to, the possession, directly or indirectly and whether acting alone or in conjunction with others, of the authority to direct or cause the direction of the management or policies of a company. Under all circumstances, beneficial ownership of more than ten percent (10%) of voting securities or partnership interest of an entity shall be deemed to confer control for purposes of these guidelines of conduct.

3. Marketing, as used in this standard, means selling or brokering natural gas to any person or entity, including the Company, by a seller that is not a local distribution company.

Standards of Conduct:

The Company must conduct its business to conform to the following standards:

1. If there is discretion in the application of tariff provisions, then the Company must apply such provisions relating to any service being offered in a consistent manner to all similarly situated entities.

2. The Company must strictly enforce a tariff provision for which there is no discretion in the application of the provision.

3. The Company must process all similar requests for services in the same manner and within the same period of time.

4. The Company may not give its marketing affiliate preference over nonaffiliated companies in natural gas supply procurement activities.

5. The Company may not give its marketing affiliate preference over nonaffiliated companies in its upstream capacity release activities.

6. The Company may not disclose to its marketing affiliate any information that the local distribution company receives from a non-affiliated marketer, unless the prior written consent of the parties to which the information relates has been voluntarily given.

7. To the extent the Company provides information related to its natural gas supply activities and upstream capacity release activities, it must do so contemporaneously to all nonaffiliated marketers, that have submitted a written request for such information to the Company.

8. To the extent the Company provides information related to natural gas services being offered to a marketing affiliate, it must do so contemporaneously to all non-affiliated marketers, that have submitted a written request for such information to the Company.

9. In transactions that involve either the purchase or receipt of information, assets, goods or services by the Company from an affiliated entity, the Company shall document both the fair market price of such information, assets, goods, and services and the fully distributed cost to the Company to produce the information, assets, goods or services for itself.

10. When the Company purchases information, assets, goods or services from an affiliated entity, the Company shall either obtain competitive bids for such information, assets, goods or services or demonstrate why competitive bids were neither necessary nor appropriate.

11. To the maximum extent practicable, the Company's operating employees and the operating employees of its marketing affiliate must function independently of each other. For the purposes of these guidelines, operating employees are those who are in any way involved in identifying and contracting with customers, locating gas supplies, making any and all arrangements with intervening pipelines and in any way managing or facilitating those contracted services.

12. The Company must maintain its books of accounts and records separately from those of its affiliate.

13. If the Company offers a discount to an affiliated marketer, it must make a comparable offer contemporaneously available to all similarly situated non-affiliated marketers.

14. The Company may not condition or tie its agreement to release its dedicated, stored, inventoried or optioned gas or supply contracts or upstream transportation and storage contracts to an agreement with a producer, customer, end-user or shipper relating to any service by its marketing affiliate, any services offered by the Company on behalf of its marketing affiliate, or any services in which its marketing affiliate is involved.

15. Prearranged, non-posted, capacity release transactions may not be entered into with any affiliate of the Company in any two consecutive thirty-day periods.

16. The Company must maintain a written log of tariff provision waivers which it grants. It must provide the log to any person requesting it within 24 hours of request. Any waivers must be granted in the same manner to the same or similar situated persons.

17. The Company shall maintain sufficiently detailed records that compliance with these guidelines can be verified at any time.

Complaints:

Any party may file a complaint relating to violations of these guidelines.

1. Any customer, marketer, or other interested third-party may file a complaint with the Authority relating to alleged violations of the affiliate standards set forth in these guidelines. At or before the time of filing, the complainant shall serve a copy of the complaint on the Company.

2. Within ten (10) days of service of the complaint upon the Company, the Company shall file a written response to the complaint with the Authority.

3. The Authority may hold hearings on any complaint filed or may take such other action (as it may deem appropriate), including requesting further information from the parties or dismissing the complaint.

4. After notice and opportunity for a hearing, should the Authority find that the Company has violated the standards contained in these guidelines, the Authority may impose any penalty or remedy provided for by law.

Reserve Margin

The Company may maintain a reserve of natural gas in excess of its projected peak day requirement and recover the cost of the reserve from their customers through the purchased gas adjustment (PGA). The projected peak day requirement shall be based upon a five-year recurrence interval or the coldest day expected in a five-year period. All firm peak day capacity contracted for by the Company, excluding the daily delivery capacity of liquefied natural gas and propane storage facilities, shall be considered as gas available to meet peak day demand. "Contract demand" shall be the amount of firm peak day capacity the Company is entitled to on a daily basis, pursuant to contract. The maximum peak day firm demand of the projected heating season shall form the base period demand to establish the Company's maximum peak day firm demand. A reserve margin of 7 5% or less in excess of the base period firm demand adjusted for specific gain or loss of customers and/or throughput on a specific case by case basis will be presumed reasonable.

UNITED CITIES GAS COMPANY, A DIVISION OF
ATMOS ENERGY CORPORATION

All capacity available to meet the peak day demand in excess of an amount needed to meet the base period peak day demand plus a 7.5% reserve margin must be shown by the Company to be necessary to meet its customers' requirements before it can be included in the PGA. All capacity available to meet demand less than an amount of base period demand plus a 7.5% reserve margin is presumed to be reasonable unless a factual showing to the contrary is made.

Determination of Shared Savings

Each month during the term of the PBRM, the Company will compute any savings or costs in accordance with the PBRM. If the Company earns any savings, a separate below the line Incentive Plan Account (IPA) will be debited with such savings. If the Company incurs any costs, that same IPA will be credited with such costs. During a plan year, the Company will be limited to overall savings or costs totaling $1.25 million. Interest shall be computed on balances in the IPA using the same interest rate and methods as used in the Company's Actual Cost Adjustment (ACA) account. The offsetting entries to IPA savings or costs will be recorded to income or expense, as appropriate.

Savings or costs accruing to the Company under the PBRM will form the basis for a rate increment or decrement to be filed and placed into effect separate from any other rate adjustments to recover or refund such amount over a prospective twelve-month period.

Each year, effective October 1, the rates for all sales customers will be increased or decreased by a separate rate increment or decrement designed to amortize the collection or refund of the March 31 IPA balance over the succeeding twelve month period. The rate increment or decrement will be established by dividing the March 31 IPA balance by the appropriate sales billing determinants for the twelve months ended March 31. During the twelve-month amortization period, the amount collected or refunded each month will be computed by multiplying the sales billing determinants for such month by the rate increment or decrement, as applicable. The product will be credited or debited to the IPA, as appropriate. The balance in the IPA will be tracked as a separate collection mechanism. Each October 1 the unamortized amount of the previous year's IPA balance will be trued-up in the new rate increment or decrement.

Filing with the Authority

The Company will file calculations of shared savings and shared costs quarterly with the Authority not later than 60 days after the end of the quarter and will file an annual report not later than 60 days following the end of each plan year. Unless the Authority provides written notification to the Company within 180 days of such reports, the Incentive Plan Account shall be deemed in compliance with the provisions of this Rider. The Company will file calculations annually to verify the reasonableness of its reserve margin.

Incentive and Rewards Program

The Company will have in place an incentive and rewards program for selected Gas Supply non-executive employees involved in the implementation of the Company's PBRM in a manner consistent with the benefits achieved for customers and shareholders through improvements in gas procurement and secondary marketing activities. Participants in the program will receive incentive compensation as recognition for their contribution to the customers and shareholders of the Company through lower gas costs and savings related thereto.

During the time this tariff is in effect, the Company will continue to have in place a gas supply Incentive and Rewards Program, the details of which will be provided to the Authority on an annual basis within 60 days of the beginning of each plan year. Unless the Company is advised within 60 days, said details will become effective. No filing for prior approval is required for changes in the performance measures.

