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BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

June 4, 2004

IN RE:	)
	)
CHATTANOOGA GAS COMPANY	**)Docket No. 03-00516**
ACTUAL COST ADJUSTMENT AUDIT	)

NOTICE OF FILING BY THE 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 hereby gives notice of its filing of the Compliance Audit Report of the Actual Cost Adjustment Audit (hereafter "ACA") component of the Purchased Gas Adjustment Rule for Chattanooga Gas Company 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 ACA audit of Chattanooga Gas Company (the "Company").

2. The Company's ACA filing was received on September 3, 2003, and the Staff completed its audit of same on May 23, 2004. The original 180-day deadline for the Staff's completion of the audit was extended to June 21, 2004 by mutual consent of Chattanooga Gas Company and the TRA Staff as provided for in the Purchased Gas Adjustment Rule (1220-4-7-.03 (2).

3. On May 24, 2004, the Energy and Water Division issued its preliminary ACA audit findings to the Company, and on June 1, 2004 the Company responded thereto.

4. The preliminary ACA audit report was modified to reflect the Company's responses and a final ACA audit report (hereafter the "Report") resulted therefrom. The Report is attached hereto as Exhibit A and is fully incorporated herein by this reference.

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 recommendations and findings contained therein.

Respectfully Submitted:

Pat Murphy

Pat Murphy
Energy and Water Division of the
Tennessee Regulatory Authority

CERTIFICATE OF SERVICE

I hereby certify that on this 4th day of June, 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:

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Pat Murphy

COMPLIANCE AUDIT REPORT
of the
ACTUAL COST ADJUSTMENT COMPONENT
of the
PURCHASED GAS ADJUSTMENT RULE
for
CHATTANOOGA GAS COMPANY

Docket No. 03-00516

Prepared by:

THE ENERGY AND WATER DIVISION
of the
TENNESSEE REGULATORY AUTHORITY

June 2004

EXHIBIT A

COMPLIANCE AUDIT REPORT
of the
ACTUAL COST ADJUSTMENT COMPONENT
of the
PURCHASED GAS ADJUSTMENT RULE
for
CHATTANOOGA GAS COMPANY
for the Year ended June 30, 2003

Docket No. 03-00516

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I. INTRODUCTION

The subject of this audit is Chattanooga Gas Company's ("Company," "Chattanooga," or "CGC") compliance with the Actual Cost Adjustment and Refund Adjustment of the Purchased Gas Adjustment Rule ("PGA Rule") of the Tennessee Regulatory Authority ("TRA" or the "Authority"). The objective of the audit was to determine whether the purchased gas adjustments, which are encompassed by the Actual Cost Adjustment ("ACA"), as more fully described in section VI., for the year ended June 30, 2003, were calculated correctly and were supported by appropriate source documentation.

II. AUDIT OPINION

The Staff concludes that except for the findings noted herein, the Purchased Gas Adjustment mechanism, as calculated in the Actual Cost Adjustment, appears to be working properly and in accordance with the TRA rules for Chattanooga Gas Company. While the monetary findings are not material, with respect to the Company's total gas costs, Finding #3 regarding the Company's Bailment Agreement with its affiliate Sequent Energy Management ("Sequent") is cause for concern. See Section VIII of this report.

III. SUMMARY OF COMPANY FILING

The Company made its Actual Cost Adjustment filing for its Tennessee service area on September 3, 2003. This ACA filing showed $56,277,403 in total gas costs, with $66,614,703 being recovered from customers through rates. Adding a beginning balance in the Deferred Gas Cost account ("ACA account") of positive $9,434,663 in under-recovered gas costs from the preceding ACA period and interest due from customers for the current period of $238,491 resulted in an ACA balance at June 30, 2003 of **negative $664,146** in **over-recovered** gas costs. The Company's filing is summarized on the following page.

CHATTANOOGA GAS COMPANY
ACA FILING FOR PERIOD JULY 2002-JUNE 2003

Line		
1	Beginning Balance (July 2002)	$ 9,434,663.29
2	Purchased Gas Costs	56,277,403.38
3	Gas Costs recovered through rates	66,614,703 24
4	Interest on monthly balances	238,491.00
5	Ending Balance (June 2003) (Line 1 + Line 2 – Line 3 + Line 4)	$ (664,145.57)

A ( ) around a number indicates a negative or credit balance in the ACA Account, which represents an over-recovery of gas costs. Over-recoveries result in a refund due to customers.

The Company filed a PGA, effective October 1, 2003, to begin refunding the balance in the ACA account as of June 30, 2003. The Staff's findings resulting from this audit are described in detail in Section VIII of this report

IV. BACKGROUND INFORMATION ON COMPANY

Chattanooga Gas Company, located at 6125 Preservation Drive in Chattanooga, Tennessee, is a wholly owned subsidiary of AGL Resources, Inc., a holding company formed in 2000 in response to the Public Utility Holding Company Act (PUCHA) of 1935. AGL Resources, Inc. is located at Ten Peachtree Place, Atlanta, Georgia. As a local distribution company ("LDC"), Chattanooga Gas provides service to customers in Chattanooga and Cleveland, Tennessee, and environs in Hamilton and Bradley Counties in Tennessee, respectively. The natural gas used to serve these areas is purchased from various suppliers and transported via three natural gas pipelines in accordance with separate and individual tariffs approved by the Federal Energy Regulatory Commission (FERC). The three interstate pipelines are Tennessee Gas Pipeline (TGP), East Tennessee Natural Gas (ETNG), and Southern Natural Gas (SNG).

