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

STAFF REPLY TO THE RESPONSE OF CHATTANOOGA GAS COMPANY TO THE ENERGY AND WATER DIVISION'S COMPLIANCE AUDIT REPORT

The TRA's Compliance Staff ("Staff") submits the following reply to the *Response of Chattanooga Gas Company to the Energy and Water Division's Compliance Audit Report* ("*Response*") filed on July 9, 2004 by the Chattanooga Gas Company ("Chattanooga" or the "Company").

Background

This docket was opened to consider issues arising out of the Compliance Audit Report of the Actual Cost Adjustment Audit Component of the Purchased Gas Adjustment Rule for Chattanooga Gas Company for the Year ended June 30, 2003 ("*Audit*") submitted by Staff on June 4, 2004. The *Audit* was attached as Exhibit A to the *Notice of Filing by the Energy and Water Division of the Tennessee Regulatory Authority*. The *Audit* contained four (4) substantive findings regarding the Actual Cost Adjustment ("ACA"). The Company concurred with Finding Nos. 1, 2 and 4 and took issue with Finding No. 3.

Audit Finding No. 3 stated: "The Company violated its 'Interruptible Margin Credit Rider' tariff regarding the sharing of gross profit margin on Off-System Sales."

The Interruptible Margin Credit Rider ("IMCR") tariff in place during the *Audit* period applied to the treatment of gross profit margin realized on gas sales made by the Company to customers not a part of its system ("off-system sales").

Finding No. 3 took issue with the Company's bailment agreement ("Agreement") with its affiliate, Sequent Energy Management ("Sequent"), entered into in May of 2001. Under the terms of the *Agreement*, Sequent paid the Company three hundred thousand dollars ($300,000.00) per year for use of Company assets and retained any profits gained through Sequent's use of Company assets when making off-system sales. The Company retained the $300,000.00 fee whether Sequent's use of Company assets resulted in profits or losses. The Agreement was never filed with the Authority for approval.

Under the IMCR tariff, applicable during the *Audit* period, the Company's ratepayers were entitled to credits for 50% of all gross profit margin generated by off-system sales of Company assets. During January 2003 to December 2003—the period of time immediately subsequent to the *Audit* period—$1.2 million was credited to the Company's customers from off-system sales under a new tariff. Staff concluded that the disparity between the $300,000.00 credited to customers during the *Audit* period and the $1.3 million credited to customers during the next subsequent audit period demonstrated that the Company's customers were likely entitled to much more under the IMCR tariff than they received as a result of the Company's Agreement with Sequent. Staff attempted to discover the actual profits achieved through Sequent's off-system sales of the Company's assets but ultimately were unable to do so, because Sequent did not track its use of Company assets.

Staff made five (5) substantive recommendations based on Finding No. 3 as follows:

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.

<u>Staff Audit Finding #3</u>

In its *Response*, the Company suggests that the Staff inappropriately extended the scope of the *Audit* to include filings made under its IMCR tariff.[1] Staff has been granted broad audit authority. Tenn. Code Ann. § 65-4-105(a) provides that the Authority "shall possess with reference to all public utilities within its jurisdiction all the other powers conferred with reference to railroads regulated by the department of transportation or

[1] *Response*, p 1 (July 9, 2004)

transportation companies regulated by the department of safety as provided by chapters 3 and 5 of this title."[2] Tenn. Code Ann. § 65-3-108 states:

> The department is given full power to examine the books and papers of the companies, and to examine, under oath, the officers, agents, and employees of the companies and any other persons, to procure the necessary information to intelligently and justly discharge its duties and carry out the provisions of this chapter and chapter 5 of this title.[3]

Staff has repeatedly taken the position that the scope of an audit can be broadened if the facts or situation warrant it. Findings, or the absence of findings, regarding certain company transactions or practices in prior audits, do not preclude Staff from diligently performing its duty and identifying and questioning such transactions or practices in subsequent audits.

The IMCR tariff is closely related to gas costs and the sharing is reported as part of a Purchased Gas Adjustment ("PGA") filing. PGA filings are reviewed for reasonableness, inadvertent errors, and mathematical accuracy, <u>not audited</u>, by Staff. An annual true-up of gas costs invoiced and recovered takes place in the Actual Cost Adjustment ("ACA") filing, which <u>is audited</u> by Staff. While the refunds that accrue to customers as a result of the IMCR tariff have not been audited by Staff in the past, they are properly addressed within the context of the ACA audit. With the Company's revision of the IMCR tariff effective January 1, 2003, the transactions related to this tariff are increasing, both in number and amount. Also, the fact that these transactions are being carried out by an affiliated asset manager dictates that Staff should audit these transactions in order to carry out its duties required by the Purchased Gas Adjustment Rule.

