BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

October 1, 2004

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

ORDER ADOPTING , IN PART, IPA COMPLIANCE AUDIT REPORT OF TENNESSEE REGULATORY AUTHORITY'S ENERGY AND WATER DIVISION

This matter came before Chairman Deborah Taylor Tate, Director Sara Kyle, and Director Ron Jones of the Tennessee Regulatory Authority (the "Authority" or "TRA"), the voting panel assigned to this docket, at a regularly scheduled Authority Conference held on April 26, 2004 for consideration of the March 29, 2004 Report (the "Report") of the Authority's Energy and Water Division (the "Staff"). The Report results from the Staff's Compliance Audit of the Incentive Plan Account ("IPA") filing of Nashville Gas Company (the "Company") for the year ended June 30, 2003. The IPA Compliance Audit was performed pursuant to Tenn. Code Ann. §§ 65-3-108, 65-4-104 and 65-4-111 and in accordance with the Performance Incentive Plan (the "Plan") previously adopted by the Company.

The Report is included in <u>Exhibit 1</u>, which is attached hereto and incorporated by this reference. <u>Exhibit 1</u> also contains the Staff's Notice of Filing the Report and the Company's TRA Service Schedule No. 14, which outlines the Plan. The actual results of the Compliance Audit are described in Section III of the Report. As stated in Section V of the Report, the Compliance Audit resulted in five findings by the Staff. As further stated in Section VI of the Report, the Compliance Audit identified areas of concern regarding IPA practices.

After consideration of the Report, a majority of the panel voted to approve and adopt the Report only as to Finding Nos. 3, 4 and 5 contained therein. A majority of the panel voted to direct the Company to file with the Authority a proposal to remedy the areas of concern identified in Section VI of the Report, Audit Conclusions and Recommendations.[1] These areas of concern were identified as: 1) the inclusion of the asset management fee; 2) the validity of the indexes used; 3) the reasonable level of excess capacity; 4) Staff oversight of the RFP process; and 5) the engagement of a consultant paid for by the Company to assist Staff with the audit process going forward. The panel unanimously voted not to suspend the Incentive Plan while these issues are being addressed.

IT IS THEREFORE ORDERED THAT:

1. With the exceptions noted in this Order, the March 29, 2004 Report of the Authority's Energy and Water Division regarding its Compliance Audit of the Incentive Plan Account filing of Nashville Gas Company for the year ended June 30, 2003, attached to this Order as part of Exhibit 1, is approved, adopted and incorporated in this Order as if fully rewritten herein.

[1] Director Jones did not vote with the majority in favor of accepting only Finding Nos 3, 4 and 5 Instead, he concluded that Finding Nos. 1 and 2 also are relevant and should be accepted It was Director Jones's opinion that a hearing officer should be appointed to develop an issues list with respect to the areas of concern identified by Staff and to prepare the matter for a hearing before the Panel Director Jones voted with the majority not to suspend the Incentive Plan while these issues are being addressed

2. The Company shall file with the Authority a proposal to remedy Finding Nos. 1 and 2 and the areas of concern identified in Section VI of the Report.

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

Deborah Taylor Tate, Chairman

Sara Kyle, Director

Ron Jones, Director

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BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

March 29, 2004

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, a Division of	)	**Docket No. 03-00489**
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, 2003.

2. The Company's IPA filing was received on August 22, 2003, and the Staff completed its audit of same on March 5, 2004

3 On March 11, 2004, the Energy and Water Division issued its preliminary IPA audit findings to the Company, and on March 18, 2004, the Company responded

EXHIBIT
1

thereto. Further communications ensued regarding the preliminary findings and the Company's final response was received on March 22, 2004.

4. The preliminary IPA audit report was modified to reflect the Company's responses 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's responses 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 findings and recommendations contained therein.

Respectfully Submitted.