V. JURISDICTION OF THE TENNESSEE REGULATORY AUTHORITY

Tennessee law provides broad jurisdiction and control over public utilities to the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA"). Tenn. Code Ann. § 65-4-104 states:

> The Authority shall have 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, Tenn. Code Ann. § 65-4-105 grants the same power to the Authority with reference to all public utilities within its jurisdiction as Tenn. Code Ann., Title 65. Chapters 3 and 5 confer oversight of the railroads to the Department of Transportation or oversight of transportation companies to the Department of Safety. By virtue of Tenn Code Ann. § 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 Energy and Water Division of the TRA is responsible for auditing those companies under the Authority's jurisdiction to ensure that each company is abiding by Tennessee statutes as well as the Rules and Regulations of the Authority. Pat Murphy of the Energy and Water Division conducted this audit.

VI. DESCRIPTION OF PURCHASED GAS ADJUSTMENT RULE

Actual Cost Adjustment Audits:

The PGA Rule can be found in Chapter 1220-4-7 of the Rules of the Tennessee Regulatory Authority. The PGA Rule permits the Company to recover, in a timely fashion, the total cost of gas purchased for delivery to its customers and to assure that the Company does not over-collect or under-collect gas costs from its customers.

The PGA consists of three major components:

1. **The Actual Cost Adjustment (hereafter the "ACA")**
2. **The Gas Charge Adjustment (hereafter the "GCA")**
3. **The Refund Adjustment (hereafter the "RA")**

The ACA is the difference between the revenues billed customers by means of the GCA and the cost of gas invoiced the Company by suppliers plus margin loss (if allowed by order of the TRA in another docket) as reflected in the Deferred Gas Cost account.

The ACA then "trues-up" the difference between the actual gas costs and the gas costs recovered from the customer through a surcharge or a refund. The RA refunds the "true-up" along with other supplier refunds. For a more complete definition of the GCA and RA, please see the PGA Formula in Appendix A of this Report.

Section 1220-4-7-.03 (2) of the PGA rule requires:

> Each year, the Company shall file with the [Authority] an annual report reflecting the transactions in the Deferred Gas Cost Account. Unless the [Authority] provides written notification to the Company within one hundred eighty (180) days from the date of filing the report, the Deferred Gas Cost Adjustment Account shall be deemed in compliance with the provisions of this Rule. This 180-day notification period may be extended by mutual consent of the Company and the [Authority] Staff or by order of the [Authority].

Prudence Audit of Gas Purchases:

Section 1220-4-7-.05 of the PGA Rule requires, unless otherwise ordered by the Authority, an "Audit of Prudence of Gas Purchases" by a qualified consultant. This specialized audit evaluates and reports annually on the prudence of any gas costs included in the PGA. At its September 11, 2001 Authority Conference, the Directors voted to approve a Performance-Based Ratemaking Mechanism for Chattanooga (Docket No 01-00619). The mechanism affects all plan years ending after June 30, 2000 and continues each year unless terminated by the Company or the Authority. For each year that the mechanism is in effect, if CGC's total commodity gas purchases are less than 1% above the total annual benchmark, its purchases are deemed prudent and the requirements of Section 1220-4-7-.05 of the PGA Rule is waived.

VII. SCOPE OF ACA AUDIT

The ACA audit is a limited compliance audit of the Company's ACA account. The audit goal is to verify that the Company's calculations of gas costs incurred and recovered are materially correct,[1] and that the Company is following all Authority rules, orders and directives with respect to its calculation of the ACA Account balance. Also included in this audit is the Company's PGA filing implementing a customer refund of the ACA Account balance, effective October 1, 2003, a PGA filing to refund the balance in the Company's Interruptible Margin Credit Rider ("IMCR"), effective July 1, 2003 and a tariff filing to amend the IMCR Rider, effective January 1, 2003. Refer to the ACA Account detail provided in Section III, Summary of Company Filing.

To accomplish the audit goal, Staff reviewed gas supply invoices, as well as supplemental schedules and other source documentation provided by Chattanooga. Where appropriate, Staff requested additional information to clarify the filing.

During the audit process, Staff encountered a scope limitation imposed by the Company. Since Sequent Energy Management, an unregulated affiliate of Chattanooga, purchases substantially all the gas supply for the Company, it is necessary for Staff to review Sequent's supplier invoices to ensure that Sequent is passing on its actual costs to Chattanooga with no mark-up. At the time of filing the ACA, the Company provided redacted invoices, "blacking out" all information on the invoices except the amount that matched Sequent's invoices to Chattanooga. When Staff requested to be provided with "unredacted" copies, the Company responded that the invoices were highly confidential and that Staff could only view the invoices at the offices of its attorney in Nashville. Copies would be provided only if the TRA agreed to issue a protective order covering these invoices. Due to audit time constraints at the time and to the fact that a protective order was not appropriate in the context of an uncontested audit, Staff agreed to a review the invoices in question at the attorney's office. However, these restrictions did not provide the Staff the opportunity to thoroughly review and analyze the invoices to ensure the Authority that Sequent is in fact acting in a prudent and fair manner in its capacity as gas supplier for Chattanooga.

