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April 8, 2004

VIA FEDERAL EXPRESS

The Honorable Deborah Taylor Tate
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

Re: Nashville Gas Company, a Division of Piedmont Natural Gas Company, Inc. Incentive Plan Account (IPA) Audit -- Docket No 03-00489

Dear Chairman Tate

I have enclosed an original and 14 copies each of confidential and non-confidential versions of:

1. Nashville Gas Company's Response to the Energy and Water Division's Incentive Plan Account Audit Report;

2. Affidavit of Keith P. Maust;

3. Affidavit of Kenneth T Valentine; and

4. Affidavit of Rich A. Flebbe.

Please accept these for filing and return one file-stamped copy of each to me.

If you have any questions regarding this filing, you may reach me at the number shown above.

Sincerely,

James H. Jeffries IV

JHJ/srl

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

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IN RE:	)	
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NASHVILLE GAS COMPANY, A	)	
DIVISION OF PIEDMONT NATURAL	)	DOCKET NO. 03-00489
GAS COMPANY, INC. INCENTIVE	)	
PLAN ACCOUNT (IPA) AUDIT	)	

Nashville Gas Company's Response to the Energy and Water Division's Incentive Plan Account Audit Report And Supporting Materials

PUBLIC VERSION

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
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DIVISION OF PIEDMONT NATURAL	)	DOCKET NO. 03-00489
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BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

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NASHVILLE GAS COMPANY, A	)	**Docket 03-00489**
DIVISION OF PIEDMONT NATURAL	)	
GAS COMPANY, INC. INCENTIVE	)	
PLAN ACCOUNT (IPA) AUDIT	)	

INDEX

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

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	)	
NASHVILLE GAS COMPANY, A	)	
DIVISION OF PIEDMONT NATURAL	)	**DOCKET NO. 03-00489**
GAS COMPANY, INC. INCENTIVE	)	
PLAN ACCOUNT (IPA) AUDIT	)	

NASHVILLE GAS COMPANY'S RESPONSE TO THE ENERGY AND WATER DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT

Nashville Gas Company, a division of Piedmont Natural Gas Company, Inc. ("Nashville Gas" or the "Company"), respectfully submits the following response to the March 29, 2004 *Notice of Filing By Energy and Water Division of the Tennessee Regulatory Authority* ("Staff Audit Report" or "Report") in the above-captioned docket The purpose of this response is to address a number of the Findings, Conclusions and Recommendations set forth in the Staff Audit Report which, in the Company's view, are unwarranted and/or based upon a flawed understanding of the relevant facts This Response is supported by affidavits and accompanying documentation filed concurrently by (1) Mr. Keith P. Maust, Director – Gas Supply & Wholesale Marketing for Nashville Gas, (2) Mr. Kenneth T Valentine, Director – Gas Supply Planning and Transportation Services for Nashville Gas, and (3) Mr. Richard A. Flebbe, Manager – Federal Regulatory and Pipeline Services for Nashville Gas. On the basis of this Response (and the supporting materials filed herewith), and for the reasons discussed herein, Nashville Gas respectfully requests that the Tennessee Regulatory Authority ("Authority") approve those uncontested aspects of the Staff's Incentive Plan Account ("IPA") audit for the period ending June 30, 2003 and reject all other findings and substantive recommendations set forth in the Staff Audit Report [1]

EXECUTIVE SUMMARY

In its Report, the Energy and Water Division ("Staff") recommends that the Authority suspend the operation of Nashville Gas' Performance Incentive Plan ("Incentive Plan" or "Plan") based upon Staff concerns over the inclusion of an asset management fee within the scope of the Plan, alleged uncertainty regarding the validity of national wholesale price indices used to set the benchmark price of gas under the Plan, and questions about the appropriate level of "excess" capacity that should be maintained by the Company. Staff further recommends that it be appointed to oversee the asset management Request For Proposal ("RFP") process for Nashville Gas due to Staff's concerns over the purported lack of an adequate audit trail for certain aspects of the RFP process. Nashville Gas strongly disagrees with both the Staff's recommendations and the factual predicates upon which they are based. Each of the Staff's recommendations is seriously flawed and based upon an inaccurate or misconstrued view of the underlying facts regarding various aspects of the Company's Incentive Plan. If granted, the Staff's recommendations will do substantial economic harm to Nashville Gas and its ratepayers with no corresponding benefit to any party.

The three concerns upon which Staff bases its recommendation to suspend Nashville Gas' Incentive Plan are unfounded. First, Staff's concerns over the asset

[1] Nashville Gas is not requesting a full evidentiary hearing on this matter in conjunction with this filing as it believes that this Response and the accompanying documentation provides a clear and convincing record upon which the Authority can and should resolve this matter as requested herein. To the extent that the Authority has further questions or believes that additional evidence would be beneficial in resolving these disputed issues, Nashville Gas would support the establishment of a hearing process with customary rights of discovery, presentation of evidence and cross-examination.

management incentive fee are misplaced because that fee is paid to Nashville Gas for the benefit of its customers, constitutes a form of savings expressly anticipated under the Plan, has been repeatedly approved by Staff and the Authority for several years, and is paid under an open bid process whereby the highest qualified bidder obtains the right to manage Nashville Gas' capacity assets for a specified period In comparison to these factors, the minor audit "flaws" alleged by Staff are not material to the operation of Nashville Gas' Incentive Plan

Second, the national wholesale price indices upon which Nashville Gas' benchmark gas costs are set are substantially more secure now than they ever have been after a series of significant industry and federal regulatory initiatives over the last few years aimed at addressing the potential for market manipulation raised by the California energy crisis. These initiatives involve federal regulations designed expressly to secure the integrity of the index reporting process and active federal oversight of these markets.

Third, and contrary to Staff's assertion, Nashville Gas' 5% reserve capacity margin has been expressly approved in the same docket as this Authority approved its Incentive Plan Further, the materials presented with this Response clearly and unequivocally establish that Nashville Gas has no "excess" capacity currently available and is, in fact, in the process of procuring additional long-term capacity needed to serve current and projected customer growth.

Suspension of the Company's Incentive Plan will cause ratepayers to lose the substantial economic benefits historically achieved by the Plan and will cause a proportional reduction in the revenues achieved by Nashville Gas. In light of the mistaken factual bases upon which the Staff's suspension recommendation is made, the harm it will cause to ratepayers and the Company, and the lack of any offsetting benefit to the Staff, the Authority or to ratepayers, Staff's recommendations to suspend Nashville Gas' Incentive Plan should be rejected

Staff's recommendation that it be granted supervisory authority over Nashville Gas' asset management RFP process should also be rejected on several grounds First, such an arrangement would represent an unwarranted and inappropriate intrusion by the Staff into what is a core business activity and responsibility of the Company Second, no material flaws have been shown to exist in the Company's RFP process that would justify such an intrusion Third, Nashville Gas questions whether the Staff has the requisite experience, assets or internal capabilities to administer the asset management RFP process given its request that a consultant be hired for future Plan audits.

Finally, the Authority should reject Staff's suggestion that a consultant be hired to review the Incentive Plan audit process going forward. Nashville Gas' plan has already been through a two year experimental phase subject to the scrutiny of an independent consultant. At the end of that period the consultant recommended the continuation of the Plan on a permanent basis. The Authority found the Plan to be in the public interest at that time and adopted the consultant's recommendation. That finding was made in 1999 and neither the Plan nor the benefits accruing to ratepayers from the Plan has changed or been challenged since that time.

BACKGROUND

Nashville Gas filed its request for approval of a natural gas Performance Incentive Plan on April 22, 1996. The purpose of the Plan was to replace the annual gas cost prudence review process with an incentive plan designed to align the Company's interests with those of its ratepayers by giving the Company an economic incentive to minimize gas costs Nashville Gas' Incentive Plan proposal was approved on a two-year experimental basis by the Tennessee Public Service Commission by Order dated May 31, 1996 [2] In the Commission's Order approving the Plan, the Commission directed Nashville Gas and the Staff to recommend a qualified independent consultant to review the progress of the Plan and to report to the Commission annually on their conclusions. The Company and Staff selected Andersen Consulting to analyze the results of the Plan for the two-year experimental period.

Following the completion of the two-year experimental period, Nashville Gas' Incentive Plan was presented to the Tennessee Regulatory Authority for approval on a permanent basis. In its March 11, 1999, *Order Approving Performance Incentive Plan*, the Authority reviewed Anderson Consulting's favorable recommendations and findings with respect to the Plan and unanimously approved the continuation of the Plan on a permanent basis. In allowing Nashville Gas to continue its Incentive Plan, the Authority found:

> It is the opinion of the Directors of the Authority that incentive plans such as that proposed by Nashville can satisfy the public interest by providing net benefits to both ratepayers and the Company. Such net benefits can be realized when an incentive plan is carefully evaluated and properly administered, consistent with state law. In Nashville's case, the Authority concludes that the Incentive plan satisfies the public interest.[3]

In the same Order, the Authority eliminated the requirement for an independent review of the Incentive Plan going forward.

Since the date of the Authority's *Order Approving Performance Incentive Plan*, Nashville Gas has operated that Plan in accordance with its terms. During this period, Nashville and its customers have both benefited from the more than $14 million in gas cost savings generated under the Plan.[4] For the last several years, Nashville Gas has utilized asset management arrangements in order to secure savings for its ratepayers under the

[2] See Exhibit A attached hereto
[3] See Exhibit B attached hereto

Plan. Under these asset management arrangements, marketing companies provide guaranteed payment to Nashville Gas for the right to manage Nashville's capacity portfolio for some period of time while simultaneously agreeing to provide Nashville's citygate delivery needs up to the Company's maximum daily quantity rights.

Since 1999, the Staff has conducted an annual audit of Nashville Gas' Incentive Plan to determine if the amounts recorded under the Plan were correct. While these audits have resulted in some relatively minor adjustments in various account balances, they have not sought to examine or change any fundamental aspect of the Plan or to raise issues about the underlying public interest of the Plan. In recent audits, the Staff has specifically approved Nashville Gas' use of asset management arrangements and have credited such arrangements with substantial increases in ratepayer savings under the Plan.[5]

In its recently released audit of the annual period ending June 30, 2003, Staff has changed its approach and has attempted to expand its audit process to encompass larger issues related to the underlying public interest of the Plan and has recommended that the Plan be suspended based on "concerns" over various such issues and has further suggested that Staff be appointed to a supervisory role with respect to the asset manager RFP process [6] The factors underlying the Staff's recommendations included concerns over documentation of minor aspects of the asset manager RFP process and the propriety of including the asset manager fee in the Incentive Plan, questions about the validity of national wholesale price reporting indices, and concerns over the proper level of "excess" capacity maintained by the Company. The concerns expressed by Staff are not based on

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[4] See Affidavit of Keith P. Maust, Exhibit K.
[5] See Exhibit C attached hereto
[6] Notably, the Staff's concerns are relatively vague in nature and do not cite to any specific instance in which ratepayers have or may have been harmed

any evidence of harm to ratepayers and are either immaterial to the proper functioning of the Plan or are founded upon an inaccurate understanding of the underlying facts

DISCUSSION OF DISPUTED FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

The Staff Audit Report contains multiple Findings, Conclusions and Recommendations which, in Nashville Gas' view, are seriously flawed and should not be adopted by the Authority.[7] Each of these is discussed below. For ease of examination, related Findings, Conclusions and Recommendations in the Staff Audit Report are discussed together

1. Staff's Concerns Over Nashville Gas' Asset Manager RFP Process are Unwarranted.

In its Report, the Staff takes issue with three aspects of the Company's asset management RFP process: (1) the fact that the Company is unable to produce a list of all parties that received a copy of the Company's asset management RFPs during the review period; (2) the fact that not all responsive bids to the Company's RFP were made in writing; and (3) the fact that the Company's RFP is not made available to the Public. In addition, the Staff challenges the practice of including the asset management payment received by the Company under the Incentive Plan. Based, in part, upon these concerns, the Staff recommends that the Authority suspend Nashville Gas' Incentive Plan For the reasons discussed below, Nashville Gas believes that the Staff's concerns and recommendation are unfounded, that the issues raised concerning its asset management activities are not material to the proper functioning of its Incentive Plan, and that adoption of the Staff's recommendations would be contrary to the Authority's prior findings regarding the Incentive Plan and harmful to ratepayers.

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[7] The Staff Audit Report also contains a number of Finding and Conclusions with which Nashville Gas agrees This response does not address those findings and conclusions

Before discussing Staff's specific concerns over the asset management activities of the Company, it is important to note that Nashville Gas has been engaging in asset management transactions since 1999 and that each such transaction has been previously audited and approved both by the Staff and the Authority. Furthermore, these transactions have dramatically increased the gains experienced by ratepayers (and the Company) under its Incentive Plan.[8] In fact, in the Staff's report on Nashville Gas' Incentive Plan activities for the year ended June 30, 2000, the Staff stated:

> The capacity release portion of the Capacity Management Mechanism generated significantly greater savings this plan year as compared to last year. Last year's savings was $11,510. The $1,650,000 savings for this year was the result of Nashville Gas assigning its pipeline capacity to an "asset manager".[9]

This use of asset management arrangements by the Company has been approved repeatedly by both the Staff and the Authority since 1999 and the Company's use of such arrangements this year does not vary materially from its past practices.[10] Further, nothing in the Staff's Audit Report this year suggests that Nashville Gas has varied from the terms of its Incentive Plan or engaged in activities that have been harmful to ratepayers. In fact, the total savings realized from the Incentive Plan for the review period are substantially higher than ever before and total in excess of $3.4 million.[11] It is against this background that the Staff's concerns must be measured.

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[8] This is dramatically illustrated by Exhibit K to the Affidavit of Keith P. Maust, which shows that gains under the Plan increased dramatically beginning in 2000 when Nashville Gas began to use such arrangements.

[9] *Notice Of Filing By Energy and Water Division of the Tennessee Regulatory Authority*, Docket No 00-00759 (April 4, 2001) A copy of the relevant pages of this Notice is attached hereto as Exhibit C

[10] Piedmont also utilizes approved asset management arrangements in both North Carolina and South Carolina Savings under these arrangements are shared with ratepayers in each state Further, the regulatory authorities in both North Carolina and South Carolina have treated these savings as capacity release revenues for purposes of the revenue sharing mechanisms in those states.

[11] See Staff Audit Report at p 3.

The first issue raised by Staff with respect to Nashville Gas' asset management process is the Company's inability to produce a definitive list of parties that received its two asset management RFPs issued during this period. As was briefly explained in the Company's response to the Staff's exception on this point, the inability of the Company to produce this list is a product of the fact that it maintains, on an ongoing basis, a list of approved asset management vendors [12] Inclusion on this list is based on several factors including financial stability and either the Company's experience with a particular vendor or that vendor's reputation in the industry.[13] That list is updated regularly as the relative economic and reliability status of vendors change over time [14] In the process of updating the list of such parties, the Company has not historically archived the prior version of the list and has not been asked to do so by Staff, the Authority, or the Company's independent auditors [15] In order to address this new concern, the Company has taken appropriate steps to initiate an archive process whereby the Company will be able to track this information on a prospective basis In the Company's view, this should satisfy the Staff's concern on this point.

Further, it is difficult for Nashville Gas to understand the Staff's concern over what appears to be a relatively minor item. Nashville Gas has clear records of all parties that responded to its RFPs with bids and has provided those records to the Staff.[16] As such, there is no doubt as to who sought to provide services to Nashville Gas as an asset manager or the relative bids of those parties. Under these circumstances, it is unclear

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[12] Affidavit of Keith P Maust at ¶ 8
[13] *Id* at ¶ 7
[14] *Id* at ¶ 8.
[15] The current version of the Company's asset manager vendor list has 26 companies listed This number is representative of the number of Companies that received the Company's RFPs for the review period Affidavit of Keith P. Maust at ¶ 8 and Exhibit E
[16] Affidavit of Keith P Maust, Exhibit G.

where the risk to ratepayers exists with respect to companies that may have received an RFP but did not submit a bid. In short, while for purposes of complete transparency the Staff may desire to know who received asset management RFPs, and Nashville Gas has agreed to provide this information on a going-forward basis, those parties who received but did not respond to such RFPs are ultimately irrelevant where multiple qualified parties did submit bids, as was the case during this period.

The second issue raised by Staff in its Report relates to the form of bids received by the Company Specifically, Staff is concerned with the fact that several bidders responded to the Company's RFP verbally. While in a perfect world, all bids would be written and signed and in exact conformance with all aspects of RFPs, the world of natural gas trading is not conducted in this manner at all times [17] In this case, Nashville Gas received several responsive bids to its RFPs verbally [18] These bids were recorded by the Company at the time they were made and are reflected in the records provided to Staff during its audit process.[19] These procedures are consistent with the methods utilized by the Company in the past for asset management RFPs which have not been previously questioned by the Staff or the Authority.[20]

In light of these facts, Nashville Gas is somewhat unclear on the potential harm to ratepayers that could arise from this process. It is clearly in both the Company's and the ratepayers best interests to achieve the highest fee possible when entering into asset management transactions. As such, there is no potential for the Company to benefit at the expense of ratepayers [21] Further, requiring written bids in all circumstances could have a

[17] *Id* at ¶ 9
[18] *Id*
[19] *Id* at ¶ 9 and Exhibit G.
[20] *Id* at ¶11
[21] To the extent that Staff is concerned that the Company could be engaging in undetected unlawful

chilling effect on the ability and willingness of potential vendors to submit bids, particularly if the bids vary in some respect from the RFP.[22] In the case of one asset management transaction utilized during this review period, ratepayers and the Company may have lost the benefit of more than $1 million if verbal bids were not accepted by the Company.[23] In any event, no asset management deal is ever entered into by the Company without a written contract.[24] These contracts supercede the bid process and incorporate all terms of the RFP In the absence of some indication that the Company accepted less than the highest bid or engaged in some biased behavior based on improper factors with respect to the bid process, Nashville Gas submits that the Staff's concerns in this regard are not material and provide no rational basis upon which to suspend the Company's Incentive Plan.

The third concern expressed by Staff in its Audit Report is the private nature of Nashville Gas' RFP process. Nashville Gas and the Staff appear to substantively disagree on this subject As is explained briefly in its response to Staff's exceptions, Piedmont considers much of the information contained in its RFPs to be competitively sensitive such that public disclosure thereof would be harmful to the Company and its ratepayers.[25] For this reason, these RFPs are marked as Privileged and Confidential when they are distributed.[26] While publication might conceivably result in a few additional bidders for

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activity with respect to its RFP process, Nashville Gas would point out that. (1) it has never engaged in such practices; (2) it has never been accused of or found to have engaged in such practices, (3) there is no evidence that it has engaged in such activities in this docket, and (4) it has approved codes of conduct in place that prohibit such activity.

[22] Obviously, the Company cannot control the form of the responsive bids it receives

[23] Affidavit of Keith P. Maust, Exhibit G The bid from the high bidder for the July, 2002 to October, 2002 period was verbal and exceeds the next highest bid by more than $1 million

[24] This was true during the period under review in this proceeding *Id* at ¶¶ 10-11 Copies of such contracts are attached to Mr. Maust's affidavit as Exhibits H and I.

[25] Affidavit of Keith P Maust at ¶ 5

[26] *Id* , Exhibits A and B

Nashville Gas' capacity, it is unlikely that the Company would consider them qualified bidders as most, if not all, such entities are well known to Nashville Gas already.[27]

The Staff appears to envisage some process whereby RFPs would be publicly noticed and responded to by any party desiring to bid. Nashville Gas is unaware of any publication (or collection of publications) where such RFPs would be posted If such publications could be found, the costs of such an approach would obviously be more than the email transmission system currently utilized by the Company. Further, and while Nashville Gas does not have perfect knowledge of what other companies do in this area, it is unaware of this type of process being utilized by other parties with respect to management of interstate pipeline capacity assets. In sum, Nashville Gas does not believe that a "public" RFP process of the type envisioned by Staff is desirable or likely to lead to the receipt of more qualified bids, but in any case Staff's apparent desire to move toward such a process does not provide a basis upon which to suspend Nashville Gas' Incentive Plan.

The final concern raised by Staff with respect to the asset management RFP process has to do with the inclusion of the asset management fee under the Incentive Plan. Staff argues that such a fee is not covered by Nashville Gas' tariff, that the Company does not "earn" the fee because it does not engage in any activities other than entry into the agreement, and that Staff cannot determine the reasonableness of the fee because the Company is "not able to provide Staff with a basis for the amount of the fee." The Company disagrees with each of these contentions.

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[27] *Id* at ¶ 7. It is critical that potential asset managers have adequate experience and economic assets sufficient to ensure that Nashville Gas' needs will be met and that if they are not and Nashville Gas has to go to the market to fill its needs, that the costs of that remedy will be recoverable

Under the Gas Procurement Incentive Mechanism in Nashville Gas' tariff, it is authorized to "use futures contracts, financial derivative products, storage swap arrangements, or other private agreements to hedge, manage or reduce gas costs" Under the Capacity Management Mechanism, the Company is authorized to "release transportation or storage capacity . . associated with off-system or wholesale sales-for-resale." In this case, the asset management arrangements are the functional equivalent of a bulk capacity release transaction whereby the Company releases all available capacity rights not needed to meet its requirements in exchange for a substantial guaranteed payment by the asset manager The Staff has previously indicated its concurrence in this conclusion by approving inclusion of the asset management fee under the Incentive Plan and reporting to the Authority the Company's conclusions that:

> the asset manager's lump sum payment is for the value acquired for utilization of the released assets when they are not needed by Nashville Gas. The lump-sum payment is considered a capacity release transaction and, as such, is accounted for in the Performance Incentive plan under the Capacity Management Incentive Mechanism.
>
> In essence, Nashville Gas and its ratepayers are "guaranteed" the up-front lump-sum payment by the asset manager, as opposed to Nashville Gas releasing capacity and entering into off-system sales transactions with third-parties.

See In re: Nashville Gas Company, a division of Piedmont Natural Gas Company Incentive Plan Audit, *Notice of Filing by Energy and Water Division of the Tennessee Regulatory Authority*, Docket No. 00-00759 at p. 4 (April 4, 2001).[28] In light of this treatment of asset management fees by the Staff with respect to the first period in which the Company utilized asset management arrangements, and the consistent treatment given these payments by both the Staff and the Authority in the intervening years, Staff's position that inclusion of the asset management payment should not be allowed under the Incentive

Plan represents a major course reversal. This reversal is not explained or supported in the Staff's Audit Report and should be dismissed given the uniform prior treatment of these payments by the Authority under the Plan

Staff's next contention is that Nashville Gas does not do anything to deserve sharing in the asset management fee under asset management arrangements. This argument seriously misconstrues the manner in which these agreements operate and the other underlying facts involved with the Company's asset management activities. First, it should be noted that the two asset management arrangements at issue in this docket covered the periods July, 2002 through October, 2002 and April, 2003 through July, 2003 During the period November, 2002 until March, 2003, the Company's pipeline assets were managed by the Company. During this period, the Company engaged in a variety of secondary marketing transactions without the aid of an asset manager and was actively engaged in managing its gas supply, storage, and mainline capacity on a daily basis.[29] Further, even when asset management contracts were effective, the Company engaged in exactly the same behaviors to monitor, manage, and schedule its capacity, and to determine if it had excess capacity, as it would have in the absence of the asset management arrangements Finally, under the terms of the asset management arrangements in effect during this review period, Nashville Gas had the ability to call upon and did call upon its capacity for the purpose of engaging in secondary market transactions.[30] In short, the major difference in the daily tasks completed during the effective period of the asset management arrangements was that the Company only transacted with one party, the asset manager, rather than multiple such arrangements with

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[28] See Exhibit C attached hereto
[29] Affidavit of Keith P. Maust, ¶12
[30] *Id*

multiple parties every time it had available supply or capacity[31] Based upon these factors, it is simply not true that the Company enjoyed some dramatic reduction in the efforts necessary to manage its supply and capacity (including its capacity available for release) as a result of the asset management agreements in place during the twelve months ended June 30, 2003.

In any event, the Company's Incentive Plan is self-policing because it encourages the Company to maximize cost-savings and margin generated for customers regardless of the form of the commercial transaction or whether services are outsourced or performed by internal employees. Further, the actual performance of the Plan since its inception indicates that customers have received a greater economic benefit when asset management arrangements are utilized Staff's approach to this issue misses the mark and almost seeks to revert back to a prudency review type approach – a process that was eliminated by this Authority in favor of incentive regulation when it approved Nashville Gas' Incentive Plan.

Staff's final basis for arguing that the asset management fee should not be included under the Incentive Plan is that it cannot determine the basis for the amount of the fee. Nashville Gas is at something of a loss to respond to this concern because the simple fact is that the basis for the fee is competition in an open bid process defined by the RFP. Nashville Gas is not able to explain the details of why a particular asset manager might value Nashville Gas' capacity at a particular price or to what purpose any prospective manager might wish to put these assets as these are matters known only to individual bidders. All that Nashville Gas can evaluate is the price offered for the right to manage the

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[31] Under the asset management arrangements, the Company also had the additional burden of engaging in the time-consuming RFP process which it would not have engaged in if it had performed all capacity release transactions by itself.

capacity and the qualifications of the bidding party to provide the services required by the RFP The extrinsic evidence in this case is that Nashville Gas entered into two different asset management agreements with two different qualified bidders for two different fees during the twelve months ended June 30, 2003 and that in both cases Nashville Gas contracted with the high bidder.[32] There is nothing about these facts that could support any inference of impropriety or risk to ratepayers

Based on the foregoing factors, Nashville Gas respectfully contends that the Staff has raised no material issue with respect to the propriety of the Company's asset management RFP process and has provided no grounds upon which this Authority reasonably could or should suspend the Company's Incentive Plan. As such, the Staff's recommendation to this effect should be rejected.

2. Staff's Concern Regarding the Potential for Market Manipulation Arising from the Company's Use of Nationally Published Pricing Indices is Unwarranted.

In its Report, the Staff cites a concern with the possibility of market manipulation associated with misuse or abuse of nationally reported wholesale price indices for setting the price benchmark under the Gas Procurement Incentive Mechanism. This concern appears to be founded on problems associated with the prior regime of voluntary and unregulated reporting of trades to those indices and forms part of the basis for Staff's recommendation that the Incentive Plan be suspended by the Authority. The situation described by Staff, however, is not reflective of current reality and does not recognize the substantial safeguards now in place to protect the integrity of the national price indices involved in reporting natural gas prices or the reaction of the marketplace to those safeguards. As such, the Staff's concern over this issue should not be relied upon to change or suspend the existing Incentive Plan mechanisms.

[32] Affidavit of Keith P Maust at ¶ 10 and Exhibits G, H, and I.

Over the course of the last several years, the natural gas industry as a whole has taken a close look at the reporting of wholesale natural gas prices to national price index developers such as Gas Daily and Inside FERC. This examination resulted in part from unscrupulous activities undertaken by some wholesale market participants in the context of the dramatic spike in natural gas and electricity prices for services provided to the State of California several years ago. The circumstances of those price spikes were the subject of multiple proceedings before the Federal Energy Regulatory Commission ("FERC") These proceedings included a FERC Staff fact-finding investigation and report of the natural gas and electric markets serving California during the price spike in FERC Docket No. PA02-2-000; the convening of a public conference proceeding on April 24, 2002 in FERC Docket No. AD03-7-000 for the purpose of investigating, with the assistance of the Commodity Futures Trading Commission, issues surrounding wholesale price indices and the reporting of sales transactions to index developers; the issuance by FERC of a *Policy Statement on Natural Gas and Electric Price Indices*,[33] and the issuance of a *Notice of Proposed Rulemaking*[34] and subsequent *Final Rule*[35] establishing new code of conduct and blanket certificate requirements designed to preclude market manipulation and improper reporting of trade information to national price indices.

Each of these investigations, policy statements and rulemaking proceedings were undertaken by FERC for the express purpose of ensuring accuracy and integrity in the reporting of natural gas trades and in preventing market manipulation of the sort raised by Staff in its Report. For example, in the *Final Rule* issued by FERC in RM03-10-000, FERC

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[33] *Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121 (2003). Affidavit of Richard A. Flebbe, Exhibit B
[34] *Notice of Proposed Rulemaking in Docket No RM03-10-000*, 103 FERC ¶ 61,350 (2003).
[35] *Final Rule in Docket No RM03-10-000*, 105 FERC ¶ 61,217 (2003) Affidavit of Richard A Flebbe, Exhibit A.

imposed the following requirements on any party making a sale of natural gas for resale (1) any effort to manipulate markets or pricing of natural gas is unlawful, (2) parties making and reporting such sales must provide accurate and complete information regarding all material terms of the sale, (3) only arms-length sales may be reported to indices providers and no transactions between affiliates may be reported whether or not they were arms-length; (4) records relating to all sales must be maintained for a period of three years; and (5) all sellers of natural gas for resale must comply with FERC's *Policy Statement on Natural Gas and Electric Price Indices*. In addition, the FERC required all parties engaging in blanket certificate sales of natural gas to inform FERC as to whether they reported trades to the national price indices[36] and also established a "safe harbor" provision to encourage the reporting of such trades.