ATTACHMENT 2

Interest Calculation: STAFF 1/

Month	Beginning Balance 3/	Gas Procurement	Capacity Management	Surcharged 2/	Ending Balance	Interest Rate	Interest	Ending Balance With Interest
Apr-00	272,859	10,242	5,205	-	288,306	8.58%	2,006	290,312
May-00	290,312	8,919	5,622	-	304,852	8.58%	2,128	306,980
Jun-00	306,980	1,206	5,194	-	313,380	8.58%	2,218	315,598
Jul-00	315,598	1,237	8,447	-	325,281	9.02%	2,409	327,690
Aug-00	327,690	1,245	7,903	-	336,838	9.02%	2,498	339,335
Sep-00	339,335	1,196	4,934	-	345,466	9.02%	2,574	348,039
Oct-00	348,039	1,208	5,133	16,000	338,380	9.50%	2,717	341,097
Nov-00	341,097	116,518	1,104	25,337	433,382	9.50%	3,066	436,448
Dec-00	436,448	126,174	1,983	49,425	515,180	9.50%	3,767	518,947
Jan-01	518,947	131,410	448	66,107	584,698	9.50%	4,369	589,067
Feb-01	589,067	122,202	429	48,336	663,361	9.50%	4,958	668,319
Mar-01	668,319	122,332	485	32,283	758,853	9.50%	5,649	**764,503** 4/
		643,888	46,886	237,487		Staff Interest	38,356	
						Company Reported Interest	14,254	
						Difference	24,102	Under-recovery

1/ Interest calculation using Company's reported savings, but correcting the beginning balance and incorporating surcharges into interest calculation
2/ Company began surcharge of first year's savings in October 2000
3/ Beginning balance for April includes Staff's adjustments from last audit
4/ Amount associated with Finding #1 is calculated as follows

764,503	Staff Ending Balance
(705,028)	Company Ending Balance
(24,102)	Difference due to Interest
35,373	Finding

ATTACHMENT 3

Interest Calculation: STAFF CORRECTED 1/

Month	Beginning Balance 3/	Gas Procurement	Capacity Management	Surcharged 2/	Ending Balance	Interest Rate	Interest	Ending Balance With Interest
Apr-00	272,859	8,996	5,409	-	287,264	8.58%	2,002	289,267
May-00	289,267	7,679	6,470	-	303,416	8.58%	2,119	305,534
Jun-00	305,534	-	5,336	-	310,870	8.58%	2,204	313,074
Jul-00	313,074	-	8,447	-	321,521	9.02%	2,385	323,906
Aug-00	323,906	-	7,903	-	331,808	9.02%	2,464	334,273
Sep-00	334,273	-	4,934	-	339,207	9.02%	2,531	341,738
Oct-00	341,738	-	5,132	16,000	330,871	9.50%	2,662	333,533
Nov-00	333,533	-	351	25,337	308,547	9.50%	2,542	311,089
Dec-00	311,089	-	1,191	49,425	262,855	9.50%	2,272	265,127
Jan-01	265,127	-	470	66,107	199,490	9.50%	1,839	201,329
Feb-01	201,329	-	517	48,336	153,510	9.50%	1,405	154,915
Mar-01	154,915	-	553	32,283	123,185	9.50%	1,101	**124,286** 4/
		16,675	46,713	237,487		Staff Interest	25,526	
						Company Reported Interest	14,254	
						Difference	11,271	Under-recovery

1/ Interest calculation using Staff's corrected savings and Beginning Balance
2/ Company began surcharge of first year's savings in October 2000
3/ Beginning balance for April includes Staff's adjustments from last audit
4/ Correct Ending Balance including interest

ATTACHMENT "

CALCULATION OF PBR RATE INCREMENT OR DECREMENT
FOR THE PERIOD APRIL 1, 2000 TO MARCH 31, 2001

GAS PROCUREMENT SAVINGS DUE COMPANY		$643,887 50
CAPACITY MANAGEMENT SAVINGS DUE COMPANY		$46,886 40
INTEREST ON MONTHLY BALANCES		$14,254 49

TOTAL SAVINGS DUE COMPANY		$705,028 39
SALES FOR ALL TENNESSEE TOWNS ** (APRIL 1999 - MARCH 2000)		158,705,444 ccf
RATE INCREMENT EFFECTIVE OCTOBER 1, 2001	$	0.00444 /ccf

** Note UCG would like to use sales for 1999-2000 to avoid the high sales from winter 2000-01 We believe these sales are more realistic

CONFIDENTIAL

ATTACHMENT 5

CONFIDENTIA

UNITED CITIES GAS COMPANY
CALCULATION OF PBR COLLECTIONS
OCTOBER 1, 2000 TO OCTOBER 1, 2001

MONTH	CCF SALES	AMOUNT COLLECTED @ $.00191	BALANCE TO BE COLLECTED
Balance to be Collected			$303,804.89
Oct-00	8,376,847	$15,999.78	$287,805.11
Nov-00	13,265,479	$25,337.06	$262,468.05
Dec-00	25,876,893	$49,424.87	$213,043 18
Jan-01	34,610,893	$66,106.81	$146,936.37
Feb-01	25,306,595	$48,335 60	$98,600 77
Mar-01	16,901,915	$32,282.66	$66,318 11
Apr-01	17,523,644	$33,470.16	$32,847.95
May-01	6,712,344	$12,820.58	$20,027.37
June-01 final	5,970,474	$11,403.61	$8,623.76
July-01 preliminary	5,262,545	$10,051.46	($1,427.70)
		$0.00	($1,427.70)
		$0.00	($1,427.70)
Previously Filed			$0.00
Residual Balance			($1,427.70)

UNITED CITIES GAS COMPANY
CALCULATION OF **PBR** INTEREST
ALL TENNESSEE TOWNS

BEGINNING BALANCE AUGUST 2001	($1,427 70)
1999-2000 AUDIT FINDINGS	($30,946 00)
ADJUSTED BEGINNING BALANCE	($32,373 70)

	BEGINNING BALANCE	GAS PROCUREMENT SAVINGS OR COSTS	CAPACITY MANAGEMENT SAVINGS OR COSTS	ENDING BALANCE	INTEREST
Apr-00	($32,373 70)	$10,242 00	$5,204 70	($16,927 00)	($176 25)
May-00	($17,103 25)	$8,919 00	$5,621 50	($2,562.75)	($70 31)
Jun-00	($2,633 06)	$1,206 00	$5,194 20	$3,767 14	$4 05
Jul-00	$3,771 20	$1,236 50	$8,446 80	$13,454 50	$64 74
Aug-00	$13,519 24	$1,245 00	$7,902.80	$22,667 04	$136 00
Sep-00	$22,803 04	$1,196 00	$4,934 30	$28,933 34	$194 44
Oct-00	$29,127 78	$1,208 00	$5,132 50	$35,468 28	$255 69
Nov-00	$35,723 97	$116,518 00	$1,104 20	$153,346 17	$748 40
Dec-00	$154,094 58	$126,173.50	$1,983 40	$282,251.48	$1,727 20
Jan-01	$283,978 68	$131,410 00	$448 20	$415,836 88	$2,770.10
Feb-01	$418,606.98	$122,201 50	$428 80	$541,237 28	$3,799 38
Mar-01	$545,036 67	$122,332.00	$485 00	$667,853 67	$4,801 02
TOTAL		$643,887 50	$46,886 40		$14,254 49

ATTACHMENT 6

CONFIDENTIAL

ATTACHMENT 7

RECEIVED
TN REG. AUTHORITY

JAN 2 5 2002

ENERGY & WATER DIVISION

United Cities Gas Company

Patrica J Childers
Vice President-Rates & Regulatory Affairs

January 22, 2002

Mr. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

Dear Mr. Waddell:

Docket No. 01-00704

United Cities Gas Company received a data request from the Staff in the above referenced Docket on December 20, 2001. The holidays created a delay in the Company's response. We filed our responses January 21, 2002 but realize the delay may necessitate more time for the staff to review our responses and issue their audit report by the deadline of February 7th. We respectfully request an extension to March 12th.

If you have any questions please contact me at 6150771-8332.

Very truly yours,

Pat Childers

Patricia J. Childers

Cc: Pat Murphy
Timothy C. Phillips
Joe A. Conner

TENNESSEE REGULATORY AUTHORITY

Sara Kyle, Chairman
Lynn Greer, Director
Melvin Malone, Director

460 James Robertson Parkway
Nashville Tennessee 37243-0505

February 28, 2002

Ms Patricia J Childers
VP – Regulatory Affairs
United Cities Gas Company
810 Crescent Centre Dr , Suite 600
Franklin, TN 37067-6226

RE United Cities Gas Company Incentive Plan Account (IPA) Audit
Docket No 01-00704

Dear Pat

Pursuant to our conversation at the February 20 meeting, I am requesting an additional extension for completion of the Staff's audit of United Cities' Incentive Plan filing The PGA Rule provides for an extension of the 180-day notification by mutual consent of both the Company and the TRA Staff As we discussed, United Cities is gathering additional information for the Staff's consideration In order to allow sufficient time for the Company to submit additional information and the Staff to review that information, I recommend an extension date of April 23, 2002, which is the second Director's Conference in April

If you have any questions or concerns regarding this request, please contact me at extension 178

Sincerely,

Pat Murphy

Pat Murphy
Senior Financial Analyst
Energy and Water Division

Cc Dan McCormac
David Waddell

Pm02-12

ATTACHMENT 8

RECEIVED
TN REG. AUTHORITY

SEP 2 7 2000

ENERGY & WATER DIVISION

BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

'00 SEP 28 PM 4 11

In Re. Petition of United Cities Gas Company Regarding Affiliated Transaction and Request for Permission to Include New Agreement Covering East Tennessee-NORA Delivery Point	))))	Docket No 00-00844

UNITED CITIES GAS COMPANY'S PETITION REGARDING AFFILIATED TRANSACTION AND REQUEST FOR PERMISSION TO INCLUDE NEW AGREEMENT COVERING EAST TENNESSEE-NORA DELIVERY POINT

COMES NOW United Cities Gas Company, a division of Atmos Energy Corporation (United Cities) and in accordance with the provisions contained in the Tennessee Regulatory Authority's (Authority) Final Order Phase One issued on January 14, 1999 and On Phase Two issued on August 16, 1999, in the above captioned matter (hereinafter referred to as the "Authority's Orders"), and in accordance with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, which are attached to the Authority's Orders, and which are attached to an Order issued by the Authority dated December 3, 1999, in this matter, files this Petition with the Authority.