In its next audit of the Company's ACA filing, Staff again intends to request copies of Sequent's unredacted invoices and will take whatever measures available under the authority of this agency to enforce compliance.

[1] 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

VIII. ACA FINDINGS

Staff's audit resulted in findings totaling a **negative $44,037**. This amount is the net total of three (3) findings and represents a credit or additional over-recovery in the ACA Account, which when added to the Company's calculated balance, results in a **negative** (over-recovered) balance in the ACA Account of **$708,183**. A summary of the ACA account as filed by the Company and as adjusted by the Staff is shown below, followed by a description of each finding.

SUMMARY OF THE ACA ACCOUNT:

Line		Company	Staff	Difference (Findings)
1	Beginning Balance at 7/1/02	$ 9,434,663.29	$ 9,434,663.29	$ 0.00
2	Gas Purchases	56,277,403.38	56,275,282.06	(2,121.32)
3	Gas Costs Recovered thru Rates	66,614,703.24	66,655,224.24	40,521.00
4	Ending Balance before Interest (line 1 plus line 2 minus line 3)	$ (902,636.57)	$ (945,278.89)	$ (42,642.32)
5	Interest on Account Balance	238,491.00	237,096.00	(1,395.00)
6	Ending Balance at 6/30/03 (line 4 plus line 5)	$ (664,145.57)	$ (708,182.89)	$ (44,037.32)

A ( ) around a number indicates a negative or credit balance in the ACA Account, which represents an over-recovery of gas costs. Over-recoveries result in a refund due to customers.

SUMMARY OF FINDINGS:

				Page No.
FINDING #1	Inventory Injections	$ 2,121.32	Over-recovery	7
FINDING #2	ACA Refunds	40,521.00	Over-recovery	8
FINDING #3	Off-Systems Sales	N/A		9
FINDING #4	Interest on Account Balance	1,395.00	Over-recovery	16
	TOTAL	**$ 44,037.32**	**Over-recovery**	

FINDING #1:

Exception:

The Company understated the amount of its storage injections for the month of September 2002.

Discussion:

In calculating its cost of storage injections for September 2002, the Company used the wrong cashout rate. The result was that storage injections were understated by **$2,121.32**, which represents an **over-collection** of gas costs.

Company Response:

Chattanooga Gas Company concurs.

FINDING #2:

Exception:

The Company understated the amount of ACA surcharges collected for the 2001-2002 audit period.

Discussion:

At the conclusion of the 2001-2002 ACA filing period, the Company implemented a surcharge[2] to begin collection of the unrecovered balance in its ACA Account at June 30, 2002. In the calculation of the October 2002 collections, the Company used the wrong sales volumes for the "All Other"[3] category of customers. Correcting these sales volumes resulted in an increase in gas cost recovery of **$40,521**[4], which represents an **over-recovery** of gas costs.

Company Response:

Chattanooga Gas Company concurs.

[2] PGA tariff filing 02-01226
[3] The "All Other" category includes the firm customers (residential, commercial and multi-family)
[4] Of this amount, $40,172 applies to the commodity portion and $349 applies to the demand portion

FINDING #3:

Exception:

The Company violated its "Interruptible Margin Credit Rider" tariff regarding the sharing of gross profit margin on Off-System Sales.

Discussion:

During six months of the period (July 2002 – December 2002) covered by this audit, the Company had a tariff in place applicable to the treatment of gross profit margin realized on gas sales that the Company made to customers that were not on its system. Revenues collected from these sales, less the actual cost of gas, resulted in additional margin for the Company. The tariff specified that this margin was to be shared 50/50 between the Company and its customers. At the inception of this tariff, companies like Chattanooga Gas marketed their own excess gas supply. In exchange for this effort, effective November 1, 1995, the Company was allowed to retain 50% of the margin generated by these sales.

In April 2001, Sequent Energy Management ("Sequent"), an unregulated affiliate of Chattanooga Gas Company, began purchasing gas for Chattanooga. In May 2001, the Company entered into a bailment agreement (the "Agreement") with Sequent that authorized Sequent to act as its asset manager.[5] The terms of the bailment agreement provided that Sequent would pay Chattanooga Gas $300,000 per year ($25,000 per month) for the right to manage Chattanooga Gas' assets when not needed by Chattanooga. Any additional profits (losses) would be retained by Sequent. This Agreement was never filed with the TRA for the Authority's approval. Therefore, Chattanooga was still operating under its Interruptible Margin Credit Rider tariff, which called for 50% of all gross profit margin generated by off-system sales to be credited to its customers.

It has now become apparent that Sequent's ability to market off-system sales far exceeds that of Chattanooga Gas. Sequent has access to pipelines and customers that are beyond the reach of the local gas distributor. Utilization of its affiliates' assets[6] affords Sequent the opportunity to greatly increase profits generated in the unregulated arena.[7] The following is taken from AGL Resources, Inc (the parent Company of Chattanooga Gas) 2002 Annual Report to its stockholders, page 23.