In addition to the FERC initiatives on this subject, Piedmont has also participated in a vibrant industry discussion on this issue. This has involved chairing a task force of the American Gas Association on this subject and participation with a number of other industry groups, including the Committee of Chief Risk Officers and FERC, in addressing issues related to price reporting and market manipulation.[37] These groups engaged in a collaborative process with the FERC to establish new standards and processes both for the submission of trade data and for index development. Further, Piedmont and Nashville Gas have adopted internal procedures to be consistent with the new reporting standards

[36] In its Report, Staff asserts that Piedmont and Nashville Gas do not report trades to the national price indices That assertion is not correct Exhibit C to Mr. Flebbe's Affidavit is a copy of the filing made by Piedmont on February 26, 2004 indicating that Piedmont (and Nashville Gas) had begun reporting trades on that date

[37] Piedmont Natural Gas Company's President and CEO, Mr. Thomas Skains, was the head of the AGA Task Force on this subject and Mr Frank Yoho, Piedmont's Senior Vice President – Commercial Operations was also active on the issue

As a result of the strong industry and regulatory response to prior anomalies in price reporting, the relative consensus of participants in the industry today is that those indices are recovering from the problems they experienced a few years ago and are reliable, safe, and accurate reflections of market prices for natural gas at various locations throughout the nation. This view is substantiated by the fact that recent reports indicate that the reporting of trades to national price indices has increased significantly [38] Nashville Gas as well as Piedmont share this view and, contrary to the Staff Audit Report, both now participate in the reporting of trades to national price indices.[39]

In sum, the situation relative to safeguards on the reporting of natural gas trades by national indices is substantially improved over where it was several years ago when abuses occurred in the Western markets. The types of behaviors that caused some concern then about the integrity of national price indices have been proscribed by FERC and are now clearly illegal. Further, FERC continues to monitor this area and it is reasonable to expect that any additional actions necessary to protect the integrity of wholesale price indices will be promptly pursued by FERC. Given these facts, Nashville Gas contends that Staff's concerns over potential market manipulation are not well-founded and should not be relied upon to suspend the operation of Nashville Gas' Incentive Plan.

3. Staff's Concern Over Possible "Excess" Capacity Retained by Nashville Gas is Unjustified.

In the Conclusions Section of its Report, Staff expresses concern over possible "excess" capacity maintained by Nashville Gas as part of its interstate pipeline transportation and storage capacity portfolio. While Staff recognizes that "a certain amount of excess capacity on the pipeline is necessary to guarantee delivery of gas to the

[38] See Affidavit of Keith P Maust, Exhibit L
[39] See Affidavit of Richard A. Flebbe, Exhibit C

firm residential customers on the coldest day of the year," Staff also states that the appropriate level of such capacity has not been addressed in Nashville's Incentive Plan. Based on this conclusion, Staff indicates that it needs assurance that the level of capacity maintained by the Company is reasonable to ensure end-users are not paying for unneeded capacity.

Nashville Gas agrees with the premise that its customers should not be required to pay for storage and transportation capacity levels that are clearly excessive with respect to the requirements needed by the Company to provide reliable and secure natural gas service in design day conditions [40] Nashville Gas strongly disagrees with the Staff, however, with respect to the assertions that (1) the appropriate level of "excess" capacity for the Company has not been addressed in Nashville Gas' Incentive Plan, and (2) Staff needs further assurance that Nashville Gas' capacity levels are reasonable. Both of these assertions are incorrect The record of prior proceedings related to Nashville Gas' incentive plan and the underlying status of Nashville Gas' existing capacity entitlements compared to its projected needs, as explained below, clearly and unequivocally establish the propriety of Nashville Gas' existing interstate capacity entitlements.

Nashville Gas utilizes a 5% reserve margin planning factor in managing and obtaining interstate pipeline storage and transportation capacity, as well as the Company's own Liquified Natural Gas ("LNG") assets.[41] This margin helps to ensure that during a peak or near peak day scenario the Company will be able to serve the needs of its heat-sensitive firm customers reliably and safely without an unreasonable risk of curtailment.[42] This 5% reserve margin allows for the possibility that one or more of Nashville Gas' peak day

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[40] The concept of "excess" capacity is somewhat subjective In Nashville Gas' view, this concept must be applied subject to the realities of the marketplace in contracting for firm long-term capacity.
[41] The 5% reserve margin is applied to design day conditions

delivery assets might be curtailed or otherwise unavailable to some degree due to circumstances beyond the Company's control or that demand by customers could exceed the design day needs calculated by the Company[43] This 5% reserve margin is utilized by Piedmont in planning for the peak day requirements of its firm heat-sensitive customers in each of the three states in which it provides local distribution and transmission services and the costs of maintaining this level of interstate pipeline capacity have been routinely and repeatedly approved by the regulatory authorities in all three states for many years.

Central to the Staff's concerns in this case, this level of reserve capacity has been specifically approved by the regulatory authorities supervising Nashville Gas' Incentive Plan in the State of Tennesee. Specifically, in the May 31, 1996 Order approving Nashville Gas Company's Performance Incentive Plan in Docket No. 96-00805, the Tennessee Public Service Commission, in decretal ordering paragraph 5 of that Order, found "[t]hat the five percent (5%) reserve margin proposed by Nashville as part of the Incentive Plan is approved."[44] This Order authorized Nashville Gas to implement its incentive plan for a two year period subject to further review by the Commission. Subsequently, in the March 11, 1999 *Order Approving Performance Incentive Plan* in Docket No. 96-00805, this Authority – after reviewing the results of the Plan over the prior two year period and based upon the recommendations of a third-party consultant – authorized Nashville Gas to:

> continue to operate under the Incentive Plan, as modified herein, in such a manner that the Incentive Plan will automatically rollover for an additional plan year on each July 1st, beginning July 1, 1998, and will continue until the Incentive Plan is either (a) terminated at the end of a Plan Year by not less than 90 days notice by Nashville to the Authority or (b) the Incentive plan is modified, amended or terminated by the Authority.[45]

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[42] Affidavit of Kenneth L Valentine, at ¶ 4
[43] *Id* at ¶ 5
[44] See Exhibit A attached hereto.
[45] See Exhibit B attached hereto

The Incentive Plan approved by the Authority in this Order included the 5% reserve margin component Further, no issue regarding the 5% reserve margin has ever been raised by the Staff or by any party after its initial approval in 1996 and it has, in fact, been an integral component of Nashville Gas' Incentive Plan since the inception of that plan Given that the 5% reserve margin has been specifically approved by the Authority's predecessor and implicitly approved and carried forward by the Authority's own authorization, Nashville Gas submits that Staff is simply incorrect when it states that the level of excess capacity needed by Nashville Gas in conjunction with its Incentive plan has not been addressed

Staff's contention that it needs additional assurance that Nashville Gas' existing level of capacity is reasonable is also mistaken. As is established in the Affidavit of Kenneth T Valentine, Nashville Gas currently has no "excess" capacity.[46] In fact, just the opposite is true Demand projections made by the Company and shared with Staff last Fall, indicate that Nashville Gas is in substantial need of additional long-term firm transportation and storage capacity in the immediate future to ensure that it is able to meet its customers current and future needs.[47] As is reflected on Exhibit A attached to Mr. Valentine's affidavit, this need has existed for the past several years but has been bridged with short-term transportation capacity purchased from Columbia Gulf Transmission Company. The expanding nature of the growth in Nashville Gas' peak day demand requirements going forward, however, precludes the continued utilization of short-term capacity to bridge the gap between its customer requirements and its existing long-term firm contracts. Nashville Gas is, in fact, pursuing long-term capacity to satisfy its

[46] Affidavit of Kenneth T Valentine at ¶ 6 and Exhibit A
[47] Staff was provided with an abbreviated three-year version of Exhibit A to Mr Valentine's Affidavit during last Fall's Natural Gas Forum as part of the Company's normal annual consultation with Staff regarding these matters Affidavit of Kenneth T Valentine at ¶ 6

growing needs and hopes to begin to have additional capacity in place by this Fall[48] To the extent that any questions existed with respect to the reasonableness of Nashville Gas' existing interstate storage and transportation capacity levels, those questions are fully addressed by Mr. Valentine's Affidavit and Exhibit A attached thereto.

In sum, Staff's concerns regarding the reasonableness of the existing levels of Nashville Gas capacity and the Company's reserve margin are unfounded. The 5% reserve margin built into the Company's Incentive Plan has been specifically approved in the context of the Plan and the Company's current long-term firm capacity entitlements are not sufficient to meet its growth in demand These concerns, as expressed in the Staff's Audit Report, are not based on an accurate understanding of the facts.

4. Staff's Request to Expand the Scope of the Incentive Plan Audit Process and to Grant it Supervisory Authority Over the Asset Manager RFP Process Should be Declined.

As Staff has acknowledged in its Report, the purpose of the IPA audit is to determine that the accounting for transactions under the Company's Incentive Plan are accurate and correct.

> The objective of the audit was to determine whether the balance in the Incentive Plan Account as of June 30, 2003, 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.[49]

In this case, however, and notwithstanding its recognition of the limited scope of its audit, Staff has reached Findings, Conclusions and Recommendations that would exponentially expand the scope of its audit role and would provide it with supervisory authority over

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[48] *Id*

[49] Staff Audit Report at p. 1 This conclusion is further supported by the Staff's description of its audit scope set forth on page 4 of its Report:

> [The] audit goal [is] to verify that the Company's calculations of incentive gains and losses [are] materially correct, and that the Company is following all Authority orders

certain aspects of Nashville Gas' Incentive Plan. Nashville Gas does not believe that this expansion of the Staff's responsibility over the Company's Incentive Plan is necessary or appropriate for several reasons.

First, the Staff's audit in this case goes well beyond ensuring that the balance shown in the IPA is calculated in conformance with the terms of the Incentive Plan. Instead, Staff's audit raises multiple and substantive issues with the underlying industry and Company parameters under which the Plan operates. While those parameters may be characterized as subjects of legitimate general interest to the Staff, it is not appropriate to insert them into their limited audit of Nashville Gas' Incentive Plan. Instead, these issues – asset management arrangements, reliability of price indices and reasonable levels of reserve capacity – are all general issues of gas procurement and would be equally applicable to all companies purchasing natural gas for distribution to end-users within Tennessee. As such, and to the extent the Staff or the Authority may have some lingering concerns about these issues, some more generic forum would be the appropriate vehicle for examination of these concerns.

Second, Staff's request for additional expert help in conducting future Incentive Plan audits is reflective of the expansion of their audit role in this case. In fact, Staff's request for additional expert assistance in future audits is expressly based upon "the complexity of the issues identified in this audit." No additional expert knowledge should be needed to simply determine if the balances in the IPA are correctly calculated consistent with the terms of the Incentive Plan. Accordingly, unless the Authority adopts and approves the expanded audit role sought by Staff, there would not appear to be any

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and directives with respect to its calculation of the IPA account balance necessity to authorize retention of expert consultants to assist with the annual audit process

Third, the Staff's expanded audit role, if approved, will substantially increase the level of review required of Nashville Gas' Incentive Plan on an annual basis. Given that the Plan has already been approved by the Authority after an experimental period, is operating in accordance with its terms, and is producing substantial savings to ratepayers, Nashville Gas does not believe that any justification for such additional levels of annual review and the expense associated therewith have been provided As such, the Authority should maintain the focus of Staff's audit on ensuring compliance with the Plan and not expand that audit to include partial re-evaluation of underlying aspects of the Plan every year.

Finally, Nashville Gas is extremely concerned about the suggestion that Staff be given supervisory authority over the Company's asset management RFP process This function is central to the provision of natural gas service to the Company's customers and the ultimate legal responsibility for such activity lies squarely with the Company subject to regulation by the Authority. In addition, execution of this process requires substantial industry expertise in buying and procuring gas supplies, scheduling, nomination and operating parameters of various interstate pipelines, and the identity and integrity of various participants in the natural gas marketplace, among other factors.[50] Insertion of the Staff in a <u>supervisory</u> role over that process would constitute a serious regulatory intrusion into what is unarguably a commercial process. This arrangement would be unprecedented in the Company's experience.[51] Further, given the minor nature of Staff's concerns over

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[50] Given Staff's asserted need for additional expertise to simply audit Nashville Gas' Incentive Plan, Nashville Gas questions how Staff will produce the industry expertise needed to engage in supervisory management functions

[51] Nashville Gas submits that the more normal regulatory process is for the Company to supervise its contractual and gas supply activities subject to the rules and requirements of the Authority. The

the Company's RFP practices (which have been repeatedly approved by the Authority in past audits) Nashville Gas does not believe that any reasonable case has been made to support Staff's recommendation in this regard.

Staff has not identified what legal authority would provide the basis for its supervision of the contractual RFP process, what remedies would be available to the Company if it were subject to claims (including corporate governance and securities claims) based on Staff's supervision, or what methods would be available to resolve disagreements between Staff and the Company. Each of these matters (and undoubtedly others) would have to be resolved before Staff could be given supervisory authority over any commercial activities of the Company such as its asset management RFP process. Based on these factors, Nashville Gas strongly requests that Staff's proposals to supervise the asset management RFP process and expand the scope of its annual IPA audit through the retention of outside experts be rejected.

5. Staff's Recommendation that Nashville Gas' Incentive Plan be Suspended Should be Rejected.

Nashville Gas' Performance Incentive Plan has been in place for more than seven years. As is shown on Exhibit K to the Affidavit of Keith P. Maust, during that period it has generated more than $14 million in savings, $7,961,180 of which has been credited directly to ratepayers. It has been evaluated by an independent consultant, by the Tennessee Public Service Commission and by the Tennessee Regulatory Authority. In each case, it has been found to be prudent, operationally efficient and in the public interest. During the last seven years, it has been a significant contributor to the economic well-being of Tennessee ratepayers and to the affordability of natural gas service. In fact, during the period covered by the Staff's audit, the Plan saved more than $3.4 million from

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Staff's suggestion would be a substantial departure from this model

Gas Procurement and Capacity Management activities.[52] During the audit, Staff became concerned about several generic[53] and one specific[54] issue, each of which has been shown to be either non-material to the functioning of the Plan or not based on fact. If the Plan is suspended, ratepayers and the Company will suffer substantial and unrecoverable economic loss through higher rates for natural gas service. In light of these factors, as discussed more fully above, Nashville Gas submits that it would be irresponsible, unreasonable and contrary to the public interest to suspend the operation of the Company's Incentive Plan in these circumstances. As such, Nashville Gas urges the Authority to reject the Staff's recommendation to this effect.

CONCLUSION

For the reasons set forth above, Nashville Gas respectfully requests that the Authority reject the specific findings, conclusions and recommendations contained in the Staff Audit report and discussed above and approve the continuation of Nashville Gas' Performance Incentive Plan in accordance with its tariff.

This the 8th day of April, 2004.

R Dale Grimes

R Dale Grimes

ATTORNEY FOR NASHVILLE GAS COMPANY

OF COUNSEL:

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315 Deaderick Street
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Nashville, Tennessee 37238-3001
Telephone: 615-742-6244

[52] Staff Audit Report at p 3
[53] The reliability of price indices and reasonable levels of "excess" capacity
[54] RFP documentation

James H. Jeffries IV

ATTORNEY FOR NASHVILLE GAS COMPANY

OF COUNSEL

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of NASHVILLE GAS COMPANY'S RESPONSE TO THE ENERGY AND WATER DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT was served upon the parties in this action by facsimile transmission and/or hand-delivery addressed as follows:

Mr. Randal Gilliam
Staff Attorney
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

This the 8th day of April, 2004

James H. Jeffries IV

EXHIBIT A

TO

NASHVILLE GAS COMPANY'S RESPONSE TO THE ENERGY AND WATER DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT

BEFORE THE TENNESSEE PUBLIC SERVICE COMMISSION
Nashville, Tennessee

May 31, 1996

IN RE: APPLICATION OF NASHVILLE GAS COMPANY, A DIVISION OF PIEDMONT NATURAL GAS COMPANY TO ESTABLISH A PERFORMANCE INCENTIVE PLAN

DOCKET NO. 96-00805

This matter came on to be heard on May 9, 1996 upon the application of Nashville Gas Company (Nashville or Company), a division of Piedmont Natural Gas Company, Inc., to establish a performance incentive plan (Incentive Plan). At the hearing, the following appearances were entered:

FOR NASHVILLE GAS COMPANY

Joseph F. Welborn
Bass, Berry & Sims
2700 First American Center
Nashville, TN 37238-2700

Jerry W. Amos
Amos & Jeffries, LLP
P O Box 787
Greensboro, NC 27402

FOR ASSOCIATED VALLEY INDUSTRIES

Henry Walker
Boult, Cummings, Conners & Berry, PLC
414 Union Street, Suite 1600
P O Box 198062
Nashville, TN 37219

FOR THE CONSUMER ADVOCATE DIVISION OF THE STATE OF TENNESSEE ATTORNEY GENERAL'S OFFICE

Vincent Williams
Consumer Advocate
450 James Robertson Parkway
Nashville, TN 37243-0485

FOR UNITED CITIES GAS COMPANY

Mark G. Thessin
5300 Maryland Way
Brentwood, TN 37027

On April 22, 1996, Nashville filed an application for approval of the Incentive Plan According to the Company, the Incentive Plan will provide Nashville with incentives to acquire gas at the lowest reasonable cost consistent with a secure gas supply, eliminate the need for time consuming and costly prudence reviews, and reduce consumer gas rates.

The Incentive Plan as originally filed may be summarized as follows:

> **Effect on Existing Ratemaking Procedures.** Under the Incentive Plan, Nashville will be permitted to increase or required to decrease the margin component of its rates to reflect its performance gains or losses. No other changes would be required in existing ratemaking procedures. Nashville's base rates and base margin would continue to be established in general rate case filings. Nashville would continue to recover its gas costs under the existing PGA procedures and its GSR costs under the existing approved procedures. Nashville would also continue to adjust its rates as permitted by the WNA procedures.
>
> **General Description of Incentive Plan.** The Incentive Plan is comprised of two interrelated components--a Gas Procurement Incentive Mechanism and a Capacity Management Incentive Mechanism. The Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which Nashville's city gate commodity cost of gas is compared, and also addresses the recovery of gas supply reservation fees, the treatment of offsystem sales and wholesale interstate sale for resale transactions, and the use of financial or private contracts in managing gas costs The Capacity Management Incentive Mechanism is designed to encourage Nashville to actively market offpeak unutilized transportation and storage capacity on pipelines in the secondary market.

General Description of the Gas Procurement Incentive Mechanism. The Gas Procurement Incentive Mechanism establishes a monthly benchmark dollar amount to which Nashville's actual city gate commodity gas costs are compared. If the total commodity gas purchase costs for a given month vary from the benchmark dollar amount by more than one percent (the monthly deadband), the variance or excess from the one percent deadband will be considered incentive gains or losses. These incentive gains or losses will be shared on a 50/50 basis between the company and its ratepayers subject to an overall annual cap of $1 6 million on gains or losses for Nashville under the plan The benchmark dollar amount is established by multiplying total actual purchase quantities each month by a monthly price index. The monthly price index is a composite price referencing monthly index prices published by *Inside FERC* weighted by location according to Nashville's firm capacity rights each month on upstream pipelines for gas supplies purchased by Nashville in the first-of-the-month market and transported under Nashville's firm transportation (FT) contracts, monthly index prices published by *Inside FERC* for spot supplies purchased in the first of the month market and delivered to the city gate using transportation arrangements other than Nashville's FT contracts, and the weighted average daily index prices published by *Gas Daily* for Nashville's daily spot purchases.

Reservation Fees. Nashville would continue to pass through reservation fees paid to gas suppliers on a dollar for dollar basis (with no profit or loss potential). With respect to new or replacement supply arrangements or price renegotiations under existing arrangements, Nashville would solicit bids or proposals for service and choose the best bid for the firm service Nashville requires consistent with its "best cost" gas procurement strategy. Nashville would continue to reserve the right to offer existing suppliers (who have performed well under expiring contracts) a right of first refusal to match the best bid

Offsystem Sales and Wholesale Sale for Resale Transactions. Any margin generated as the result of offsystem sales or wholesale sale for resale transactions using Nashville's firm transportation or storage capacity entitlements (the costs of which are recovered from Nashville's ratepayers) would be credited to gas costs and would be shared with ratepayers under the Gas Procurement Incentive Mechanism Margin would be defined as the difference between the sales proceeds and the total variable costs incurred by Nashville in connection with the transaction, including transportation and gas costs, taxes, fuel, or other costs. For purposes of gas costs, Nashville would impute such costs for its related supply purchases at the benchmark first-of-the-month or daily index, as appropriate, on the pipeline and in the zone in which the sale takes place. The difference between Nashville's actual costs and such index price is already taken into account under the plan. As to transportation costs, Nashville would impute such costs up to the transporting pipeline's maximum interruptible transportation (IT) rate. The difference between the maximum IT rate and Nashville's actual transportation commodity costs would be treated as capacity release margin under the Capacity Management Incentive Mechanism. After deducting the total transaction costs from the sales proceeds, any remaining margin would be credited to commodity gas costs and shared on a 50/50 basis with ratepayers.

Financial and Other Private Contracts. To the extent Nashville uses futures contracts, other financial derivative products, storage swap arrangements or other private contractual arrangements to hedge, manage or reduce gas costs, it would flow through any gains or losses through the commodity cost component of the Gas Procurement Incentive Mechanism.

Capacity Management Incentive Mechanism. The Capacity Management Incentive Mechanism is designed to provide Nashville an incentive to release unutilized offpeak firm transportation or storage capacity in the secondary interstate market and reduce Nashville's demand charges paid under those contracts to pipelines. The plan would flow back to Nashville's ratepayers 75% of the resulting cost savings and credit Nashville with 25% of the savings Transportation or storage margin embedded in offsystem sales or wholesale interstate sale for resale transactions (as described above) would also be subject to the same variable sharing formula. Like the other components of Nashville's incentive plan, the Capacity Management Incentive Mechanism would be subject to the $1 6 million overall annual cap on gains and losses for Nashville established for the plan.

New Pipeline Capacity Demand Costs and Gas Supply Reservation Fees. New pipeline capacity demand costs and/or gas supply reservation fees would be recovered through the PGA on a dollar for dollar basis (with no profit or loss potential) Nashville would solicit bids and will choose the bid which best matches Nashville's requirements. As new firm transportation capacity or supply services are added to Nashville's portfolio, Nashville would amend the monthly price index formula set forth in the Gas Procurement

Incentive Mechanism to take into account any new weighting of capacity entitlements within the supply zones.

Cap on Gain and Losses. Nashville would be limited to overall gains or losses totaling $1.6 million under the Incentive Plan in any plan year. Such gains or losses would 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.

Accounting Procedures. Each month during the term of plan, Nashville would compute any gains or losses under the Incentive Plan. If Nashville earns a gain, a separate non-interest bearing Incentive Plan Account (IPA) would be debited with such gain. If Nashville incurs a loss, that same IPA would be credited with such loss The offsetting entries to IPA gains or losses would be recorded to income or expense, as appropriate. At its option, however, Nashville may temporarily record any monthly gains in a non-regulatory deferred credit balance sheet account until results for the entire plan year are available. Each year, effective November 1, the rates for all customers, excluding interruptible transportation customers who receive no direct benefits from any gas cost reductions resulting from the plan, would be increased or decreased by a separate rate increment or decrement designed to amortize the collection or refund of the June 30 IPA balance over the succeeding twelve month period. The increment or decrement would be established by dividing the June 30 IPA balance by the appropriate volumetric billing determinants for the twelve months ended June 30. During the twelve month amortization period, the amount collected or refunded each month would be computed by multiplying the billed volumetric determinants for such month by the increment or decrement, as applicable. The product would be credited or debited to the IPA, as appropriate. The balance in the IPA would be tracked as a separate collection mechanism.

Reports. Nashville would file interim quarterly reports of the IPA account with the Commission not later than 60 days following the end of each fiscal quarter and would file an annual report of IPA activity not later than 60 days following the end of each plan year.

Proposed Effective Date. Nashville requests an effective date of July 1, 1996, with the first plan year contiruing through June 30, 1997. The plan would rollover into a second year commencing July 1, 1997 and ending June 30, 1998 with the agreement of Nashville and the approval of the Commission Nashville would inform the Commission of its intention to roll over the plan for a second year no later than April 1, 1997.

In conjunction with the proposed Incentive Plan, Nashville also proposed to establish a five percent "reserve margin."

On April 30, 1996, the Commission gave notice that it had scheduled a hearing in this matter for May 9, 1996 at 9·00 a m. in the Commission Hearing Room on the Ground Floor at 460 James Robertson Parkway, Nashville, Tennessee.

On May 2, 1996, the Consumer Advocate filed a Petition to Intervene, Suspend Tariff, and Continue. On April 30, 1996, United Cities Gas Company (United Cities) filed a Petition to Intervene. On May 7, 1996, Associated Valley Industries Group (AVI) filed a Petition to Intervene. On May 9, 1996, the Consumer Advocate filed a motion to withdraw

On May 9, 1996, the hearing was held as scheduled. At the start of the hearing, counsel for Nashville announced that as a result of discussions with representatives of the Consumer Advocate, the Company had agreed to make the following modifications to the Incentive Plan.

a. Interest will be computed on the average monthly balance of the Incentive Plan Account (IPA) at the same interest rate and in the same manner as used to compute interest on the "Refund Due Customers' Account" of the Company's Purchased Gas Adjustment (PGA).

b) To the extent that Nashville renegotiates existing reservation fee supply contracts or executes new reservation fee supply contracts with commodity pricing provisions at a discount to the first-of-the-month price index, Nashville would modify the monthly commodity price index to reflect such discount

c. To the extent Nashville is able to release transportation or storage capacity, or generate transportation or storage margin associated with off-system or wholesale sales-for-resale, the associated cost savings shall be shared by Nashville and customers according to the following sharing formula.

Capacity Management Incentive cost savings as a percent of Nashville's annual transportation and storage demand costs.	Sharing percentages Nashville/Customers. (Percent)
Up to and including 1 percent	0/100
Greater than 1 percent but less than or equal to 2 percent	10/90
Greater than 2 percent but less than or equal to 3 percent	25/75
Greater than 3 percent	50/50

The sharing percentages shall be determined based on the actual demand costs incurred by Nashville (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 gains or losses resulting from adjustments to the sharing percentages caused by refunds or surcharges shall be recorded in the current Incentive Plan Account (IPA).

A copy of the tariff containing the modified Incentive Plan was received in evidence along with the prefiled direct and supplemental direct testimony of the Company. The Company's witnesses were made available for cross examination

At the conclusion of the hearing, Commissioner Hewlett made a motion to approve the proposed Incentive Plan as modified by the agreement between Nashville and the Consumer Advocate and to direct the Company and the Commission Staff to recommend a qualified independent consultant to review the progress of this mechanism and to annually report their findings to the Commission The motion was seconded by Commissioner Kyle and unanimously adopted.

IT IS THEREFORE ORDERED:

1. That Nashville Gas Company's Service Schedule No. 14, Performance Incentive Plan, as attached to this Order is approved effective July 1, 1996.

2. That the first plan year shall begin on July 1, 1996 and end on June 30, 1997. The Incentive plan will rollover into a second year commencing July 1, 1997 and ending June 30, 1998 upon the request of the Company and the approval of the Commission.

3. That Nashville Gas Company is relieved of any responsibility for prudence reviews during the initial term of the Incentive Plan and any extension thereof.

4. That the Company and the Commission Staff recommend a qualified independent consultant to review the progress of the approved Incentive Plan and to annually report their findings to the Commission.

5. That the five percent (5%) reserve margin proposed by Nashville as part of the Incentive Plan is approved.

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

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

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

**

CHAIRMAN

COMMISSIONER

COMMISSIONER

ATTEST

EXECUTIVE DIRECTOR

** Chairman Bissell voted in favor of this petition as reflected in the transcript in this docket.

NASHVILLE GAS COMPANY
665 Mainstream Drive
Nashville, Tennessee 37228
A Division of Piedmont Natural Gas Company
TPSC Service Schedule No 14

SERVICE SCHEDULE NO. 14
Performance Incentive Plan

APPLICABILITY
The Performance Incentive Plan replaces the current reasonableness or prudence review of Nashville Gas Company's (Nashville) gas purchasing activities overseen by the Commission. The plan is designed to provide incentives to Nashville in a manner that will produce rewards for its customers and its shareholders and improvements in Nashville's gas procurement activities Each plan year will begin July 1. The annual provisions and filings herein would apply to this annual period

OVERVIEW OF STRUCTURE
Nashville's Performance Incentive Plan is comprised of two interrelated components

- Gas Procurement Incentive Mechanism
- Capacity Management Incentive Mechanism

The Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which Nashville's commodity cost of gas is compared It also addresses the recovery of gas supply reservation fees, the treatment of off-system sales and wholesale interstate sale for resale transactions, and the use of financial or private contracts in managing gas costs The net incentive benefits 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 Nashville to actively market off-peak unutilized transportation and storage capacity on upstream pipelines in the secondary market. The net incentive benefits or costs will be shared between the Company's customers and the Company utilizing a graduated sharing formula, with sharing percentages for Nashville ranging between zero and fifty percent

The Company will have a cap on incentive gains and losses During the initial plan year, Nashville's overall gains or losses cannot exceed $1.6 million annually Also as a part of the Performance Incentive Plan, Nashville submitted a Three Year Supply Plan and will obtain additional firm gas supply related thereto Included in the Three Year Supply Plan is support for a capacity reserve margin

GAS PROCUREMENT INCENTIVE MECHANISM
The Gas Procurement Incentive Mechanism addresses the following areas

- Commodity Costs
- Gas Supply Reservation Fees

NASHVILLE GAS COMPANY
665 Mainstream Drive
Nashville, Tennessee 37228
A Division of Piedmont Natural Gas Company
TPSC Service Schedule No 14

- Off-System Sales and Sale for Resale Transactions
- Use of Financial Instruments or Other Private Contracts

COMMODITY COSTS

Each month Nashville will compare its *total city gate commodity cost of gas*[1] to a benchmark dollar amount The benchmark gas cost will be computed by multiplying total actual purchase quantities for the month by a price index. The monthly price index is defined as

$$I = F_f(P_0K_0+P_1K_1+P_cK_c+\ldots P_n K_n)+F_oO+F_dD; \text{ where}$$

$$F_f+F_o+F_d= 1, \text{ and}$$

I = the monthly city gate commodity gas cost index.