A. COMPLIANCE FILING REGARDING AFFILIATED TRANSACTIONS

1. The Authority's Order issued on August 16, 1999, in this matter contains the following provision

> Prior to any affiliate transactions being included in the computation of savings or losses from this performance-based ratemaking mechanism,

THIS PETITION CONTAINS CONFIDENTIAL AND COMPETITIVELY SENSITIVE INFORMATION THAT UNITED CITIES GAS COMPANY REQUESTS THAT THE AUTHORITY KEEP CONFIDENTIAL

> said affiliate transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions. Documentation of compliance is to be presented by the Company to the Authority during the TRA's annual audit of the Incentive Plan Account. The Authority, at the conclusion of each annual audit, will make a determination of the Company's compliance with all of the affiliate guidelines;

Authority's Order, page 27.

2. The Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions include the following guideline:

> 10. When the Company purchases information, assets, goods or services from an affiliated entity, the Company shall either obtain competitive bids for such information, assets, goods or services or demonstrate why competitive bids were neither necessary nor appropriate.

Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, paragraph 10, page 2.

3. The order issued by the Authority in this matter on December 3, 1999, which made a determination of United Cities' compliance with affiliated guidelines for year one of the Company's permanent PBR plan (April 1, 1999-March 31, 2000), contained the following requirement:

> 4. On a going-forward basis, Standard of Conduct No 10 will be in effect and United Cities must provide proof of competitive bids before a contract with an affiliate will be included in the PBR computation.

Order Re: Determination Of Compliance With Affiliate Guidelines, Docket No. 97-01364, dated December 3, 1999, page 8.

4. United Cities' current gas supply agreement covering requirements for its NORA/Dickerson #1 Delivery Point on the NORA/East Tennessee Natural Gas Pipeline expires October 31, 2000. In order to replace the gas supplies under the expiring contract, United Cities has

requested competitive bids from the two suppliers which currently hold capacity on the NORA/East Tennessee Natural Gas Pipeline system. The request for bids was made, in part, so United Cities could comply with the Authorities Guidelines on Affiliate Transactions. One of the two suppliers holding capacity on the NORA/East Tennessee Natural Gas Pipeline is Woodward Marketing L.L.C. (Woodward), an affiliate of United Cities.

5 Beginning in the fall of last year, United Cities made its request for competitive bids to the two companies currently holding pipeline capacity on the NORA/East Tennessee Pipeline: Equitable Energy and Woodward Marketing, LLC.

6. In response to its request for competitive bids, United Cities received responses from both suppliers. A copy of each of the responses is attached to this compliance filing as Exhibit A, and is incorporated herein by reference. The responses are being submitted to the Authority under seal, and United Cities would request that the Authority treat these documents as containing highly confidential and competitively sensitive information.

7. Upon receipt of the two competitive bids, United Cities' Gas Supply Planning employees submitted their evaluation and analysis of the bids to the management of United Cities. A summary of that evaluation is attached to this compliance filing as Exhibit B, and is incorporated herein by reference. Because United Cities' summary of its evaluation of the bids contains the highly confidential and competitively sensitive information contained in the bids received by United Cities, this information is being submitted under seal. United Cities would request that the Authority treat the information contained in Exhibit B as confidential.

8. Based upon its evaluation of the bids received from the two gas suppliers, United Cities' management has determined that the contract price under the proposal submitted by Woodward

is the most competitive. A copy of the contract with Woodward is attached hereto as Exhibit C. United Cities would request that the Authority treat the information contained in Exhibit C as confidential.

9. United Cities' respectfully submits that the information being provided in this compliance filing clearly demonstrates that the affiliated transaction with Woodward complies with the above mentioned guidelines and requirements established by the Authority in this docket and that the new Woodward contract should be included in the PBR computation for the period.

B. REQUEST FOR PERMISSION TO INCLUDE NEW AGREEMENT COVERING EAST TENNESSEE/NORA DELIVERY POINT

10. The Authority's Order issued on January 14, 1999 in this matter contains the following provision:

> After considering the testimony given during the Phase One hearing, the Authority concludes that (1) NORA contract existed prior to the PBR mechanism, and (2) it required no change in purchasing behavior by the Company. The NORA contract was not negotiated in response to the incentive mechanism, but acted as a catalyst to hasten the benefits derived therefrom. Including it in the incentive mechanism would "guarantee" a bonus to the Company. Thus, the Authority concludes that the NORA contract is to be excluded from United Cities' incentive mechanism after the first year of the plan. **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 the time.**

Order, Re: Final Order on Phase One, Docket No. 97-01364, dated January 14, 1999, page 27 (Emphasis added).

11. The current NORA contract expires on October 31, 2000. United Cities has obtained a new gas supply under a new agreement on the NORA/East Tennessee Gas Pipeline. 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.

WHEREFORE, for the reasons set forth herein, United Cities Gas Company respectfully requests that its petition be granted.

Respectfully submitted,

James G Flaherty, Kansas Supreme Court No. 11177
ANDERSON, BYRD, RICHESON, FLAHERTY & HENRICHS
216 S. Hickory, P. O. Box 17
Ottawa, Kansas 66067
(785) 242-1234

Mr. Mark G. Thessin, Tennessee Bar No. 13662
UNITED CITIES GAS COMPANY
800 Crescent Centre Drive, Suite 600
Franklin, Tennessee 37067
(615) 771-8330

Attorneys for United Cities Gas Company, a division of Atmos Energy Corporation

CERTIFICATE OF SERVICE

I hereby certify that a copy of the above and foregoing was mailed, postage prepaid, this 21st day of September, 2000, addressed to:

Mr. L. Vincent Williams
Mr. Vance Broemel
Consumer Advocate Division
426 5th Avenue North, 2nd Floor
Nashville, Tennessee 37243

Mr. Richard Collier
Tennessee Regulatory Authority
Legal Division
460 James Robertson Parkway
Nashville, Tennessee 37243

James G. Flaherty

THIS PETITION CONTAINS CONFIDENTIAL AND COMPETITIVELY SENSITIVE INFORMATION THAT UNITED CITIES GAS COMPANY REQUESTS THAT THE AUTHORITY KEEP CONFIDENTIAL

VERIFICATION

STATE OF KANSAS)
)ss:
FRANKLIN COUNTY)

James G. Flaherty, of lawful age, being first duly sworn on oath, states:

That he is an attorney for United Cities Gas Company, a division of Atmos Energy Corporation; that he has read the above and foregoing UNITED CITIES GAS COMPANY'S PETITION REGARDING AFFILIATED TRANSACTION AND REQUEST FOR PERMISSION TO INCLUDE NEW AGREEMENT COVERING EAST TENNESSEE-NORA DELIVERY POINT, knows the contents thereof; and that the statements contained therein are true.

James G. Flaherty

SUBSCRIBED AND SWORN to before me this 21st day of September, 2000.