> "Although Sequent is a nonregulated business, some of its underlying assets are regulated. Under varying agreements and practices, Sequent acts as asset

[5] Asset managers have the ability to market excess capacity on the pipelines that are not being used, as well as selling excess gas supplies to off-system customers

[6] Sequent manages Atlanta Gas Light (AGLC) and Virginia Natural Gas (VNG) assets also

[7] Effective January 1, 2003, Chattanooga amended its Interruptible Margin Credit Rider tariff regulating off-system sales to include all transaction with non-jurisdictional customers made by Sequent using Chattanooga's assets The Company realized that potential profits greatly exceeded $600,000 (50% of which Sequent paid Chattanooga Gas under its Agreement) The amount credited to Chattanooga customers as their 50% share for the first year under the new tariff (January – December 2003) was $1 3 million (PGA tariff filing #20040260)

manager and/or gas manager for AGL Resources' regulated utilities. Sequent aggregates gas from other marketers and producers and sells to third parties. In addition, Sequent bundles commodity with transportation and redelivers short-term and long-term transported commodity. The VSCC approved an asset management agreement that provides for a sharing of profits between Sequent and VNG's customers. Sequent and CGC have an agreement whereby Sequent pays CGC's ratepayers an annual fee for the right to act as CGC's asset manager. Sequent also operates as asset manager for AGLC. By statute, earnings from capacity release transactions are required to be shared 90% with Georgia's USF. By GPSC order, net margin earned by Sequent, for transactions involving AGLC assets other than capacity release, is required to be shared 50/50 with Georgia's USF."

The above citation refers to approvals from the Virginia State Corporation Commission (VSCC) and the Georgia Public Service Commission (GPSC). However, no approval was received from the Tennessee Regulatory Authority for the agreement with Chattanooga Gas.

Staff attempted to discover the actual profits that Sequent experienced during this audit period using Chattanooga's assets. In its response to several Data Requests from the TRA Staff, the Company stated that during the time the Agreement with Sequent was in place, Sequent did not track off-system sales by affiliate. It also did not track other transactions by affiliate, or by regulated versus unregulated assets. The Georgia Public Service Commission also had this problem when auditing the AGLC's Universal Service Fund (October 2002 GPSC Staff Audit Report, pages 19 and 20).[8]

Staff believes that Chattanooga has violated its tariff for off-system sales sharing during six months of the period covered by this audit. Staff also believes that the customers of Chattanooga are entitled to significantly more credits for gross profit margins realized by Sequent using the assets Chattanooga customers have paid for. The Company credited $25,000 per month from July 2002 through December 2002 or $150,000 for the audit period. The customers' share of profits made in 2003 under an amended tariff,[9] was $1.3 million,[10] more than four (4) times the amount credited under the "Bailment Agreement." Staff believes that in the absence of proof to the contrary, Chattanooga Gas customers are entitled to half the profits made by Sequent for all transactions during the time period July – December 2002. Since Sequent is unable to identify profits accruing as a result of transactions using Chattanooga's assets during this time, the burden of proof lies with Sequent to present to this Authority for its consideration,

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[8] The GPSC audited AGLC's Universal Service Fund (USF) for the period 1998 through September 2002 and issued an order on December 23, 2002 (Docket No 16193-U) requiring an additional $3 9 million related to capacity assets and $2 2 million related to Flexibility Fees (determined by the GPSC to be off-system sales) should be paid to the USF

[9] For the period of January 2003 to June 2003, Chattanooga began operating under a new tariff, effective January 1, 2003 On February 27, 2004, the Company filed a PGA (tariff #20040260) to implement a refund of $1 3 million for the customers' share of profits made during 2003 using Chattanooga's assets

[10] The 5th paragraph of the Company's response to "draft" Finding #3, stated that the Staff incorrectly "alleged" that the amount credited to CGC customers for the calendar year 2003 was $1 8 million Staff has corrected this "typo" in the final report

Sequent's determination of a "fair" amount (along with proper supporting documentation) that should be refunded to Chattanooga's customers

Company Response:[11]

Chattanooga Gas Company ("CGC") does not concur.

First and foremost, CGC did not violate its "Interruptible Margin Credit Rider" tariff by crediting CGC's ratepayers $25,000 per month during July 2002-December 2002 for Sequent's use of CGC's assets. CGC entered into the Gas Storage Asset Bailment Agreement with Sequent Energy Management, LP ("Sequent") on May 1, 2001 (the "Agreement"). At that time, the Interruptible Margin Credit Rider provided that CGC retain 50% of gain from off-system sales if such sales occur. The rider did not provide for the sharing of gain from any other non-jurisdictional transactions that utilize such assets. In May 2001, CGC negotiated the Agreement under which Sequent assumed 100% of the risk associated with such non-jurisdictional transactions and guaranteed that ratepayers would receive $300,000 annually. This $300,000 annual payment was equivalent to sharing $600,000 gain from off-system sales.

CGC worked very hard to create an Agreement that limited the ratepayers' risk and provided the most benefit to its ratepayers under the current market conditions. The $300,000 fee was not an arbitrary amount, but was based on a multi-year average of off-system sales. In fact, AGL Services Company's ("AGLS") Director of Rates and Regulatory Analysis conducted a thorough review of prior off-system sales before determining that $300,000 was a reasonable sharing of the potential gains and risks associated with Sequent's management of CGC's assets. This bailment fee was also reviewed for reasonableness by an independent auditor, Deloitte and Touche, and found to be reasonable. Moreover, under the Agreement, CGC's ratepayers were guaranteed $300,000 *even if Sequent lost money.*