F_f = the fraction of gas supplies purchased in the first-of-the-month market which are transported to the city gate under Nashville's FT service agreements

P = the *Inside FERC Gas Market Report* price index for the first-of-the-month edition for a geographic pricing region, where subscript 0 denotes Tennessee Gas Pipeline (~~TPG~~ TGP) Rate Zone 0; subscript 1 denotes TGP Rate Zone 1, subscript C denotes Columbia Gas Transmission (CGT), Louisiana, plus applicable transportation and fuel charges in CGT's FT tariff to Rayne, and

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[1] Gas purchases under Nashville's existing supply contract on the Tetco system are excluded from the incentive mechanism Nashville will continue to recover 100 percent of these costs through its PGA with no profit or loss potential Extension or replacement of such contract shall be subject to the same competitive bidding procedures that will apply to other firm gas supply agreements In addition, Nashville's gas procurement incentive mechanism will measure storage gas supplies against the benchmark index during the months such quantities are purchased for injection. For purposes of comparing such gas purchase costs against the monthly city gate index price, Nashville will exclude any commodity costs incurred downstream of the city gate to storage so that Nashville's actual costs and the benchmark index are calculated on the same basis

Issued By John H Maxheim
Issued On April 2, 1996

Effective July 1, 1996
Docket No 96-00805

NASHVILLE GAS COMPANY
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TPSC Service Schedule No 14

subscript ∝ denotes new incremental firm services to which Nashville may subscribe in the future[2] The commodity index prices will be adjusted to include the appropriate pipeline maximum firm transportation (FT) commodity transportation charges and fuel retention to the city gate under Nashville's FT service agreements

K = the fraction (relative to total maximum daily contract entitlement) of Nashville's total firm transportation capacity under contract in a geographic pricing region, where the subscripts are as above[3]

F_o = the fraction of gas supplies purchased in the first-of-the-month spot market which are delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts

O = the weighted average of *Inside FERC Gas Market Report* first-of-the-month price indices, plus applicable maximum IT rates and fuel retention, from the source of the gas to the city gate, where the weights are computed based on actual purchases of gas supplies purchased by Nashville and delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts

F_d = the fraction of gas supplies purchased in the daily spot market

D = the weighted average of daily average index commodity prices taken from *Gas Daily* for the appropriate geographic pricing regions, where the weights are computed based on actual purchases made during the month The

[2] To the extent that Nashville renegotiates existing reservation fee supply contracts or executes new reservation fee supply contracts with commodity pricing provisions at a discount to the first-of-the-month price index, Nashville would modify the monthly commodity price index to reflect such discount

[3] Because the aggregate maximum daily contract quantities in Nashville's FT contract portfolio vary by month over the course of the year, the weights would be recalculated each month to reflect actual contract demand quantities for such month The contract weights, and potentially the price indices used, would also vary as Nashville renegotiates existing or adds new FT contracts As new contracts are negotiated, Nashville would modify the index to reflect actual contract demand quantities and the commodity price indices appropriate for the supply regions reached by such FT agreements

Issued By John H Maxheim
Issued On April 2?, 1996

Effective July 1, 1996
Docket No 96-00805

commodity index prices will be adjusted to include the appropriate maximum transportation commodity charges and fuel retention to the city gate

If the actual total commodity gas purchase cost in a month is within one percent of the benchmark dollar amount, then there will be no incentive gains or losses If the actual total commodity gas purchase cost varies from the benchmark dollar allowance by more than one percent, then the variance in excess of the one percent threshold shall be deemed incentive gains or losses under the plan. Such gains or losses will be shared 50/50 between the Company and the ratepayers.

Gas Supply Reservation Fees

Nashville will continue to recover 100% of gas supply reservation fee costs through its PGA with no profit or loss potential For new contracts and/or contracts subject to renegotiation during the Plan year, Nashville will solicit bids for gas supply contracts containing a reservation fee

Off-System Sales And Sale For Resale Transactions

Margin on off-system sales and wholesale sale-for-resale transactions using Nashville's firm transportation and capacity entitlements (the costs of which are recovered from Nashville's ratepayers) shall be credited to the commodity gas cost component of the Gas Procurement Incentive Mechanism and will be shared with ratepayers Margin on such sales will be defined as the difference between the sales proceeds and the total variable costs incurred by Nashville in connection with the transaction, including transportation and gas costs, taxes, fuel, or other costs For purposes of gas costs, Nashville will impute such costs for its related supply purchases at the benchmark first-of-the-month or daily index, as appropriate, on the pipeline and in the zone in which the sale takes place The difference between Nashville's actual costs and such index price is taken into account elsewhere under the plan As to transportation costs, Nashville will impute such costs up to the transporting pipeline's maximum interruptible transportation (IT) rate The difference between the maximum IT rate and Nashville's actual transportation commodity costs will be treated as capacity release margin under the Capacity Management Incentive Mechanism After deducting the total transaction costs from the sales proceeds, any remaining margin will be credited to commodity gas costs and shared on a 50/50 basis with ratepayers

Use Of Financial Instruments Or Other Private Contracts

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

CAPACITY MANAGEMENT INCENTIVE MECHANISM

To the extent Nashville is able to release transportation or storage capacity, or generate transportation or storage margin associated with off-system or wholesale sales-for-resale, the associated cost savings shall be shared by Nashville and customers according to the following sharing formula

Capacity Management Incentive cost savings as a percent of Nashville's annual transportation and storage demand costs.	Sharing percentages Nashville/Customers (Percent)
Less than or equal to 1 percent	0/100
Greater than 1 percent but less than or equal to 2 percent	10/90
Greater than 2 percent but less than or equal to 3 percent	25/75
Greater than 3 percent	50/50

The sharing percentages shall be determined based on the actual demand costs incurred by Nashville (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 gains or losses resulting from adjustments to the sharing percentages caused by refunds or surcharges shall be recorded in the current Incentive Plan Account (IPA)

DETERMINATION OF SHARED SAVINGS
The calculations and recording of incentive gains or losses under the various elements of the Gas Procurement Incentive Mechanism and the Capacity Management Incentive Mechanism shall be performed in accordance with the benchmark formulas approved by the Commission in Docket No 96-00805 Nashville will compute the gain or loss using the approved formulas monthly

During a plan year, Nashville will be limited to overall gains or losses totaling $1 6 million Such gains or losses 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 month during the term of plan, Nashville will compute any gains or losses under the plan If Nashville earns a gain, a separate Incentive Plan Account (IPA) will be debited with such gain If Nashville incurs a loss, that same IPA will be credited with such loss. Interest shall be computed on balances in the IPA using the same interest rate and methods as used in Nashville's Actual Cost Adjustment (ACA) account The offsetting entries to IPA gains or losses will be recorded to income or expense, as appropriate At its option, however, Nashville may temporarily record any monthly gains in a non-regulatory deferred credit balance sheet account until results for the entire plan year are available

Each year, effective November 1, the rates for all customers, excluding interruptible transportation customers who receive no direct benefit from any gas cost reductions resulting from the plan, will be increased or decreased by a separate rate increment or decrement designed to amortize the collection or refund of the June 30 IPA balance over the succeeding twelve month period The increment or decrement will be established by dividing the June 30 IPA balance by the appropriate volumetric billing determinants for the twelve months ended June 30 During the twelve month amortization period, the amount collected or refunded each month will be computed by multiplying the billed volumetric determinants for such month by the 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.

FILING WITH THE COMMISSION

The Company will file calculations of shared savings and shared costs quarterly with the Commission not later than 60 days after the end of each interim fiscal quarter and will file an annual report not later than 60 days following the end of each plan year

PERIODIC REVIEW

Because of the experimental nature of the Performance Incentive Plan, it is anticipated that the indices utilized, and the composition of the utility's purchased gas portfolio may change. The Company shall, within 30 days of identifying a change to a significant component of the mechanism, provide notice of such change to the Commission Staff.

EXHIBIT B

TO

NASHVILLE GAS COMPANY'S RESPONSE TO THE ENERGY AND WATER DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

March 11, 1999

IN RE:	)	
	)	
APPLICATION OF NASHVILLE GAS COMPANY,	)	
A DIVISION OF PIEDMONT NATURAL GAS	)	**DOCKET NO. 96-00805**
COMPANY, TO ESTABLISH A PERFORMANCE	)	
INCENTIVE PLAN	)	

ORDER APPROVING PERFORMANCE INCENTIVE PLAN

On August 18, 1998, this matter came before the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA") for consideration of the Application of Nashville Gas Company (hereafter "Nashville" or "Company"), a division of Piedmont Natural Gas Company, to extend its previously-approved Performance Incentive Plan (hereafter the "Incentive Plan") on a permanent basis or until further order of the Authority. The Company also proposed to revise the Incentive Plan to clarify and/or simplify certain language in a manner that does not change any of its substantive or material provisions. In addition, the Company proposed to eliminate the requirement for an independent annual review.

I. BACKGROUND

On May 31, 1996, the Tennessee Public Service Commission (hereafter the "TPSC"), the predecessor to the Authority, issued an order approving the Incentive Plan for an experimental two-year period, beginning July 1, 1996. The Incentive Plan replaces the reasonableness or prudence review of Nashville's gas purchasing activities overseen by the Authority and is designed to produce rewards for Nashville's customers and its shareholders and to produce improvements in Nashville's gas procurement activities. The Incentive Plan approved by the TPSC was the result of an agreement between Nashville and the Consumer Advocate Division of the Office of the Tennessee Attorney General (hereafter "Consumer Advocate") and was not opposed by any party. The TPSC's order approving the Incentive Plan required Nashville and the TPSC's Staff to recommend a qualified independent consultant to review the progress of the Incentive Plan and to annually report the independent consultant's findings to the TPSC. The order also required Nashville to inform the TPSC by April 1, 1997, if it wished to continue the Incentive Plan for a second year.

On November 27, 1996, Nashville and the Authority's Staff submitted for the Authority's approval a contract for Andersen Consulting to perform annual reviews regarding the progress of the Incentive Plan. By Order dated January 2, 1997, the Authority determined that it was appropriate to accept the recommendation of the Company and the TRA's Staff that Andersen Consulting be employed as the independent consultant. The Authority approved the Andersen Consulting contract dated November 21, 1996.

By letter dated March 31, 1997, Nashville informed the Authority that it proposed to continue the plan for a second year, without modification. By letter dated April 7, 1997, Associated Valley Industries notified the Authority that it did not object to the Company's request No party filed an objection to the Company's request. In accordance with its contract, Andersen Consulting filed its First Year Review of Performance Incentive Plan dated May 1, 1997, (hereafter the "First Report") and recommended that the Incentive Plan be continued for another year without modification. By Order dated June 30, 1997, the Authority authorized Nashville to continue the Incentive Plan for a second year, commencing July 1, 1997.

Andersen Consulting completed its Second Year Review of Performance Incentive Plan (hereafter the "Second Report") on March 23, 1998. By its Application dated March 31, 1998, Nashville requested that the Authority approve the Incentive Plan on a permanent basis, relying in large part upon the recommendations made by Andersen Consulting in its Second Report.

In the Second Report, Andersen Consulting found that:

> I. Based upon a review of Nashville's workpapers that were available following the publication of the First Report, the Incentive Plan's performance during the period July 1, 1996, through June 30, 1997, the first year of the Incentive Plan, was as follows:
>
> 1. Net savings totaled $1,379,000, the amount available to be split between the ratepayers and Nashville, subject to the 1% deadband.
>
> 2. Ratepayers "earned" $925,000 in savings during the first full year of the plan or about 67% of the amount available from the sharing mechanism and the amount within the 1% deadband.
>
> 3. Nashville "earned" $455,000 during the first full year of the plan or about 33% of the amount available from the sharing mechanism and the amount within the 1% deadband.
>
> 4. Nashville's share of gains/losses for the first full year of the plan was approximately 1/3 of the $1.6 million gains/losses cap.
>
> II. Based upon a review of Nashville's workpapers, the Incentive Plan's performance during the period July 1, 1997, through December 31, 1997, a period of six months into the second year of the Incentive Plan, was as follows:
>
> 1. Net savings for the first six months of the second year of the Incentive Plan totaled $769,000, the amount available

to be split between the ratepayers and Nashville, subject to the 1% deadband.

2. Ratepayers "earned" $598,000 in savings during the first six months of the second year of the Incentive Plan or about 78% of the amount available from the sharing mechanism and the amount within the 1% deadband.

3. Nashville "earned" $171,000 during the first six months of the second year of the Incentive Plan or about 22% of the amount available from the sharing mechanism and the amount within the 1% deadband.

4. Nashville's share of gains/losses for the first six months of the second year of the Incentive Plan was less than 11% of the $1.6 million gains/losses cap.

5. Nashville's net gains during the first six months of the second year of the Incentive Plan was largely attributable to the Incentive Plan's Gas Procurement Mechanism, a reversal from the first year of the Incentive Plan.

After summarizing the activity in the Gas Procurement Incentive Mechanism and Capacity Management Incentive Mechanism for the period July 1, 1997, through December 31, 1997, as well as evaluating Nashville's organizational policies and practices, Andersen Consulting made the following recommendations in the Second Report:[1]

1. Implement a permanent performance based ratemaking mechanism, based upon the merits of the Incentive Plan.[2]

2. Rollover the permanent plan automatically each year, unless Nashville gives advance notice of its need to either withdraw or change the Incentive Plan, or the Authority elects to modify, amend, or terminate the Incentive Plan.

[1] The Second Report also pointed out that "[t]he existence or absence of an incentive plan similar to [Nashville] is not, in itself, a confirmation or an indictment of [Nashville's] plan Instead the case studies demonstrated the various plans used by other utilities operating in other jurisdictions and that [Nashville's] performance incentive plan was generally consistent with those industry practices " Second Year Review, dated March 23, 1998, at page 15

[2] This recommendation was based, in part, upon the judgment of Andersen Consulting that the objectives of the two year period of the Incentive Plan were satisfied and the Incentive Plan resulted in benefits to both the ratepayers and Nashville Id at page 16

3. Retain the employee incentive compensation plan that links reward with performance to ensure alignment of behavior and risk-taking with results.

4. Retain the primary features of the Incentive Plan, without modifications. A summary of those features include:

    A. Gas Procurement Mechanism:[3] 50/50 sharing arrangement, with a performance indicator of 99% of Index for Gains, and 101% of Index for Penalties.

    B. Capacity Management Mechanism:[4] Sliding scale from 100/0 to 50/50 as the sharing arrangement,[5] using the demand costs for transportation and storage capacity as the performance indicator.

5. Retain, without modifications, the "monthly price index" composite formula, as defined in the Appendix to the Second Report, that serves to compare Nashville's total city gate commodity cost of gas to a benchmark amount.

6. Having concluded the experimental period, remove the need for the permanent plan to be independently reviewed by a consultant, consistent with the Incentive Plan's objective of streamlining regulation and lowering regulatory costs.

At a regularly scheduled Authority Conference held on April 21, 1998, the Directors unanimously appointed the General Counsel or his designee to act as Hearing Officer to hear certain preliminary matters and to set a procedural schedule. A Pre-Hearing Conference was publicly noticed on June 4, 1998, and held on June 15, 1998, at 10:00 a.m. before Authority counsel, Dennis McNamee. Prior to the Pre-Hearing Conference, no party sought intervention in

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[3] The Gas Procurement Mechanism includes the primary elements of commodity costs, gas supply reservation fees, off-system sales and sale for resale transactions, use of financial instruments, both public and private contracts, hedges and swaps

[4] The Capacity Management Mechanism includes the primary elements of release of transportation capacity, release of storage capacity, transportation of storage margin associated with off-system or wholesale sales-for-resale.

[5] As outlined in the Second Report, Nashville's share of the associated cost savings is calculated based on the actual capacity demand charges incurred by Nashville Thus, the lower the demand charges and the greater the savings, the higher Nashville's sharing percentage Id

this proceeding. No interested parties, other than Nashville, appeared at the Pre-Hearing Conference. On June 15, 1998, the Hearing Officer filed his Report and Recommendation.

At a regularly scheduled Authority Conference held on June 30, 1998, the Directors considered the Hearing Officer's Report and Recommendation which recommended that the Application of Nashville Gas be brought before the Directors for consideration without a hearing since no parties had intervened nor had any objections to the Application been filed with the Authority. After reviewing the Report and Recommendation, and other relevant portions of the record, the Directors unanimously approved and adopted the Report and Recommendation of the Hearing Officer. This matter was scheduled for the Directors' consideration in July and, since the experimental period of the Incentive Plan expired on June 30, 1998, the Directors unanimously voted to allow the Company to continue operating under the incentive plan as it existed on June 30, 1998, until such time as the Authority further deliberated upon the matter and rendered a final decision on Nashville's Application.

On July 17, 1998, the Authority issued two Requests for Clarification to Nashville, the first of which outlined three (3) issues affecting Nashville's proposed Tariff Service Schedule No. 14. The Company responded to this first request by submitting, on July 23, 1998, a revised proposed tariff which incorporated the following new language:

> 1. Applicability Section: The Plan will continue until the Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville to the Authority or (b) the Plan is modified, amended or terminated by the Authority.
>
> 2. Filing with the Authority Section: 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 Service Schedule.

3. Periodic Index Revisions Section: Unless the Authority provides written justification to the Company within 30 days of such notice, the price indices shall be deemed approved as proposed by the Company.

The second clarification request inquired as to the status of the Company's "feedback and reward system." The Company responded to this request by letter dated July 23, 1998, which further detailed Nashville's "feedback and reward system." Company representative, Bill R. Morris, executed an affidavit on July 31, 1998, attesting to his responses to each of these clarification requests. This affidavit, together with the clarification requests and responses thereto, was officially filed with the Authority and are part of the record considered in this matter.

This matter came before the Authority again at the regularly scheduled Authority Conference held on August 18, 1998. Having considered the First Report,[6] the Second Report,[7] the verified responses of Nashville to the Requests for Clarification, and other relevant portions of the record, the Authority unanimously approved Nashville's Application to extend its Incentive Plan, and directed Nashville to file a revision to its Service Schedule No. 14 Tariff, stating the following:

1. Nashville will continue to have in place the Gas Supply Incentive Compensation Program, as detailed to the Authority in its letter dated July 23, 1998, and,

2. Nashville will submit to the Authority, in writing, any proposed changes to the Gas Supply Incentive Compensation Program and, if the Authority elects to take no action concerning such proposed changes

[6] On July 31, 1998, Frank H Creamer executed as affidavit, which is a part of the evidentiary record in this matter, stating that to the best of his knowledge his analysis, conclusions, and recommendations in his first and second year reports are true and accurate to the best of his knowledge and belief
[7] Id

> prior to the end of sixty (60) days after the same shall have been filed with the Authority, then such proposed changes shall become effective.

The Authority unanimously agreed to allow the Incentive Plan, as revised, to be automatically renewed on July 1st of each year, beginning July 1, 1998, unless and until the Incentive Plan is either (a) terminated at the end of a plan year by not less than ninety (90) days notice by Nashville to the Authority or (b) the Incentive Plan is modified, amended or terminated by the Authority.

The Authority also found it appropriate to eliminate the requirement for an independent review of the Incentive Plan. Based upon the independent consultant's analysis, the benefits of the Incentive Plan have now been demonstrated. Furthermore, Nashville will continue to submit quarterly and annual reports of the operations of the Incentive Plan and, if such reports or any other information should raise questions about the continued operations of the Incentive Plan, the Authority may take such action as it deems appropriate.

It is the opinion of the Directors of the Authority that incentive plans such as that proposed by Nashville can satisfy the public interest by providing net benefits to both ratepayers and the Company.[8] Such net benefits can be realized when an incentive plan is carefully evaluated and properly administered, consistent with state law. In Nashville's case, the Authority concludes that the Incentive Plan satisfies the public interest. The Authority further concludes that it is consistent with the goal of keeping expenses at a minimum to establish a Gas Supply Incentive Compensation Program to recognize selected Gas Supply non-executive employees

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[8] In formulating its decision in this matter, the Authority is mindful of the dicta offered by the Court of Appeals in its March 5, 1997, decision in Tennessee Consumer Advocate v Tennessee Regulatory Authority, 1997 WL 92079, *4 (Tenn Ct App.), wherein the Court noted "Of particular interest and concern are the propriety of . 'rewarding' [a] utility for keeping its expenses at the minimum, and of utilizing the services of an expert employed by the utility "

who are directly involved in managing such expenses. The public interest is served by performance measures for the Incentive Plan being established on an annual basis and by employees receiving incentive compensation as recognition for their contribution to the ratepayers and Nashville's shareholders through lower gas costs and gains related thereto.

IT IS THEREFORE ORDERED THAT:

1. Consideration of Nashville Gas Company's application for the extension of the Incentive Plan on a permanent basis does not require a hearing because no parties have intervened and no objections to Nashville's Application have been filed with the Authority;

2. Nashville Gas Company is authorized to continue to operate under the Incentive Plan, as modified herein, in such a manner that the Incentive Plan will automatically rollover for an additional plan year on each July 1st, beginning July 1, 1998, and will continue until the Incentive Plan is either (a) terminated at the end of a Plan Year by not less than 90 days notice by Nashville to the Authority or (b) the Incentive Plan is modified, amended or terminated by the Authority;

3 The requirement for an independent review of the Incentive Plan is eliminated;

4. The Company shall amend Service Schedule No. 14 of its Tariff by inserting a section entitled "Gas Supply Incentive Compensation Program" which provides that while the plan is in effect the Company will continue to have in place its "Gas Supply Incentive Compensation Program" as detailed in the Company's July 23, 1998, response to the Authority's second clarification request of July 17, 1998. This section of the tariff shall further provide that

the Company is required to notify the Authority in writing of any changes to the Gas Supply Incentive Compensation Program and, unless the Company is otherwise notified by the Authority within sixty (60) days, said changes will become effective.

5. 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 the date of this Order; and

6. 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 the date of this Order.

Melvin J. Malone, Chairman

H. Lynn Greer, Jr., Director

Sara Kyle, Director

ATTEST:

K David Waddell, Executive Secretary

EXHIBIT C

TO

NASHVILLE GAS COMPANY'S RESPONSE TO THE ENERGY AND WATER DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT

REC'D IN
REGULATORY AUTH.
'01 APR 4 PM 12 00
OFFICE OF THE
EXECUTIVE SECRETARY

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

April 4, 2001

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, a Division of	)	**Docket No. 00-00759**
PIEDMONT NATURAL GAS COMPANY	)	
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 Nashville 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 Nashville Gas Company's (hereafter the "Company") IPA for the year ended June 30, 2000

2 The Company's IPA filing was received on August 25, 2000, and the Staff completed its audit of same on April 2, 2001

3 On April 3, 2001, the Energy and Water Division issued its preliminary IPA audit findings to the Company, and on April 4, 2001 the Company responded thereto

4 The preliminary IPA audit report was modified to reflect the Company's response and a final IPA audit report (the "Report") resulted therefrom The Report is attached hereto as Exhibit A and is fully incorporated herein by this reference The Report contains the audit findings of the Energy and Water Division, the Company response thereto and the recommendations of the Energy and Water Division in connection therewith

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 4th day of April, 2001, 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

Mr Bill R Morris
Director - Rates
Piedmont Natural Gas Company
PO Box 33068
Charlotte, NC 28233

Mr. Paul C Gibson
Vice President - Rates
Piedmont Natural Gas Company
PO Box 33068
Charlotte, NC 28233

Pat Murphy
Pat Murphy

COMPLIANCE AUDIT REPORT
OF

NASHVILLE GAS COMPANY'S
INCENTIVE PLAN ACCOUNT

Docket No 00-00759

PREPARED BY

TENNESSEE REGULATORY AUTHORITY

ENERGY AND WATER DIVISION

APRIL, 2001

EXHIBIT A

TENNESSEE REGULATORY AUTHORITY'S COMPLIANCE AUDIT of NASHVILLE GAS COMPANY'S INCENTIVE PLAN ACCOUNT Docket No. 00-00759

TABLE OF CONTENTS

I. INTRODUCTION

The subject of this compliance audit is the Performance Incentive Plan (hereafter "Incentive Plan" or "IPA") of Nashville Gas Company (hereafter "Nashville Gas" or the "Company"), a division of Piedmont Natural Gas Company The objective of the audit was to determine whether the balance in the Incentive Plan Account as of June 30, 2000 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 II below

The following chart summarizes the results of the current period of the Incentive Plan, as presented in the Company's filing

		Year Ended 6/30/00
Total Actual City Gate Purchases	$	53,609,675
Total Annual Benchmark	$	53,828,287
Percentage Actual Purchases to Benchmark		99 59%
Total Incentive Savings from:		
Gas Procurement	$	271,861
Capacity Management		1,950,692
Total Incentive Savings	$	2,223,553
Incentive Savings retained by Ratepayers:		
Gas Procurement	$	152,088
Capacity Management		1,119,941
Total Incentive Savings to Ratepayers	$	1,272,029
Incentive Savings retained by Company:		
Gas Procurement	$	120,772
Capacity Management		830,751
Total Incentive Savings to Company	$	951,523

The results of the audit indicate that during the plan year under review, the Company's calculations were in conformance with the terms of the Incentive Plan Section III of this report further describes the actual results of the plan year and Section IV details the Staff's findings

II. BACKGROUND AND DESCRIPTION OF PERFORMANCE INCENTIVE PLAN

On May 31, 1996, the Tennessee Public Service Commission (hereafter the "TPSC"), the predecessor to the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA"), issued an Order in Docket Number 96-00805 approving the Incentive Plan on an experimental basis for Nashville Gas. The specific details of the Incentive Plan were included in Nashville Gas' Service Schedule No 14 tariff entitled Performance Incentive Plan, which was issued on April 22, 1996, and was effective July 1, 1996 A copy of this tariff is attached to the report as Attachment 1

The experimental period began July 1, 1996, and ended June 30, 1998 On March 31, 1998, the Company filed an Application for Extension of the Performance Incentive Plan, which would allow the plan to continue on an annual basis The Authority issued an Order on March 11, 1999, authorizing the Company to continue under a modified Incentive Plan The Incentive Plan automatically rolls over for an additional plan year on each July 1st, beginning July 1, 1998, 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 Nashville Gas to the Authority or (b) modified, amended or terminated by the Authority

The Incentive Plan consists of two mechanisms (1) the Gas Procurement Mechanism and (2) the Capacity Management Mechanism. Under the Gas Procurement Mechanism Nashville Gas retains 50% of the savings on gas purchased below 99% of a pre-determined index. Should the Company purchase gas above 101% of the same pre-determined index, the Company is penalized for 50% of the excess The Capacity Management Mechanism is tied to the Company's total annual demand cost and the sharing ratio is a sliding scale, with Nashville Gas earning a larger percentage with a higher level of cost savings Interest is accrued on the outstanding monthly balance in the account using the same computation as is provided for in the Authority's Purchased Gas Adjustment Rule 1220-4-7-03(vii). A more detailed explanation of each mechanism can be found in Attachment 1, the Company's Service Schedule No 14

III. ACTUAL PLAN YEAR RESULTS

On August 25, 2000, Nashville Gas submitted a rate adjustment to recover the balance in the Incentive Plan Account as of June 30, 2000 According to the Company filing, the Incentive Plan generated $2,223,553 in total incentive savings Of this amount, $1,272,029 benefited the ratepayer and $951,523 was retained by Nashville Gas Adding the -$17,941 over-recovered balance from the prior year and $24,650 in calculated monthly interest due, resulted in an **under-recovered balance** in the account at June 30, 2000 of **$958,231** To recover this balance, the Company filed a PGA for the TRA Staff's approval to implement a $0 00580 per therm surcharge, effective November 1, 2000.

The Company was able to purchase gas at less than the benchmark during four (4) of the twelve- (12) months in the audit period However, in only two (2) of those months was the Company able to participate in the savings generated from the Gas Procurement Mechanism This was due to the total monthly purchases for one month being not only less than the benchmark, but also less than the lower limit of the deadband of 99%. In the other month, the purchases were not below the lower limit of the deadband However, the Company was eligible to participate in the gain generated by Off System Sales as provided for in its Incentive Plan In none of the months did the Company's purchases exceed 101% of the benchmark, so there were no losses to be shared Total actual city gate purchases for the year averaged 99 59% of the total annual benchmark Of the $272,861 in total savings under the Gas Procurement Mechanism, the Company retained $120,772

The Capacity Management Mechanism generated a total of $1,950,692 in savings, of which $300,692 was due to off system sales and $1,650,000 was due to capacity release The Company's total actual demand costs for the year were $12,573,481 Therefore, the Company did not participate in any savings until the savings reached $125,735 (1% of the total demand costs), as provided for in the Incentive Plan Of the total savings, the Company retained $830,751 and $1,119,941 benefited the ratepayers

The capacity release portion of the Capacity Management Mechanism generated significantly greater savings this plan year as compared to last year Last year's savings was $11,510. The $1,650,000 savings for this year was the result of Nashville Gas assigning its pipeline capacity to an "asset manager" The Company provided the following summary of its Gas Asset Management Agreement to the TRA Staff

> "Under the Gas Asset Management agreement, Nashville Gas assigns its firm pipeline transportation (capacity), storage (excluding local LNG) and supply rights to the "Asset Manager" In return for this assignment, Nashville Gas receives a lump-sum payment from the asset manager for the assignment of these rights.
>
> Nashville Gas retains the right to call on supply from the asset manager for its city gate needs consistent with its rights as they existed prior to their

assignment to the asset manager. The asset manager's lump-sum payment is for the value acquired for utilization of the released assets when they are not needed by Nashville Gas. The lump-sum payment is considered a capacity release transaction and, as such, is accounted for in the Performance Incentive Plan under the Capacity Management Incentive mechanism

In essence, Nashville Gas and its ratepayers are "guaranteed" the up-front lump-sum payment by the asset manager, as opposed to Nashville Gas releasing capacity and entering into off-system sales transactions with third parties "

IV. IPA FINDINGS

After review of Company's filing, the Staff noted one finding

Exception

The Company **understated** its share of Capacity Release savings by **$4,866** It overstated the Ratepayer's share by the same amount

Discussion

The Incentive Plan provides for a sliding scale of the sharing percentages between the Company and the Ratepayer The sharing percentages are based on the Company's total actual demand costs for the plan year as adjusted by any refunds or surcharges from suppliers. For this plan year, the actual costs were $12,573,481 The Company based their sharing percentages on this amount (sharing began when savings reached 1% of the demand costs or $125,735)

However, at the end of the last plan year, a Tennessee Gas Pipeline GSR (Gas Supply Realignment) refund for June 1999 was received after the close of the Incentive Plan year and not known to the Company at the time of the IPA filing The $423,109 refund credit should have been a prior period adjustment to the total demand cost in this plan year The effect of the adjustment was to lower the demand costs by this amount Therefore, the 1% level at which the Company began sharing in the savings was lowered to $121,504 Total savings remained the same However, the effect was to increase the Company's share by $4,866 and decrease the ratepayers share by the same amount

Company Response

The Company agrees with this finding

V. 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 This audit was performed by Pat Murphy of the Energy and Water Division

ATTACHMENT 1

SERVICE SCHEDULE NO. 14
Performance Incentive Plan

APPLICABILITY

The Performance Incentive Plan (the plan) replaces the reasonableness or prudence review of Nashville Gas Company's (Nashville or Company) gas purchasing activities overseen by the Tennessee Regulatory Authority (Authority). The plan is designed to provide incentives to Nashville in a manner that will produce rewards for its customers and its shareholders and improvements in Nashville's gas procurement activities. Each plan year will begin July 1. The annual provisions and filings herein would apply to this annual period. The Plan will continue until the Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville to the Authority or (b) the Plan is modified, amended or terminated by the Authority.