NOTARY PUBLIC – State of Kansas
RONDA ROSSMAN
My Appt. Expires 5/25/2002

Ronda Rossman
Notary Public

My Commission Expires:

THIS PETITION CONTAINS CONFIDENTIAL AND COMPETITIVELY SENSITIVE INFORMATION THAT UNITED CITIES GAS COMPANY REQUESTS THAT THE AUTHORITY KEEP CONFIDENTIAL

ATTACHMENT a

Pat Murphy - Audit extension

From: Pat Murphy
To: Int patricia childers@unitedcitiesgas com
Date: 02/28/2002 12 13 PM
Subject: Audit extension

Pat,

Attached is my letter requesting an extension of the audit deadline from March 12 to April 23 Director's Conference The original is being mailed today

To meet the above revised deadline, the report will need to be released by April 8 In order to give you at least a week to respond to any audit findings, the draft report will need to be completed by March 28 (Friday the 29th is a state holiday) Considering I will be in Richmond for the NARUC subcommittee meetings March 18 thru March 21, I need to receive any additional information or calculations you wish to submit for our consideration as soon as possible I am especially interested in seeing the NORA purchases savings (if any) calculated according the tariff, comparing to the average of the three indexes (adjusted for avoided transportation, if applicable) I would like to receive this additional information no later than March 8, a week from tomorrow

Thanks,

Pat

ATTACHMENT 10

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

August 16, 1999

IN RE:	)	
APPLICATION OF UNITED CITIES GAS	)	
COMPANY TO ESTABLISH AN	)	DOCKET NO. 95-01134
EXPERIMENTAL PERFORMANCE-BASED	)	now DOCKET NO. 97-01364
RATEMAKING MECHANISM	)	

FINAL ORDER ON PHASE TWO

MELVIN J. MALONE
CHAIRMAN

H. LYNN GREER, JR.
DIRECTOR

SARA KYLE
DIRECTOR

This matter came before the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA") on February 16, 1999, for decision on the Phase Two issues of the petition of United Cities Gas Company (hereafter the "Company" or "United Cities") to continue, on a permanent basis, its experimental performance based ratemaking mechanism. This matter was heard by the Authority on March 26, 27, and 31, 1998. The Order reflecting the Authority's decisions on the Phase One issues was entered on January 14, 1999 The findings of fact and conclusions of law rendered by the Authority on February 16, 1999, on the Phase Two issues are set forth herein

I. PROCEDURAL BACKGROUND

On January 20, 1995, United Cities filed an application with the Tennessee Public Service Commission ("TPSC") requesting that it be authorized to conduct a two-year experiment wherein the TPSC would use a different method to determine whether the Company was performing reasonably in managing and acquiring its gas supply Instead of reviewing United Cities' performance after-the-fact by way of a prudency review,[1] as had been traditionally done, United Cities proposed that the TPSC review its performance on an ongoing basis Under the proposal, United Cities' performance would be measured against pre-defined benchmarks that would act as surrogates for the market price of gas.

The proposal was designed to create an incentive for United Cities to perform better than (or "out-perform") the market and to penalize the Company if its acquisition of gas supplies

[1] Under the Purchased Gas Adjustment (PGA) Rules (TRA Rule Section 1220-4-7-.05) an audit of the prudence of gas purchases applies to any gas company with operating revenues of $2,500,000 or more. The Rule states that a qualified consultant, hired by the TRA, is to evaluate and report annually to the TRA on the prudence of all gas costs which were incurred by the gas company during the previous year.

resulted in a price of gas above the pre-defined benchmarks United Cities contended that under its performance-based proposal, the Company would become more accountable to customers for its management and acquisition of gas supplies. If the Company out-performs the market, both the Company and the customers would benefit by sharing equally in the savings. If, on the other hand, United Cities' performance resulted in the Company paying a price for gas above the pre-defined benchmark, the Company would absorb half of the costs in excess of an established deadband.

On May 12, 1995, after conducting a hearing on United Cities' application and after considering the evidence presented at the hearing by United Cities and the Consumer Advocate Division of the Office of the Tennessee Attorney General (hereafter the "Consumer Advocate"), the TPSC issued an order setting forth its unanimous decision approving the proposal with modifications The TPSC stated that changes in the natural gas industry prompted it to look "to incentive programs and more streamlined regulation to improve efficiency and hold down costs to consumers "[2]

In approving United Cities' proposal, the TPSC adopted the following modifications and incorporated them into the Company's proposal [3]

1. United Cities would be limited to a maximum of $25,000 per month on gains and losses for all of the approved PGA mechanisms.

2 The Gas Procurement Mechanism would be modified to include a 2% reasonableness zone that applies to both sides of the market. The Company would share equally with its customers all gas costs savings below 98% of the market and would also bear a share of the costs in excess of 102% of the market. In regard to the other mechanisms, 90% of all gains or losses would go to the consumers and 10% would go to the Company

[2] Tennessee Public Service Commission Order dated May 12, 1995, page 4, paragraph 3
[3] Tennessee Public Service Commission Order dated May 12, 1995, pages 4 and 5.

3. The Company would be required to contract with an independent consulting firm to review this mechanism and report to the TPSC annually during the two-year experimental period. This review would not be an audit or a substitute for the current prudence review, which would not be required during the experimental period, but would be for the purpose of informing the TPSC if the proper incentives were in place and what, if any, further modifications should be made to the program

4. The TPSC would review the initiative in one (1) year and consider any proposed adjustments filed by the parties.

5. Any proposed adjustments requested by the parties would be required to be filed not less than thirty (30) days nor more than sixty (60) days before the anniversary date of the program which would be April 1.

6. The TPSC would again review this matter in two (2) years to consider any further adjustments and whether the program should be made permanent

There was no appeal of the TPSC's May 12, 1995, Order establishing the two-year experiment.

At a regularly scheduled conference held on November 7, 1995, the TPSC approved the selection of the independent consultant This action was memorialized in a TPSC Order dated May 3, 1996 On February 2, 1996, the consultant's first report, containing a review of the Company's performance as it related to the approved mechanism was provided to the TPSC. The consultant's report recommended certain modifications to the mechanism for the second year. After the consultant's report was filed, the TPSC received pre-filed testimony from United Cities and the Consumer Advocate and conducted a hearing on the matter on March 5, 1996. Over the objections of the Consumer Advocate, the TPSC took administrative notice of the consultant's report. In addition the TPSC did not permit the Consumer Advocate to cross-examine the consultant, Mr Frank Creamer. On May 3, 1996, the TPSC issued an order modifying the mechanism/program in accordance with the consultant's report and directing the consultant to file a second report addressing the results from the second year of the experiment

On June 27, 1996, the Consumer Advocate filed a petition for review of the May 3, 1996, Order in the Tennessee Court of Appeals In the petition, the Consumer Advocate requested that the Court also review the TPSC's May 12, 1995, Order On October 3, 1996, the Court issued an Order denying the request for a review of the May 12, 1995, Order on the grounds that such request was not timely With respect to the May 3, 1996, Order, the Consumer Advocate argued before the Court that it was denied due process when, during the hearing giving rise to the May 3, 1996, Order, the TPSC took official notice of Frank Creamer's consulting report without permitting the Consumer Advocate to effectively challenge the report. On March 5, 1997, the Court issued an Order in which it found that the TPSC had violated the Consumer Advocate's due process rights by denying the Consumer Advocate access to all evidence considered by the TPSC and by failing to afford the Consumer Advocate an opportunity to impeach the same by cross-examination. On June 30, 1996, the TPSC was dissolved by act of the Tennessee General Assembly

In a March 5, 1997, opinion, the Court of Appeals vacated the May 3, 1996, Order of the TPSC and remanded the case to the Authority "for such further proceedings and actions as it may deem appropriate including a reconsideration of the subject of the May 3, 1996, Order of the Public Service Commission "[4]

[4] *Tennessee Consumer Advocate v Tennessee Regulatory Authority and United Cities Gas Company*, Court of Appeals, Middle District, No 01A01-9606-BC-00286, March 5, 1997, page 7.

On February 28, 1997, the consultant filed his second report, which contained a review of the Company's performance during the second year of the mechanism Among other things, the consultant recommended the implementation of a permanent performance-based ratemaking mechanism. In the consultant's judgment, the experimental mechanism provided demonstrable benefits to the Company's customers

Following the entry of the Court of Appeals' March 5, 1997, Order, United Cities filed a petition on March 31, 1997, requesting the Authority to adopt the 1996 and 1997 reports of Frank Creamer and to permanently approve the mechanism The Consumer Advocate opposed United Cities' petition and on May 20, 1997, the Authority convened a contested case in this matter and appointed a Pre-Hearing Officer to assist the parties in formulating the issues to be considered by the Authority. Thereafter, the parties engaged in extensive discovery which resulted in several pre-hearing conferences addressing discovery issues

Prior to the beginning of the hearing, the Authority bifurcated this case to consider the issues arising from the remand by the Court of Appeals (Phase One) separate from the issues arising from United Cities' petition seeking approval of a permanent performance based ratemaking mechanism (Phase Two). In accordance with the Court of Appeals' decision, the Consumer Advocate was permitted ample time to take the deposition of Frank Creamer in advance of the hearings. Further during the hearings, the Consumer Advocate conducted cross-examination of Mr Creamer and of other witnesses concerning Mr. Creamer's reports The Phase One and Phase Two hearings took place on March 26, 27, and 31, 1998 The Consumer Advocate cross-examined