CGC does not understand why the Staff is now attempting to argue this sharing arrangement violated CGC's tariff Significantly, CGC met with the Staff and discussed with them this arrangement before it was implemented. Prior to the meeting, CGC had become aware, through the review of TRA Staff reports, that another utility had in place a similar asset management agreement. When asked about the other utility's agreement, the Staff explained that the other utility had not been required to file the agreement for approval. Based on these discussions with the Staff, it was believed that it was not necessary to file for approval. Moreover, in a March 25, 2002 filing to credit customers for gains under the Interruptible Margin Credit Rider, CGC again informed the Staff of the Agreement and its terms [12]and implemented a credit to refund to the ratepayers the

[11] The response in this section has been provided by the Company and has not been altered or paraphrased by Staff Footnotes 12-15 in this section were also composed by the Company

[12] "In addition, effective May 1, 2001, the Company entered into an Asset Management Agreement with its affiliate, Sequent Energy Management, L P Under the Asset Management Agreement, the Company assigns its firm pipeline capacity, storage, and supply rights to the Asset Manager in exchange for an annual fee of $300,000 to be paid in equal monthly payments of $25,000 per month " March 25, 2002

payments from Sequent for the period of May 1, 2001 through December 2001. The arrangement with Sequent remained in place during the July 2001-June 2002 period that was previously audited by the Staff. The Staff made no mention of any alleged tariff violation in that final report. Based on the very open nature of this process and the lack of any communications to the contrary from the Staff or any such findings in any previous audit CGC believed and continues to believe that this sharing arrangement was in accordance with its tariff.

The Staff incorrectly states: "The customers' share of profits made in 2003 under an amended tariff,[13] was $1.8 million, more than four (4) times the amount credited under the "Bailment Agreement." In its February 27, 2004 filing, CGC implemented a credit to distribute approximately $1.3 million of shared gain for the twelve months ended December 31, 2003, not the $1.8 million alleged by the Staff. However, the gain for calendar year 2003 is not reflective of the gain from off-system for the last six months of 2002. First, Sequent was able to increase its overall profits in 2003 due to increased volatility in the market. When prices spiked in the first quarter of 2003, Sequent was able to capture margins which resulted in the $1.3 million shared with CGC's ratepayers for the calendar 2003. Such transactions could not have occurred during the latter part of 2002 because it would have been imprudent to withdraw stored gas inventory that could be required to supply customers during the heating season. However once into the first quarter of 2003, the gas needed to supply customers could be determined and transactions that resulted in the gain realized in 2003 were undertaken. It is inappropriate to attempt to utilize calendar year 2003 as a surrogate for the last six months of 2002 during which very different market conditions existed, and during a time when prudent management of stored gas inventory would have prevented transactions that resulted in the gains realized in 2003. Second due to this anticipated volatility, CGC, on its own initiative, undertook to eliminate the bailment relationship in December 2002 and amended its tariff in order to maximize credits for its ratepayers.[14] The amended tariff made <u>all transactions</u> with non-jurisdictional customers subject to sharing, not just off-systems sales as provided under the previous tariff. This is another factor that enabled Sequent to return $1 3 million to ratepayers from transactions that occurred during 2003.

Finally, as CGC previously explained in data request responses, due to the nature of the Agreement and the bailment fee, Sequent did not track the revenue generated from off-system sales using CGC's assets.[15] However, the Agreement and the bailment fee were appropriate at the time. Moreover, CGC terminated the Agreement as soon as it

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letter to Mrs Pat Murphy TRA Energy and Water Division from Earl Burton, Manager Rates/Marketing CGC

[13] For the period of January 2003 to June 2003, Chattanooga began operating under a new tariff, effective January 1, 2003 On February 27, 2004, the Company filed a PGA (tariff #20040260) to implement a refund of $1 3 million for the customers' share of profits made during 2003 using Chattanooga's assets

[14] In fact, CGC met with the Staff before implementing these changes Although Staff now complains that the fixed payment was inappropriate, at the time Staff expressed concern over CGC's decision to terminate the Agreement because CGC would not be guaranteed a payment under its tariff

[15] Sequent did track the volumes, however, there is no correlation between volumes and revenues

determined that changing market conditions necessitated a new arrangement in order to maximize gain. CGC will continue to monitor the market and is committed to ensuring that the asset management arrangement remains in the best interest of it ratepayers.

Staff Response:

After considering the Company's response to this finding, Staff again maintains that a tariff violation has occurred. The Interruptible Margin Credit Rider ("IMCR") tariff that was in effect during the term of the Bailment Agreement between Chattanooga and Sequent is attached to this report as "Attachment A." The pertinent part, under section Intent and Application, states "This Interruptible Margin Credit Rider is also intended to authorize the Company to recover **not more than** fifty percent (50%) of the gross profit margin that results from off-system sales of gas should such sales be made to off-system customers by the Company." [Emphasis added] Staff has never, despite suggestions made by the Company, interpreted this tariff to mean other than what it says, a 50/50 sharing between the Company and its customers.

At the heart of this finding is a real doubt on the part of Staff that the customers have in fact received at least 50% of the gross profit margin realized by Sequent as a result of engaging in off-system sales on behalf of Chattanooga Gas. The Staff is not suggesting that the Company be penalized for the use of an asset manager. The question to be answered is whether the $300,000 paid by Sequent for the right to use Chattanooga's assets is greater or less than the 50% guaranteed to customers by this tariff.