OVERVIEW OF STRUCTURE

Nashville's Performance Incentive Plan is comprised of two interrelated components.

- Gas Procurement Incentive Mechanism
- Capacity Management Incentive Mechanism

The Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which Nashville's commodity cost of gas is compared. It also addresses the recovery of gas supply reservation fees, the treatment of off-system sales and wholesale interstate sale for resale transactions, and the use of financial or private contracts in managing gas costs. The net incentive benefits 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 Nashville to actively market off-peak unutilized transportation and storage capacity on upstream pipelines in the secondary market. The net incentive benefits or costs will be shared between the Company's customers and the Company utilizing a graduated sharing formula, with sharing percentages for Nashville ranging between zero and fifty percent

The Company is subject to a cap on overall incentive gains or losses of $1.6 million annually. In connection with the Performance Incentive Plan, Nashville shall file with the Authority Staff, and update each year a Three Year Supply Plan. Nashville will obtain additional firm capacity and/or gas supply pursuant to such plan

GAS PROCUREMENT INCENTIVE MECHANISM

The Gas Procurement Incentive Mechanism addresses the following areas·

- Commodity Costs
- Gas Supply Reservation Fees
- Off-System Sales and Sale for Resale Transactions
- Use of Financial Instruments or Other Private Contracts

COMMODITY COSTS

Each month Nashville will compare its *total city gate commodity cost of gas*[1] to a benchmark dollar amount. The benchmark gas cost will be computed by multiplying total actual purchase quantities for the month by a price index. The monthly price index is defined as

$$I = F_f(P_0K_0+P_1K_1+P_cK_c+\ldots P_\propto K_\propto)+F_oO+F_dD\text{; where}$$

$$F_f+F_o+F_d= 1\text{; and}$$

I = the monthly city gate commodity gas cost index.

F_f = the fraction of gas supplies purchased in the first-of-the-month market which are transported to the city gate under Nashville's FT service agreements.

P = the *Inside FERC Gas Market Report* price index for the first-of-the-month edition for a geographic pricing region, where subscript 0 denotes Tennessee Gas Pipeline (TGP) Rate Zone 0; subscript 1 denotes TGP Rate Zone 1; subscript C denotes Columbia Gas Transmission (CGT), Louisiana, plus applicable transportation and fuel charges in CGT's FT tariff to Rayne, and subscript $\propto$ denotes new incremental firm services to which Nashville may

---

1 Gas purchases under Nashville's existing supply contract on the Tetco system are excluded from the incentive mechanism. Nashville will continue to recover 100 percent of these costs through its PGA with no profit or loss potential. Extension or replacement of such contract shall be subject to the same competitive bidding procedures that will apply to other firm gas supply agreements. In addition, Nashville's gas procurement incentive mechanism will measure storage gas supplies against the benchmark index during the months such quantities are purchased for injection. For purposes of comparing such gas purchase costs against the monthly city gate index price, Nashville will exclude any commodity costs incurred downstream of the city gate to storage so that Nashville's actual costs and the benchmark index are calculated on the same basis.

subscribe in the future.[2] The commodity index prices will be adjusted to include the appropriate pipeline maximum firm transportation (FT) commodity transportation charges and fuel retention to the city gate under Nashville's FT service agreements.

K = the fraction (relative to total maximum daily contract entitlement) of Nashville's total firm transportation capacity under contract in a geographic pricing region, where the subscripts are as above.[3]

F_o = the fraction of gas supplies purchased in the first-of-the-month spot market which are delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts.

O = the weighted average of *Inside FERC Gas Market Report* first-of-the-month price indices, plus applicable maximum IT rates and fuel retention, from the source of the gas to the city gate, where the weights are computed based on actual purchases of gas supplies purchased by Nashville and delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts.

F_d = the fraction of gas supplies purchased in the daily spot market.

D = the weighted average of daily average index commodity prices taken from *Gas Daily* for the appropriate geographic pricing regions, where the weights are computed based on actual purchases made during the month. The commodity index prices will be adjusted to include the appropriate maximum transportation commodity charges and fuel retention to the city gate.

---

2 To the extent that Nashville renegotiates existing reservation fee supply contracts or executes new reservation fee supply contracts with commodity pricing provisions at a discount to the first-of-the-month price index, Nashville shall modify the monthly commodity price index to reflect such discount.

3 Because the aggregate maximum daily contract quantities in Nashville's FT contract portfolio vary by month over the course of the year, the weights will be recalculated each month to reflect actual contract demand quantities for such month. The contract weights, and potentially the price indices used, will also vary as Nashville renegotiates existing or adds new FT contracts. As new contracts are negotiated, Nashville shall modify the index to reflect actual contract demand quantities and the commodity price indices appropriate for the supply regions reached by such FT agreements

If the actual total commodity gas purchase cost in a month is within one percent of the benchmark dollar amount, there will be no incentive gains or losses. If the actual total commodity gas purchase cost varies from the benchmark dollar allowance by more than one percent, the variance in excess of the one percent threshold shall be deemed incentive gains or losses under the plan. Such gains or losses will be shared 50/50 between the Company and the ratepayers.

Gas Supply Reservation Fees

Nashville will continue to recover 100% of gas supply reservation fee costs through its PGA with no profit or loss potential. For new contracts and/or contracts subject to renegotiation during the Plan year, Nashville will solicit bids for gas supply contracts containing a reservation fee.

Off-System Sales And Sale For Resale Transactions

Margin on off-system sales and wholesale sale-for-resale transactions using Nashville's firm transportation and capacity entitlements (the costs of which are recovered from Nashville's ratepayers) shall be credited to the commodity gas cost component of the Gas Procurement Incentive Mechanism and will be shared with ratepayers. Margin on such sales will be defined as the difference between the sales proceeds and the total variable costs incurred by Nashville in connection with the transaction, including transportation and gas costs, taxes, fuel, or other costs. For purposes of gas costs, Nashville will impute such costs for its related supply purchases at the benchmark first-of-the-month or daily index, as appropriate, on the pipeline and in the zone in which the sale takes place. The difference between Nashville's actual costs and such index price is taken into account under the Gas Procurement Incentive Mechanism. As to transportation costs, Nashville will impute such costs up to the transporting pipeline's maximum interruptible transportation (IT) rate. The difference between the maximum IT rate and Nashville's actual transportation commodity costs will be treated as capacity release margin under the Capacity Management Incentive Mechanism. After deducting the total transaction costs from the sales proceeds, any remaining margin will be credited to commodity gas costs and shared on a 50/50 basis with ratepayers.

Use Of Financial Instruments Or Other Private Contracts

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

CAPACITY MANAGEMENT INCENTIVE MECHANISM

To the extent Nashville is able to release transportation or storage capacity, or generate transportation or storage margin associated with off-system or wholesale sales-for-resale, the associated cost savings shall be shared by Nashville and customers according to the following sharing formula:

Capacity Management Incentive cost savings as a percent of Nashville's annual transportation and storage demand costs.	Sharing percentages Nashville/Customers. (Percent)
Less than or equal to 1 percent	0/100
Greater than 1 percent but less than or equal to 2 percent	10/90
Greater than 2 percent but less than or equal to 3 percent	25/75
Greater than 3 percent	50/50

The sharing percentages shall be determined based on the actual demand costs incurred by Nashville (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 gains or losses resulting from adjustments to the sharing percentages caused by refunds or surcharges shall be recorded in the current Incentive Plan Account (IPA).

DETERMINATION OF SHARED SAVINGS

Each month during the term of plan, Nashville will compute any gains or losses in accordance with the plan. If Nashville earns a gain, a separate Incentive Plan Account (IPA) will be debited with such gain. If Nashville incurs a loss, that same IPA will be credited with such loss. During a plan year, Nashville will be limited to overall gains or losses totaling $1.6 million. Interest shall be computed on balances in the IPA using the same interest rate and methods as used in Nashville's Actual Cost Adjustment (ACA) account. The offsetting entries to IPA gains or losses will be recorded to income or expense, as appropriate. At its option, however, Nashville may temporarily record any monthly gains in a non-regulatory deferred credit balance sheet account until results for the entire plan year are available.

Gains or losses accruing to the Company under the Plan 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 November 1, the rates for all customers, excluding interruptible transportation customers who receive no direct benefit from any gas cost reductions resulting from the plan, will be increased or decreased by a separate rate increment or decrement designed to amortize the collection or refund of the June 30 IPA balance over the succeeding twelve month period. The increment or decrement will be established by dividing the June 30 IPA balance by the appropriate volumetric billing determinants for the twelve months ended June 30. During the twelve month amortization period, the amount collected or refunded each month will be computed by multiplying the billed volumetric determinants for such month by the 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.

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 each interim fiscal 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 Service Schedule

PERIODIC INDEX REVISIONS

Because of changes in the natural gas marketplace, the price indices utilized by the Company, and the composition of the Company's purchased gas portfolio may change. The Company shall, within 30 days of identifying a change to a significant component of the mechanism, provide notice of such change to the Authority. Unless the Authority provides written justification to the Company within 30 days of such notice, the price indices shall be deemed approved as proposed by the Company.

GAS SUPPLY INCENTIVE COMPENSATION PROGRAM

The Company has in place a Gas Supply Incentive Compensation Program (the Program) designed to provide incentive compensation to selected Gas Supply non-executive employees involved in the implementation of the Nashville Incentive Plan and Secondary Marketing Programs 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 receive incentive compensation as recognition for their contribution to the customers and shareholders of the Company through lower gas costs and gains related thereto. Performance measures are established for the Program each year

During the time this tariff is in effect, the Company will continue to have in place the Gas Supply Incentive Compensation Program, as detailed to the Authority, as it relates to the Nashville Incentive Plan. The Company will advise the Authority in writing of any changes to the Program, and unless the Company is advised within 60 days, said changes will become effective. No filing for prior approval is required for changes in the performance measures.

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, A DIVISION OF PIEDMONT NATURAL GAS COMPANY, INC. INCENTIVE PLAN ACCOUNT (IPA) AUDIT	))))	**DOCKET NO. 03-00489**

AFFIDAVIT OF KEITH P. MAUST

I, Keith P Maust, being first duly sworn, depose and say

1 I am a citizen and resident of Weddington, Union County, North Carolina

2 I am neither an infant nor incompetent and have personal knowledge of the matters discussed herein

3 I am Director – Gas Supply and Wholesale Marketing for Piedmont Natural Gas Company, Inc ("Piedmont") and Nashville Gas Company ("Nashville Gas")

4. The purpose of my affidavit is to provide the Tennessee Regulatory Authority with information relevant to its consideration of the March 29, 2004 Notice of Filing by Energy and Water Division of the Tennessee Regulatory Authority in Docket No 03-00489 relating to Nashville Gas' Performance Incentive Plan ("Incentive Plan") during the period July 1, 2002 through June 30, 2003.

5 Nashville Gas engaged in two asset management arrangements during the period July 1, 2002 through June 30, 2003 In pursuing these arrangements, Nashville Gas engaged in a Request For Proposal ("RFP") process whereby it transmitted confidential RFPs to a list of potential vendors maintained by Piedmont for this purpose A copy of the two RFPs issued during this period are attached hereto a Exhibits A and B

6 The purpose of these RFP's was to seek bids from parties to manage Nashville Gas' interstate pipeline capacity, storage and supply contract assets, subject to meeting Nashville Gas' supply requirements, in exchange for payments to Nashville Gas by these asset managers

7 These RFP's were transmitted by email to the list of potential vendors maintained by Nashville Gas on September 20, 2001 and September 23, 2002 respectively Copies of these email transmissions are attached as Exhibits C and D To be considered as an asset manager by Nashville Gas, a vendor must be financially stable and must either have some experience with Nashville Gas that establishes the ability of the vendor to accomplish the goals of an asset management relationship or it must have a solid reputation for competence in the industry I am confident that as a result of my experience and daily work in the natural gas supply and capacity marketplace that I am familiar with the vast majority of companies that would be considered qualified vendors by Nashville Gas for an asset management arrangement

8 Nashville Gas is not able to identify exactly which parties received this email because Nashville Gas maintains this list on an ongoing basis and, at the time of these transmissions, did not keep archived copies of the list A copy of the current list of potential asset management vendors, which is generally representative of what the list would have looked like during the period under review in this Docket, is attached hereto as Exhibit E.

9. Nashville Gas received multiple responses to each of its two RFPs issued during this review period The form of those responses varied Some were written and some were verbal Verbal bids for gas supply and asset management arrangements, while not ideal, are commonly used in the industry In my view, this is a result of the fact that negotiations over these types of arrangements are often dynamic in nature (and sometimes include bids that are different from the precise RFP terms) and because it is understood that any successful bid will be ultimately reduced to a written contract. Representative copies of written responses actually received by Nashville Gas in response to its RFPs are attached hereto as Exhibit F A summary table of all responsive bids provided to Nashville Gas in connection with these two RFPs, in the form provided to the Staff during discovery in this Docket, is attached hereto as Exhibit G

10 The RFP process described above led to the execution of two asset management contracts during the period of review in this Docket One contract was with

[redacted] and the other was with [redacted] Copies of these contracts are attached hereto as Exhibits H and I In both cases, the bids received from these companies were verbal but were later reduced to written form in the contract documents In both cases, these Companies were the high-bidders by a substantial margin

11 These contracts and the RFP process utilized by Nashville Gas in arriving at these agreements are substantially similar to the process and agreements previously utilized by Nashville Gas with respect to asset management arrangements To the best of my knowledge, this process and the use of asset management arrangements has been approved by the Staff and the Authority in each of the prior annual reviews of Nashville Gas' Incentive Plan covering the periods ended June 30, 2000, 2001, and 2002 The same is true with respect to the inclusion of the asset management fee under the Incentive Plan

12 Nashville Gas did not enter into an asset management arrangement during the period November, 2002 through March, 2003 Instead, during that period, the Company managed this capacity itself and actively engaged in secondary market transactions utilizing its capacity and supply assets during this time period Even during the periods those assets were subject to an asset management agreement, the Company continued to engage in daily activities to forecast its supply requirements and to dispatch assets for its system supply requirements as it would in the absence of such arrangements Further, during the period its assets were subject to the asset management agreements, Nashville Gas had the ability to call upon and did call upon certain supply assets for the purpose of engaging in secondary market transactions.

13 Over the approximately five year period during which Nashville Gas has been engaging in asset management arrangements with respect to its interstate capacity, storage and supply contracts utilized to serve its customers, Nashville Gas and its customers have received a substantial economic benefit from guaranteed payments by asset managers A table summarizing these payments, in the form produced to Staff during discovery in this Docket, is

attached hereto as Exhibit J and a table illustrating the gains achieved by Nashville Gas under its approved Incentive Plan mechanism is attached hereto as Exhibit K

14 As a result of various industry and Federal Energy Regulatory Commission initiatives over the last several years designed to address concerns about national price indices, the current consensus within the industry is that national price indices are reliable, safe and accurate reporters of market prices for natural gas at various locations throughout the nation This conclusion is supported by the increased level of reporting to these indices A copy of a recent press release attesting to these increased levels of reporting is attached hereto as Exhibit L

This the 6th day of April, 2004

Keith P Maust

Keith P Maust

Sworn to and subscribed before me
this the 6th day of
April 2004

Sandra K Hammond
Notary Public

My Commission Expires
August 4, 2008

SANDRA K. HAMMOND
NOTARY PUBLIC
MECKLENBURG COUNTY, N C.
My Commission Expires 8/4/2008

EXHIBIT A

Privileged and Confidential

PUBLIC VERSION

Confidential Information Removed

EXHIBIT B

Privileged and Confidential

PUBLIC VERSION

Confidential Information Removed

EXHIBIT C

Scott Searcy
09/20/2001 10 02 AM

To Asset Management
cc James Jessee/GS/PNG@PNG

Subject Nashville Asset Management RFP

Valued Supplier,

Piedmont Natural Gas Company is requesting bids for the right to manage its Nashville Gas Division's supply, transportation and storage assets Please review the attached files and submit your bid no later than 5 p m Eastern Standard Time on Wednesday, October 3, 2001 Thank you for your time and consideration

Sincerely,
Scott Searcy

Exhibit A.DOC Nashville 2001 Asset Management d Nashville Asset FlowChart XLS nashvillewinterhistory xls

EXHIBIT D

Scott Searcy
09/23/2002 04 31 PM

To·
cc Keith Maust/GS/PNG@PNG, James Jessee/GS/PNG@PNG

Subject Nashville Asset Management

Please review the attached Nashville Asset Management Proposal & Exhibits and submit your bids no later than 5pm E S T on Friday, October 4, 2002

Nashville 2002-03 Asset Management dExhibit A DOC Nashville Asset FlowChart XLS

EXHIBIT E

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT F

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT G

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT H

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT I

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT J

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT K

Piedmont Natural Gas Co.
Tennessee Gas Supply Incentive Plan
Summary of Shared Gains

Plan Year Ended Julne 30,	**Total Gain Realized Under Plan**	**Ratepayer Gain**	**Shareholder Gain**
1997	$1,379,383	$924,554	$454,829
1998	1,340,957	832,300	508,657
1999	629,489	459,665	169,824
2000	2,223,552	1,272,029	951,523
2001	2,785,665	1,375,465	1,410,200
2002	2,592,578	1,207,494	1,385,084
2003	3,489,673	1,889,673	1,600,000
Total	$14,441,297	$7,961,180	$6,480,117

EXHIBIT L

Market Price Reporting Action Committee
Contacts: Jim Pierobon, (202) 557-0853,
Mark Stultz, (202) 326-9316

FOR IMMEDIATE RELEASE

Newly-Released Energy Industry Data Show Increased Reporting of Natural Gas Transactions

WASHINGTON, March 10 – Newly released energy industry data show a significant increase in reporting of natural gas market transactions to price index publishers and exchanges, according to a 30-member stakeholder coalition of energy companies, industrial customers, publishers, exchanges and industry trade associations

The increased reporting, coupled with index enhancements recommended last year by the Federal Energy Regulatory Commission (FERC), provides evidence of increased transparency in the nation's natural gas markets, according to the Market Price Reporting Action Committee

"Our members have confidence in the natural gas price indices published today and continue to use these indices when we structure our natural gas purchases. We believe that the natural gas indices are robust, functional, and improving, and definitely meet the needs of industrial users, today," said Alex Strawn, chairman of the Process Gas Consumers Group (PGC), the leading trade association of industrial end-use consumers of natural gas.

Two main publishers of natural gas price indices, Platts and Natural Gas Intelligence, both reported continuing increases in volumes, transactions and the number of companies reporting based on data from the so-called March "bid week," which reflects transactions in the monthly baseload market that accounts for a large part of wholesale natural gas transactions Simultaneously, the 10X / IntercontinentalExchange (ICE) trading system set a monthly record for the amount of bid-week gas trading on its system According to the New York Mercantile Exchange, the market's reliance on natural gas basis contracts – which utilize published index prices in the reference price for final settlement – has grown more than four-fold from November 2002 to February 2004.

Bob Anderson, executive director of the Committee of Chief Risk Officers, credits a year-long drive by FERC with helping to increase reporting of transaction data.

"Particularly effective was FERC's requirement in January that companies go on the public record with whether they were -- or were not -- reporting. Since then, we've seen that more and more companies have been getting on board," said Anderson, whose group is hosting the Action Committee The Action Committee is working to provide the Commission with valuable insight on the extent, depth and quality of current price reporting

The Process Gas Consumers Group, whose members employ millions of people and consume more than half a trillion cubic feet of natural gas annually, is also a member of the stakeholder coalition, which identified FERC's clarity on this issue as another key to the stepped-up reporting

"We support FERC's recent policy statement setting forth new requirements for those who price report and the publication of the price indices, and believe that it has had a positive impact on price reporting and transparency," said Strawn "PGC is encouraged by the recent announcements that many large players will once again be reporting their transactions to index providers and continues to value having a choice in indices "

FERC itself will be launching another survey before the end of the month to further assess index participation, but already the initial data sets from the publishers are very encouraging, said Joe Blount, president of Unocal Midstream & Trade and 2004 chairman of the Natural Gas Council (NGC), comprising the major natural gas trade associations.

Specifically, participation in the monthly surveys has tripled and quadrupled since the market's low point in November 2002 The number of transactions submitted to Platts has gone up 256 percent during that time period, while volumes have more than doubled to 12 4 billion cubic feet per day (Bcf/d). NGI has been on a similar track and reported March 2004 volumes of 12 1 Bcf/d, compared to volumes in November 2002 of 4 9 Bcf/d for Platts and 3.9 Bcf/d for NGI.

"Beyond these numbers, the NGC members are also increasingly encouraged by the fact that their price reporting now happens in a controlled and auditable environment," Blount said. "Industry heard FERC's message that this is a problem we need to solve. We took that message to heart and we are delivering. There are challenges that remain, but the solution has been set in motion and rapid progress will continue "

According to Platts, at least a half dozen additional companies have started reporting gas prices within the past month, bringing the total number of companies reporting natural gas transactions to nearly 60 Of the 17 largest natural gas marketers, all but two are either reporting prices or have said they intend to resume shortly.

According to data from Natural Gas Intelligence, the total number of transactions reported during the monthly bid weeks has increased 41 percent during the last five months. Total gas volumes reported during the same period jumped 36 percent. Although progress has sometimes been bumpy, February transactions increased to nearly 1,800, while volumes rose to just under 12 Bcf/d. In March, the market confirmed the February increase.

"While it is not possible to know precisely at this point how much of this increased volume is a result of higher trading volumes, and how much is a result of increased reporting of transactions to the index publishers, this latest data should go a long way toward demonstrating the quality of ongoing market price quotes. It is becoming increasingly clear that the indices are more about the fundamentals of energy supply and demand than a lack of competition or choice," Blount said.

As it works to advance the process of reporting of natural gas and electric power transaction data, the Market Price Reporting Action Committee is encouraged by the data and will continue to analyze whether further enhancements to current reporting practices are necessary.

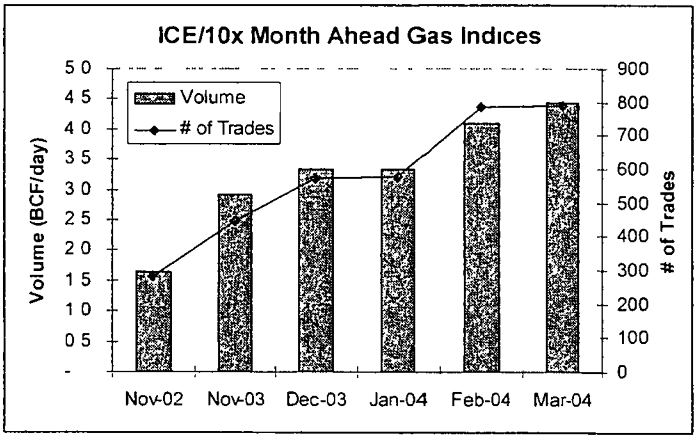
Below are the organizations supporting this initiative through the Action Committee and data submitted by IntercontinentalExchange, Natural Gas Intelligence, Platts and the New York Mercantile Exchange

American Gas Assn
Dow Jones
Electric Power Supply Assn.
Intercontinental Exchange
Natural Gas Intelligence
New York Mercantile Exchange
Process Gas Consumers Group
Committee of Chief Risk Officers
Edison Electric Institute
Independent Petroleum Assn. of America
Interstate Natural Gas Assn. of America
Natural Gas Supply Assn
Platts

10x Month Ahead Natural Gas Price Report: ICE Monthly Indices

	ICE		Non-ICE (eConfirm)		Total		
Month	Volume (BCF/day)	# of Trades	Volume (BCF/day)	# of Trades	Volume (BCF/day)	# of Trades	# of Counter parties
Nov-02	1.6	284	0.0	0	1.6	284	48
Nov-03	2.9	446	0.0	0	2.9	446	53
Dec-03	3.3	566	0.0	6	3.3	572	60
Jan-04	3.1	564	0.2	16	3.3	580	58
Feb-04	4.0	766	0.1	20	4.1	786	74
Mar-04	4.2	758	0.2	30	4.4	788	69

Note All trades included in the ICE Monthly Indices were negotiated, non-affiliate, fixed price or physical basis trades executed during the last 5 business days of the month on the ICE trading platform or confirmed by the eConfirm trade confirmation system after having been executed directly between the counterparties or through a broker



For more information, contact Kelly Loeffler at 770-857-4726 (Kelly Loeffler@theice com)

New York Mercantile Exchange Basis Average Daily Volume

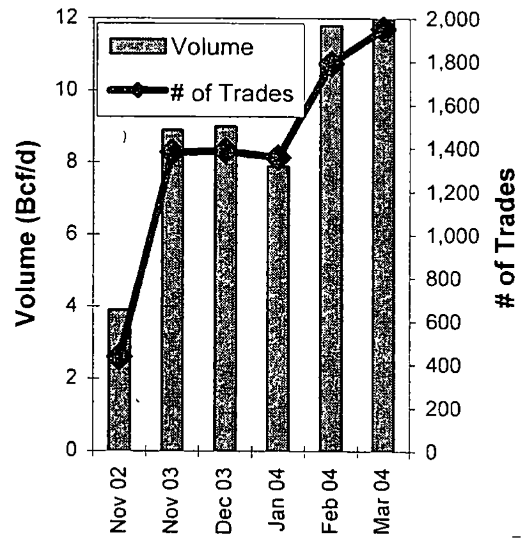
Month	Volume (Bcf/day)
Nov. 2002	8.6
Nov. 2003	22.9
Dec. 2003	24.3
Jan. 2004	38.0
Feb. 2004	39.0

For more information, contact Nachamah Jacobovits at 212 299-2390 (njacobovits@nymex.com)

NGI's Bidweek Natural Gas Price Survey Statistics						
	Volume (Bcf/d)	# of Trades	Indices Published	Tier 1	Tier 2	Tier 3
Nov 02	3.9	435	68	na	na	na
Nov 03	8.9	1,381	79	27	31	21
Dec 03	9.0	1,387	78	29	28	21
Jan 04	7.9	1,357	75	26	24	25
Feb 04	11.8	1,792	80	32	25	23
Mar 04	12.1	1,951	81	40	30	11

Notes: In response to industry requests for more market price transparency, *NGI* began posting tiers in July 2003 to show volume of trading observed at various market locations Tier 1 over 100,000 MMBtu/day, Tier 2 over 25,000 MMBtu/day, Tier 3 less than 25,000 MMBtu/day

NGI's Bidweek Natural Gas Price Survey Data



.For more information, contact Dexter Steis at 703-318-8848 (dexter@intelligencepress.com)

Platts Bidweek Natural Gas Survey

Month	Volume (Bcf/day)	Total Transactions	Tier 1 points	Tier 2 points	Tier 3 points
Nov. 2002	4.9	540	NA	NA	NA
Nov. 2003	11.0	1,548	30	18	18
Dec. 2003	10.2	1,508	27	19	17
Jan. 2004	9.2	1,450	26	15	25
Feb. 2004	11.8	1,784	32	15	19
Mar. 2004	12.4	1,920	35	21	7

Note No price was reported for four locations in November 2003, seven in December 2003, four in January 2004, four in February 2004 and seven in March 2004 To increase transparency, Platts in 2003 began grouping pricing points in its monthly survey into three tiers tier 1, volumes of at least 100,000 MMBtu/day and at least 10 trades, tier 2, volumes of 25,000 to 99,999 MMBtu/day and at least five trades, and tier 3, volumes below 25,000 MMBtu/day and/or fewer than five trades Bidweek volumes typically decline in early winter due to seasonal factors

For more information, contact Larry Foster at 202-383-2140 (larry_foster@platts com)

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the Affidavit of Keith P. Maust was served upon the parties in this action by facsimile transmission and/or hand-delivery addressed as follows:

Mr. Randal Gilliam
Staff Attorney
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

This the 8th day of April, 2004

James H. Jeffries IV

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, A	)	
DIVISION OF PIEDMONT NATURAL GAS	)	**DOCKET NO. 03-00489**
COMPANY, INC. INCENTIVE PLAN	)	
ACCOUNT (IPA) AUDIT	)	

AFFIDAVIT OF KENNETH T. VALENTINE

I, Kenneth T Valentine, being first duly sworn, depose and say

1. I am a citizen and resident of Charlotte, Mecklenburg County, North Carolina

2 I am neither an infant nor incompetent and have personal knowledge of the matters discussed herein

3 I am Director – Gas Supply Planning and Transportation Services for Piedmont Natural Gas Company, Inc. ("Piedmont") and Nashville Gas Company ("Nashville Gas")

4 Piedmont and Nashville Gas both utilize a 5% reserve margin in planning design day requirements for its heat-sensitive firm load. This margin has been in place for a number of years in all three states in which Piedmont and Nashville Gas provide service This margin helps to ensure that the Company will be able to serve the needs of its core heat-sensitive firm customers in peak or near peak conditions without unreasonable risk of curtailment.