Pat Murphy /blp

Pat Murphy
Energy and Water Division of the
Tennessee Regulatory Authority

CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of March 2004, 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:

Deborah Taylor Tate
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

Mr Bill R Morris
Director of Corporate Planning and Development Services
Piedmont Natural Gas Company
P.O. Box 33068
Charlotte, NC 28233

Mr. David Carpenter
Director-Rates
Piedmont Natural Gas Company
P.O Box 33068
Charlotte, NC 28233

Pat Murphy /blp
Pat Murphy

COMPLIANCE AUDIT REPORT
OF

NASHVILLE GAS COMPANY'S
INCENTIVE PLAN ACCOUNT

Docket No. 03-00489

PREPARED BY

TENNESSEE REGULATORY AUTHORITY

ENERGY AND WATER DIVISION

MARCH 2004

EXHIBIT A

TENNESSEE REGULATORY AUTHORITY'S COMPLIANCE AUDIT of NASHVILLE GAS COMPANY'S INCENTIVE PLAN ACCOUNT Docket No. 03-00489

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," "Nashville" 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, 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. The IPA consists of two mechanisms, which are more fully described in *Section II.*

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

		Plan Year Ended 6/30/03
Total Actual City Gate Purchases	$	107,496,621
Total Annual Benchmark	$	108,374,618
Percentage Actual Purchases to Benchmark	$	99.19%
Total Incentive Savings (Losses) from:		
Gas Procurement	$	1,288,018
Capacity Management		2,201,654
Total Incentive Savings	$	3,489,672
Incentive Savings (Losses) Retained by Ratepayers:		
Gas Procurement	$	654,443
Capacity Management		1,235,229
Total Incentive Savings to Ratepayers	$	1,889,672
Incentive Savings (Losses) Retained by Company:		
Gas Procurement	$	633,575
Capacity Management		966,425
Total Incentive Savings to Company	$	1,600,000

Section III of this report further describes the actual results of the plan year and *Section V* 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 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 benchmark. Should the Company purchase gas above 101% of the same pre-determined benchmark, 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 IPA 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

III. ACTUAL PLAN YEAR RESULTS

On August 22, 2003, Nashville Gas submitted its annual report to the TRA Staff, showing its calculation of the balance in the Incentive Plan Account as of June 30, 2003 According to the Company filing, the Incentive Plan generated $3,489,672 in total incentive savings. Of this amount, $1,889,672 benefited the ratepayer and $1,600,000 was retained by Nashville Gas.[1] Adding the under-recovered balance from the previous period and accrued interest on the monthly balances, and subtracting the surcharges recovered from customers, resulted in an **under-recovered balance** in the account at June 30, 2003 of **$1,438,294**. To recover this balance, the Company filed a PGA (tariff filing 03-00563) with the TRA Staff seeking approval to discontinue the previous year's surcharge and to implement a $0.00718 per therm surcharge, effective November 1, 2003.

The Company was able to purchase gas at less than the benchmark in only six (6) months of the twelve (12) months in the audit period. In three (3) of these months, purchases fell within the 1% deadband, and the Company could not share in the savings. In three (3) months, the Company shared in that portion of the savings that fell below the 1% lower limit of the deadband.[2] Purchases for the remaining six (6) months of the plan year were higher than the calculated benchmark. In two (2) of those months, the purchases also exceeded the 1% upper limit of the deadband Therefore, the Company should have shared 50/50 with the ratepayers the portion of losses exceeding the 1%. Nashville Gas reflected its share of losses for one of those months. In the other month Nashville allocated the total loss to the ratepayers.[3] Total actual city gate purchases for the year averaged 99.19% of the total annual benchmark. Of the $1,288,018 total net gain reported under the Gas Procurement Mechanism, the Company retained $633,575 and $654,443 benefited the ratepayers.

Nashville reported savings under the Capacity Management Mechanism of $2,201,654, of which $607,767 was the result of off system sales and capacity release and $1,593,887 was the payment received from its Asset Manager.[4] The Company's total actual demand costs for the year were $9,391,980. Therefore, the Company did not participate in any savings until the savings reach $93,920 (1% of the total demand costs), as provided for in the Incentive Plan. Of the total savings achieved, the Company retained $966,425 and $1,235,229 benefited the ratepayers [5]

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[1] Nashville has a cap on overall incentive gains and losses of $1 6 million (Service Schedule No 14, Performance Incentive Plan, page 1)

[2] The deadband is the 1 % range on either side of the benchmark, in which there is no sharing of incentive gains or losses

[3] See Staff Finding #1, in Section V of this report

[4] 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 (Taken from the Company's description of its agreement)

[5] The Company's share was reduced by $26,396 because of the $1 6 million cap

IV. AUDIT SCOPE

The IPA audit is a limited compliance audit of the Company's Incentive Plan account. The audit goal was to verify that the Company's calculations of incentive gains and losses were materially correct,[6] and that the Company is following all Authority orders and directives with respect to its calculation of the IPA account balance. Also included in this audit is the Company's PGA filing implementing a customer surcharge of the IPA account balance, effective November 1, 2003[7]

To accomplish the audit goal, Staff reviewed gas supply invoices, as well as supplemental schedules and other source documentation provided by Nashville. Where needed, Staff issued data requests to the Company to obtain additional information to clarify the filing.