At the onset of the Bailment Agreement, Staff was led to believe that not only would Sequent be able to generate more off-system sales than Chattanooga could, but that $300,000 would more than cover Chattanooga's right to 50% of gross margin resulting from these sales. In its response to this finding, the Company references a March 25, 2002 letter to Staff (see footnote 12) In that letter,[16] the Company asserted that the Bailment Agreement fee represented 50% more than the customers' share of off-system sales for the period July 1999 – June 2000 and 200% more than their share during the period July 1998 – June 1999. That is true; however, the results of the July 2000 – June 2001 period were not evident to Staff until the Company's PGA tariff filing effective April 1, 2002. That filing (in conjunction with the previous filing effective December 2001) showed that the customers' 50% share of off-system sales margin for the **10 months** ended April 2001 was approximately $909,000, or **three (3) times** the annual fee under the Bailment Agreement.

To repeat, until the current audit period Staff was still operating under the impression that the $300,000 fee met the threshold of a 50/50 sharing of off-system sales margin.[17] At the time of Staff's audit of the July 2001-June 2002 period (referenced by

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[16] See Attachment B

[17] If Staff had believed that the $300,000 fee did not represent a reasonable estimate of 50% or more of off-system sales margin as required by the IMCR tariff, Staff would have instructed the Company to file an amendment to its tariff for approval by the Authority for a flat rate fee that was not contingent on actual

the Company in its response), the Company had credited the customers with eight (8) months of the annual fee (for May 2001 – December 2001). During its review, Staff did not ask the Company for documentation of off-system sales transactions for that period. Perhaps we should have, but that fact does not preclude Staff from investigating this area in a subsequent audit.

Since the last audit report was released in April 2003, it has become apparent to Staff that Sequent's potential for gain at the expense of Chattanooga customers is a real possibility. It is evident that this idea has also occurred to the Company. In June 2003, the Company filed for a revision to its Interruptible Margin Credit Rider, to be effective January 1, 2003. In its letter of June 16, 2003,[18] CGC admits that market conditions have changed since the adoption of the IMCR tariff. To that end, CGC proposed to expand its tariff language to include 50% sharing of all transactions involving the use of Chattanooga's assets. Keep in mind that the above-referenced assets have been entirely paid for by the customers of Chattanooga. Staff suspects that in the "unregulated" arena the potential for gain utilizing "regulated" assets is significant. Therefore, it is the duty of the Authority to ensure that customers receive the fair share they are entitled to.

Since the Company did not file to refund off-system sales credits for the period January 2002 through December 2002 until July 2003, the review of those refunds fall under the current audit. Therefore, in contrast to the "draft" findings to which the Company responded above, $300,000 ($25,000 times 12 months) of the Bailment Agreement fees are in question rather than $150,000 ($25,000 times 6 months). During the period of discovery, Staff issued four (4) separate data requests with questions regarding the amounts that Sequent earned using the assets of Chattanooga. The Company was not forthcoming on any of them The standard response was that Sequent did not (during the period May 2001 through December 2002) separately track **any transactions** using the assets of its affiliates,[19] whether for off-system sales or any other transactions. Staff believes that whenever a Company enters into an agreement of any kind with its affiliate, it is incumbent on the Company to document not only the arrangement, but the affiliate transactions as well. This documentation must be made available to regulators on request for audit purposes. This requirement is implicit in a Company's tariff. Staff finds it unacceptable that neither Chattanooga nor Sequent can provide reliable evidence that the customers of CGC are receiving the return on their investment envisioned in the IMCR tariff.[20]

Therefore, Staff has no option but to render its opinion that the terms of the tariff have been violated. Staff also takes this opportunity to put the Company on notice that in its next ACA audit of CGC, Staff will be reviewing the transactions underlying the credits refunded to customers under the terms of the amended tariff effective January 1,

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sales dollars Conditions appear to have changed since May 2001 and Staff is now looking for assurance that the customers are receiving their share which was contemplated under the IMCR tariff

[18] See Attachment C

[19] See footnote 6

[20] Staff again references the docket in Georgia that addressed a similar situation between Atlanta Gas Light and Sequent See footnote 8

2003. If the Company is not able to substantiate the refund amounts, Staff will be forced to recommend that its affiliate Sequent not be permitted to manage Chattanooga's assets.

Staff's recommendations to the Authority regarding this finding and other concerns can be found in <u>Section IX</u>.

FINDING #4:

Exception:

The Company over-stated the amount of interest due from customers.

Discussion:

Staff recalculated the amount of interest due on account balance after making corrections for Findings #1 and #2. The result is a reduction of interest in the amount of $1,395.[21] This represents an over-recovery of gas costs

Company Response:

Chattanooga Gas Company concurs.

[21] Of this amount, $1,384 applies to the commodity portion and $11 applies to the demand portion

IX. STAFF AUDIT RECOMMENDATIONS

During the audit of Chattanooga Gas's Actual Cost Adjustment for the current period, Staff became aware of several areas of concern, foremost among them the asset management agreement between the Company and its affiliate Sequent Energy Management. While there is no direct finding relative to this arrangement per se, Staff does have concerns regarding the affiliate relationship that need to be explored in more depth. An example of one concern is Staff's Finding #3 (payments made under the Company's Bailment Agreement). Therefore, Staff makes the following recommendations to the Authority for its consideration.

1. The Authority should consider sanctions and/or penalties against Chattanooga for failure to document off-system sales margin in order to comply with the terms of its IMCR tariff.