Frank Creamer on the Phase One issues on March 26, 1998,[5] and on the Phase Two issues on March 27, 1998.[6]

II. SUMMARY OF THRESHOLD AND PHASE ONE ISSUES

In bifurcating this proceeding, the TRA addressed certain threshold issues in Phase One. The Authority also considered, in Phase One, the issues associated with the remand of the 1996 proceeding, including the 1996 Creamer Report and whether to continue the mechanism for the second year. In Phase Two, the Authority addressed the issues raised in the 1997 petition filed by United Cities, including a review of the 1997 Creamer Report and a decision as to whether the mechanism should continue beyond its second year on a permanent basis. In order to adequately and properly address these issues, the Authority conducted separate hearings for each phase. The hearing on Phase One was held on March 26 and 27, 1998, and the hearing on Phase Two was held on March 27 and 31, 1998. At a regularly scheduled Authority Conference held on August 18, 1998, the Authority rendered its decision on the threshold and Phase One issues as follows:[7]

1. The Tennessee Regulatory Authority has the statutory power to approve a performance-based incentive mechanism which automatically penalizes or rewards the public utility for its performance in procuring the natural gas that it sells to customers;

2. The parties to this proceeding are not entitled to have access to staff information formulated for the Directors in preparation and final deliberation of this case,

[5] TRA Hearing, United Cities Gas, Volume I, March 26, 1998, page 69 through page 98, page 101 through 161, and page 177 through 180

[6] TRA Hearing, United Cities Gas, Volume II, March 27, 1998, pages 467 through page 503

[7] A final Order reflecting the Authority's decisions was issued on January 14, 1999. A Petition for Reconsideration filed by United Cities was considered by the Authority at its February 16, 1999, Conference and denied at that time

3. United Cities' performance-based ratemaking mechanism does not violate the PGA rules governing natural gas public utility companies;

4 The May 12, 1995, Order issued by the Tennessee Public Service Commission was not invalidated by the fact that the Court of Appeals vacated the Order issued by the Tennessee Public Service Commission on May 6, 1996 The May 12, 1995, Order of the Tennessee Public Service Commission is active subject to further consideration and modification as is deemed appropriate by the Authority in this docket,

5. United Cities has the burden to prove that any and all changes in rates are just and reasonable under T.C A §65-5-203(a),

6 The May 12, 1995, Order issued by the Tennessee Public Service Commission instituted a just and reasonable rate,

7. The May 12, 1995, Order issued by the Tennessee Public Service Commission did not constitute retroactive ratemaking;

8 The Authority declined to adopt the four recommendations made by Mr. Creamer in his report dated February 2, 1996, for the second year of the PBR experiment (April 1, 1996 – March 31, 1997),

9 The NYMEX index, which is one of the three basket of indices used to determine the benchmark price of natural gas in United Cities' PBR ratemaking mechanism shall not be excluded from the basket of indices,

10. Sufficient evidence existed in the record to show that United Cities' PBR ratemaking mechanism has improved United Cities' performance in purchasing natural gas and has benefited United Cities' customers,

11 The NORA contract is excluded from the United Cities' PBR plan because it predated the existence of said plan;

12. Gains and losses under the plan will be calculated on a monthly basis rather than on a transaction basis,

13 The lower end of the existing deadband around the benchmark price is set for the second year at 97.7% which is 1% below the level that existed prior to the initiation of United Cities' PBR plan. The high end of the deadband remains at 102%,

14 Affiliate party transactions were not present during the first year of the plan and will be considered during Phase Two; and

15. The Authority did not find with the Consumer Advocate that United Cities' PBR plan is too complex

The above decisions by the Directors concluded Phase One of this docket. Subsequent to the Directors' decisions on Phase One, the Company submitted, on October 28, 1998, a revised compliance filing for the second year of the performance-based ratemaking mechanism incorporating the above applicable modifications to the calculation of incentive savings for the second year of the experimental period [8]

III. PHASE TWO ISSUES

Phase Two of this proceeding encompasses a review of the second year results of the Company's incentive plan and a determination of whether the plan should continue on a permanent basis Pursuant to the stipulation of the parties and the recommendation of the Pre-Hearing Officer, the following three issues were approved by the Authority for consideration during Phase Two of this proceeding

1 Whether the TRA should adopt, in whole or in part, the recommendations made by the consultant in his report dated February 28, 1997, including.

   a Whether the TRA should establish a fixed limit of five years for the plan;

[8] Whereas the Company's original filing, which was filed on September 9, 1997, indicated it had reached the cap of $300,000 during the second year of the plan, the revised filing indicated the Company's revised share of savings during the second year of the mechanism should have been $296,570

b. Whether the TRA should establish an interim review period at the midpoint of the recommended five-year fixed term period,

c Whether the TRA should establish automatic special trigger events, such as dramatic increase/decrease in gas prices, no activity in the gas purchasing mechanism for an extended period, or a fundamental change in the utility's marketplace including the potential of unbundling,

d. Whether the TRA should modify the basket of indices used to determine benchmark pricing, such as deleting the NYMEX index when it deviates more than $0.151 MMBtu from the average of the other two indices;

e. If the TRA decides to completely delete the NYMEX from the performance plan, should the historical band of 98-102% be recalculated,

f Whether the TRA should increase the 1996 earnings cap from $600,000 per year to $1.25 million per year, or by some other amount;

g Whether the TRA should establish an earnings cap on the NORA contract;

h. Whether the TRA should simplify the plan by collapsing the five incentive mechanisms (gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost, and storage capacity cost) into two mechanisms (gas commodity and capacity release sales);

i 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, and

j Whether the utility should establish internal feedback and reward systems which link individual or department performance to achievement of performance goals.

2 Whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the utility

3 Whether United Cities' PBR plan has resulted in substantial benefits to its customers.

Issues 1(d), 1(e), 1(g), and 3 above were resolved by the Authority as a part of the Phase One deliberations The remaining Phase Two issues and the question of whether the plan should be made permanent were deliberated by the Directors during a regularly scheduled Authority Conference on February 16, 1999 In addition, the Directors deliberated on affiliate transactions, an issue that materialized during discovery into Phase Two issues.

A. Affiliate Transactions:

In its Post-Hearing Brief the Consumer Advocate pinpointed the issue of affiliate transactions as significant to Phase Two of this proceeding:

> In general, most of the issues in the 1996/Phase One portion of the hearing are also issues in the 1997/Phase Two portion of the hearing ...In the 1997/Phase Two portion of the hearing, however, the problems related to affiliate transactions became even clearer [9]

Company representative, William Senter, stated "[d]uring the second year of the experiment United Cities beat the benchmark and saved $2.4 million in gas costs."[10] According to the Company's Post-Hearing Brief, these savings were derived from entering into and administering various gas purchase contracts including the gas purchase contract which United Cities entered into with its marketing affiliate, Woodward Marketing LLC (hereafter "WMLLC"), on April 1, 1996.[11]

WMLLC is a limited liability corporation of which Woodward Marketing, Inc , (hereafter "WMI") owns 55% and UCG Energy Corporation (hereafter "UCG Energy") owns 45%. WMI is

[9] Consumer Advocate Division's Post-Hearing Brief, page 25 through page 26

[10] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 573, lines 3 and 4.

a nonregulated gas marketing company which was formed in 1986 [12] It has bought and sold gas in Tennessee since 1987 and has; on occasion, sold spot market gas to United Cities Gas Company. During this time, United Cities owned a nonregulated gas marketing company, UCG Energy Corporation. In the latter half of 1993, WMI contacted UCG Energy regarding the possibility of merging the two companies Negotiations lasted nearly twelve months and, on October 19, 1994, the two companies entered into a letter of intent to form Woodward Marketing LLC.[13] The purchase price paid by United Cities' for its 45% interest was $5 75 million in cash and stock with WMI having the right to earn an additional $1 million over a five-year period [14] The $1 million "earnout schedule" was based upon projections of annual income derived from the Willamette Study.[15] Following regulatory approval, the LLC became effective May 1, 1995.[16]

The Consumer Advocate alleged that the gas sales contract between United Cities and WMLLC was not a direct response to the experimental PBR mechanism approved by the TPSC in 1995 but, was, in fact, anticipated when WMLLC was formed Dr. Stephen Brown, the Consumer Advocate's economist, concluded that based upon the information provided by the Company, the Woodward contract predated the PBR and that the PBR appeared to be a response to the contract and to the formation of the merged company rather than the other way around [17] Witnesses for the

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[11] United Cities Gas Company's Post-Hearing Brief, page 43
[12] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 678, lines 8 and 9
[13] Prepared Rebuttal Testimony of J D Woodward, March 16, 1998, page 2, line 8, through page 3, line 21.
[14] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 696, line 21, through page 697, line 11
[15] The Willamette Study is an appraisal report dated July 28, 1994, prepared by Willamette Management Associates for United Cities Gas Energy Corporation the title of which is "Fair Market Value of the Common Stock of Woodward Marketing, Inc on a Controlling Interest Basis" See also Exhibit JDW-1 to the Prepared rebuttal Testimony of J D Woodward.
[16] See Order of the Tennessee Public Service Commission dated December 16, 1994 See also TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 3 through 5
[17] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 788, lines 6 through 11.