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[2] Tenn Code Ann § 65-4-105(a)
[3] Tenn Code Ann § 65-3-108

The IMCR tariff in effect prior to January 2003 stated:

> 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)

The Agreement allowed Sequent to engage in a myriad of transactions, the least of which was the sale of **gas** as provided for in Chattanooga's tariff. Since the Company now characterizes the Agreement as "one" off-system sale,[4] Sequent went way beyond the "sales of gas" which the tariff provided for when it used Chattanooga's assets to generate profits on other types of transactions.

The Company likens the Agreement with the Asset Management Agreement of Nashville Gas Company ("Nashville"). Nashville has a third party asset manager that was obtained through an RFP process. While Staff raised questions regarding this process in Nashville's last incentive plan audit, Staff agrees that, if the process is made more transparent and able to be audited, it will provide the most benefit to Nashville's customers. However, Chattanooga has made an asset management agreement with **itself**. There was no RFP process to place the agreement out for bids from other qualified asset managers. Staff cannot therefore determine if the benefit Chattanooga's customers have received or will receive under the new IMCR tariff provides an appropriate return on the investment of assets for which they have paid.

Since Chattanooga's incentive plan does not provide for any sharing between the Company and its customers, it appears the Company has utilized this IMCR tariff as a means of generating additional profits for its non-regulated affiliate, Sequent. When Staff attempted to confirm the Company's claim of reasonableness of the amount paid

[4] *Response*, p. 2 (July 9, 2004) The Company did not refer to this agreement as "one off-system sale" in its response to the *Audit* See *Audit*, pp 11-13 (June 4, 2002)

under its Agreement, it encountered "red flags." The Company has the burden of proof to document affiliate transactions. It documented transactions in Virginia and Georgia. Why not Tennessee? The Company states that since it was paying a flat rate, it didn't need to document affiliate transactions using Chattanooga's assets. That is the very reason Staff is recommending that the IMCR tariff be amended to include affiliate rules, in order to safeguard Tennessee customers against potential affiliate abuse.

Staff Recommendations

1. ***Sanctions and/or penalties:*** Based on the Company's responses, the Staff chooses not to pursue its recommendation of penalties against the Company. However, this does not mean that Staff is in agreement with the Company that documentation of affiliate transactions made relative to the IMCR tariff was not needed.

2. ***Amount of refund:*** The Staff is prepared to accept the Company's method of supporting the "reasonableness" of its payments under the Agreement. However, the tariff contemplated 50% of actual gas sales. Due to the fact that the Company (through its Agreement with Sequent) did not track these transactions, Staff cannot assure the Directors that the customers of Chattanooga Gas have received their fair share of profit margin absent an audit of the transactions that took place.

3. ***Tracking system:*** Staff accepts that a system is now in place to track all transactions made by Sequent using Chattanooga's assets. The Staff will, in its next audit, review these transactions to verify the amounts credited to customers under the revised IMCR tariff.

4. ***Affiliate rules:*** As stated in the Staff's response to the Company regarding Finding #3, Staff strongly recommends that the Authority amend Chattanooga's tariff to include affiliate rules governing the selection of an asset manager.[5]

5. ***Outside Consultant:*** Staff again strongly recommends that the Authority approve the engagement of an outside consultant to assist in the audits of Chattanooga Gas' Actual Cost Adjustment and Incentive Plan Account. Sequent Energy Management manages Chattanooga's entire gas supply requirements and the release of its assets as well. Without an in-depth audit of the gas costs that are passed on to Chattanooga's customers

[5] Affiliate rules were made a part of Atmos' Performance Based Ratemaking tariff, to protect its customers against possible abuse when an affiliate managed its gas purchasing

through the PGA and that are compared to a benchmark in the incentive plan, Staff has no assurance that Sequent is billing Chattanooga appropriately for the gas that it purchases. Based on the limited review of Sequent's supplier invoices, Staff has real questions regarding how Sequent determines the amounts it bills Chattanooga. This area will be one focus of Chattanooga's next compliance audit.

Respectfully submitted,

Pat Murphy

Pat Murphy, Manager
Energy and Water
Utilities Division

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of November, 2004, a true and correct copy of the foregoing has been either hand-delivered or delivered via U.S. Mail, postage pre-paid, to the following persons:

Pat Miller
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

D. Billye Sanders, Attorney for Chattanooga Gas Company
Waller, Lansden, Dortch & Davis
Nashville City Center
511 union Street, Suite 2100
P.O. Box 198966
Nashville, TN 37219-8966