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.

[6] The audit goal is not to guarantee that the Company's results are 100% correct Where it is appropriate, Staff utilizes sampling techniques to determine whether the Company's calculations are materially correct Material discrepancies would dictate a broadening of the scope of Staff's review

[7] PGA/Tariff filing 03-00563

V. INCENTIVE PLAN (IPA) FINDINGS

Staff reviewed the purchasing activities of Nashville Gas to determine whether the Company correctly calculated the amount of gains and losses under its Incentive Plan. Below is a summary of the IPA account as filed by Nashville and as adjusted by Staff. A description of findings follows.

SUMMARY OF THE IPA ACCOUNT:

	Company Filing	Staff Audit Results	Difference (Findings)
IPA Account Balance at 6/30/02	$ 1,741,051	$ 1,741,051	$ 0
Plus Gas Procurement Savings	633,575	616,529	-17,046
Plus Off-System Sales Margin	195,877	195,877	0
Plus Capacity Release Savings	770,548	787,594	17,046
Subtract Customer Surcharges	1,973,027	1,973,027	0
Plus Interest on Account Balance	70,270	70,209	-61
Equals IPA Account Balance at 6/30/03	$ 1,438,294	$ 1,438,233	$ -61

SUMMARY OF FINDINGS:

				Page No.
FINDING #1	Retention of Records	$ 0	No effect	6
FINDING #2	Request for Proposal (RFP) Process	0	No effect	7
FINDING #3	Gas Procurement Savings Overstated	-17,046	Over-recovery	9
FINDING #4	Capacity Release Savings Understated	17,046	Under-recovery	10
FINDING #5	Interest on Account Balance Overstated	-61	Over-recovery	11
	Net Result	**$ -61**	**Over-recovery**	

FINDING #1:

Exception

The Company failed to retain complete records (documentation) of its RFP process in the selection of an Asset Manager.

Discussion

The asset management fee has been included in the Incentive Plan filing for sharing between Nashville and its ratepayers. Staff asked Nashville Gas (through data requests) to provide copies of the winning bids submitted by the two asset managers who ultimately were selected to manage Nashville's assets during the plan year under review. Staff also asked Nashville for a copy of the complete list of companies to which it emailed the RFP. The Company responded that the bids requested were provided verbally and that the list of RFP recipients is no longer available.

In order to audit Nashville's compliance with its Incentive Plan tariff, Staff must have access to all documentation needed to support savings claimed by the Company for sharing between the Company and its ratepayers. In the case of the Asset Management payment, the Company should be able to provide complete documentation of the RFP process [8]

Company Response

Nashville was unable to provide a copy of the winning bidder's response to the Company's RFP because the various bidders responses were provided to the Company verbally; however, Nashville did provide Staff copies of contracts that were executed by both asset managers that detail the terms under which they agreed to provide their asset management service and the compensation provided to Nashville for such service. In essence, the contracts are the written confirmation of the asset manager's response to the RFP.

Staff did ask Nashville for a copy of the complete list of the companies to which it E-Mailed the RFP. Nashville did provide a copy of the E-Mail sent out to potential asset managers. The E-mail references the RFP list kept by the Company. Nashville continuously updates its RFP list as new suppliers are used by the Company and the Company establishes a record of the potential asset manager's reliability, credit and trustworthiness. In the past, Nashville has not archived its RFP list as it is updated but will do so going forward. Nashville did send the RFP to all suppliers that were on the supplier list at the time the RFP was sent.

Staff Response

The Company states in its response, "In essence, the contracts are the written confirmation of the asset manager's response to the RFP." Staff agrees that the contract reflects

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[8] TRA Rule 1220-4-5- 05 Retention of Records The NARUC publication referenced states that the minimum retention period for contracts for services, including supporting documentation, is six (6) years (pages 38-39)

the final agreement between the parties. However, without written documentation, Staff has no assurance that the winning bid was not manipulated by the parties.

FINDING #2:

Exception

The Company cannot provide a clear audit trail for its RFP process used in the selection of an Asset Manager.