5 This margin allows for anomalies in Nashville Gas' ability to meet its peak day needs such as the unavailability of one or more peak day delivery assets or customer usage in excess of planned demand and provides some margin of safety

6. As is reflected on Exhibits A and B hereto, which are a long-term demand/supply planning matrix for Nashville Gas and the three year supply plan summary provided by the Company to Staff in last Fall's natural gas forum, Nashville Gas currently has no "excess" capacity available to serve its customers in Tennessee. In fact, Nashville Gas is currently engaged in an effort to procure additional long term firm capacity needed to serve its customers and hopes to begin to have such arrangements in place by this Fall This capacity is required in order to replace existing short term firm supplies that have been used over the last several

years to bridge a growing gap between Nashville Gas' Design Day needs and its long term firm capacity entitlements

This the 6th day of April, 2004

Kenneth T. Valentine

Kenneth T. Valentine

Sworn to and subscribed before me
this the 6th day of
April 2004

Sandra K. Hammond
Notary Public

My Commission Expires
August 4, 2008

SANDRA K. HAMMOND
NOTARY PUBLIC
MECKLENBURG COUNTY, N C
My Commission Expires 8/4/2004

EXHIBIT A

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

EXHIBIT B

PRIVILEGED AND CONFIDENTIAL

PUBLIC VERSION

Confidential Information Removed

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the Affidavit of Kenneth T. Valentine was served upon the parties in this action by facsimile transmission and/or hand-delivery addressed as follows

Mr. Randal Gilliam
Staff Attorney
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

This the 8th day of April, 2004.

James H. Jeffries IV

BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, A	)	
DIVISION OF PIEDMONT NATURAL GAS	)	**DOCKET NO. 03-00489**
COMPANY, INC. INCENTIVE PLAN	)	
ACCOUNT (IPA) AUDIT	)	

AFFIDAVIT OF RICHARD A. FLEBBE

I, Richard A Flebbe, being first duly sworn, depose and say:

1 I am a citizen and resident of Charlotte, Mecklenburg County, North Carolina

2 I am neither an infant nor incompetent and have personal knowledge of the matters discussed herein.

3. I am Manager – Federal Regulatory and Pipeline Services for Piedmont Natural Gas Company, Inc and Nashville Gas Company

4 Attached hereto as Exhibit A is a copy of the Federal Energy Regulatory Commission's Order No 644 issued on November 17, 2003 in Docket No. RM03-10-000.

5. Attached hereto as Exhibit B is a copy of the Federal Energy Regulatory Commission's Policy Statement on Natural Gas and Electric Price Indices issued on July 24, 2003 in Docket No. PL03-3-000.

6. Attached hereto as Exhibit C is a letter filed by Piedmont Natural Gas Company, Inc. ("Piedmont") in Docket No. on February 26, 2004, notifying the Federal Energy Regulatory Commission that Piedmont had begun reporting natural gas transactions to a publisher of natural gas price indices effective February 24, 2004.

This the 6th day of April, 2004.

Richard A Flebbe

Richard A. Flebbe

Sworn to and subscribed before me
this the 7th day of
April 2004

Sandra K. Hammond
Notary Public

My Commission Expires
August 4, 2008

SANDRA K. HAMMOND
NOTARY PUBLIC
MECKLENBURG COUNTY, N. C.
My Commission Expires 8/4/2008

EXHIBIT A

C

FEDERAL ENERGY REGULATORY COMMISSION
*1 Commission Opinions, Orders and Notices

Before Commissioners: Pat Wood, III, Chairman; William L. Massey, and Nora Mead Brownell.

Amendments to Blanket Sales Certificate

Docket No. RM03-10-000

ORDER NO. 644

(Issued November 17, 2003)

FINAL RULE

I. Introduction

1. The Federal Energy Regulatory Commission (Commission) is amending the blanket certificates for unbundled gas sales services held by interstate natural gas pipelines and the blanket marketing certificates held by persons making sales for resale of gas at negotiated rates in interstate commerce to require that pipelines and all sellers for resale adhere to a code of conduct with respect to gas sales. The purpose of the revisions is to ensure the integrity of the gas sales market that remains within the Commission's jurisdiction. This rule is another part of the Commission's continuing effort to restore confidence in the nation's energy markets. Contemporaneously with this rule, the Commission is also issuing a rule to require wholesale sellers of electricity at market-based rates to adhere to certain behavioral rules when making wholesale sales of electricity. In an order dated June 26, 2003, [FN1] the Commission, acting under the authority of Section 7 of the Natural Gas Act, proposed to revise Section 284.288 of its regulations, which is currently reserved, to require that pipelines providing unbundled sales service adhere to a code of conduct when making gas sales. The Commission also proposed to add a new Section 284.403 to Part 284, Subpart L to require persons holding blanket marketing certificates under Section 284.402 to adhere to a code of conduct when making gas sales. [FN2]

2. The need for this code of conduct, we stated, was informed by the types of behavior that occurred in the Western markets during 2000 and 2001, by Commission Staff's Final Report concerning these markets, [FN3] and by our experience in other competitive markets. We stated that in formulating our proposed code of conduct rules, we were required to strike a careful balance among a number of competing interests. We noted, for example, that while customers must be given an effective remedy in the event anticompetitive behavior or other market abuses occur, sellers should be provided rules of the road that are clearly-delineated. We noted that while regulatory certainty was important for individual market participants and the marketplace in general, the Commission must not be impaired in its ability to provide remedies for market abuses whose precise form and nature cannot be

envisioned today. We specifically sought comments on whether our proposed code of conduct rules had achieved the appropriate balance among these competing interests.

3. Here, based on the extensive comments received by the entities listed in the Appendix to this order and based on our further consideration of the issues presented, we will adopt the code of conduct rules proposed in the June 26 NOPR subject to certain modifications discussed below. These rules, as revised, are set forth below in, 18 CFR § § 284.288 and 284.403.

*2 4. Under Sections 284.288 and 284.403 of the new codes of conduct, a pipeline providing unbundled natural gas sales service under Section 284.284, or any person making natural gas sales for resale in interstate commerce pursuant to Section 284.402, is prohibited from engaging in actions without a legitimate business purpose that manipulate or attempt to manipulate market conditions, including wash trades and collusion.

5. New Sections 284.288 and 284.403 also contain various reporting obligations. To the extent a pipeline providing service under Section 284.284, or any person making natural gas sales for resale in interstate commerce pursuant to Section 284.402, engages in reporting of transactions to publishers of gas price indices, the pipeline or blanket marketing certificate holder shall provide complete and accurate information to any such publisher. Further, such entities must retain all relevant data and information upon which they billed the prices they charged for natural gas they sold pursuant to their market based sales certificate or the prices they reported for use in price indices for three years. Moreover, such entities that engage in reporting must do so consistent with the Policy Statement on Natural Gas and Electric Price Indices, 104 FERC ¶ 61,121 (2003) (Policy Statement), which provides that a data provider should only report each bilateral, arm's-length transaction between non-affiliated companies. Violation of the preceding provisions may result in disgorgement of unjust profits, suspension or revocation of a pipeline's blanket certificate or other appropriate non-monetary remedies. Finally, any person filing a complaint for a violation of the preceding provisions must do so no later than 90 days after the end of the calendar quarter in which the alleged violation occurred unless that person could not have known of the alleged violation, in which case the 90-day time limit will run from the discovery of the alleged violation.

6. This code of conduct is designed to provide market participants adequate opportunities to detect, and the Commission to remedy, market abuses. This code is clearly defined so that its does not create uncertainty, disrupt competitive commodity markets or simply prove ineffective. However, since competitive markets are dynamic, it is important that we periodically evaluate the impact that these regulations have on the energy markets. We direct our office of Market Oversight and Investigation to evaluate the effectiveness and consequences of these regulations on an annual basis and to include this analysis in the State of the Markets Report.

II. Background

A. Changes in Natural Gas Industry

7. A decade ago, as a result of changes in the natural gas industry, Congressional legislation and various Commission rulemaking proceedings restructuring the gas industry, the Commission issued blanket certificates to allow pipelines and other persons selling natural gas to make sales for resale of natural gas at market-based or negotiated rates. These certificates were granted in two final rules issued by the Commission: Order No. 6361 and Order No. 547.2

*3 8. In Order No. 636, the Commission required all pipelines that provide open-access transportation to offer their sales services on an unbundled basis. To this end, the Commission issued to pipelines holding a blanket transportation certificate under subpart G of Part 284 of the Commission's regulations, or performing transportation under subpart B, a blanket certificate authorizing firm and interruptible sales for resale.3 The Commission required that all firm and interruptible sales services be provided as unbundled services under the blanket sales certificate. The Commission found that this form of regulation would enable the pipelines to compete directly with other gas sellers on the same terms at prices determined in a competitive market. The unbundled sales services were also afforded pregranted abandonment authority.

9. In Order No. 636, the Commission authorized pipelines to make unbundled sales at market-based rates because it concluded that, after unbundling, sellers of short-term or long-term firm gas supplies (whether they be pipelines or other sellers) would not have market power over the sale of natural gas. The Commission's determination was also based on Congress' express finding that a competitive market exists for gas at the wellhead and in the field. The Commission indicated that it was instituting light-handed regulation, relying upon market forces at the wellhead or in the field to constrain unbundled pipeline sales for resale gas prices within the Natural Gas Act's "just and reasonable" standard. In addition, the requirement that pipelines provide open access transportation from the wellhead to the market also permitted the Commission to exercise light-handed regulation over jurisdictional gas sales. Finally, the Commission stated that it would be regulating the pipeline sales in the same manner as it had done for sales for resale by marketers.

10. The Commission also determined that a pipeline as a gas merchant would be the functional equivalent of a pipeline's marketing affiliate. The Commission concluded that standards of conduct set forth by Order No. 497 would apply to the relationship between the pipeline transportation function and its merchant function.4 Accordingly, the regulations issuing pipelines blanket sales certificates included standards of conduct and reporting requirements. The purpose of imposing the requirements set forth in Order No. 497 was to ensure that the pipeline did not favor itself as a merchant over other gas suppliers in performing its transportation function.

11. In Order No. 547, as part of the industry restructuring begun by Order No. 636, the Commission issued blanket certificates to all persons who are not interstate pipelines authorizing them to make jurisdictional gas sales for resale at negotiated rates with pregranted abandonment authority.5 The blanket certificates were issued by operation of the rule itself and there was no requirement for persons to file applications seeking such authorization. The Commission determined that the competitive gas commodity market would lead all gas suppliers to charge rates that are sensitive to the gas sales market and cognizant

of the variety of options available to gas purchasers. The Commission further stated that, in a competitive market, the basis for the rate to be negotiated between a willing buyer and seller is a commercial, not a regulatory, matter. The requirement that pipelines provide open access transportation from the wellhead to the market also permitted the Commission to exercise light-handed regulation over jurisdictional gas sales. The Commission also determined that marketing certificates issued by the final rule are of a limited jurisdiction. The Commission held that the holders of marketing certificates are not subject to any other regulation under the Natural Gas Act jurisdiction of the Commission by virtue of transactions under the certificates.

B. Events in Western Energy Markets

*4 12. In March 2003, in Docket No. PA02-2-000, the Commission Staff concluded its Fact Finding Investigation of Potential Manipulation of Electric and Gas Prices and issued a Final Report on Price Manipulation in Western Markets (Final Report). A key conclusion of the Final Report is that markets for natural gas and electricity in California are inextricably linked, and that dysfunctions in each fed off one another during the California energy crisis. Staff found that spot gas prices rose to extraordinary levels, facilitating the unprecedented price increase in the electricity market. The Final Report found that dysfunctions in the natural gas market appear to stem, at least in part, from efforts to manipulate price indices compiled by trade publications. The Final Report stated that reporting of false data and wash trading are examples of efforts to manipulate published price indices.

13. While the Final Report contained numerous recommendations which will not be discussed here, the Staff did recommend that Sections 284.284 and 284.402 of the Commission's regulations be amended to provide explicit guidelines or prohibitions for trading natural gas under Commission blanket certificates. The specific recommendations include: (1) conditioning natural gas companies' blanket certificates on providing accurate and honest information to entities that publish price indices; (2) conditioning blanket certificates on retaining all relevant data for three years for reconstruction of price indices; (3) establishing rules banning any form of prearranged wash trading; and (4) prohibiting the reporting of trades between affiliates to industry indices.

III. Comment Analysis

A. Application of Code of Conduct to Jurisdictional Sellers

14. As an initial matter, the Commission will clarify the extent of its jurisdiction over resales of natural gas. As stated above, the Commission's NGA jurisdiction to regulate the prices charged by sellers of natural gas has been substantially narrowed by the Natural Gas Policy Act of 1978 (NGPA) and Congress' subsequent enactment of the Natural Gas Wellhead Decontrol Act of 1989. As a result of these statutory provisions first sales of natural gas were deregulated. Under the NGPA, first sales of natural gas are defined as any sale to an interstate or

intrastate pipeline, LDC or retail customer, or any sale in the chain of transactions prior to a sale to an interstate or intrastate pipeline or LDC or retail customer. NGPA Section 2(21)(A) sets forth a general rule stating that all sales in the chain from the producer to the ultimate consumer are first sales until the gas is purchased by an interstate pipeline, intrastate pipeline, or LDC. [FN4] Once such a sale is executed and the gas is in the possession of a pipeline, LDC, or retail customer, the chain is broken, and no subsequent sale, whether the sale is by the pipeline, or LDC, or by a subsequent purchaser of gas that has passed through the hands of a pipeline or LDC, can qualify under the general rule as a first sale on natural gas. In addition to the general rule, NGPA Section 2(21)(B) expressly excludes from first sale status any sale of natural gas by a pipeline, LDC, or their affiliates, except when the pipeline, LDC, or affiliate is selling its own production.

*5 15. Therefore, the Commission's jurisdiction under the NGA includes all sales for resale by interstate and intrastate pipelines and LDCs and their affiliates, other than their sales of their own production. The Commission's jurisdiction also includes a category of sales by entities that are not affiliated with any pipeline or LDC. Such entities are those making sales for resale of gas that was previously purchased and sold by an interstate or intrastate pipeline or LDC or retail customer.

16. Given that the Commission does not have jurisdiction over the entire natural gas market, several commenters raise concerns regarding the potential adverse effect of imposing the proposed code of conduct only on the portion of the natural gas market under the Commission's jurisdiction. [FN5] Commenters assert that the proposed rules could tilt capital markets against those subject to the code of conduct because they would be viewed as a riskier proposition than those entities selling gas that do not have the same regulatory risk. Commenters argue that to impose these regulations on a portion of the market causes an uneven playing field and amounts to undue discrimination because those under the rules would be: (1) subject to sanctions such as loss of certificate authority and disgorgement of profits; (2) hesitant to engage in legitimate transactions due to uncertainty imposed by vague and inconsistent standards developed in different proceedings; (3) subject to the increased risk of private enforcement actions by gas purchasers before the Commission; (4) subject to the shifting of investment to non-jurisdictional marketers, and; (5) subject to increased recordkeeping costs for jurisdictional entities.

17. Commenters argue that the proposed regulations are duplicative because other government agencies such as the Federal Trade Commission, the Department of Justice, and various state agencies already exercise jurisdiction over anticompetitive behavior. [FN6] Further, commenters argue that in addition to stifling innovation, the proposed regulations will erode regulated marketer participation, and thereby reduce the efficiency of the markets and deprive the customers of the benefits of deregulation. Furthermore, since this code regulates only a small portion of the market, [FN7] they argue that the rules will be ineffective in achieving uniform compliance.

18. Finally, commenters maintain that before imposing these potentially burdensome compliance conditions, the Commission should ascertain critical information on its effects, including the percentage of the natural gas sellers that would be required to comply with the proposed rule or the amount of the gas

affected. Commenters argue that uncertainty caused by the proposed rules would be particularly damaging in light of the current need for additional supplies and the current need to regain investor confidence.

19. However, several commenters support the Commission's action in imposing a code of conduct. [FN8] These commenters state that if jurisdictional gas sellers seek to avoid a requirement that they do business honestly by restructuring their business to escape the Commission's jurisdiction, Congress might be interested in broadening the Commission's jurisdiction to prevent such outcomes. Moreover, they assert that the only way that jurisdictional certificate holders could be at a competitive disadvantage is if they are competing against companies that are engaging in the very illegal acts that the Commission's code of conduct is proscribing. Finally, commenters argue that the proposed regulations should not harm any market participant and should not have a negative impact on natural gas prices, but will only require action consistent with a competitive market.

*6 20. The Commission has reviewed the comments setting forth possible problems in placing a code of conduct regulations over the portion of the natural gas marketplace within its jurisdiction. In the Commission's view, implementing these regulations designed to prevent manipulation of market prices and prevent abusive behavior which distorts the competitive marketplace for natural gas will not present an undue burden for gas sellers under the Commission's jurisdiction or disrupt the competitive gas market.

21. As stated above, the Commission retains jurisdiction of sales of domestic gas for resale by pipelines, local distribution companies and affiliated entities, if the seller does not produce the gas it sells. The fact that the Commission does not regulate the entire natural gas market does not compel the Commission to refrain from exercising its authority over that portion of the gas market which is within its jurisdiction to prevent the manipulation of prices. By its action here, the Commission will maintain and protect the competitive marketplace within its jurisdiction. On balance, the Commission finds that its statutory responsibility to ensure just and reasonable rates for the sales over which it does have jurisdiction outweighs concerns that a portion of the market will not be subject to these regulations and the potential resulting market disruptions. [FN9]

22. This finding is based upon a balancing of factors raised by the commenters against the Commission's duty to maintain the competitive marketplace for natural gas within its jurisdiction. Although all sellers of natural gas will not be under the same set of regulations, this does not by itself place an undue burden, or for that matter, a competitive disadvantage of any consequence upon the sellers of natural gas within the Commission's jurisdiction. This is because the regulations to be placed upon jurisdictional natural gas sellers only prevent such market participants from distorting the competitiveness of the marketplace by engaging in abusive or manipulative acts in the marketplace. For instance, commenters argue that the increased regulatory risk could shift capital markets against those subject to the new regulations. This argument is speculative and it appears to the Commission that it is at least equally likely that investors and gas buyers would gain confidence in the knowledge that the jurisdictional seller of natural gas was required to engage in business practices that do not abuse or manipulate the marketplace.

B. Limited Jurisdiction of Blanket Certificates

23. In its June 26 NOPR, the Commission proposed to delete the last sentence of 18 CFR § 284.402(a) (2003) from its regulations. That sentence reads, "[a] blanket certificate issued under Subpart L is a certificate of limited jurisdiction which will not subject the certificate holder to any other regulation under the Natural Gas Act jurisdiction of the Commission by virtue of the transactions under the certificate."

*7 24. Several commenters raise concerns regarding this deletion. [FN10] Commenters argue that the statement of limited jurisdiction for the subject blanket certificates should remain in the regulations in order to relieve blanket holders of market sales certificates from any aspect of the Commission's jurisdiction which does not apply to market based rates such as the filing of tariff rates and various forms. Retaining this statement of limited jurisdiction is of particular concern to LDCs that are comprehensively regulated at the state level. [FN11] Commenters argue that the Commission should clarify that blanket certificate holders are not subject to any other regulations except as provided in Subpart L of Part 284. Finally, commenters argued that the new rules and burdens are inappropriate for affiliates of small pipelines, particularly where the pipeline is non-major and serves few customers and the affiliated seller is selling supplies for the primary purpose of balancing its purchases with its manufacturing needs. [FN12] These commenters argue that the Commission should establish a procedure to exempt such affiliates of small pipelines.

25. The Commission has reviewed the comments and has determined that it will not delete the affirmative statement of limited jurisdiction from its regulations; rather, in keeping with the points raised by the comments it will modify the sentence to read, "[a] blanket certificate issued under Subpart L is a certificate of limited jurisdiction which will not subject the certificate holder to any other regulation under the Natural Gas Act jurisdiction of the Commission, other than that set forth in this Subpart L, by virtue of the transactions under this certificate." Because the regulations adopted by the instant rulemaking will be placed in Subpart L, this action will maintain the original intent of the limited market based blanket certificate while allowing for the new conditions found necessary by the Commission.

26. Further, the Commission will not grant a generic exception to these regulations for small entities. In the Commission's view, entities with a small number of customers making few, or low volume, transactions should incur only minimal administrative or financial burden by virtue of these regulations.

C. Code of Conduct

1. General Language Prohibiting Manipulation

27. As revised Section 284.288(a) of the Commission's regulations provides that:

A pipeline that provides unbundled natural gas service under § 284.284 is prohibited from engaging in actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas. [FN13]

28. As discussed above, several commenters raise concerns regarding the general language prohibiting manipulation. [FN14] Commenters contend that the regulation contains too many ambiguous terms such as "legitimate business purpose," "manipulation," and "legitimate forces of supply and demand." NJR Companies assert that the proposal violates due process requirements, and that parties must receive fair notice before being deprived of their property. NJR Companies suggest that the Commission replace vague language with straightforward requirements.

*8 29. Sempra recommends that the Commission take a cue from the jurisprudence of the CFTC and SEC by adopting a standard for manipulation that includes ability, intent, and effect as required elements of an offence. Reliant, Select, Merrill Lynch and Morgan Stanley assert that the Commission should establish four essential elements to prove manipulation: (1) the ability to move market prices, (2) the specific intent to create an artificial price, (3) the existence of an artificial price, and (4) causation of the artificial price by the accused.

30. Coral contends that adoption of the proposed regulation could have the effect of deterring blanket certificate holders from aggressively or creatively marketing their gas or developing new products that may benefit competitive gas markets. NASUCA argues that the Commission should clarify what types of manipulative behavior is prohibited. It adds that manipulation that results from inadequate planning, inept design, incompetent personnel, or poor supervision should not be exempted from enforceable action.

31. Hess believes that the Commission should not adopt this measure, asserting that, among other things, it has not sufficiently explained how it intends to enforce the standard. EnCana and Mirant question the necessity of the rule since the Commission and other agencies have already shown an ability to police allegedly manipulative behavior.

32. We find that our rules, including specifically the prohibitions set forth relating to market manipulation, are not unduly vague as asserted by some commenters. While constitutional due process requirements mandate that the Commission's rules and regulations be sufficiently specific to give regulated parties adequate notice of the conduct they require or prohibit, [FN15] this standard is satisfied "[i]f, by reviewing [our rules] and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with ascertainable certainty, the standards with which the agency expects parties to conform." [FN16] The Commission's rules will be found to satisfy this due process requirement "so long as they are sufficiently specific that a reasonably prudent person, familiar with the conditions the regulations are meant to address and the objectives the regulations are meant to achieve, would have fair warning of what the regulations require." [FN17]

33. As applied by the courts, this due process standard has been held to allow for flexibility in the wording of an agency's rules and for a reasonable breadth in their construction. [FN18] The courts have recognized, in this regard, that specific regulations cannot begin to cover all of the infinite variety of cases to which they may apply and that "[b]y requiring regulations to be too specific,

[courts] would be opening up large loopholes allowing conduct which should be regulated to escape regulation." [FN19]

*9 34. The Supreme Court has further noted that the degree of vagueness tolerated by the Constitution, as well as the relative importance of fair notice and fair enforcement, depend in part on the nature of the rules at issue. [FN20] In Hoffman, for example, the Court held that in the case of economic regulation (as opposed to criminal sanctions), the vagueness test must be applied in less strict manner because, among other things, "the regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process." [FN21]

35. Applying these standards here, we find that our rules satisfy the requirement of due process. It cannot be said that the prohibitions against market manipulation, as set forth in the rules, are unclear in their intent. For example, our requirement that a seller's actions must have a "legitimate business purpose" is clearly intended to give sellers some latitude in determining their business actions, while safeguarding market participants against market manipulation for which there can be no legitimate business purpose. Sellers will not be required to guess at the meaning of the above- referenced term because it can only have meaning with specific reference to seller's own business practices and motives. In other words, if the seller has a legitimate business purpose for its actions, it cannot be sanctioned under this rule.

36. In establishing these rules, we have worked to strike a necessary balance. On the one hand, this prohibition allows the Commission to protect market participants from market abuses that cannot be precisely envisioned at the present time. At the same time, we have attempted to set forth with sufficient specificity the class of behaviors prohibited in a manner that will inform market-based rate sellers of the type of activities that are consistent with just and reasonable rates. This provides the Commission the ability to codify these requirements and provide a regulatory vehicle for their prospective enforcement. Thus, our rules have been designed to meet these twin objectives -- to be specific in order to inform sellers as to the type of behavior that is prohibited today, while containing enough breadth and flexibility to address new and unanticipated activities, as they may arise down the road.

37. Nonetheless, we are committed to making our rules as specific as possible and thus, we are adopting a number of the revisions proposed by commenters in order to clarify the scope and application of our rules.

38. We clarify that we are focusing on behavior undertaken without an appropriate commercial underpinning for the purpose of distorting prices from those that would otherwise occur in the competitive market. However, the proposed term that would have characterized as manipulative behavior an act resulting in "market prices which do not reflect the legitimate forces of supply and demand" has resulted in confusion. While we do not believe that our use of this term was inappropriate or unjustified (as we intended it), many commenters appear to have misunderstood its purpose, suggesting that causes other than manipulation may explain a given dysfunction in the interplay between supply and demand. To avoid confusion on this point, then, and because our objectives with respect to this rule can be satisfied under the surviving clause, discussed above, we have eliminated this term from our rule. We clarify that this rule is not meant to say that we will identify prices

that properly reflect supply and demand and then take action against sellers whose prices (however they may be established) differ. Rather, our rule is designed to prohibit market-based rate sellers from taking actions without a legitimate business purpose that are intended to or foreseeably could interfere with the prices that would be set by competitive forces. [FN22] One such action would be a wash trade. As discussed below, wash trades have no economic risk or substance, and create a false price for use in indices or in the market in general.

*10 39. Commenters have also raised questions regarding how the Commission will determine whether this rule has been violated. In determining whether an activity is in violation of our rule, we will examine all relevant facts and circumstances surrounding the activity to evaluate whether there is a legitimate business purpose attributable to the behavior. We will evaluate whether the activity was designed to lead to (or could foreseeably lead to) a distorted price that is not reflective of a competitive market. Our approach will be to consider the facts and circumstances of the activity to determine its purpose and its intended or foreseeable result. However, the Commission recognizes that manipulation of energy markets does not happen by accident. We also recognize that intent often must be inferred from the facts and circumstances presented. Therefore, a violation of the instant rule must involve conduct which is intended to, or would foreseeably distort prices. [FN23]

40. Some ambiguity necessarily arises from the fact that we cannot expressly identify all behaviors that are precluded by the instant rule. However, in the Commission's view, the rule and its implementation provide sufficient clarity for market-based rates sellers to understand the scope of precluded behaviors. The rule clearly prohibits behaviors that are undertaken without a legitimate business purpose which are designed to, or foreseeably would, distort prices for jurisdictional natural gas sales.

41. Many commenters have raised concerns with the Commission's inclusion of the phrase "legitimate business purpose." The Commission's inclusion of the phrase is to assure sellers that transactions with economic substance in which a seller offers or provides service to a willing buyer where value is exchanged for value will not be considered prohibited by our rule. While several commenting sellers have raised concerns regarding the inclusion of the phrase "legitimate business purpose" in the rule, we believe that not only is the inclusion of the phrase necessary, it acts to ensure that such sellers acting in a pro-competitive manner will be able to show that their actions were not designed to distort prices or otherwise manipulate the market. Behaviors and transactions with economic substance in which a seller offers or provides service to a willing buyer where value is exchanged for value will be recognized as reflecting a legitimate business purpose consistent with just and reasonable rates. However, an action or transaction which is anticompetitive (even though it may be undertaken to maximize seller's profits), could not have a legitimate business purpose attributed to it under our rule. [FN24]

42. Prices for transactions undertaken in the competitive marketplace where value is exchanged for value should be disciplined by market forces. On the other hand, all gas transactions may not be constrained by market forces. For example, if a gas merchant bought natural gas at a location typically used as an index reference point in a manner that drives prices higher (and promptly thereafter sold such gas at the market prevailing price at a loss) while also possessing a derivative position at a notional quantity significantly in excess of its physical gas

position, that benefits from the increase in the market price of natural gas at this index reference point, these physical purchases may be interpreted as a component of a broader manipulative scheme and the cash market transactions may be found to be without a legitimate business purpose. [FN25]

*11 43. We recognize that we are establishing a general rule that will become more clear and concrete after we have had the opportunity to consider actual cases. As with all new requirements of this nature, with caselaw comes further clarity. This reflects the fact that we oversee a dynamic and evolving market where addressing yesterday's concerns may not address tomorrow's. Nevertheless, experience in applying this rule should be instructive to both the Commission and market-based rates sellers. As we apply the rule, we will be mindful of the fact that we are not only taking steps to assure just and reasonable rates for a specific transaction but also providing guidance to sellers in general. As such, in determining the appropriate remedy for violations of this rule, we will take into account factors such as how self evident the violation is and whether such violation is part of a pattern of manipulative behavior.