Company denied that there was any connection between the formation of the LLC in 1994 and the gas sales contract entered into in 1996. Ron McDowell testified that it was not until February of 1996 that he initiated negotiations with Mr. Woodward for a gas purchasing contract.[18] Mr. Woodward corroborated that account in his testimony and stated that the contract was negotiated to be effective April 1, 1996, with the price of gas tied to a basket of indices [19] In his rebuttal testimony, Mr. Woodward also addressed this issue several times and stated that there were no discussions between United Cities and Woodward Marketing in 1993 or 1994 regarding WMLLC selling gas to United Cities [20] James Harrington, United Cities' consultant, testified:

> Their [the Consumer Advocate's] conspiracy theory is groundless on a number of bases, including . the Woodward contract was not in effect during the first year I participated in the design and implementation of the PBR and never met or knew of Mr Woodward during that period.[21]

The Consumer Advocate based its assertions concerning the affiliate transactions in part on the Willamette earnout schedule [22] Dan McCormac, however, admitted during his testimony for the Consumer Advocate that he had no firm evidence to dispute United Cities' statement that the first time the Company approached WMLLC about being its sole supplier of gas in Tennessee was in 1996 [23]

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[18] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 638, lines 20 through 25

[19] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 11 through 25 and page 680, lines 1 through 9

[20] Prepared Rebuttal Testimony of J D Woodward dated March 16, 1998, page 4, lines 1 through 9, page 5, lines 7 through 22, page 6, lines 1 through 9 and page 9, lines 1 through 10

[21] TRA Hearing - United Cities Gas Transcript, Volume II, March 27, 1998, page 513, lines 16 through 21

[22] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 697 line 2 through page 698 line 6

[23] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 737, line 17, through page 739, line 5

The Authority received notice on September 6, 1996, of the execution of the gas sales agreement between WMLLC and United Cities. This notice, however, did not result from the Company's initiative but was received in response to a written inquiry by the Authority dated August 8, 1996 In the Company's response, Mark Thessin stated the Authority was not advised of this agreement because the Authority does not have any rules requiring approval of affiliate transactions.[24] The apparent discrepancy between Mr. Thessin's statement and the testimony of Company witness, Ron McDowell, that he knew if the Company used an affiliate that it would be examined,[25] was not reconciled at the hearing nor did the Company offer an adequate explanation as to why relevant information was not forthcoming from the Company

While there were no separate rules in place governing affiliate transactions, TRA Rule 1220-4-7-.03-(5)(iii) of the Purchased Gas Adjustment ("PGA") Rules anticipates the possibility of affiliate transactions

> If the Company proposes to recover any Gas Costs relating to (1) **any payments to an affiliate** or (2) any payments to a nonaffiliate for emergency gas, over-run charges, or (3) the payment of any demand or fixed charges in connection with an increase in contract demand, **the Company must file with the Commission a statement setting forth the reasons why such charges were incurred and sufficient information to permit the Commission to determine if such payments were prudently made under the conditions which existed at the time the purchase decisions were made.** [Emphasis added]

The Company failed to comply with the above rule when it did not notify the Authority of its contract and subsequent purchases with WMLLC since the Company retains a 45% interest in

[24] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 633, line 22, through page 634, line 2

[25] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 630, lines 15 through 19

this limited liability corporation The Woodward contract[26] is a three-year contract, with the initial date of expiration of March 31, 1999 The Woodward contract is automatically extended for three (3) year periods in the absence of a ninety (90) day notice of termination by either party. Under the terms of the contract, United Cities purchases all of its daily purchase volumes from Woodward for a price equal to $.08 below the basket of indices used in the "United Cities' gas purchase incentive mechanism currently in effect in the state of Tennessee "[27] The gas is to be transported according to United Cities' Summer and Winter operational plans The contract is considered an "all requirements" contract since Woodward is responsible for making all nominations, scheduling volumes, and releasing capacity.[28]

Pursuant to PGA rule 1220-4-7-.03-(5)(iii), the TRA has the authority to review the Company's purchases from an affiliate and to determine the prudency of such purchases In this instance, the TRA was prevented from doing so due to the Company's failure to notify the TRA of its contract with WMLLC[29] Although Dan McCormac of the Consumer Advocate's office acknowledged that, all other things being equal, the eight cents below the basket of indices is a good deal,[30] the Consumer Advocate contended that it was not provided the necessary information to properly analyze the contract. Mr McCormac testified.

> And I think they did what they felt was best for their stockholders I have no doubt about that And it may be that they did what was best for the ratepayers But I do have some doubts about that because of the

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[26] A copy of the Woodward contract was provided by Company witness, J D Woodward, as Exhibit JDW-2 to his Prepared Rebuttal Testimony dated March 16, 1998

[27] Exhibit JDW-2 of J D Woodward's Prepared Rebuttal Testimony dated March 16, 1998, page 7

[28] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 16 through 24.

[29] The Authority recognizes that absent more specific affiliate rules or guidelines for Tennessee, it would have been more complicated and time consuming, even with notification of the contract from the Company, to determine whether preferential treatment had been afforded the affiliate

[30] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 761 lines 10 through 13.

> unanswered questions We simply do not know what the total costs to consumers are after the Woodward contract started We don't have the full picture [31]

The Consumer Advocate further explained that "the TRA does not have the full picture because United Cities' affiliate, Woodward Marketing L.L.C., does not bill United Cities according to the cost and source of Woodward's supply of gas."[32] The Consumer Advocate contends that WMLLC switched pipelines in the winter months of 1996-1997 from a lower cost (Tennessee Gas Pipeline) to a higher cost (Columbia Gulf) pipeline This shift, according to the Consumer Advocate, permitted WMLLC to earn substantial profits at the expense of the Tennessee consumers.[33] Dan McCormac testified that United Cities' consumers were charged rates based on a benchmark price of gas on a pipeline other than that on which the gas was actually purchased.[34] In its Post-Hearing Brief, the Consumer Advocate asserted.

> . . . United Cities, and its consumers, are forced to purchase gas from wherever Woodward chooses to buy it Woodward pretends to buy it from the source specified by United Cities, but United Cities and the consumers are billed for the transportation costs associated with the purchase point determined by Woodward [35]

The Consumer Advocate, however, never produced any evidence to support its theory that pipelines were switched [36]

The United Cities' contract with WMLLC contains a Purchase Agreement (Exhibit A to the contract) detailing the purchase price and the manner in which WMLLC invoices United Cities for

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[31] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 726 line24 through page 727 line 7

[32] Consumer Advocate's Post Hearing Brief, page 27

[33] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 708, lines 12 through 21

[34] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 710, lines 7 through 10

[35] Consumer Advocate Division's Post-Hearing Brief, page 28

its gas purchases. Within the Agreement, the parties agreed to a definition of "purchase price" as set forth at Section #2 (Purchase Price/MMBtu) of the Purchase Agreement·

> The basket of indices used to determine benchmark pricing for monthly baseload spot purchases described in United Cities' gas purchase incentive mechanism currently in effect in the state of Tennessee minus 8 cents plus other pass-through charges described below under 'Service Provisions'.

The Agreement further states in Section #3 (Daily Purchase Volume) that WMLLC will provide "full United Cities Gas Company requirements in the states of Tennessee and Virginia pursuant to Summer Operational and Winter Operational Plans." Each of these operational plans is detailed under the Service Provisions section (Section #6) on page 2 of the Purchase Agreement. WMLLC must invoice United Cities based on the Summer and Winter Plans WMLLC is allowed to deviate from the plan only if "such deviation will not cause any operational or economic degradation to its services." The Purchase Agreement also specifies, under paragraph H of Section #6, that WMLLC is the Agent for managing United Cities' contracts And as such.

