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August 16, 2004

VIA HAND DELIVERY

Pat Miller, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37219

Re: Petition of Chattanooga Gas Company for Approval of Adjustment of its Rates and Charges and Revised Tariff
Docket Number 04-00034
Rebuttal Testimony of Chattanooga Gas Company

Dear Chairman Miller:

Enclosed you will find the original and fourteen copies of the rebuttal testimony of Chattanooga Gas Company. This filing includes testimony from Steve Lindsey, Mike Morley, Dr. Roger A. Morin, Darilyn Jones and Doug Schantz.

Sincerely,

D. Billye Sanders

D. Billye Sanders
Attorney for Chattanooga Gas Company

DBS/hmd
Enclosures

cc: Archie Hickerson
Steve Lindsey
John Ebert, Esq.
Elizabeth Wade, Esq.

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CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of August 2004, a true and correct copy of the enclosed rebuttal testimony was delivered by hand delivery, email, facsimile or U.S. mail postage prepaid to the other Counsel of Record listed below.

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BEFORE THE
TENNESSEE REGULATORY AUTHROITY

REBUTTAL TESTIMONY
OF
DARILYN JONES

Q. Please state your name and business address.

A. My name is Darılyn Jones. My business address ıs 1200 Smith Street, Suite 900, Houston, Texas 77002.

Q. What is your position with Sequent Energy Management, LP?

A. I am Vıce President, Risk Control, of Sequent Energy Management, LP ("SEM").

Q. Please provide a summary of your background and professional experience.

A. I graduated from Universıty of Houston ın 1974 receiving a Bachelor ın Business Administratıon Degree in Accounting and graduated from Universıty of Houston ın 1992receıvıng a Masters in Busıness Admınıstration in Fınance. Prior to joining SEM, I worked at Accenture, LLP in the Global Strategy, Trading and Risk Management Practice. I have over 25 years of experience in the energy business working for merchant energy and Exploratıon and Production companıes During my career ın energy, I have held several senior management posıtıons. I began working for SEM in August 2003 as the Vıce Presıdent of Rısk Control My prımary responsıbilıtıes include management and oversight of all risk related actıvıtıes conducted at SEM, ıncludıng Market, Credıt, Compliance and Contract Admınıstratıon Groups.

Q. What is the purpose of your testimony in this proceeding?

A. I will respond to CAPD witness Dr. Steve Brown's assertion that SEM is "imposing losses on CGC." I will also address CAPD witness Daniel McCormac's question regarding why CGC's February 27, 2004 Interruptible Margin Credit Rider ("IMCR") Report ("IMCR Report") reflected "Unrealized Losses, net of $2,257,061."

Q. Do you agree with Dr. Brown's allegation on page 57 of his testimony that SEM imposes losses on CGC?

A. No. Dr. Brown bases this allegation on his review of a table found in Attachment D (page 7 of 14) of the IMCR Report. The table shows SEM's profits by month for 2003. While it is true that SEM does report a loss in six of the twelve months, these "losses" are a result of how SEM is required to account for an over-all transaction . They are not actual "losses" passed on to CGC's ratepayers. Let me assure you that SEM does not call upon CGC's assets unless the over-all transaction would result in profits that are ultimately shared with CGC's ratepayers. SEM's accounting will be more fully described below.

Q. What do you mean by "over-all transaction?"

A. Many of SEM's transactions consist of both physical and financial transactions. Significantly, SEM may report a loss (or gain) on one of the transactions before it reports the gain (or loss) on the over-all transaction. However, when the transactions are considered together, profits are generated for sharing with CGC's ratepayers.

Q. Can you please explain how the IMCR Report appears to show a loss even though the over-all transaction ultimately results in a gain?

A. Yes, but first it would be helpful if I explain some "Key Terms and Concepts," as well as how SEM evaluates and enters into transactions. I will refer to these "Key Terms and Concepts" throughout my testimony.

1 Derivative – a financial instrument. Commonly used derivatives are futures, NYMEX Swaps, and Basis Swaps. A natural gas derivative's value is based on the underlying commodity, natural gas. Derivatives are revalued daily using Marked –to - Market Accounting.

2. Marked- to- Market (MtM) – is the accounting methodology used to revalue a derivative transaction at market prices. The calculation equals volume times the difference between market price less contract price. The MtM value is carried as an unrealized gain or loss on SEM's books until the financial derivatives are settled When the derivatives are settled in the appropriate contract month, the gain or loss associated with the financial derivative is booked as a realized gain or loss.