44. The Commission rejects arguments that it should identify and prohibit only expressly-defined acts of manipulation. For all the reasons discussed above, it is essential and appropriate that we have a prohibition designed to prohibit all forms of manipulative conduct. In sum, we believe our rules, as modified, explained and adopted herein, put sellers and all market participants on fair notice regarding the conduct we seek to encourage and the conduct we seek to prohibit. Stripped to their essentials, these guidelines amount to the following: (i) act consistently within the Commission's established rules; (ii) do not manipulate or attempt to manipulate natural gas markets; (iii) be honest and forthright with the Commission and the institutions it has established to implement open-access transportation and entities publishing indices for the purpose of price transparency; and (iv) retain associated records. Viewed in this context, there can be no reasonable uncertainty over the underlying objectives embodied in our rules or their requirements going forward.

45. Our code of conduct rules would not supercede or replace parties' rights under Section 5 of the NGA to file a complaint contending that a contract should be revised by the Commission (pursuant to either the "just and reasonable" or "public interest" test as required by the contract). Rather, any party seeking contract reformation or abrogation based on a violation of one or more of these regulations would be required to demonstrate that such a violation had a direct nexus to contract formation and tainted contract formation itself. If a jurisdictional seller enters into a contract without engaging in behavior that violates these regulations with respect to the formation of such contract, we do not intend to entertain contract abrogation complaints predicated on our instant code of conduct rules. 2. Wash Trades

46. Proposed Section 284.288(a)(1) provides that:

Prohibited actions and transactions include but are not limited to pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk, and no net change in beneficial ownership (sometimes called "wash trades"). [FN26]

*12 47. TXU comments that wash trades should be more precisely defined, contending that the present definition does not explicitly limit the applicable transaction to one involving the same location, price, quantity, and term, and can be interpreted to prohibit legitimate exchange transactions that occur through displacement or backhauls.

48. Merrill Lynch and Morgan Stanley request that the Commission modify the definition of wash trades to clarify that it applies to parties who intended to enter into simultaneous offsetting trades to effectuate a wash trade. They request that the Commission further clarify its definition by specifying that wash trades must involve: (1) a deliberately pre-arranged pair of trades, (2) trades made at the same time, at the same price, and at the same delivery points, and (3) trades made between the same legal entities. NGSA submits that the proposed ban on wash trades should be narrowed to encompass only simultaneous offsetting trades that are intended to manipulate market prices or rules. It explains that parties may enter into legitimate business arrangements that may appear as wash trades, for example, trades made to correct a scheduling or nomination error, or to liquidate a position at a pricing point based on subsequent changes in market conditions. NGSA suggests that the proposed regulation regarding wash trades be rewritten as: "knowingly pre-arranged simultaneous offsetting trades of the same product among the same parties, which involve no economic risk, and no net change in beneficial ownership (sometimes called 'wash trades')."

49. Reliant recommends the definition of wash trades be refined to eliminate the possibility that multiple traders within the same company who are trading with multiple traders in another company do not stand accused of engaging in wash trades by the mere coincidence that their trades offset one another. Reliant suggests that the regulation be re-written as: "trades of the same product among the same parties, which trades are pre- arranged to be offsetting and involve no economic risk, and no net change in beneficial ownership (sometimes called "wash trades").

50. The Oversight Board asserts that the definition of wash trade is unduly narrow, because it limits wash trades to transactions involving the same parties, the same quantity, and no economic risk whatsoever. The Oversight Board joins NASCUA in contending the proposed definition would permit a party to evade the wash trade prescription by engaging in transactions that result in the net financial position near to, but not equal to, zero. The Oversight Board contends that the Commission should qualify its wash trade definition to ensure that the codes of conduct can effectively react to unforeseen, novel attempts to circumvent the regulatory process. The Oversight Board requests that the Commission clarify that it will define wash trades as those necessarily affecting market prices or modify the definition to include pre-arranged multi- party transactions.

***13** 51. Commenters such as Select, Duke and NEMA suggest that the Commission's definition of a "wash trade" is too broad and may encompass transactions not intended to be wash trades such as "sleeving" and "bookout" transactions. Select explains that "sleeving" is a commonly performed trading practice in which a creditworthy party agrees to act as an intermediary in transactions between two parties who do not have a credit relationship. Duke recommends that legitimate trades may include the so-called "bookout" transactions, in which companies with offsetting delivery obligations resulting from heavy trading activity agree not to deliver to one another the offsetting amounts of energy. In the same vein, NEMA submits that there may be instances where legitimate business purposes appear to be wash trades (e.g., when traders "book out" or "test the waters"), and that the

Commission should not deem such trade to be illegal. Sempra request that the wash trade prohibition to only apply to trades that affect the market and asks that the Commission clarify the definition accordingly.

52. Other commenters such as Shell Offshore, NEMA, and Coral question whether the Commission has provided adequate definitions for the terms used in its regulations. For example, Shell Offshore questions what the regulations mean by a "pre-arranged" trade, and how it differs from any other negotiation leading to a trade. It also questions how to define an "offsetting trade," and how the value is measured. It also asks what constitutes the "same product" (i.e., does an exchange of gas among the same parties constitute the same product, and thus qualify as an illegal wash trade). It also notes that there are legitimate transactions that involve "no economic risk," such as a transaction providing a guaranteed supply at a guaranteed price. NEMA also requests additional clarification of the terms "wash trades" and "pre-arranged deals" and requests that the Commission investigate the meanings of the terms "intentional manipulation" and "wash trades" as they apply to securities and commodity futures trading.

53. The Commission will adopt Section 284.288(a)(1) as proposed. Thus, the regulation will state that:

> Prohibited actions and transactions include but are not limited to pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called "wash trades"). [FN27]

54. The Commission disagrees with the comments that its definition of wash trades is ill conceived or vague. The definition of wash trades states the two key elements that the Commission sees as the fundamentally manipulative aspects of wash trading: (1) that the transaction or transactions are prearranged to cancel each other out; and (2) that they involve no economic risk. As such, the prohibition against wash trades is illustrative of the Commission's prohibition against the manipulation of market conditions.

***14** 55. Transactions such as "sleeving" or "bookouts" as described by the commenters do not fall with the key elements of the Commission's definition and therefore would not be prohibited by the regulation. Further, trades made to correct scheduling or nomination errors, or trades that do not result from an attempt to manipulate the market would not be prohibited by the Commission's regulation. Moreover, displacement or backhauls are not wash trades as they are transportation services obtained from a pipeline if operationally feasible and simply do not meet the definition of wash trades as set forth herein. A sleeve is not an off-setting trade but rather a mechanism to accomplish a gas sale among parties that have not established a credit relationship by including a third party seller that has acceptable credit in the transaction chain. The two resulting sales (which are only offsetting to the "sleeving" seller) are each with economic risk with a change in beneficial ownership and, usually at slightly different prices to reflect the use of the "sleeving" seller's credit. A "bookout" is not a pre-arranged trade but rather a subsequent arrangement to financially close out trades that were not prearranged and executed (and, in fact, closed out) with economic risk.

56. Commenters argue that the Commission should impose an "intent" standard

relating to wash trading. The language, as proposed and finalized in this order, does include the element of intent. We recognize that buyers and sellers trade the same products with the same counterparties over the course of a trading day. Entering into a set of trades that happen to offset each other is not market manipulation. Wash trades are by their nature manipulative. By definition, parties must purposefully create prearranged off-setting trades with no economic risk to engage in a wash trade. We know of no legitimate business purpose to such behavior and no commenter has suggested one. Accordingly, as opposed to many other behaviors which would not, standing alone, violate Sections 284.288(a) or 284.403(a), wash trades will constitute a per se violation.

57. The Commission finds that its definition of wash trading, as explained here, satisfies the requirements that parties will generally know what is expected of them and what actions are prohibited. Therefore, the Commission will not further define its regulations at this point.

3. Collusion

58. As revised Section 284.288(a)(2) of the Commission's regulations provides that prohibited actions and transactions include but are not limited to:

collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for natural gas. [FN28]

59. Several commenters argue that the Commission should better define the term collusion. [FN29] For instance, TXU recommends that the Commission and market participants rely on federal and state antitrust laws specifically defining collusion in order to ensure certainty concerning the conduct that is prescribed. Sempra argues that the Commission's prohibition of collusion is unconstitutionally vague, as well as unnecessary since such conduct is already proscribed under other statutory and regulatory schemes administered by other federal agencies with specialized expertise in those areas of law.

*15 60. NEMA argues that for conduct to constitute collusion, there must be an element of intent to manipulate prices in the marketplace as well as an actual impact on commodity prices. Shell asks what standard the Commission would rely upon to determine whether or not there was collusion to "create" prices at levels that differ from those set by market forces.

61. While commenters such as Sempra are correct in their observation that the prohibition set forth in Sections 284.288(a)(1) and 284.403(a)(1) may be similar, in certain respects, to the prohibitions set forth in federal antitrust laws, our authority, as it relates to Sections 284.288(a)(1) and 284.403(a)(1), is not derived from federal antitrust law. Rather, our authority comes from the NGA itself and its requirement that all rates and charges made, demanded, or received by any natural gas company selling natural gas subject to the jurisdiction of the Commission and all rules and regulations affecting or pertaining to such rates and charges be just and reasonable. [FN30] Although our regulatory approach includes elements of anti-trust law, it is not limited to the structure of those laws. For example, our regulatory approach encompasses "partnerships" whose existence does not implicate anti- trust concerns that may, nonetheless, undertake manipulative

behavior. Therefore, these regulations will be interpreted and enforced by the Commission consistent with our own policies and precedents. As such, we need not be concerned here whether, or to what extent, federal antitrust law may be broader in scope or more narrow in scope. [FN31] These regulations are expressly tailored to our statutory duties and our competitive goals with respect to the natural gas market. [FN32]

62. To avoid possible confusion regarding the interpretation and scope from our originally proposed language which prohibited collusion for the purpose of creating market prices differing form those set by market forces, we have replaced this term with language consistent with our prohibition against manipulation set forth above. Therefore, the instant regulation prohibits collusion with another party for the purpose of manipulating market prices, market conditions or market rules for natural gas. We find such collusive acts to be illustrative of our prohibition against the manipulation of market prices and clarify that Sections 284.288(a)(2) and 284.403(a)(2) merely expand our general manipulation standard set forth in subparagraphs (a) of these rules to include acts taken in concert with another party. In other words, these regulations prohibit market manipulation undertaken by one market participant acting alone and market manipulation undertaken collectively by more than one market participant.

4. Reporting to Gas Index Publishers

***16** 63. Proposed Regulation Section 284.288(b) states that:

To the extent a pipeline that provides unbundled natural gas sales service under § 284.284 engages in reporting of transactions to publishers of gas price indices, the pipeline shall provide complete, accurate and factual information to such publisher. The pipeline shall notify the Commission of whether it engages in such reporting for all sales. In addition, the pipeline shall adhere to such other standards and requirements for price reporting as the Commission may order. [FN33]

64. Commenters argue that the Commission should not prescribe reporting requirements that might prevent innovation of better long-term solutions to the industry's evolving future needs for price information. [FN34] Others argue that the proposed penalties may discourage market participants from voluntarily reporting price data.

65. Commenters also argue that the confidential treatment of reported data, as required by the Policy Statement, is critical to the voluntary reporting process. [FN35] Moreover, several commenters recommend that the Commission articulate specific reporting requirements, consistent with the Policy Statement. Commenters submit that many aspects of the reporting process remain unclear. For instance, they argue that it is unclear what data must be reported, the format for the data, the policy for confirming the accuracy of the data, and to which entities the seller must report. BP seeks clarification of this rule, contending that it does not mandate reporting, but simply requires that any information reported be "complete." Specifically, BP asks the Commission to clarify that where an entity voluntarily reports, that entity should not be required to report all sales at all locations. Coral suggests that general reviews followed by spot checks should be all that is required to assure a reasonable level of accuracy in reported trade

price information. [FN36] Other commenters argue that the Policy Statement obviates the need for a reporting rule. [FN37]

66. Several other commenters assert that the rule does not go far enough. [FN38] They recommend that the Commission require that all entities holding blanket certificates report all of their trades to the data collectors. They assert that only reporting occasional bits of information could lead to inaccuracies.

67. Moreover, several commenters request clarification as to whether the Commission notification requirement is a one-time or ongoing obligation. [FN39] BP argues that the Commission should clarify that it is only necessary to indicate to the Commission that the entity engages in reporting. Merrill Lynch and Morgan Stanley requests that the Commission clarify that if new entrants or entities that currently do not report to indices subsequently initiate reporting, such entities must notify the Commission within 30 days from the first date they initiated reports.

***17** 68. As part of the reporting provisions, numerous parties recommend that the Commission incorporate a safe harbor provision into its proposal so that an industry participant who, in good faith, provides trade data to index developers, will not be subject to penalties for inadvertent mistakes in reporting the information. Several commenters ask that the safe harbor provisions mirror the one adopted in the Commission's Policy Statement. [FN40] Commenters submit that incorporation of a safe harbor provision will encourage the voluntary reporting of information. Commenters also request the Commission to clarify the proposed false reporting prohibition so that it only applies to information that is known to be false at the time it is reported, as opposed to false reports based on inadvertent mistakes or human error. [FN41] Nicor and NGSA add that the Commission should expressly state that the safe harbor protections in the Policy Statement are not eliminated or negated by the subject reporting requirements.

69. Calpine contends that any safe harbor provision must be adopted into the proposed code without the burden on industry participants to self-audit and self-correct errors not otherwise discovered in the ordinary course of business. Given the volumes of data to be reported, Calpine believes it a certainty that inadvertent errors that do no harm to the overall integrity of the indices will be made. NEMA urges that the safe harbor be extended to index prices published by parties that meet the Commission's protocols.

70. The Commission proposed this regulation to assure that to the degree that a market-based rates seller reports its transactions to publishers of natural gas price indices, such seller must do so honestly and accurately. The Commission also proposed to require sellers to inform it if they undertook such reporting. Based upon the comments received, we have modified Sections 284.288(b) and 284.403(b) to read as follows:

To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas indices, Seller shall provide accurate and factual information and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the Policy Statement on Natural Gas and Electric Price Indices, issued by the Commission in Docket No. PL03-3-000 and any clarifications thereto. Seller shall notify the Commission within 15 days of the effective date of this tariff provision of whether it engages in such reporting of its transactions and update the Commission within 15 days of any subsequent change to its transaction reporting status. In addition, Seller shall adhere to such other standards and requirements for price reporting as the Commission may order.

*18 71. In our June 26 NOPR, we referred to our on-going proceeding investigating price index formation. As many commenters have pointed out, since our proposal regarding these rules was issued we have also issued a Policy Statement addressing standards we believe appropriate for the formation of price indices that will be robust and accurate in the context of a voluntary reporting regime. [FN42] Included in the Policy Statement is a "Safe Harbor" under which reporting errors will not be subject to Commission sanction. Here, we explicitly adopt the standards set forth in the Policy Statement for transaction reporting. Further, we also adopt the "Safe Harbor" set forth therein as a component of our enforcement policy with respect to this rule.

72. The Commission clarifies that the requirement that entities notify the Commission of any change in status with regard to price reporting to indices is an ongoing obligation. As such, the entities must, upon the implementation of these regulations, inform the Commission of whether they report to the index publishers. As shown above, the Commission will modify the text of Sections 284.288(b) and 284.403(b) of its proposed regulations to provide that the blanket marketing certificate holder shall, after the initial notification to the Commission, inform the Commission of its reporting status within 15 days of the effective date of these regulations and within 15 days of any subsequent change in reporting status.

73. Finally, some commenters have asked that we require mandatory reporting while others contend that we have created requirements that will have a chilling effect on reporting. We believe that we have struck an appropriate balance in these rules. For the moment, we are attempting to work within the framework of voluntary reporting. We are awaiting our staff's review of the comprehensiveness of reporting in the wake of our Policy Statement. At this time, we are not mandating reporting. However, we have engaged in a comprehensive investigation of transaction reporting and related issues and believe that the practices set forth in our Policy Statement represent the necessary minimum for those entities that choose to report. Accordingly, we will not require reporting, but will seek to learn which sellers are reporting and set forth standards for those that do.

5. Three-Year Data and Information Retention Requirement

74. Proposed Section 284.288(c) of the Commission's regulations provides that:

A pipeline that provides unbundled natural gas sales service under § 284.284 shall retain all relevant data and information necessary for the reconstruction of price indices for three years. [FN43]

75. Several entities comment on the Commission's proposed three-year data and information retention requirement. [FN44] Other commenters request clarification as to what constitutes "relevant data", and suggest that the Commission specify what types of data and information must be retained, and in what format (e.g., paper or

electronic). [FN45] Commenters are concerned that the required documentation will prove too burdensome due to both the time and the money required to store and retrieve information. NJR Companies argues that the proposal may create a new set of business records that could lead to decreased market activity, and a slow-down or elimination of certain transactions.

*19 76. BP asserts that relevant data should be limited to accounting data that records the details of each reported transaction, along with a record of the data transmitted to the index developer, if applicable. BP adds that requiring data maintained in the accounting records would be consistent with the Commission's proposed requirement for price reporting in its recent Policy Statement, which requires that price, volume, buy/sell indicator, delivery/receipt point, transaction date and time, term, and any counterparty name be maintained. It argues that negotiation materials and other ancillary data should not be required to be maintained.

77. Several commenters argue that the three-year retention period is too long, and that the burden may dissuade blanket marketing certificate holders from reporting data. [FN46] Other commenters argue that the three-year retention period is too short, and that with current computer technology, a longer retention period should not result in additional costs to market participants. [FN47] Finally, some commenters argue that the three-year record retention period is consistent with the commercial practices of many natural gas sellers. [FN48]

78. Several commenters argue that the record retention requirement will only be meaningful if the Commission makes reporting of all trade data mandatory. [FN49] At the same time, other commenters argue that if an entity does not report, then documentation is not necessary to verify the accuracy of price indices. [FN50] Other commenters submit that only relevant data should be retained and not peripheral documents that may have been generated in association with a transaction, but which have no bearing on the data reported to index publishers. [FN51]

79. This proposed rule requires that sellers maintain relevant records regarding their sales for three years. After review of the comments received, we revise Section 284.288(c) to read:

A pipeline that provides unbundled natural gas sales service under 284.284 must retain, for a period of three years, all data and information upon which it billed the prices it charged for the natural gas it sold pursuant to this certificate or the prices it reported for use in price indices for a period of three years. [FN52]

80. In revising the proposed rule, we clarify that we are not seeking retention "cost-of service" or analytical data related to sellers' sales as some commenters perceived from our suggestion that entities retain all relevant data "necessary for the reconstruction of price indices" in our original proposal. Rather, we are requiring that sellers retain the complete set of contractual and related documentation upon which such entities billed their customers for sales. The Commission is indifferent as to whether this material is retained in paper form or in an electronic medium as long as the data can be made accessible in a reasonable fashion if its review is required. In addition, commenters raise several issues in regard to the three-year retention period. On balance, the Commission does not believe that requiring sellers to retain records for a three-year period

constitutes an undue burden given the fact that the Commission is prepared to allow the records to be kept in electronic or paper form. To permit a shorter retention period may not allow sufficient time for the investigations into possible violations.

6. Prohibition on Reporting Transactions with Affiliates

*20 81. Proposed section 284.288(d) of the Commission's regulations provides that:

A pipeline that provides unbundled natural gas sales transactions under § 284.284 is prohibited from reporting any natural gas sales transactions between the pipeline and its affiliates to industry indices. [FN53]

82. Commenters generally agree with this restriction. [FN54] NASUCA agrees to the prohibition of affiliate transactions from price indices calculations, but contends that other non-price information, such as the number of trades and the volumes associated with each trade, is important information that will help determine the liquidity at various hubs for which prices are calculated. It recommends that the regulation be modified to state that pipelines and certificate holders should separately report other non-price data associated with affiliate transactions.

83. Although the separate reporting of other non-price data associated with affiliate transactions may provide additional information regarding liquidity at certain points, the Commission finds that this information is not necessary for the purposes of these rules.

84. Although commenters generally agree with reporting restrictions on transactions between affiliates in the June 26 NOPR, new Sections 284.288(b) and 284.403(b) of the Final Rule provide that to the extent a Seller engages in the reporting of transactions to publishers of price indices, the Seller shall do so in a manner consistent with the procedures set forth in the Policy Statement. The Policy Statement states that "a data provider should report each bilateral, arm's length transaction between non-affiliated companies in the physical (cash) markets at all trading locations." [FN55] Therefore, an entity filing consistent with the Policy Statement will not include sales to affiliates in its report. Accordingly, the Commission believes the addition of these two regulations (Sections 284.288(d) and 284.403(d) of the June 26 NOPR) is redundant, and shall be deleted.

D. Remedies

1. General Issues

85. Several commenters responded to the Commission's proposal that the violations of its code of conduct may result in various remedial actions by the Commission including the disgorgement of unjust profits, suspension or revocation of the blanket sales certificates or other appropriate remedies.

86. In regard to the Commission's inclusion of disgorgement as a potential remedy various commenters argue that the Commission does not have authority to condition NGA Section 7 certificates with such a retroactive refund obligation. [FN56] Commenters argue that the courts have held that the Commission's power to condition certificates cannot be permitted to diminish an entity's rights under NGA Sections 4 and 5. [FN57] These commenters argue the proposed disgorgement remedy is a refund condition that is not permitted under Section 5 of the NGA and that such disgorgement of unjust profits from a just and reasonable rate is tantamount to retroactive ratemaking because NGA Section 5 provides only for prospective relief. [FN58] The commentors argue the Commission is attempting to expand its authority to order retroactive refunds, or, change retroactively the filed rate. They argue that courts have been clear that the Commission cannot (i) use its conditioning authority to circumvent other provisions of the NGA and (ii) do indirectly what it may not do directly and therefore the Commission cannot condition rates as it proposes to do so here, and subject them to retroactive refunds because Congress did not include such authority in the NGA.

*21 87. Several commenters express concern that the term "unjust profits" is vague and subjective, the calculation of which would necessitate a review of all market conditions. [FN59] AGA recommends that the Commission limit the disgorgement of unjust profits to all illegal activity and not impose penalties for violation of those regulatory provisions associated with reporting activities. [FN60] NJR Companies object to the disgorgement remedy when the violation is inadvertent. [FN61]

88. Several commenters argue that the Commission should consider additional remedies such as a remedy that would require the offending entity to make the market whole for losses incurred because of its actions. [FN62] They argue that if an entity must simply disgorge unjust profits, even if is caught for every infraction of the code, it is no worse off than if it had followed the rules in the first place. Therefore, they argue that disgorgement of unjust profits does not serve as a penalty or deterrent to future, similar actions. In sum, they argue that the failure to comply with the filed rate by engaging in prohibited manipulative behavior should include a potential remedy that is greater than disgorgement, such as a make the market whole remedy.

89. Regarding the issue of appropriate non-monetary penalties, PSCNY states that all violations of the regulations should be publicly disclosed in a public file that may be accessed by buyers and the public. A list of bad actors and dates could be maintained on the Commission's web site. Such public disclosure, PSCNY argues, would provide an additional deterrent for companies to avoid the stigma associated with engaging in anticompetitive behavior. PSCNY states that in the event of a particularly blatant and serious violation, or multiple violations, the Commission should place parties on notice that appropriate remedies could include revocation of market-based rate authority. NASUCA recommends that the Commission clarify that revocation of market-based rate authority will be for a specified minimum period of time that depends on the severity of the violation.

90. In Order No. 636, the Commission determined that after gas services were unbundled, sellers of gas supplies would not have market power over the sale of natural gas. This determination was based in large part upon Congress' finding that a competitive market exists for gas at the wellhead and in the gas field. The Commission determined that it would institute light-handed regulation and would

rely on market forces at the wellhead to constrain sales for resale of natural gas within the just and reasonable standard set forth by the NGA. In implementing its findings in Order No. 636 and Order No. 547, the Commission issued blanket certificates to all persons who are not interstate pipelines which authorized such persons to make jurisdictional gas sales for resale at negotiated rates with pre-granted abandonment. [FN63] In issuing these certificates the Commission determined that the competitive natural gas market would lead all gas suppliers to charge rates that are sensitive to the gas sales market.

*22 91. The Commission has determined that in order to protect and maintain the competitive natural gas market and to continue its light-handed regulation of the gas sales within its jurisdiction, it is necessary to place additional conditions on its grant of market-based sales certificates. In formulating such conditions to the market based rate certificates the Commission is fulfilling its obligation to appropriately monitor markets and to ensure that market-based rates remain within the zone of reasonableness required by the NGA. [FN64]

92. In order to find the market based sales service to be in the public convenience and necessity the Commission finds that the conditions herein must be met. Once the sales service is so conditioned, in the Commission's view adequate safeguards are in place so that the Commission may grant market based sales authority to jurisdictional sellers of natural gas. In so conditioning this service, the Commission is not prohibiting a jurisdictional seller of natural gas from requesting a certificate for a different form of service or filing pursuant to Section 4 of the NGA for a different rate or conditions of service. Neither does the Commission prohibit a customer of such a seller from raising objections under Section 5 of the NGA.

93. Moreover, if the conditions of service are not met, the Commission has the authority to impose the appropriate remedy for the violation. [FN65] In particular, the Commission does not agree with the comments that a violation of an existing condition of service may not be remedied by the Commission from the time the violation occurred. The Commission has the authority to remedy violations of certificate conditions. [FN66] Moreover, the courts have held that the Commission has a great deal of discretion when imposing remedies devised to arrive at maximum reinforcement of Congressional objectives in the NGA. [FN67] In devising its remedy the Commission is required to exercise its discretion to arrive at an appropriate remedy, [FN68] and to explore all the equitable considerations, and practical consequences of its action and the purposes of the NGA. [FN69]

94. This action of remedying a violation of a certificate condition is not the same as the Commission's action in finding an existing rate unjust and unreasonable after hearing under Section 5 of the NGA. At the initiation of an NGA Section 5 proceeding the existing condition has not yet been found to be unjust and unreasonable. In contrast, in a remedial proceeding the issue is whether the entity has violated an existing condition of the tariff or the regulations. Therefore, in a remedial proceeding, unlike an NGA section 5 proceeding, the regulated entity has notice of the conditions required for service at the time of the implementation of the service condition and the Commission may, at its discretion, fashion an appropriate remedy.

95. In appropriate circumstances these remedies may include disgorgement of unjust profits, suspension or revocation of the blanket sales provision or other

appropriate non-monetary remedies. Which of these remedies is appropriate will depend on the circumstances of the case before it and the Commission will not determine here which remedy or remedies it will utilize. [FN70]

2. 90-Day Time Limit on Complaints

*23 96. Several commenters raise concerns about the 60-day time limit on complaints proposed in the June 26 NOPR. [FN71] Most of the commenters argue that the 60-day time period is unreasonably too short. Some commenters suggest a limit of six months. [FN72] Many commenters suggest modification of the provision's discovery exception, by adopting a "reasonableness" standard, i.e., a reasonable person exercising due diligence could not have known of the wrongful conduct.

97. Several commenters argue that the Commission errs in not applying the 60- day deadline to itself. They argue that if the Commission is allowed to initiate unlimited retroactive investigations, this vitiates any time constraints the rule otherwise places on private complainants. Commenters recommend that the scope of any investigation that might stem from a complaint, or the Commission's own motion, be narrowly defined, and require the demonstration and quantification of the individual harm resulting from the prohibited conduct. [FN73] These commenters are concerned about the lack of finality for transactions under the proposed discovery exception to the 60-day requirement. Merrill Lynch and Morgan Stanley suggest either a hard and fast deadline of 60 days from the event with no exceptions or a rebuttable presumption the complainant knew about the alleged violation within the 60-day time period.

98. Upon consideration of the comments received concerning our 60-day proposal, in the Commission's view the 60-day time period may be insufficient time for parties to discover and act upon violations of these regulations. Accordingly, the Commission will modify its original proposal to allow 90 days from the end of the quarter from which a violation occurred for a party to bring a complaint based on these regulations. A 90-day time period provides a reasonable balance between encouraging due diligence in protecting one's rights, discouraging stale claims, and encouraging finality in transactions. Furthermore, the Commission clarifies that the language in Sections 284.288(e) and 284.403(e), "unless that person could not have known of the alleged violation", incorporates a reasonableness standard, i.e., the 90-day time period to file a complaint does not begin to run until a reasonable person exercising due diligence should have known of the alleged wrongful conduct. Rather than being impermissibly vague, this safeguard ensures a sufficient time-period for complainants to discover hidden wrongful conduct and submit a claim.

99. We will also place a time limitation on Commission enforcement action for potential violations of these regulations. The Commission, unlike the market participants who may be buyers or otherwise directly affected by a transaction, may not be aware of actions or transactions that potentially may violate our rules. Thus, the Commission will act within 90 days from the date it knew of an alleged violation of these code of conduct regulations or knew of the potentially manipulative character of an action or transaction. Commission action in this context means a Commission order or the initiation of a preliminary investigation by Commission Staff pursuant to 18 CFR section 1b. If the Commission does not act

within this time period, the seller will not be exposed to potential liability regarding the subject action or transaction. Knowledge on the part of the Commission will take the form of a call to our Hotline alleging inappropriate behavior or communication with our enforcement Staff.

*24 100. We also clarify that in this context the Commission's action will have reference to a Commission order or to the initiation to a preliminary investigation by Commission Staff. If the Commission does not act within this period, the Seller will not be exposed to potential liability regarding the subject transaction. In such a proceeding, knowledge on the part of the Commission must take the form of a call to our Hotline alleging inappropriate behavior or communication with our enforcement staff.