2. The Authority should instruct Chattanooga to provide a reasonable method to determine a <u>fair</u> amount that should be refunded to Chattanooga customers for the use of the assets they have paid for during the period January 2002 through December 2002. Should the Company be unable or unwilling to provide a reasonable method, Staff recommends that Chattanooga customers be refunded 50% of the gross margin on <u>all</u> transactions that Sequent engaged in using <u>all</u> assets at its disposal during this period.

3. The Company should be instructed to make sure a system is in place to track all transactions made using Chattanooga's assets going forward.

4. Considering the confusion arising in this audit over the use of an affiliated asset manager, the Authority should consider formalizing an amendment to the IMCR tariff addressing the basic requirements for affiliate agreements such as this one.

5. Due to the complexity of current market conditions and the affiliate arrangement existing between Chattanooga and Sequent, the Authority should engage an outside consultant to assist Staff in future audits of Chattanooga's ACA Account and Incentive Plan. This consultant would work under the direction of the TRA Staff, with consulting fees paid for by Chattanooga and reimbursed by the ratepayers in the Actual Cost Adjustment.

APPENDIX A

PGA FORMULA

The computation of the GCA can be broken down into the following formulas:

$$\text{Firm GCA} = \frac{D + DACA}{SF} - DB + \frac{P + T + SR + CACA}{ST} - CB$$

$$\text{Non-Firm GCA} = \frac{P + T + SR \;\; CACA}{ST} - CB$$

where

GCA = The Gas Charge Adjustment in dollars per Ccf/Therm, rounded to no more than five decimal places

D = The sum of all fixed Gas Costs.

DACA = The demand portion of the ACA.

P = The sum of all commodity/gas charges.

T = The sum of all transportation charges.

SR = The sum of all FERC approved surcharges.

CACA = The commodity portion of the ACA.

DB = The per unit rate of demand costs or other fixed charges included in base rates in the most recently completed general rate case (which may be zero if the Company so elects and the Commission so approves).

CB = The per unit rate of variable gas costs included in base rates in the most recently completed general rate case (which may be zero if the Company so elects and the Commission so approves).

SF = Firm Sales.

ST = Total Sales.

The computation of the RA can be computed using the following formulas:

$$\text{Firm RA} = \frac{DR1 - DR2}{SFR} + \frac{CR1 - CR2 + CR3 + i}{STR}$$

$$\text{Non-Firm RA} = \frac{CR1 - CR2 + CR3 + i}{STR}$$

where

RA = The Refund Adjustment in dollars per Ccf/Therm, rounded to no more than five decimal places.

DR1 = Demand refund not included in a currently effective Refund Adjustment, and received from suppliers by check, wire transfer, or credit memo.

DR2 = A demand surcharge from a supplier not includable in the GCA, and not included in a currently effective Refund Adjustment.

CR1 = Commodity refund not included in a currently effective Refund Adjustment, and received from suppliers by check, wire transfer, or credit memo.

CR2 = A commodity surcharge from a supplier not includable in the GCA, and not included in a currently effective Refund Adjustment.

CR3 = The residual balance of an expired Refund Adjustment.

i = Interest on the "Refund Due Customers" account, using the average monthly balances based on the beginning and ending monthly balances. The interest rates for each calendar quarter used to compute such interest shall be the arithmetic mean (to the nearest one-hundredth of one percent) of the prime rate value published in the "Federal Reserve Bulletin" or in the Federal Reserve's "Selected Interest Rates" for the 4th, 3rd, and 2nd months preceding the 1st month of the calendar quarter.

SFR	=	Firm sales as defined in the GCA computation, less sales under a transportation or negotiated rate schedule.
STR	=	Total sales as defined in the GCA computation, less sales under a transportation or negotiated rate schedule.

INTERRUPTIBLE MARGIN CREDIT RIDER

APPLICABILITY

This Rider shall apply to and become part of each of the Company's Rate Schedules under which gas is sold on a firm basis (hereinafter referred to as "Firm Schedule").

INTENT AND APPLICATION

This Interruptible Margin Credit Rider is intended to authorize the Company to recover ninety percent (90%) of the gross profit margin losses that result from rates negotiated under the provisions of Special Service Rate Schedule SS-1 or from customers who switch to alternate fuels where the Company is unable to meet alternate fuel competition.

This Interruptible Margin Credit Rider is also intended to authorize the Company to recover not more than fifty percent (50%) of the gross profit margin that results from off-system sales of gas should such sales be made to off-system customers by the Company.

DETERMINATION OF GROSS PROFIT MARGIN LOSSES

The gross profit margin loss shall be calculated as ninety percent (90%) of the difference between the Test-Year Targeted Rate Margin as determined in the Company's most recent rate case order of the Authority and the Actual Negotiated Rate Margin.

Any amount of gross profit margin losses shall be recovered from the firm commodity component of gas costs as determined under the presently effective Purchased Gas Adjustment Provision.

FILING WITH THE AUTHORITY

Each negotiated rate gross profit margin loss accounting/recovery period shall correspond with the Company's Fiscal Year, which ends December 31, each year.

The Company shall charge all authorized negotiated rate gross profit margin losses to the "Deferred Gas Cost" account in accordance with Section III.C. of the Authority's PGA Docket No. G86-1 and shall file the supplemental sheets required by this Rule showing the calculation of the margin losses.