Discussion

As stated in Finding #1, Staff attempted to review Nashville Gas's RFP process used in the selection of the asset managers during the audit period under review. Staff identified several issues that are cause for concern. One, the Company does not retain a copy of its email list of RFP recipients Therefore, the Company could only report to Staff the companies that responded in some manner to the RFP. Two, the RFP was not publicly published. The Company determined which companies it wanted to consider and other potentially qualified companies were not given the opportunity to bid. Three, in the cases of Dynegy and Sempra, the winning bidders, Nashville could not produce a copy of their original bids . Nashville's response to Staff's inquiry was that these bids were provided "verbally." When asked for copies of the follow-up bids from the two highest bidders, again the Company said the bids (Sempra and Entergy Koch) were provided verbally.

It is obvious from the Company's responses that there is no clear audit trail for Staff to determine whether or not preference was given to any bidder in the RFP process At the time Dynegy was selected as asset manager, Piedmont was involved in the SouthStar joint venture with Dynegy and a third party. Piedmont states, "In all of its dealings with Dynegy as a supplier or asset manager, Piedmont treated Dynegy the same as it did all other suppliers/asset managers with which it had similar experience."[9] However, based on the information provided by Piedmont, Staff cannot provide assurance to the Authority that the selection process was transparent and unbiased.

Company Response

The Company responded to the first of Staff's issues in response to finding number one.

In response to issue number two, the Company, by publicly publishing its RFP, would disclose information regarding its business, which Piedmont considers to be competitively sensitive Secondly, Piedmont typically sends its RFP's to suppliers that have established a reliable relationship with Piedmont through previous supply and/or sales arrangements or an asset manager that has acquired the same reputation through dealings with others known to Piedmont. Piedmont would only engage in an asset management arrangement with an entity that has satisfactory credit sufficient to pay damages in the event of non-performance. For the period that Dynegy was selected as the asset manager, six companies responded to Nashville's RFP, with Dynegy out bidding the next highest bidder by $1,399,000. Lastly, the Company also incurs no cost in E-mailing the RFP to suppliers that meet its reliability and credit requirements. Publicly publishing an RFP would result in considerable cost given the length

[9] Company's response to Staff's February 10, 2004 data request, question 4 (b)

and detail of an asset management RFP. The Company is also not aware of any publication or company that publicly publishes RFP's for asset management.

FINDING #3:

Exception

The Company understated its share of calculated losses under the Gas Procurement Mechanism for the month of May 2003 by $17,046. This represents a **$17,046 over-recovery** from customers.

Discussion

The Incentive Plan tariff under the Gas Procurement Mechanism provides for 50/50 sharing of any gains that occur below 99 per cent of the calculated benchmark and losses that occur above 101 percent of the same benchmark. In May 2003, the actual gas purchases were $4,452,632. The calculated benchmark for that month was $4,374,792. Since actual gas purchase costs were greater than the benchmark, a loss of $77,840 occurred, of which $34,092 was above the 101 percent ceiling. According to the terms of the tariff, Nashville should absorb $17,046 of this loss.

Company Response

Nashville agrees with the conclusions of Staff in Finding #3. The deadband was miscalculated by the Company by the amount stated by Staff.

FINDING #4:

Exception

The Company understated its share of savings under the Capacity Release Mechanism by $17,046 This represents a **$17,046 under-recovery** from customers.

Discussion

Nashville had two asset managers during the audit period. Dynegy managed Nashville's assets July through October 2002 and Sempra managed the assets April through June 2003. Sempra made a payment to Nashville in April 2003 for the use of these assets during periods of time when Nashville did not need them. The payment agreed upon in the contract dated January 28, 2003 was $1 1 million plus an additional amount depending on the ending storage balances at March 31, 2003 The total amount Nashville received was $1,593,887.

Based on the sliding scale outlined in the Capacity Management mechanism, the sharing percentage for this amount is 50/50. While the Company did calculate its share as $796,944, it reduced its share by $26,396, since its total calculated savings exceeded the $1.6 million cap[10] by this amount. Staff's total calculated savings exceeded the cap by $9,350, due to the reduction in Gas Procurement savings as shown in Finding #4. Therefore, Staff increased the Capacity Release savings by the difference between the $26,396 (Company) and $9,350 (Staff) or $17,046.

Company Response

Nashville agrees with the conclusions of Staff in Finding #4.

[10] Nashville Gas Service Schedule No 14 (Performance Incentive Plan), Overview of Structure, page 1

FINDING #5:

Exception

The Company overstated the amount of interest owed by ratepayers by $61. This represents a **$61 over-recovery** from customers.