> Buyer and Seller recognize that as consideration for selling gas at the purchase price agreed upon in this agreement, Seller has the right to manage and to use for its own purposes, subject to certain conditions which protect Buyer, all components of Buyer's upstream pipeline(s) supplier's services Absent this consideration to Seller, the parties recognize that the purchase price would be at a rate different than that set forth in paragraph 2 of this purchase agreement

Based on the terms of the gas purchase agreement and the testimony as presented, the Authority concludes that Woodward has been billing United Cities appropriately pursuant to the contract agreement United Cities' witnesses testified repeatedly that United Cities did not care how Woodward sourced its gas as long as it met the requirements of United Cities' customers as

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[36] The Consumer Advocate referred to page 847 of the transcript to support this statement This citation does not

outlined in the Summer and Winter operational plans.[37] During the hearing, Consumer Advocate witness Dr Brown acknowledged that as a result of FERC Order 636,[38] United Cities is assigned capacity on specific pipelines which require United Cities to pay reservation and demand charges. Dr Brown testified that he did not review those assignment contracts.[39] Dr. Brown further acknowledged that United Cities developed their Summer and Winter operational plans within the constraints of transportation capacity contracts and the Company's storage capacity Dr Brown did not study, however, how the plans were developed or form any opinion as to the reasonableness of the plans [40]

Dr. Stephen Brown's testimony indicates that, even though the contract is quite specific, the Consumer Advocate may not have understood the operation of this gas sales contract going into this Hearing.[41] The Consumer Advocate alleged that WMLLC switched pipelines in order to maximize its profits at the expense of Tennessee consumers,[42] implying that consumers were forced to pay more under the contract than they would have without the contract when the "full costs" of delivery were considered [43] Transportation costs were cited as a major issue,[44] even though Dr.

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refer to any discussion on the testimony of this subject

[37] Prepared Rebuttal Testimony of Ron W McDowell, page 5, lines 9 through 23 and Prepared Rebuttal Testimony of J D Woodward, page 11, lines 3 through 12 and lines 18 through 22.

[38] Following the deregulation of sales at the wellhead by Congress, Order 636 of the Federal Energy Regulatory Commission (FERC) unbundled the sale of gas from the transportation services which had been previously provided by interstate pipelines.

[39] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 791, lines 5 through 19

[40] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 802 line 19 through page 803 line 12, and page 805, lines 1 through 18

[41] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 810, lines 15 through 22 and page 815 line 5 through page 817 line 15

[42] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 708, lines 11 through 21

[43] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 714, lines 16 through 20 and page 819, lines 10 through 21

[44] Consumer Advocate's Post-Hearing Brief dated May 4, 1998, page 30

Brown testified that transportation costs were a small part of the overall costs [45] United Cities presented testimony that if transportation costs are included, higher cost gas could actually result in a net lower cost of gas[46] at the city gate [47] The Consumer Advocate witness, Dan McCormac, conceded this point in his testimony

> 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 though 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 [48]

Further, Company witness, Ron McDowell, testified that the operational plans called for delivery at the least cost feasible, taking into consideration United Cities' transportation and storage contracts and other factors [49]

The Consumer Advocate argued that, as an affiliate, WMLLC should only bill its costs to United Cities [50] The Company countered that WMLLC was a supplier like any other and as such was entitled to make a profit [51] The independent consultant, Frank Creamer,[52] and the Company's

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[45] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 799, lines 23 through 25.

[46] 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 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 costs (commodity plus transportation) for the cheaper gas

[47] Prepared Rebuttal Testimony of J D Woodward, page 9, lines 11 through 21

[48] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 713, line 22, through page 714, line 6

[49] Prepared Rebuttal Testimony of Ron W McDowell, page 1, lines 21 through 40, page 2, lines 1 through 19.

[50] Prepared Rebuttal Testimony of James R. Harrington, page 13, lines 9 through 14

[51] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 656, line 16, through page 657, line 12

[52] TRA Hearing - United Cities Gas Transcript, Volume II, March 28, 1998, page 456, lines 22 through 25

consultant, Mr. Harrington,[53] both testified that WMLLC, even though a sole supplier, should be treated as any other gas supplier Mr. Woodward testified that WMLLC could not afford to offer such a guaranteed low price to United Cities if it could not use United Cities' capacity to generate a profit.[54] Ron McDowell, who negotiated the Woodward contract for the Company, testified that the contract took the risk out of the Company's gas supply since WMLLC assumed all the penalties regarding scheduling [55] Mr. McDowell also testified that as a gas aggregator, WMLLC was in a position to acquire gas from sources unavailable to United Cities which enabled WMLLC to acquire gas for less than United Cities could and thus make a profit.[56] Mr Woodward's unrefuted testimony was that the price offered to United Cities was at least five cents ($0.05) below the price offered to any of WMLLC's other customers [57]

Consumer Advocate witness, Mr McCormac, while suggesting that consumers might be paying more under the contract, conceded that the agreement with WMLLC was a good contract.[58] He also acknowledged that, all things being equal, United Cities should contract for a guaranteed delivery at a good price, considering that WMLLC was assuming the risk for price volatility and scheduling penalties [59] There was no evidence of collusion between WMLLC and United Cities regarding the gas sales contract [60] Both consultants testified that the contract price was

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[53] Prepared Rebuttal Testimony of James R Harrington, page 13, lines 9 through 14
[54] Prepared Rebuttal Testimony of J D Woodward, page 15, lines 1 through 13
[55] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 630, lines 6 through 19
[56] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 649 line 11 through page 650 line 2
[57] Prepared Rebuttal Testimony of J W Woodward, page 8, lines 12 through 17
[58] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 760, line 3 through 18
[59] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 730 line 22 through page 731 line 4
[60] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 721, line 20 through 25

exceptional.[61] Based upon the record, the Authority concludes that the contract price is good, if not exceptional, and that the contract benefits Tennessee consumers, as well as United Cities.

The Consumer Advocate also raised the issue whether the TRA can look beyond the Woodward contract to Woodward's sources and Woodward's cost of the gas sold to United Cities, so that the profits earned by Woodward are shared with the ratepayers of Tennessee Although the Authority does not believe that the profits of an affiliated supplier should be passed on to the ratepayers of the local distribution company, the Authority does conclude that Authority rules cannot go unenforced nor can affiliate party transactions go unmonitored if performance-based ratemaking mechanisms are to be considered on a basis which is honest, meaningful, fair, and beneficial to the Company and its ratepayers. Still, however, United Cities should have notified the TRA of the Company's intention to enter into an "all requirements" contract with an affiliate. To act in accordance with the PGA rule, the Company should have voluntarily submitted the Woodward contract to the Authority prior to the effective date of the contract as the Company had in Georgia [62]

The evidentiary record of the Phase Two proceeding demonstrates that the gas sales contract with WMLLC was not anticipated at the time WMLLC was formed and was initiated by United Cities after the experimental PBR plan had been approved in Tennessee The record further demonstrates that WMLLC has invoiced United Cities according to the provisions of the contract. In considering the record in this proceeding, the Authority concludes that, as a condition for

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[61] TRA Hearing - United Cities Gas Transcript, Volume II, March 27, 1998, page 446, lines 2 through 6, page 456, lines 19 through 21, page 516, lines 8 and 9

[62] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 673, line 23, through page 674, line 2

including affiliate transactions in any PBR mechanism, affiliate transactions must be subject to certain guidelines

United Cities presented evidence that in a similar proceeding in Georgia, United Cities agreed to abide by certain affiliate guidelines, as a condition to implementing a PBR mechanism in Georgia.[63] In its Post-Hearing Brief, United Cities agreed to be bound in Tennessee by these same guidelines[64] As a result of this proceeding, the Authority deems it necessary to expand these guidelines and concludes that before any affiliate transactions can be included in the computation of savings or losses from the Company's PBR mechanism in Tennessee, those specific transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, a copy of which is attached as Exhibit 1 hereto. Documentation of the Company's compliance with these guidelines is to be presented to the Authority during its annual audit of the Incentive Plan Account A determination of compliance with all of the affiliate guidelines will be made at the conclusion of each annual audit.

B. Whether the PBR mechanism should be made permanent:

As to the issue of whether the PBR mechanism should be made permanent, the Authority considered the following sub-issues

(a) Whether a fixed limit of five years should be set for the plan,

(b) Whether an interim review period at the midpoint of the fixed term should be established, and,

[63] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 600 line 19 through page 601 line 11
[64] United Cities Gas Company Post-Hearing Brief dated May 1, 1998, page 54.