VI. Administrative Finding and Notices

A. Information Collection Statement

101. The code of conduct rules adopted herein would require jurisdictional gas sellers to retain certain records for three years and also require them to notify the Commission whether or not they engage in the reporting of natural gas sales transactions to publishers of gas indices. [FN74]

102. The Office of Management and Budget's (OMB) regulations require that OMB approve certain information collection requirements imposed by agency rule. [FN75] This final rule does not make any substantive or material changes to the information collection requirements specified in the NOPR, which was previously submitted to OMB for approval on July 14, 2003. OMB has elected to take no action on the NOPR. Thus, the information collection requirements in this rule are pending OMB approval. Comments were solicited and received on the need for this information, whether the information will have practical utility, the accuracy of the provided burden estimates, ways to enhance the quality, utility, and clarity of the information to be collected, and any suggested methods for minimizing respondents' burden, including the use of automated information techniques. The Commission addressed these issues in sections III (C)(4)-(5) of this order. The burden estimates for complying with this proposed rule are as follows:

Data Collection	Number of Respondents	Number of Responses	Hours Per Response	Total Annual Hours
FERC-549				
(Reporting)	222	222	1	222
(Recordkeeping)	222	222	2	444
Totals			3	666

Total annual hours for Collection (reporting + recordkeeping) = 666.

Information Collection Costs: The Commission seeks comments on the cost to comply with these requirements. It has projected the average annualized cost of all respondents to be: Annualized Capital Startup Costs: 666 / 2080 x $117,041 = $37,475. This is a one time cost for the implementation of the proposed requirements.

*25 103. OMB's regulations require it to approve certain information collection requirements imposed by agency rule. The Commission is submitting a copy of this order to OMB.

104. Title: FERC-549, Gas Pipeline Rates: Natural Gas Policy Act, Section 311.

105. Action: Proposed Data Collection

106. OMB Control No. 1902-0086.

107. Respondents: Businesses or other for profit.

108. Frequency of Responses: On occasion.

109. Necessity of Information: The code of conduct rules approved herein would revise the Commission's regulations to require that pipelines that provide unbundled sales service or persons holding blanket marketing certificates adhere to a code of conduct when making gas sales. In addition, the Commission will require blanket sales certificate holders to maintain certain data for a period of three years. The addition of the codes of conduct, retention of data and standards for accuracy are efforts by the Commission to ensure the integrity of the natural gas market that remains within its jurisdiction.

110. Internal review: The Commission has reviewed the requirements pertaining to blanket sales certificates and has determined the proposed revisions are necessary to ensure the integrity of the gas sales market that remains within its jurisdiction. These requirements conform to the Commission's plan for efficient information collection, communication, and management within the natural gas industry. The Commission has assured itself, by means of internal review, that there is specific, objective support for the burden estimates associated with the information requirements.

111. Interested persons may obtain information on the information requirements by contacting the following: Federal Energy Regulatory Commission, 888 First Street, NE, Washington, D.C. 20426 [Attention: Michael Miller, Office of the Executive Director, Phone (202)502-8415, fax: (202)273-0873, e-mail: Michael.Miller@ferc.gov.]

112. For submitting comments concerning the collection of information(s) and the associated burden estimate(s), please send your comments to the contact listed above and to the Office of Management and Budget, Office of Information and Regulatory Affairs, Washington, D.C. 20503, [Attention: Desk Officer for the Federal Energy Regulatory Commission, phone: (202)395-7856, fax: (202)395- 7285].

B. Environmental Analysis

113. The Commission is required to prepare an Environmental Assessment or an Environmental Impact Statement for any action that may have a significant adverse effect on the human environment. [FN76] The Commission has categorically excluded certain actions from these requirements as not having a significant effect on the human environment. [FN77] The actions proposed to be taken here fall within categorical exclusions in the Commission's regulations for rules that are clarifying, corrective, or procedural, for information gathering, analysis, and dissemination, and for sales, exchange, and transportation of natural gas that requires no construction of facilities. [FN78] Therefore, an environmental assessment is unnecessary and has not been prepared in this rulemaking.

C. Regulatory Flexibility Act Certification

*26 114. The Regulatory Flexibility Act of 1980 (RFA) [FN79] generally requires a description and analysis of final rules that will have significant economic impact on a substantial number of small entities. The Commission is not required to make such analyses if a rule would not have such an effect. [FN80]

115. The Commission does not believe that this rule would have such an impact on small entities. Most of the entities required to comply with the proposed regulations would be pipelines, LDCs or their affiliates who do not meet the RFA's definition of a small entity whether or not they are under the Commission's jurisdiction. It is likely that any small entities selling natural gas would be making gas sales that are no longer subject to the Commission's jurisdiction. Therefore, the Commission certifies that this rule will not have a significant economic impact on a substantial number of small entities.

D. Document Availability

116. In addition to publishing the full text of this document in the Federal Register, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through FERC's Home Page (http://www.ferc.gov) and in FERC's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street, N.E., Room 2A, Washington D.C. 20426

117. From FERC's Home Page on the Internet, this information is available using the eLibrary link. The full text of this document is available on eLibrary in PDF and Microsoft Word format for viewing, printing, and/or downloading. To access this document in eLibrary, type the docket number excluding the last three digits of this document in the docket number field.

118. User assistance is available for eLibrary and the FERC's website during normal business hours at FERCOnLineSupport@ferc.gov or by calling (866)208-3676 or

for TTY, contact (202)502-8659.

E. Effective Date and Congressional Review

119. These regulations are effective [insert date that is 30 days after publication in the FEDERAL REGISTER]. The Commission has determined, with the concurrence of the administrator of the Office of Information and Regulatory Affairs of OMB, that this Final Rule is not a "major rule" as defined in Section 351of the Small Business Regulatory Enforcement Fairness Act of 1996. The Commission will submit the Final Rule to both houses of Congress and the General Accounting Office.

List of Subjects in 18 CFR Part 284

Continental Shelf; Incorporation by reference; Natural gas; Reporting and recordkeeping requirements.

By the Commission. Commissioners Massey and Brownell concurring in part with separate statements attached.

(SEAL)

Linda Mitry

Acting Secretary

FN1. 103 FERC ¶ 61,350 (2003) (June 26 NOPR).

FN2. Section 284.5 of the Commission's regulations also states that "[t]he Commission may prospectively, by rule or order, impose such further terms and conditions as it deems appropriate on transactions authorized by this part."

FN3. Final Report on Price Manipulation in Western Markets: Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000 (March 2003) (Final Report).

FN4. NGPA Section 2(21)(A) states:

General Rule.- The term "first sale" means any sale of any volume of natural gas- (i) to any interstate pipeline or intrastate pipeline; (ii) to any local distribution company; (iii) to any person for use by such person; (iv) which precedes any sale described in clauses (i),(ii), (iii); and (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this Act.

FN5. See, e.g., AGA, Peoples, NiSource, Nicor, Cinergy, Sempra, FPL Group, Reliant, Coral, NJR Companies, EPSA, ProLiance, Duke Energy, Questar, Western.

FN6. Coral at 5.

FN7. See NiSource at 9 (stating that the sales for resale by interstate pipelines and off-system sales by LDCs constitute a small portion of the gas sales transactions in the market, in contrast to producers and independent marketers that account for a very substantial portion of gas sold, which are not subject to the proposed regulations).

FN8. See, e.g., BP, EMIT, CPUC, NASUCA.

FN9. We note that the Commission also does not have jurisdiction over all sales for resale in electric markets. The Commission nevertheless exercises its authority to prevent manipulation of the market by those sellers over whom it does have jurisdiction.

FN10. See, e.g., Peoples, TXU, NiSource, USG, AGA, NGSA, NJR Companies, Shell Offshore, BP, Western.

FN11. See NiSource.

FN12. See USG.

FN13. Section 284.403(a) of the Commission's regulation provides that:

> Any person making natural gas sales for resale in interstate commerce pursuant to § 284.402 is prohibited from engaging in actions or transactions that are without a legitimate business purpose and are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas.

FN14. See, e.g., TXU, NGSA, Shell, NJR Companies, NEMA, EMIT, Cinergy, Sempra, Reliant, Select, Merrill Lynch and Morgan Stanley, Coral, Hess, Peoples, EnCana, Mirant, NASUCA.

FN15. See Freeman United Coal Mining Company v. Federal Mine Safety and Health Review Commission, 108 F.3d 358, 362 (D.C. Cir. 1997) (Freeman).

FN16. See General Electric Co. v. EPA, 53 F.3d 1324, 1329-30 (D.C. Cir. 1995) (holding that the agency's interpretation of its rules was "so far from a reasonable person's understanding of the regulations that [the regulations] could not have fairly informed GE of the agency's perspective.").

FN17. See Freeman, 108 F.3d at 362. See also Faultless Division, Bliss & Laughlin Industries, Inc. v. Secretary of Labor, 674 F.2d 1177, 1185 (7th Cir. 1982) ("[T]he regulations will pass constitutional muster even though they are not drafted with the utmost precision; all that due process requires is a fair and reasonable warning.").

FN18. See Grayned v. City of Rockford, 408 U.S. 104, 110 (1971) (holding that an anti-noise ordinance was not vague where the words of the ordinance "are marked by flexibility and reasonable breadth, rather than meticulous specificity.").

FN19. See Ray Evers Welding Co. v. OSHRC, 625 F.2d 726, 730 (6th Cir. 1980).

FN20. See Village of Hoffman Estates, et al. v. The Flipside, Hoffman Estates, Inc., 455 U.S. 489, 498 (1981) (Hoffman).

FN21. Id. See also Texas Eastern Products Pipeline Co. v. OSHRC, 827 F.2d 46, 50 (7th Cir. 1987) ("Texas Eastern, as a major pipeline company, in which trenching and excavation are a part of its routine, had ample opportunity to know of the earlier interpretation, should have been able to see the sense of the regulations on their face, and if still in doubt Texas Eastern should have taken the safer position both for its employees and for itself.").

FN22. Our rules are designed to cover actions that are intended to manipulate prices regardless of whether such actions actually resulted in distorted prices. We note, however, that in most such cases there will be no unjust profits to disgorge.

FN23. When deciding how best to allocate our enforcement resources, we intend to focus our efforts primarily on those actions or transactions that have, in fact, caused distorted market prices.

FN24. See Enron Power Marketing, Inc., 103 FERC ¶ 61,343 (2003) (revoking Enron's blanket marketing certificate authorization based on Enron's participation in wash trades having "no legitimate business purpose").

FN25. Although the instant example focused upon gas market prices manipulated upward in order to benefit the merchant derivative position, the transactions implementing any manipulation of the natural gas market will not be considered legitimate. For further discussion of several manipulative strategies see the Commission Staff's Final Report on Price Manipulation in Western Markets, Chapter IX, p. IX-9 through IX-24.

FN26. Proposed Section 284.403(a)(1) applies these same prohibited actions and transactions to "[a]ny person making natural gas sales for resale in interstate commerce pursuant to § 284.402...."

FN27. The Commission also adopts Section 284.403(a)(1) as proposed, which will apply the same prohibited actions and transactions to "[a]ny person making natural gas sales for resale in interstate commerce pursuant to § 284.402...."

FN28. Section 284.403(a)(2) of the Commission's regulations contains an identical prohibition.

FN29. See, e.g., Merrill Lynch and Morgan Stanley, Duke, TXU, Sempra, NGSA, NEMA, Shell, EnCana, Hess, Mirant.

FN30. Section 4(a) of the NGA, 15 U.S.C. § 717c.

FN31. Similarly, we need not revise our rule so that violations of the antitrust laws are also prohibited by our rule. Federal antitrust law will continue to apply where it is found to apply, with or without our rule.

FN32. See Pennsylvania Water & Power Co. v. FPC, 193 F.2d 230, 236 (D.C. Cir. 1951) ("A rate is not necessarily illegal because it is the result of a conspiracy in restraint of trade in violation of the Anti-Trust Act. What rates are legal is determined by the regulatory statute." [cit. omit.]).

FN33. Proposed regulation Section 284.403(b) provides a similar requirement stating:

*27 To the extent that blanket marketing certificate holder engages in reporting of transactions to publishers of gas price indices, the blanket certificate holder shall provide complete, accurate and factual information to any such publisher. The blanket marketing certificate holder shall notify the Commission of whether it engages in such reporting for all sales. In addition, the blanket marketing certificate holder shall adhere to such other standards and requirements for price reporting as the Commission may order.

FN34. See, e g., Western.

FN35. See, e.g., PSCNY, NEMA, NGSA, Reliant, TXU.

FN36. See Coral at 7.

FN37. See, e.g., Mirant, Hess, Coral.

FN38. See, e.g., EMIT, Platts, NASUCA.

FN39. See, e.g., AGA, BP (recommending a one-time obligation), Peoples.

FN40. See, e.g., Select; see also AGA (recommending that rather than incorporating a safe harbor provision into the subject proceeding, the Commission should clarify that the safe harbor announced in the Policy Statement applies specifically to a blanket marketing certificate holder's obligation, to the extent it engages in reporting of transactions to publishers of gas price indices, to provide complete, accurate, and factual information to any publisher).

FN41. See, e.g., Merril Lynch and Morgan Stanley, Select, Mirant.

FN42. Policy Statement, 104 FERC ¶ 61,121 (2003).

FN43. Similarly, proposed Section 284.403(c) provides:

A blanket marketing certificate holder shall retain all relevant data and information necessary for the reconstruction of price indices for three years.

FN44. See, e.g., BP, NJR Companies, NEMA, NGSA, EMIT, Western, Sempra, Reliant, Coral, Hess, Peoples, Mirant, EnCana, NASUCA, ProLiance, Merrill Lynch and Morgan Stanley, PG&E, Duke.

FN45. See, e.g., BP, NJR Companies, NEMA, Coral, Peoples, Mirant, EnCana, ProLiance, Merrill Lynch and Morgan Stanley, PG&E.

FN46. See, e.g., ProLiance (requesting a 2-year retention period), NEMA (requesting a 1-year retention period), Coral.

FN47. See, e.g., NASUCA (requesting a 6-year retention period).

FN48. See, e.g., Western.

FN49. See, e.g., EMIT.

FN50. See, e.g., Sempra.

FN51. See, e.g., BP, Hess, Mirant, Merrill Lynch and Morgan Stanley.

FN52. The Commission will modify Section 284.403(c), applying to blanket marketing certificate holders, in a like manner.

FN53. Proposed Section 284.403(d) of the Commission's regulations provides that:

A blanket marketing certificate holder is prohibited from reporting any natural gas sales transactions between the blanket market certificate holder and its affiliates to industry indices.

FN54. See ProLiance, NASUCA, EnCana, Hess, NEMA.

FN55. See Policy Statement, 104 FERC ¶ 61,121 at P 34 (2003).

FN56. See, e.g., Comments of AGA, the FPL Group, NGSA, Duke, NGSA and Cinergy.

FN57. Citing Panhandle Eastern Pipe Line Co. v. FERC, 613 F.2d 1120 (D.C. Cir. 1979); Cf. Northern Natural Gas Co. v. FERC, 827 F.2d 779 (D.C. Cir. 1987).

FN58. Several commenters such as EnCana, Hess and Mirant argue that the term "unjust profits" is vague and subjective and therefore difficult to calculate. Hess requests that that the Commission either adopt a more workable formula for calculating monetary remedies or clarify how the unjust profits standard will be applied. Mirant and EnCana suggest that the Commission adopt a presumption that unjust profits will be defined as the difference between a reported transaction's fixed price and a then-existing published index price for the market and time period in question. Mirant asserts that it would oppose any Commission proposal to recreate or somehow adjust previously reported index prices based on an after-the-fact review of reported data.

FN59. See, e.g., Mirant, Cinergy, EnCana, Hess.

FN60. See AGA at 10.

FN61. NJR Companies at 19.

FN62. See e.g., CPUC, NASUCA, EMIT, PG&E, PSCNY and the Oversight Board.

FN63. See 18 CFR § § 284.401-402 (2003).

FN64. The Court of Appeals for the D.C. Circuit has held that, while the Commission "enjoys substantial discretion in ratemaking determinations... by the same token, this discretion must be bridled in accordance with the statutory mandate that the resulting rates be 'just and reasonable."' Farmers Union Cent. Exch. Inc. v. FERC, 734 F.2d 1486 at 1501 (D.C. Cir. 1984). In addition, the regulatory regime itself must contain some form of monitoring to ensure that rates remain within a zone of reasonableness and to check rates that depart from this zone. Id. at 1509. See also Louisiana Energy and Power Authority v. FERC, 141 F.3d 364 (D.C. Cir. 1998); Elizabethtown Gas Co. v. FERC, 10 F.3d 866 (D.C. Cir. 1993).

FN65. See e.g., Coastal Oil & Gas Corp. v. FERC, 782 F.2d 1249 (1986).

FN66. Consolidated Gas Transmission Corp., et al., 771 F.2d 1536 (D.C. Cir. 1985) (holding that the Commission has the authority under section 16 of the Natural Gas Act to order retroactive refunds to enforce conditions in certificates).

FN67. The courts have held that "the breadth of agency discretion is, if anything, at its zenith when the action assailed relates... to the fashioning of policies, remedies and sanctions." Columbia Gas Transmission Corp., v. FERC, 750 F.2d 105, 109 (D. C. Cir. 1984), quoting, Niagara Mohawk Power Corp. v. FPC, 379 F.2d 153, 159 (D.C. Cir.1967).

FN68. Gulf Oil Corp. v. FPC, 536 F.2d 588 (3rd. Cir. 1977), cert. denied, 4344 U.S. 1062 (1978), reh'g denied, 435 U.S. 981 (1978).

FN69. See Continental Oil Co. v. FPC, 378 F.2d 510 (5th Cir. 1967) and FPC v. Tennessee Gas Transmission Co., 371 U. S. 145 (1962).

FN70. Moreover, if Congress grants the Commission additional remedial power, including the authority to levy civil penalties, the Commission will, in addition to the remedies set forth herein, implement such authority and utilize it when appropriate for violations of these code of conduct regulations.

FN71. The Oversight Board, Mirant, NiSource, Cinergy, Sempra, Reliant, EMIT, EnCana, Hess, Coral, NGSA, CPUC, NASUCA, PG&E, Merrill Lynch and Morgan Stanley, ProLiance.

FN72. See the Oversight Board, EMIT, Coral, NASUCA (suggesting 6 months), and ProLiance (suggesting a two-year limit).

FN73. See also EPSA (arguing that the Commission should clarify that it will act quickly to review and discourage frivolous complaints).

FN74. See Sections 284.288(b)-(c), and 284.403(b)-(c).

FN75. 5 C.F.R. § 1320 (2003).

FN76. Order No. 486, Regulations Implementing the National Environmental Policy Act, 52 FR 47897 (Dec. 17, 1987), FERC Stats. & Regs. Preambles 1986-1990 ¶ 30,783 (1987).

FN77. 18 C.F.R. § 380.4 (2003).

FN78. See 18 C.F.R. § 380.4(a)(2)(ii), 380.4(a)(5), 380.4(a)(27) (2003).

FN79. 5 U.S.C. 601-612.

FN80. 5 U.S.C. 605(b).

*28 In consideration of the foregoing, the Commission proposes to amend Part 284, Chapter I, Title 18, Code of Federal Regulations, as follows.

PART 284 -- CERTAIN SALES AND TRANSPORTATION OF NATURAL GAS UNDER THE NATURAL GAS POLICY ACT OF 1978 AND RELATED AUTHORITIES

The authority citation for Part 284 continues to read as follows:

Authority: 15 U.S.C. 717-717w, 3301-3432; 42 U.S.C. 7101- 7532; 43 U.S.C.1331-1356.

Section 284.288 is added to read as follows:

§ 284.288 Code of conduct for unbundled sales service.

(a) A pipeline that provides unbundled natural gas sales service under § 284.284 is prohibited from engaging in actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas. Prohibited actions and transactions include but are not limited to:

(1) pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called "wash trades"); and

(2) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for natural gas.

(b) To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas indices, Seller shall provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the Policy Statement on Natural Gas and Electric Price Indices, issued by the Commission in Docket No. PL03-3-000 and any clarifications thereto. Seller shall notify the Commission within 15 days of the effective date of this regulation of whether it engages in such reporting of its transactions and update the Commission within 15 days of any subsequent change to its transaction reporting status. In addition, Seller shall adhere to such other standards and requirements for price reporting as the Commission may order.

(c) A pipeline that provides unbundled natural gas sales service under § 284.284 shall retain, for a period of three years, all data and information upon which it billed the prices it charged for natural gas it sold pursuant to its market based sales certificate or the prices it reported for use in price indices.

***29** (d) Any violation of the preceding paragraphs may subject Seller to disgorgement of unjust profits from the date when the violation occurred. Seller may also be subject to suspension or revocation of its blanket certificate under § 284.284 or other appropriate non-monetary remedies.

(e) Any person filing a complaint against a pipeline for violation of paragraphs (a) through (c) must do so no later than 90 days after the end of the calendar quarter in which the alleged violation occurred unless that person could not have known of the alleged violation, in which case the 90-day time limit will run from the discovery of the alleged violation. The Commission will act within 90 days from the date it knew of an alleged violation of these code of conduct regulations or knew of the potentially manipulative character of an action or transaction. Commission action in this context means a Commission order or the initiation of a preliminary investigation by Commission Staff pursuant to 18 CFR section 1b. If the Commission does not act within this time period, the seller will not be exposed to potential liability regarding the subject action or transaction. Knowledge on the part of the Commission will take the form of a call to our Hotline alleging inappropriate behavior or communication with our enforcement Staff.

In Section 284.402, the second sentence of paragraph (a) of § 284.402 is revised to read as follows:

§ 284.402 Blanket Marketing Certificates

A blanket certificate issued under Subpart L is a certificate of limited jurisdiction which will not subject the certificate holder to any other regulation under the Natural Gas Act jurisdiction of the Commission, other than that set forth in this Subpart L, by virtue of the transactions under this certificate.

Section 284.403 is added to read as follows:

§ 284.403 Code of conduct for persons holding blanket marketingcertificates.

(a) Any person making natural gas sales for resale in interstate commerce pursuant to § 284.402 is prohibited from engaging in actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for natural gas. Prohibited actions and transactions include but are not limited to:

(1) pre-arranged offsetting trades of the same product among the same parties, which involve no economic risk and no net change in beneficial ownership (sometimes called "wash trades"); and

(2) collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for natural gas.

*30 (b) To the extent Seller engages in reporting of transactions to publishers of electricity or natural gas indices, Seller shall provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the Policy Statement on Natural Gas and Electric Price Indices, issued by the Commission in Docket No. PL03-3-000 and any clarifications thereto. Seller shall notify the Commission within 15 days of the effective date of this regulation of whether it engages in such reporting of its transactions and update the Commission within 15 days of any subsequent change to its transaction reporting status. In addition, Seller shall adhere to such other standards and requirements for price reporting as the Commission may order.

(c) A blanket marketing certificate holder shall retain, for a period of three years, all data and information upon which it billed the prices it charged for the natural gas sold pursuant to its market based sales certificate or the prices it reported for use in price indices.

(d) Any violation of the preceding paragraphs may subject Seller to disgorgement of unjust profits from the date when the violation occurred. Seller may also be subject to suspension or revocation of its blanket certificate under § 284.284 or other appropriate non-monetary remedies.

(e) Any person filing a complaint against a blanket marketing certificate holder for violation of paragraphs (a) through (c) must do so no later than 90 days after the end of the calendar quarter in which the alleged violation occurred unless that person could not have known of the alleged violation, in which case the 90-day time limit will run from the discovery of the alleged violation. The Commission will act within 90 days from the date it knew of an alleged violation of these code of conduct regulations or knew of the potentially manipulative character of an action or transaction. Commission action in this context means a Commission order or the initiation of a preliminary investigation by Commission Staff pursuant to 18 CFR Section 1b. If the Commission does not act within this time period, the seller will not be exposed to potential liability regarding the subject action or transaction. Knowledge on the part of the Commission will take the form of a call to our Hotline alleging inappropriate behavior or communication with our enforcement Staff.

Appendix

LIST OF COMMENTERS

Amerada Hess Corporation (Hess)

American Gas Association (AGA) [FNa1]

Atmos Energy Corp.

BP America Production Company and BP Energy Company (BP)

California Electricity Oversight Board (Oversight Board)

Calpine Corporation

Cinergy Marketing & Trading, LP (Cinergy) [FNa1]

Coalition for Energy Market Integrity and Transparency (EMIT)

***31** Coral Energy Resources, L.P. (Coral)

Duke Energy Corporation (Duke)

Electric Power Supply Association (EPSA)

EnCana Marketing (USA) Inc. (EnCana)

FPL Group, Inc. (FPL Group)

Intercontinental Exchange, Inc. (ICE)

Merrill Lynch Capital Services, Inc. and Morgan Stanley Capital Group, Inc. (Merill Lynch and Morgan Stanley) [FNa1]

Mirant Americas Energy Marketing, LP (Mirant)

Missouri Public Service Commission (Missouri PSC)

National Association of State Utility Consumer Advocates (NASUCA)

National Energy Marketers Association (NEMA)

Natural Gas Supply Association (NGSA)

New Jersey Resources Corporation (NJR Companies)

Nicor Gas (Nicor)

NiSource, Inc. (NiSource)

Pacific Gas and Electric Company (PG&E)

Peoples Gas Light and Coke Company, North Shore Gas Company, and Peoples Energy Resources Corp. (Peoples)

Piedmont Natural Gas Co., Inc.

Platts

ProLiance Energy, LLC (ProLiance)

Public Service Electric and Gas Co., PSEG Power LLC and PSEG Energy Resources & Trade LLC (collectively, PSEG Companies)

Public Service Commission of the State of New York (PSCNY)

Public Utilities Commission of the State of California (CPUC)

Questar Energy Trading Company (Questar)

Reliant Energy Power Generation, Inc. and Reliant Energy Services, Inc. (Reliant)

Select Energy, Inc. (Select)

Sempra Energy (Sempra)

Shell Offshore Inc. (Shell Offshore)

TXU Portfolio Management Company LP (TXU)

USG Pipeline Company, B-R Pipeline Company, and United States Gypsum Company (USG)

Virginia Industrial Gas Users' Association (VIGUA)

Virginia Natural Gas, Inc. [FNaa1]

Western Gas Resources, Inc. (Western)

FNa1. Entities filing reply comments in addition to initial comments

FNaa1. Entity filing reply comments only

MASSEY, Commissioner, concurring in part:

The tariff conditions that the Commission approves today send a clear message to market-based rate sellers: don't lie, don't manipulate market conditions, don't violate market rules and don't collude with others. For sellers who choose to behave otherwise, the Commission now has the tools to sanction such bad behavior and we give notice of what some of those sanctions could be. This action should help to restore the faith in energy markets that has been lost in the last few years.

There is one aspect of today's order, however, that I would have written differently. I would not limit the monetary penalty for tariff violations to disgorgement of unjust profits. Market manipulation can raise the market prices paid by all market participants and collected by all sellers. In such a case, the appropriate remedy may be that the manipulating seller makes the market whole. I would prefer to not take this or any monetary remedy off of the table, but instead to allow the Commission the flexibility to tailor the remedy to the circumstances of each case.

This one concern with today's order should not be interpreted, however, as diminishing in any way my enthusiastic support for this otherwise excellent order. I commend my colleagues for taking this important and much needed step.

*32 For these reasons, I concur in part with today's order.

William L. Massey

Commissioner

BROWNELL, Commissioner, concurring:

1. We are adopting behavioral rules for market participants in the electric and natural gas markets. No one can question the good intention behind these behavioral rules. As I have stated before, if there are violations of our rules, regulations or policies, we must be willing to punish and correct. Concurrently, if there is misconduct by market participants that is intended to be anticompetitive, we must have the ability to remedy those market abuses.

2. Conversely, when we originally proposed behavioral rules, I had a number of concerns. I was concerned that the use of vague terms would create uncertainty and, thereby, undermine the good intentions of the rules. I feared that subsequent applications of the proposed behavior rules to real world actions could result in overly proscriptive "rules of the road" that will dampen business innovation and creative market strategies. The net effect would be less competition and the associated higher costs to consumers. I was concerned that we may be proposing a model that simply does not fit with the larger lessons we have learned in fostering competition over the past two decades, particularly in the gas market.

3. It is difficult to strike the right balance. I have carefully weighed the comments and believe the revisions and clarifications to the proposed behavioral rules achieve the appropriate balance. We clarify that these rules do not impose a "must offer" requirement. We revise the definition of manipulation to relate to actions that are "intended to or foreseeably could" manipulate markets. We add the exclusion that action taken at the direction of an RTO or ISO does not constitute manipulation.

4. Commenters also challenge the sufficiency of the term "legitimate business purpose" in distinguishing between prohibited and non-prohibited behavior. We clarify that transactions with economic substance, in which a seller offers or provides a service to a buyer where value is exchanged for value, are not

prohibited behavior. Behavior driven by legitimate profit maximization or that serves important market functions is not manipulation. Moreover, I think it is important to recognize that scarcity pricing is the market response to a supply/demand imbalance that appropriately signals the need for infrastructure. For example, the high prices of 2000-2001 that reflected supply/demand fundamentals resulted in the first new power plants being constructed in California in ten years; price risk being hedged through the use of long-term contracting; and renewed efforts to correct a flawed market design.

5. We have also adopted measures that require accountability. A complaint must be brought to the Commission within 90 days after the calendar quarter that the manipulative action was alleged to have occurred. The 90-day time limit strikes an appropriate balance between providing sufficient opportunity to detect violations and the market's need for finality. The Order also places a similar time limit on Commission action. As a matter of prosecutorial policy, the Commission will only initiate a proceeding or investigation within 90 days from when we obtained notice of a potential violation through either a hotline call or communications with our enforcement staff.

*33 6. While these rules are designed to provide adequate opportunity to detect, and the Commission to remedy, market abuses and are clearly defined so that they do not create uncertainty, disrupt competitive commodity markets or prove simply ineffective, competitive markets are dynamic. We need to periodically evaluate the impact of these rules on the electric and gas markets. We have directed our Office of Market Oversight and Investigation to evaluate the effectiveness and consequences of these behavioral rules on an annual basis and include their analysis in the State of the Market Report.