Discussion

Staff recalculated the amount of interest on monthly account balance after making adjustments for Findings #3 and #4.

Company Response

Nashville agrees with the conclusions of Staff in Finding #5.

VI. AUDIT CONCLUSIONS AND RECOMMENDATIONS

Conclusions

Nashville Gas, except for the findings noted, has correctly calculated its share of savings under its Service Schedule No. 14, Performance Incentive Plan, for the plan year ended June 30, 2003. The net findings are immaterial to the Company's filing. However, Staff has identified issues pertaining to the Incentive Plan tariff that need to be addressed going forward The following concerns came to light during this audit

The first concern is the asset management payment. Staff now believes that it was in error in allowing the inclusion of this payment for sharing under the Incentive Plan. The Company acted in good faith by including this payment for the current year under audit, based on past decisions of this Authority Going forward, however, Staff believes this payment should be excluded from the Incentive Plan. The tariff reads:

> "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."[11]

The tariff, as written, does not provide for an asset management fee. The only transactions included in the plan under the Capacity Management Incentive Mechanism are the Company's release of excess capacity and off-system sales. The engagement of an asset manager by Nashville to manage its assets is not a transaction covered by the tariff.

Also, the goal of an incentive plan is to encourage or "incent" companies to actively engage in purchase activities that generate approved gas cost savings for consumers. These activities should go beyond the normal prudent gas purchasing that is expected of a regulated utility Engaging an asset manager to perform the activities on behalf of the company, does not demonstrate additional effort on the part of the company. As described in Finding #2, Nashville's RFP process consists primarily of emails to prospective asset managers and email or verbal responses. This process takes place typically once a year.

Additionally, Nashville is not able to provide Staff with a basis for the amount of the fee paid by the asset manager The assets committed to the asset manager have been paid for by the consumer and therefore the consumer is entitled to a fair return on those assets. Logic dictates that the asset manager is making profits well in excess of the payment made to Nashville. Due to the complexity of this issue, Staff does not have the ability to determine whether or not the payments are fair and reasonable.

The second concern is the RFP process. The selection process should be transparent and fair to all parties. Failure to retain documentation, restricting RFP recipients and verbal bids that are not documented are all red flags to auditors In the current accounting environment,

[11] Service Schedule No 14, Performance Incentive Plan, page 4

following the collapse of such companies as Enron and WorldCom, financial transactions must be transparent and able to be audited. The federal government responded to these high-profile business failures with the Sarbanes-Oxley Act of 2002. This legislation has significant impact on the standards to which the accounting profession is held.

The third concern is the use of nationally published indexes in the Incentive Plan. There have been recent reports of flaws in the price indexes that are compiled by trade magazines. They include allegations of false reporting and manipulation of the indexes. The Commodity Future Trading Commission (CFTC) has imposed civil penalties against a number of energy companies. Reporting of prices is voluntary and the number of companies participating has declined As an example, the following gas companies do not report their trades to a national index service: Nashville Gas, Piedmont Natural Gas, Atmos Energy and Woodward Marketing.[12] With a smaller sample population, there is more likelihood that market prices could be manipulated.

The final concern is the level of excess capacity maintained by Nashville Gas A certain amount of excess capacity on the pipeline is necessary to guarantee delivery of gas to the firm residential customers on the projected coldest day of the year What this level reasonably needs to be has not been addressed in Nashville's Incentive Plan During the remainder of the year, excess capacity can be released to third parties to generate additional savings under the Incentive Plan that will benefit the Company's shareholders. Staff needs assurance that the level of capacity is reasonable and that the customers are not paying for capacity they don't need

Recommendations

1 The Authority should suspend the Incentive Plan[13] going forward and address the following issues:

   a. Inclusion of the Asset Management Fee
   b Validity of the indexes used
   c. Reasonable level of excess capacity

2. The Authority should instruct Staff to oversee the RFP process.

3. The Authority should engage a consultant (paid for by the Company) to assist Staff with the audit process going forward. The complexity of the issues identified in this audit requires expert knowledge of the industry.

[12] Atmos response to Staff DR dated March 1, 2004, #7 (Docket 03-00515) and Piedmont response to Staff DR dated December 17, 2003, #4 (Docket 03-00489)

[13] Service Schedule No 14, Performance Incentive Plan, page 1 states, "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 "

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

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 ∝ 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.

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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