(c) Whether there should be established automatic special trigger events such as a dramatic increase/decrease in gas prices, no activity in the gas purchasing mechanism for an extended period, or a fundamental change in the utility's marketplace including the potential of unbundling

Based on the evidentiary record, the Authority unanimously approved United Cities' PBR plan as a permanent plan to commence April 1, 1999. Rather than set a fixed term limit of five years, an interim review period, or automatic special trigger events, the Authority determined that the plan could continue on an annual basis under the same terms and conditions as specified in this Order until the Authority is otherwise notified by the Company not less than ninety (90) days prior to the end of any plan year that the Company wishes to terminate the plan or the plan is either modified, amended, or terminated by the Authority.[65]

C. Adjustments to the deadband:

During the Phase One deliberations, the Authority decided that any savings or losses from the gas procurement mechanism of the Company's PBR would be subjected to a "deadband" of 97.7% to 102%.[66] The Authority decided to allow this deadband to remain fixed for the first three years of the permanent PBR[67] Should the PBR continue beyond the first three (3) years of the permanent plan, the Authority decided that the deadband would be adjusted at the conclusion of the initial three (3) period, and every three (3) years thereafter, to one percent (1%) below the most recent annual audited results of the incentive plan Adjusting the deadband every three (3) years

[65] By Order issued on March 11, 1999, the Tennessee Regulatory Authority approved a performance incentive plan for Nashville Gas Company which contains the same terms and conditions for continuance on an annual basis

[66] Final Order on Phase One, Docket No 97-01364 dated January 14, 1999, page 24

[67] Chairman Malone dissented finding fault with the majority's reasoning in applying year-end 1994 data, when year-end 1997 is available, to a plan that commences in 1999 He opined that use of such data is inappropriate and poor policy

assures the consumers that the Company must continue to use its best efforts to outpace the arithmetic mean of its historical performance while allowing the Company to participate in the savings generated by any long term contracts which it has negotiated

D. Whether the TRA should increase the earnings cap to $1.25 million per year, or by some other amount:

During the two-year experimental phase of the PBR, the Company's earnings were limited to $300,000 per year on overall gains and losses [68] Issue 1(f) addresses whether the TRA should increase this earnings cap to $1.25 million per year The Authority found that the cap should be increased $1 25 million annually beginning April 1, 1999.[69] This increase in the earnings cap effective April 1, 1999, should provide the Company with the necessary incentives to continue to become more aggressive by assuming additional risk in the purchasing of natural gas and in managing its firm transportation capacity on the upstream pipelines

E. Whether the TRA should simplify the plan by collapsing the five incentive mechanisms into two mechanisms:

Under Issue 1(h) the Authority considered whether the original five incentive mechanisms (gas procurement, seasonal pricing differential, storage gas commodity, transportation capacity cost, and storage capacity cost) should be collapsed into two mechanisms (gas commodity and capacity release sales) The record clearly demonstrates that during the two-year experimental period of the PBR, all of the savings were attributable exclusively to the gas commodity and

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[68] During the Phase One deliberations, the Authority determined an increase in the cap to $600,000 was not warranted for the second year of the experimental plan and, therefore, decided not to accept the consultant's recommendation to increase the cap.

capacity release mechanisms. Based upon this finding, the Authority concludes that collapsing the five mechanisms into two would simplify the plan without having any adverse consequences to the ratepayers.

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.

G. <u>Whether the Company should establish internal feedback and reward systems which link individual or department performance to achievement of performance goals.</u>

Issue 1(j) questions whether an internal feedback and reward system should be established by the Company to reward its employees for achievement of performance goals. The Authority finds support in the record for Frank Creamer's recommendation that a departmental and individual feedback and rewards system should be implemented to reinforce desired behaviors that support the

[69] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting. April 1, 1995 - November 30, 1996, page 25

business objective[70] Contrary to the Company's statement in its Post-Hearing Brief that "UCG has sufficient feedback and reward systems in place to accomplish department performance goals and disagrees with the reward system that focuses merely on each individual employee," Mr. Creamer found, during his review of the second year of the experimental plan, "no evidence of a feedback and reward system that directly shares company rewards and penalties with the staff responsible through some type of pay-for-performance, gain-sharing, or salary-at-risk program"[71] Mr. Creamer further found that UCG's existing incentive practices may not be sustainable in the absence of a feedback and reward system that prompts individuals to adopt desired behaviors that support business goals and objectives.[72] The Authority concludes that a feedback and reward system for those employees involved in the activities detailed in the plan must be in place as long as the Company is operating under a PBR mechanism

H. Whether the NYMEX index should remain in the basket of indices:

During Phase One the Authority considered the issue of whether to include or exclude NYMEX from the basket of indices and decided during those deliberations that the NYMEX should remain in the basket of indices to which the Company's gas purchases are to be compared During the Phase Two deliberations, that issue was again considered by the Directors with the

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[70] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting. April 1, 1995 - November 30, 1996, page 26

[71] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting April 1, 1995 - November 30, 1996, page 22

[72] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting April 1, 1995 - November 30, 1996, at page 22

majority voting to continue to retain NYMEX as one of the three indices utilized in computing the benchmark[73]

I. Whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the Company:

Issue 2 of the Pre-Hearing Officer's report was whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the Company. During the first year of the experimental plan, the capacity release incentive mechanism accounted for only 35% of the gains realized During the first eight months of the second year of the experimental plan, only 30% of the gains were attributable to capacity release[74] Therefore, the Authority does not find it necessary to modify the Capacity Release Incentive Mechanism to provide additional incentive for the Company

IT IS THEREFORE ORDERED THAT:

1. United Cities Gas Company is authorized to operate under the Performance-Based Ratemaking Mechanism, as modified herein, beginning April 1, 1999, and continuing each year thereafter until the mechanism is either (a) terminated at the end of a Plan Year by not less than ninety (90) days notice by United Cities to the Authority, or (b) the PBR mechanism is modified, amended, or terminated by the Authority,

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[73] Chairman Malone disagreed with the majority on this issue. It is his opinion that United Cities failed to carry the burden in demonstrating that NYMEX is representative of the other indices used in the mechanism For any mechanism of this type to be truly effective and not result in unwarranted and unintended pricing behavior, aberrations must be normalized According to the Chairman, it matters little whether the component to be normalized is a well-known national indicator, or an obscure formula misapplied What is important is that any force or computational dynamics be normalized or removed to neutralize the ruinous effects of a skewed component

2 For each plan year in which this Performance-Based Ratemaking Mechanism is in effect, the requirements of Section 1220-4-7- 05 of the Purchased Gas Adjustment Rules of the Tennessee Regulatory Authority entitled "Audit of Prudence of Gas Purchases" are hereby waived;

3 The Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, a copy of which is attached to this Order as Exhibit 1 are hereby adopted and are in effect as to United Cities' performance-based ratemaking mechanism,

4 Prior to any affiliate transactions being included in the computation of savings or losses from this performance-based ratemaking mechanism, said affiliate transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions Documentation of compliance is to be presented by the Company to the Authority during the TRA's annual audit of the Incentive Plan Account The Authority, at the conclusion of each annual audit, will make a determination of the Company's compliance with all of the affiliate guidelines,

5 The NYMEX index shall continue to be included as one of the three indices in the basket used to determine the benchmark price of natural gas in Unites Cities' PBR mechanism,

6 The lower end of the deadband around the benchmark price of 97.7%, which was set under Phase One, shall remain in effect for the first three (3) years of the PBR mechanism. Thereafter, as long as the PBR mechanism remains in effect, the deadband will be adjusted every three (3) years to one percent (1%) below the most recent annual audited results of the PBR mechanism,

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[74] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting April 1, 1995 - November 30, 1996, at pages 12 and 13

7 During a plan year, United Cities will be limited to an earnings cap for incentive gains and losses of $1 25 million,

8 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,

9 United Cities will submit on an annual basis to the Authority, for the Authority's approval, a procedure to verify the Company's reserve margin to ensure that the Company's level of contract demand is prudent,

10 While the PBR mechanism is in effect, the Company will have in place a gas supply incentive and rewards program for its non-executive employees involved in the implementation of the PBR mechanism, the details of which will be provided to the Authority on an annual basis within sixty (60) days of the beginning for each plan year Unless the Company is notified otherwise within sixty (60) days of the filing, said plan will become effective,

12 United Cities will file a separate tariff to be effective April 1, 1999, which clearly identifies the specific procedures of the performance-based ratemaking mechanism. 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,[75]

[75] Tennessee Regulatory Authority Rule 1220-4-7-03(c)

13. Any party aggrieved with the Authority's decision in this matter may file a Petition for Reconsideration with the Authority within ten (10) days from and after the date of this Order; and

14 Any party aggrieved with the Authority's decision in this matter has the right of judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from and after the date of this Order

Melvin J. Malone, Chairman

H Lynn Greer, Jr, Director

Sara Kyle, Director

ATTEST

K. David Waddell, Executive Secretary