Nora Mead Brownell

105 FERC P 61,217, 2003 WL 22758080 (F.E.R.C.)

END OF DOCUMENT

EXHIBIT B

C

FEDERAL ENERGY REGULATORY COMMISSION
*1 Commission Opinions, Orders and Notices

Before Commissioners: Pat Wood, III, Chairman; William L. Massey, and Nora Mead Brownell.

Price Discovery in Natural Gas and Electric Markets

Docket No. PL03-3-000

POLICY STATEMENT ON NATURAL GAS AND ELECTRIC PRICE INDICES

(Issued July 24, 2003)

1. In Docket No. AD03-7, Natural Gas Price Formation, the Commission has been exploring the process by which price indices influence and reflect the formation of wholesale prices for natural gas and electricity. The Commission's current process began with the initial staff report in Docket No. PA02-2, issued August 13, 2002, in which staff reported concerns over the characteristics of publicly-reported natural gas price indices. On January 15, 2003, staff presented a discussion paper to the Commission on staff's efforts to assure accurate and dependable wholesale natural gas price information. The Commission encouraged its staff to work with industry representatives to restore confidence in price indices.

2. On April 24, 2003, the Commission's staff held a technical conference participating with the staff of the Commodity Futures Trading Commission (CFTC) to explore price formation issues with respect to natural gas. Subsequently on June 13, 2003, staff issued a "Staff Paper on Price Formation Issues" and on June 24, 2003, held a second technical conference that considered price formation in wholesale electricity markets as well as natural gas markets. The June 24 technical conference was held with the participation of the National Association of Regulatory Utility Commissioners as well as the staff of the CFTC.

3. Discussion at the second conference pointed out the desirability of providing some degree of regulatory certainty to industry participants that would encourage them voluntarily to report energy transactions to the providers of price indices. This certainty, sometimes referred to as a "safe harbor" for good faith reporting, was the subject of a follow-up staff workshop on July 2, 2003.

4. The Commission received numerous comments from interested parties in conjunction with each of the three staff conferences. These comments and the statements presented at the conferences persuade us that the Commission can assist the industry in restoring confidence in price indices by providing guidance on some vital aspects of price reporting and price index development.

5. Accordingly, the Commission is issuing this policy statement to explain what the Commission expects of natural gas and electricity price indices and under what conditions the Commission will give industry participants safe harbor protection

for good faith reporting of transactions data to entities that develop price indices. In particular, the Commission will create a rebuttable presumption that companies and individuals that report trade data to index developers in accordance with the standards adopted here are doing so in good faith, and will not be investigated or subjected to administrative penalties for inadvertent mistakes made in the course of reporting energy transaction information. This should provide a measure of regulatory certainty to the process of reporting transaction data and encourage more industry participants to contribute to the formation of price indices.

I. Background

*2 6. Price indices are widely used in bilateral natural gas and electric commodity markets to track spot and forward prices. They are often referenced in contracts as a price term; they are related to futures markets and used when futures contracts go to delivery; basis differentials in indices are used to hedge natural gas transportation costs; indices are used in many gas pipeline tariffs to settle imbalances or determine penalties; and state commissions use indices as benchmarks in reviewing the prudence of gas or electricity purchases. Since index dependencies permeate the energy industry, the indices must be robust and accurate and have the confidence of market participants for such markets to function properly and efficiently.

7. Currently, daily and monthly price indices are compiled and published by several trade press entities, a practice which has followed more established oil markets. These index developers obtain information provided on a voluntary basis by various market participants about trades occurring at a number of trading locations. The information is verified, compiled, and in some cases assessed, and a price representing trading activity at each location is published. In addition, other indices are provided by operators of electronic trading platforms based upon trades made on the platform and transactions confirmed by the platform operator.

8. As the June 13 staff paper noted, however, uncertainty over industry expectations and government regulatory guidelines has inhibited the amount of transactions voluntarily reported to index developers, resulting in a lack of confidence in the reliability of energy price indices. There also have been reports of past attempts at index manipulation and concern about the adequacy of controls over price reporting. [FN1] Subsequent investigations of false reporting to price index developers has led some market participants to curtail their reporting, resulting in a decline in the number of trades voluntarily reported to index developers. This in turn raised concerns about a lack of information about liquidity and whether market participants were making their decisions without adequate or accurate information about how many actual transactions were used to set the price.

9. There are also concerns about changes in the amount of trading, both generally and with certain types of contracts There is evidence that activity in natural gas commodity markets appears to have become greater for next-day and balance-of-month markets than for next-month (bid week) markets. Nevertheless many contractual price references are to month-ahead market indices. Transactions for next-day delivery appear to be more robust, and some contend that a majority of next-day transactions

are being executed on electronic exchange platforms. Similarly, next-day transactions for electricity appear robust in both organized regional markets and on electronic platforms. The apparent decline in fixed-price transactions in the month-ahead gas market, however, could be related to unwillingness to report transactions or to less fixed-price trading. The Commission is concerned about the strength of this market, because monthly indices apparently remain important reference points for indexed contracts, settlements for swaps, and settlements for pipeline imbalances.

*3 10. Another concern is the degree of reliance on index-based contracts as opposed to fixed-price contracts. It appears that many natural gas producers often sell with reference to an index and that many local distribution company purchasers buy at index-linked prices in lieu of negotiating fixed prices. Some have commented that there is over-reliance on index pricing and that it is due in part to perceptions of what state commissions will consider to be prudent components of a procurement portfolio. Without enough fixed-price transactions, there is a real concern that reported prices will not reflect a liquid competitive market at the affected location. [FN2]

11. The Commission wants to strengthen confidence in the day-ahead, month-ahead and forward natural gas markets and the day-ahead and forward electricity markets by encouraging comprehensive reporting of energy transactions to price index developers and by encouraging price index developers to provide useful information to the industry on the volumes of transactions and number of participants trading at various trading hubs. Through such reporting, the Commission and market participants can be assured that the reported index prices are accurate and can gauge the liquidity at various reported locations through measures such as the number of deals and numbers of counterparties.

12. The records of the staff-sponsored conferences and workshops in Docket Nos. AD03-7-000, et al., show that significant progress has been made by the industry. Index developers have taken steps to make the process of compiling and publishing their indices more transparent, and to provide index users with information about the degree of liquidity at each trading point. Industry representatives, meanwhile, have worked together to develop agreement on basic principles for reporting trade data to index developers.

II. Policy goals and objectives

13. There is considerable agreement in the industry on many of the steps needed to improve the accuracy, reliability, and transparency of price formation. The Commission intends to build upon that consensus to provide guidance on the desirable characteristics of a good price index and the terms under which companies or individuals should report prices to index developers. The current system has evolved on a voluntary basis with the gradual deregulation of energy markets.

14. The Commission's views on desirable characteristics of a price index should provide price index developers with guidance on how their products can enhance both fixed-price and index-based trading and increase market awareness of liquidity conditions. Similarly, setting forth the standards companies should use when reporting energy transactions to index developers will assure the Commission that

trade data reported in accordance with those standards are trustworthy. Moreover, when such entities report energy transactions in accordance with these standards, the Commission will presume that the prices are being reported honestly and accurately and that errors made are inadvertent.

*4 15. The Commission is basing its position upon representations made by industry representatives that we should expect to see much more voluntary participation in the price formation process. Greater participation in turn should give all industry participants more confidence in the liquidity and transparency of reported prices. The Commission will monitor developments under this policy statement. If the expected improvements in indices and the level of industry's participation in price formation do not result, the Commission will take additional steps to ensure accurate, dependable, and trustworthy wholesale price information.

III. Industry views

16. The Committee of Chief Risk Officers (CCRO) addressed concerns over the adequacy of price reporting with the issuance of "Best Practices for Energy Price Indices" on February 27, 2003. [FN3] This document noted the importance of price indices in energy transactions and on economic and business decisions generally, and provided guidance on best practice attributes and processes for the construction of indices by index developers and data submission by market participants.

17. Among the CCRO recommendations for index developers were that they: carefully define the product, location, and type of commodities; establish cut- off times for transactions qualifying for an index and for submission of data; establish an error resolution process both before and after publication; specify minimum sample sizes to be deemed representative; resolve double- counting of data received from multiple parties on the same transaction; explain the treatment given to outliers in data; document publicly the index calculation methodology; have a challenge process for data suspected of having been excluded; publish values to indicate the level of liquidity at various trading points; and publicly document the index construction method.

18. The CCRO also recommended that index developers publish indices through a department independent from journalistic activities, provide adequate confidentiality assurances to data providers, and conduct annual independent audits of all processes involved in formulating and publishing the indices.

19. For data providers, the CCRO recommended that they: provide raw data on a transaction-by-transaction basis; submit data from all applicable transactions; submit a complete set of data as specified by the index developer; submit additional data such as counterparty name and buy/sell indicator if possible; provide information to enable the index developer to match transactions and eliminate duplication; and exclude intracompany and nonstandard transactions.

20. Additionally, the CCRO recommended that data providers submit data through an office independent of the trading office (corporate risk control, middle office, or back office), adhere to the error resolution and revision processes of the index developer, provide sufficient protection against misuse of transactions data by

employees, and conduct an independent audit of the data gathering and submission process at least annually.

*5 21. The CCRO paper provided useful context for comments submitted in the course of the April 24, June 24, and July 2 conferences and workshops. Many parties endorsed all or part of the CCRO recommendations.

22. A number of parties also supported the development and use of an independent third party to serve as a "data hub" for transaction data. While variations were proposed, the essential concept was that an independent entity could receive transactions data from market participants; match, verify, and scrub the data; and provide the resulting clean data to others for use in publishing indices, research, and the like.

23. For example, the University of Houston Global Energy Management Institute proposed to create an energy price data hub for these purposes and the Energy Transactions Registry proposed to create a repository for transaction data. The New York Mercantile Exchange proposed creation of one or more "self-regulatory organizations" (SRO), under conditions to be set by the Commission, to perform the function of gathering, verifying, and providing uniform data sets for use in calculating indices. Similarly, the Merchant's Exchange proposed to provide third party price collection and dissemination under the supervision of the National Futures Association. The IntercontinentalExchange (ICE) proposed to use its existing eConfirm settlement service as the basis for independent collection and dissemination of price data.

24. Some of these proposals may have significant long-term potential The Commission notes that data hubs have evolved in certain financial industries, and encourages energy industry participants to consider whether some form of a data hub or hubs may improve price discovery in the energy industry in the longer term.

25. At present, however, it is imperative to take immediate steps to improve the existing mechanisms for price discovery. Many parties focused on this issue and worked together to develop broad industry consensus on near-term improvements. A number of industry stakeholders submitted a consensus document on steps to reform natural gas price reporting and index publication. [FN4]

26. The consensus document called for index developers to: adopt a public code of ethics; disclose their price collection and dissemination methodologies, which should include only reported and verified transactions; refrain from using subjective judgment or assessments; verify reported data by matching buys and sells, using counterparty data if necessary and available; contact data providers about discrepancies; publish indices which include total volume, number of transactions, number of counterparties, range of prices, and volume-weighted average price; monitor data to identify possible attempts at manipulation and, if warranted, report incidents to the Commission; submit to an annual audit; and provide all data to the Commission or other Federal agency upon request for investigative purposes.

27. The consensus recommendations for data providers are to: adopt a public code of ethics; report trades by middle or back offices; provide data on all bilateral, arms-length transactions in the physical markets only; report on each transactions separately, providing the price, volume, a buy/sell indicator, the delivery/receipt

location, the transaction date, and the term of the transaction; and submit to an annual process audit.

*6 28. The industry stakeholders accomplished a great deal. They reported that the only areas on which they did not reach consensus were the use of data collection hubs, whether reporting should be mandatory or voluntary, and whether counterparty identities were necessary for verification.

29. Meanwhile, index developers have been making significant changes in their published indices. For example, on June 2, 2003, ICE began reporting the number of trades and the number of companies trading for each location reported in ICE's daily gas and electric indices; more recently ICE has begun publishing a monthly natural gas index. [FN5] Reuters informed the Commission that it was adopting a new transparent and objective index methodology that will report the price, volume, high/low prices, and number of transactions at each trading point, and that will not use any subjective assessments of market activity. [FN6] Platts has encouraged data providers to adopt better standards for reporting trade information and, effective July 1, 2003, began publishing a three-tier system grouping trading points according to the volume and number of trades to indicate the degree of liquidity at each point. [FN7]

30. At the June 24 conference several parties stated that one obstacle to increased voluntary reporting is the concern that the Commission could take action against companies that make a mistake when reporting price data to index developers. Many parties commented on the need for regulatory certainty and urged the Commission to adopt a safe harbor approach to good faith reporting.

31. Accordingly, Commission staff held the workshop on use of a safe harbor approach on July 2, 2003. [FN8]

32. The Commission appreciates the contributions of all participants in the debate on rebuilding confidence in price indices. The Commission issues this Policy Statement, building on the consensus views of many industry stakeholders, to provide certainty that index development and price reporting done in accordance with the standards set forth herein will not be the subject of remedial action by the Commission. The Commission urges index developers and market participants are urged to continue voluntary actions to rebuild confidence in indices according to the standards set forth below.

IV. Price index developers

33. Price index developers should adopt the following minimum standards for creation and publication of any energy price index:

1. Code of conduct and confidentiality. An index developer should adopt and make public a written code of conduct that discloses how the developer will obtain, treat, and maintain price data. Specifically, the code of conduct should inform customers how the price information was developed, including index calculation method, relevant formulas and algorithms, treatment of aberrant data, and use of judgments, assessments, or similar subjective adjustments. The code should also specify that all trade data will be treated as confidential, and will not be shared

beyond those employees whose responsibility it is to examine and verify data, confirm trading information, and develop and publish the index. With respect to confidentiality, an index developer should enter into uniform confidentiality agreements with market participants that specify that commercially sensitive individual transaction data will be held in confidence except to the extent necessary to verify the index, and allow for Commission access necessary for performance of its statutory duties such as a specific administrative investigation of price reporting.

*7 2. Completeness. Price reporting systems should maximize the amount of useful and appropriate information they collect and disseminate. Complete information should be collected for individual transactions, including price, volume, buy/sell indicator, delivery/receipt location, transaction date/time, and term (next day or month). In publishing prices, an index developer should provide, for each pricing location for the day-ahead or month-ahead market, (a) the total volume, (b) the number of transactions, (c) the number of transaction entities, (d) the range of prices (high/low), and (e) the volume-weighted average price. Index developers should create liquidity measures that classify trading points by liquidity and/or provide specific information about the number of trades or indicate graduated levels of activity in order to inform customers how many actual transactions led to an index price.

3. Data verification, error correction, and monitoring. An index developer should verify price data through methods such as matching buys and sells and immediately contacting data providers about any data discrepancies. An index developer should request counterparty identities if necessary to resolve data discrepancies. An error resolution process should be adopted to ensure timely correction of mistakes. If significant errors are discovered after the publication of the price index, an index developer should publish a correction notice. Moreover, an index developer should have sufficient monitoring and surveillance systems in place to identify in a timely manner activity that may reflect an attempt to manipulate energy price indices. In the event the systems detect anomalous reported data, and the index developer is unable to resolve the accuracy of the data with the data provider, the index developer should notify the Commission and any other relevant federal agency.

4. Verifiability. An index developer should undergo an independent audit or verification of its processes and index production at least once annually. The process should review the data systems, quality control measures, and data to confirm that the index is developed in accordance with the published methodology, and the report's results should be made public. The audit may be performed by a combination of: (a) an external process audit and (b) an internal data review/implementation audit performed by personnel from the corporate auditing department.

5. Accessibility. All interested customers should have reasonable access to published price reports on a timely basis. The Commission should have access to relevant data in the possession of an index developer where necessary (a) to conduct an investigation of suspected bad faith price reporting or potential market manipulation or (b) to otherwise carry out its statutory duties. In any such instance, the confidential data made available by an index developer will be treated on a confidential basis by the Commission.

V. Price reporting

*8 34. Data providers, including exchanges reporting trades that occurred on their platform or brokers reporting trades executed, should adopt the following minimum standards for reporting transaction data to index developers:

1. Code of conduct. Each data provider should adopt and make public a clear code of conduct that its employees will follow in buying or selling natural gas or electricity, and in reporting data from such transactions to index developers.

2. Source of data. A data provider should have trade data reported by a department of the company that is independent from and not responsible for trading. [FN9] The personnel responsible for reporting trade data should also verify the accuracy and completeness of the data before submitting it. Even in small companies, there are individuals who have accounting, bookkeeping, and other responsibilities separate from trading activities, and thus even small companies can arrange for independent personnel to report trade data.

3. Data reported. Subject to an appropriate confidentiality agreement with the index developer, a data provider should report each bilateral, arm's-length transaction between non-affiliated companies in the physical (cash) markets at all trading locations. Physical (cash) market reporting shall not include financial hedges, financial transactions, or swaps or exchanges of gas or electricity. Data should be provided for each transaction separately. For each transaction, the following information should be provided: (a) price; (b) volume; (c) buy/sell indicator; (d) delivery/receipt location; (e) transaction date and time; and (f) term (next day or next month).

Any errors identified in undertaking such reporting should be corrected as soon as practicable. While the Commission understands that, due to deadlines, index developers will not always be able to incorporate such corrections in their indices, we believe it is appropriate to require errors to be reported to help provide assurance that appropriate internal vigilance is being conducted and repetitive errors are not occurring.

4. Error resolution process. A data provider should cooperate with the error resolution process adopted by the index developer, including adhering to the process and timeline for submitted corrections and for responding to inquiries from the index developer. Like the original data submission, this function should be carried out by personnel independent from and not responsible for trading.

5. Data retention and review. A data provider should retain all relevant data relating to reported trades for a minimum period of three years. The data provider should have an independent auditor review the implementation of and adherence to data gathering and submission process adopted by the company at least once annually. The results of the audit should be made available to any index developer to which the data provider submits trade data, and the data provider should permit the index developer to recommend changes to improve the accuracy and timeliness of data reporting.

*9 35. As noted earlier, industry stakeholders were not able to reach consensus on requiring submission of counterparty information. Many parties support providing such information to improve matching and verification of trade data, but other parties contend that such data may require disclosure of sensitive proprietary commercial data. In addition, some parties note that confidentiality agreements prevent them from submitting counterparty information or object to providing such confidential information. While the Commission agrees with the CCRO best practices that counterparty information is the best means of creating accurate indices, it will not require data providers to report counterparty data at this time in order to gain safe harbor status (discussed below) for price reporting.

36. The Commission is taking this step in recognition of the representations made at the July 2, 2003 workshop that, by not requiring counterparty data at this time, we will see a material increase in voluntary reporting. We will monitor the progress in reporting and determine whether any revisions need to be made to our policy. The Commission also encourages industry participants to amend their master agreements to permit counterparty reporting to index providers that provide appropriate confidentiality. We understand generic language has been developed to implement such amendments and expect that parties which are committed to improved indices will undertake such amendments.

VI. Safe harbor policy

37. For data providers that can demonstrate that they have adopted and followed the standards discussed above, the Commission will presume that transaction data submitted to index developers is accurate and timely and submitted in good faith. The Commission does not intend to prosecute and/or penalize parties for inadvertent errors in reporting, nor will it refer such issues to other agencies having jurisdiction. Companies adhering to these guidelines, including the error resolution processes, should be able to report all relevant trade data with confidence.

38. At the same time, however, the Commission will prosecute or refer to other agencies having jurisdiction instances in which companies violate the good faith standards, including instances of intentional submission of false, incomplete or misleading information to index developers. The good faith reporting presumption is a rebuttable presumption, and actions taken to manipulate, misinform, or mislead index developers and/or market participants will not be permitted.

VII. Future action

39. The Commission issues this Policy Statement to encourage existing market processes for price discovery. The Policy Statement is not intended to interfere with improvements in current price indices or any future evolution of the price discovery process that will bring more accurate, reliable, and transparent price information to energy markets.

40. The current system of published price indices is a voluntary one. The Commission notes that on June 26, 2003, it issued a notice of proposed rulemaking to adopt a code of conduct for unbundled pipeline sales service and holders of blanket marketing certificates [FN10] and a related order seeking comment on the

adoption of market behavior rules for holders of electric market-based tariffs and authorizations. [FN11] In both cases, the Commission included in the proposed rules a requirement that, to the extent that the pipeline, blanket certificate holder, or market-based rate seller reported transactions to index developers, the information provided must be "complete, accurate, and factual" and that the entity "shall notify the Commission of whether it engages in such reporting for all sales." In addition, the Commission provided that the seller "shall adhere to such other standards and requirements for price reporting as the Commission may order." [FN12]

*10 41. The Commission will require that any prospective use of any index in its jurisdictional tariffs meet the criteria set forth above for price index developers and reflect adequate liquidity at the referenced location to be reliable.

42. While the Commission is hopeful that this policy statement will encourage more voluntary price reporting and that confidence in the accuracy, reliability, and transparency of price indices will increase, the Commission will watch developments over the next several months closely. The Commission will assess the degree to which voluntary reporting increases and how index developers and data providers implement the Commission's recommended standards. If voluntary reporting does not increase to the point that indices are sufficiently robust to support a healthy market, or if the standards recommended by the Commission herein are not widely adopted, the Commission will consider further action.

43. To accomplish the foregoing, we instruct our staff to monitor both the level of reporting to index developers and the amount of adherence to the standards set forth herein. To that end, staff should take steps to: identify the level of market participants currently reporting; identify increases (or lack thereof) in reporting by market participants currently not reporting; determine the quality of reporting (i.e., adherence to the above standards by data providers); review the quality of reported indices (i.e., adherence to the above standards by index developers); and communicate with index developers to insure appropriate Commission data access when needed. We encourage market participants and their trade associations and index developers to assist our staff in its efforts.

44. In the event the Commission is required to take further action, we note that we have broad authority to obtain price information from market participants. For natural gas, the Commission has broad authority under Sections 14(a) and 16 of the Natural Gas Act (NGA), 15 U.S.C. § § 717m(a) & 717o (2000), to investigate and gather relevant data and to make such orders, rules and regulations as may be necessary to carry out the provisions of the NGA. It is noteworthy that the Commission's investigative power extends over all persons, not just natural-gas companies subject to the Commission's rate and certificate authority. Of course, the Commission has direct regulatory authority over companies that transport natural gas in interstate commerce or that make sales of natural gas in interstate commerce for resales that are not "first sales."

45. Moreover, the Commission has authority under Section 315 of the Natural Gas Policy Act of 1978 (NGPA) to "require any first sale purchaser of natural gas under a new contract, a successor to an existing contract, or a rollover contract to file with the Commission a copy of such contract, together with all ancillary agreements and any existing contact applicable to such natural gas." [FN13] As defined in Sction 2(21) of the NGPA, first sale purchasers would include interstate or intrastate pipelines, local distribution companies, certain end-users, or sales

that precede sales to these entities. Id. at § 3301(21). This authority would permit the Commission to require the submission of price information for a broad array of natural gas transactions.

*11 46. With respect to wholesale sales of electricity, the Commission has significant authority to require data reporting and obtain data. under the Federal Power Act (FPA) including the broad investigatory authority described with reference to the NGA, 16 U.S.C. § 824d(c) (2000). For example, recently the Commission revised its Section 205(c) filing requirements to keep pace with the changes in electricity markets. As the Commission explained in Order No. 2001, "the Electric Quarterly Reports' more accessible format will make the information more useful to the public and the Commission and will better fulfill the public utilities' responsibility under FPA Section 205(c) to have rates on file in a convenient form and place. The data should provide greater price transparency, promote competition, enhance confidence in the fairness of markets, and provide a better means to detect and discourage discriminatory practices." [FN14] These goals are consistent with the goals of better price discovery. While the Electronic Quarterly Reports are not designed to achieve the data needed for index formation, they are illustrative of the authority that the Commission has under the FPA to require jurisdictional entities to report price data.

47. Taken together, the authorities of the NGA, NGPA, and FPA provide the Commission with strong tools to mandate price reporting if voluntary price reporting does not increase to a level that adequately restores confidence in natural gas and electric price indices.

By the Commission.

(SEAL)

Linda Mitry

Acting Secretary

FN1. In 2002 the Western Markets Task Force investigated the role natural gas indices played in the prices charged for electricity in California. The "Final Report on Price Manipulation in Western Markets," issued March 2003 in Docket No. PA02-2-000, determined that employees of several companies had reported false information to publishers of price indices in an effort to skew indices in favor of their trading activities positions (short or long) taken in both the physical and financial markets. In addition, the investigation found that other companies had no system in place to ensure the accuracy of the data being reported to the index developers.

FN2. For example, Natural Gas Intelligence (NGI) recently issued an open letter to the Commission and a "Statement on Natural Gas Price Surveys" in which it noted the collapse in fixed-price trading and the increased use of indices during volatile periods. NGI urged "buyers and sellers to do less indexing... and more fixed-price trading, particularly in the monthly baseload market." See www.intelligencepress.com/features/ngistatement.html.

FN3. The CCRO document is available on the CCRO website at http:// www.ccro.org/pdf/energy.pdf

FN4. "Joint Recommendation from Industry Stakeholders To Reform Gas Price Reporting and Index Publication," filed June 23, 2003. The joint recommendation was sponsored by the American Gas Association, the Coalition for Energy Market Integrity and Transparency (EMIT is made up of over 200 organizations and individuals, including the American Public Gas Association, the American Public Power Association, Apache Corporation, the Louisiana Independent Oil and Gas Association, the National Association of Royalty Owners, the National Association of State Utility Consumer Advocates, the National Rural Electric Cooperative Association, the Oklahoma Independent Producers Association, and the Public Energy Authority of Kentucky), the Committee of Chief Risk Officers, the Independent Petroleum Association of America, the Interstate Natural Gas Association of America, the Natural Gas Supply Association, the National Energy Marketers Association, and the Process Gas Consumers Group.

FN5. See http://www.theice.com/press/20030602.html.

FN6. "Comments from Reuters on Natural Gas Price Reporting and Index Formation," filed June 20, 2003. Reuters also supports the creation of a single independent data collection hub.

FN7. "Comments by Platts on Staff Paper on Price Formation Issues," filed June 20, 2003.

FN8. Several parties subsequently filed comments on the safe harbor concept discussed at the workshop. For instance, index developer Platts suggested immediate issuance of a policy statement based on the industry stakeholders' consensus standards, and strongly urged the Commission to require that a buy/sell indicator be included in all reporting. Platts also suggested that data providers be required to report all trades for both gas and electricity at every market location. The Edison Electric Institute and the Alliance of Energy Suppliers urged the Commission to issue a policy statement to provide safe harbor protection against inadvertent mistakes in natural gas price reporting, but recommended that electric indices be allowed to develop further before being subjected to specific standards. The Energy Transaction Repository recommended a policy statement followed by a rulemaking to establish measures of voluntary compliance and steps to mandatory reporting if necessary. PacifiCorp and PPM Energy, Inc., similarly urged the Commission to issue a policy statement followed by a rulemaking to establish permanent policies. Peoples Gas Light and Coke Company, North Shore Gas Company, and Peoples Energy Resources Corporation urged interim adoption of the industry stakeholders consensus recommendation as a step towards a mandatory system of reporting prices to a governmental entity. In other comments, ICE stated that its platform trading and eConfirm services provide direct price discovery that obviates the need for safe harbor protection for price reporting; the University of Houston suggested that a safe harbor should be coupled with independent third party data verification; and Mark Lively commented that use of an auction process would obviate the need for reliance on price indices.

FN9. The CCRO recommended that trade data be provided by corporate risk control, middle office or back office personnel.

FN10. "Amendments to Blanket Sales Certificates," Notice of Proposed Rulemaking, Docket No. RM03-3-000 (Code of Conduct NOPR).

FN11. "Order Seeking Comments on Proposed Revisions to Market-Based Rate Tariffs and Authorizations," Docket Nos. EL01-118-000, et al. (Behavior Rules Order).

FN12. Code of Conduct NOPR at 24; Behavior Rules Order at 22.

FN13. 15 U.S.C. § 3375 (2000). Current Section 315 was originally Section 315(c) when the NGPA was enacted in 1978. Section 315(a) addressed contract duration and Section 315(b) addressed the right of first refusal. The Wellhead Decontrol Act of 1989 removed Sections 315(a) and (b) but left Section 315(c), redesignated as Section 315. The House Report on the Wellhead Decontrol Act states that "the Committee intends that the Energy Information Administration of the Department of Energy, and the FERC as well, continue to collect and publish all appropriate data, including wellhead pricing data and other natural gas-related statistics, which may be reasonably necessary to a full understanding of this important industry by the public, the industry, the Congress, and others." See H.R. Rep. No. 29, 101st Cong., 1st Sess. At 10-11 (1989).

FN14. "Revised Public Utility Filing Requirements," Order No. 2001, FERC Stats. & Regs. ¶ 31,127 at 30,123 (2002).

104 FERC P 61,121, 2003 WL 21725984 (F.E.R.C.)

END OF DOCUMENT

EXHIBIT C

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February 26, 2004

Magalie Roman Salas
Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Re: Amendments to Blanket Sales Certificates
Docket No. RM03-10-000

Dear Ms. Salas:

Piedmont Natural Gas Company, Inc. (Piedmont) submits this filing to revise its initial notification of January 26, 2004 pursuant to Order No. 644, to advise the Commission that effective February 26, 2004, Piedmont began reporting natural gas transactions to a publisher of natural gas indices. If there is a change in status, Piedmont will inform the Commission of such.

Sincerely,

James H. Jeffries IV

James H. Jeffries IV

JHJ/srl

c: All Parties of Record

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the Affidavit of Richard A. Flebbe was served upon the parties in this action by facsimile transmission and/or hand-delivery addressed as follows

Mr. Randal Gilliam
Staff Attorney
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

This the 8th day of April, 2004.

James H Jeffries IV