RECEIVED
TN REG. AUTHORITY

ATTACHMENT B MAR 2 6 2002

ENERGY & WATER DIVISION

Chattanooga Gas Company / 6125 Preservation Drive/ Chattanooga TN 37416

March 25, 2002 Amended Filing

Mr. Pat Murphy
Tennessee Regulatory Authority
Energy and Water Division
460 James Robertson Parkway
Nashville, TN 372430-0505

Dear Ms. Murphy,

Pursuant to the Tennessee Regulatory Authority's Rules and Regulations, Chattanooga Gas Company, or the "Company", hereby files two (2) amended copies of the following revisions to Chattanooga Gas Tariff No 1:

Seventieth Revised Sheet No. 53
Sixty-Eighth Revised Sheet No 55

We propose an effective date of April 1, 2002 The net cost of gas filed herein reflects the Company's anticipated cost of natural gas for the month of April The Company proposes to use a price of $4.42/mcf for gas costs which reflects the approximate WACOG storage gas costs that the Company projects as the primary supply for the month of April 2002 Higher withdrawals from the Company's storage are necessary to manage cost and to replace storage gas with lower gas costs for future benefit to the Company's ratepayers. Additionally, the Company's deferred gas account is currently in a considerable under-collection position and the Company wants to avoid any further undercollections for the remaining ACA year.

This filing also contains the Company's refund of 50% of the total value earned through Off-System Sales from October 1, 2000 through April 30, 2001 in the amount of $275,140 92. The detail of the Off-System Sales calculation is provided in Attachment A Historically, this filing has taken place within 60 days of the close of the Company's fiscal year However, effective October 1, 2001, the Company changed its reporting form a fiscal year ending September 30, to a calendar year basis Because of this change, the Off-system Sales Report which was previously filed by November 30, has been delayed until now to coincide with the 60 day requirement. As a result we have also extended the time period on which interest on refunds due to customers is calculated.

In addition, effective May 1, 2001, the Company entered into an Asset Management Agreement with its affiliate, Sequent Energy Management, L.P . Under the Asset Management Agreement, the Company assigns its firm pipeline capacity, storage, and supply rights to the Asset Manager in exchange for an annual fee of $300,000 to be paid in equal monthly payments of $25,000 per month. The Company asserts that the annual payment received from the asset manager is approximately 50% greater than the amount credited to the customers for the twelve months ended June 2000, and 200% greater than that for the twelve months ended June 1999 for Off-system Sales Even though the gas supply assets have been assigned to the Asset Manager, the Company still retains the right to call on the gas 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 monthly payment is solely for the value acquired for utilization of the released assets when they are not needed by the Company

Because the Company has entered into an agreement with an affiliate to manage its un-utilized capacity and storage assets, we also contracted with the accounting firm of Deloitte and Touche ("D&T") for the purpose of performing an independent valuation on the Asset Management Agreement D&T's valuation report affirms that the $300,000 annual fee paid to the Company is consistent with the market value for the use of these assets. A copy of D&T's valuation report, as well as D&T's memorandum of services to be performed, is attached to this filing. This filing therefore includes $200,000 from the Asset Management fees for the period of May 1, 2001 through December 31, 2001 as detailed in Attachment B.

A total of the Off-system Sales revenues, Asset Management fees, and accrued interest through December 1, 2001 is itemized on page 14 of this PGA filing. Additionally, the refund includes an IMCR balance from the prior 99-00 IMCR refund that was discontinued in November 2001. This outstanding balance has been added to this filing and is itemized on Page 13

Should there be any questions, I will be please to discuss this filing in further detail with you

Sincerely,

Earl Burton P E.
Manager of Rates/Marketing

CC Mr Dan McCormac
Mr Archie Hickerson
Ms Amanda Hwang
Mr. Hal Novak
Ms Felicia McKinley
Mr Russell T Perkins

ATTACHMENT C

RECEIVED
TN REG. AUTHORITY
JUN 1 6 2003
ENERGY & WATER DIVISION

Chattanooga Gas Company / 2207 Olan Mills Drive/ Chattanooga TN 37421
Telephone 1-800-427-5463

June 16, 2003

Mr Mike Gaines, Chief
Energy and Water Division
Tennessee Regulatory Authority
Energy & Water Division
460 James Robertson Parkway
Nashville, TN 37243-0505

Dear Mr Gaines,

Pursuant to the Tennessee Regulatory Authority's Rules and Regulations, Chattanooga Gas Company (CGC) hereby files three (3) copies of the following revisions to Chattanooga Gas Tariff No 1.

Sixth Revised Sheet No. 48

The Company proposes that this filing be made effective January 1, 2003 to coincide with the beginning of the next period for reporting CGC's off-system sales activity. The report for the calendar year 2003 will be filed after all required data is available in early 2004

The current tariff provision addresses off-system sales, but does not address other non-sales transactions that involve CGC and non-jurisdictional customers Such transactions were not envisioned at the time the current tariff language was adopted The revised language clarifies that the current treatment of off-system sales applies to all such transaction that involve the use of CGC's gas supply assets

For your convenience, a red lined copy of the revised tariff identifying the changes from the current tariff is provided Should there be any questions, I will be pleased to discuss this filing in further detail with you.

Sincerely,

Archie R. Hickerson
Manager-Rates

C. Mr. Dan McCormac
Ms Amanda Hwang