An example of Marked-to-Market accounting is as follows:

- On 8/1/03, Company XYZ buys one futures contract (10,000 mmbtus) at $5 for September
- On 8/2/03 the futures market price for September is $5.10

Volume	Contract Price	Market Price	MtM Value
10,000	$5.00	$5.10	$1,000

3 Hedge – buying or selling a derivative (futures contract, NYMEX Swap, or Basis Swap) with the intent of protecting the value of a commodity transaction from adverse price movements.

4 NYMEX Futures – In April 1990, the New York Mercantile Exchange (NYMEX) introduced and began trading natural gas futures contracts with the Henry Hub in Louisiana as the delivery location. The introduction of the NYMEX gas futures contracts provides an efficient means of price discovery in the market. One futures contract is equal to 10,000 mmbtus.

5. NYMEX Contract Price – The forecasted contract price published during the day by NYMEX for a given contract month.

6. NYMEX Settlement Price - at the end of each trading day, NYMEX publishes a final daily settlement price for each specific contract month.

7. NYMEX Swap – actively traded natural gas swap that performs a similar function as a NYMEX futures contract Swaps are settled financially each contract month based on final published Index Prices (refer to Index Price definition).

8. Index Price – A forecasted market price which represents the most commonly traded gas price at a major trading point. The indexes for several major trading points are published monthly. Inside Ferc Gas Market Report (IFerc) and Gas Daily are the two largest publications. This price is used to settle physical gas transactions and financial derivatives.

9 Index Settlement Price - IFerc publishes monthly settlement prices for major trading locations. Gas daily publishes daily and monthly settlement prices for major trading locations.

10. Basis Swap – an actively traded derivative that represents the basis price difference between a futures price and an Index Price.

11 Basis Price – price differential between the NYMEX price and an Index Price for a specific contract month.

12 Cash Month – current month of physical gas flow.

13 Forward Month – future month of physical gas flow

14. WACOG – weighted average purchase price of all gas purchases from inception to date.

15. Internal cross/swap – swap transaction between related parties or companies, i.e , a swap between CGC and SEM. This is a cashless transaction.

16. Deal Legs – individual components of a transaction.

17. Fees – transport costs and related storage injection and withdrawals costs.

Q. Using these terms, can you please explain how SEM evaluates whether to enter into a transaction using CGC's assets?

A. Yes Prior to executing transactions, SEM identifies the expected economic value of CGC's unused capacity based on market prices or forecasted index prices as described in *Key Terms and Concepts*. The expected economic value of CGC's unused capacity is derived by calculating the difference between the current index price for the injection month compared to the current index price for the withdrawal month less all applicable costs. As more fully described below, SEM hedges by buying or selling NYMEX and Basis Swaps for the applicable month to lock-in economic value.

Q. Please elaborate on how SEM evaluates whether or not it is profitable to buy gas in a cash month at an index price, inject the gas into storage in the cash month, withdraw the gas from storage in a future month, and sell the gas in the future month at an index price?

A SEM calculates the difference between the current index price for the planned injection month compared to the current index price for the planned withdrawal month less all applicable costs. The forecasted index price for a major trading

location for a specific contract month equals NYMEX Price + Basis Price. Let's refer to the sum of these two prices as "P", the planned injection month as "Inj", and the planned withdrawal month as 'Wd".

The calculation of estimated economic value is

(P_{Wd} less P_{Inj}) less costs = Economic value or Net Margin

Q. How does SEM manage commodity price risks associated with these transactions?

A SEM manages these risks by hedging planned storage injections and withdrawals using financial derivatives, such as futures, NYMEX Swaps, and/or Basis Swaps as described in *Key Terms and Concepts* Hedging activities are initiated with the intent of mitigating market price risks associated with an existing transaction.

Q. How does SEM hedge a planned storage injection and withdrawal?

A. SEM hedges a planned storage injection by buying a futures contract or NYMEX Swap to lock-in value at a specific trading location. SEM will also buy a Basis Swap, if needed Also, SEM will hedge a storage withdrawal by selling a futures contract or NYMEX Swap and selling a Basis Swap, if applicable.

Q. Can you provide an example?

A. An example of hedging an injection and withdrawal is as follows:

a. Injection Hedge - SEM buys one September futures contract at $4.00

b. Withdrawal Hedge – SEM sells one December futures contract at $5.00

c. Total costs associated with storage injections and withdrawals = $ 40 per mmbtu

d. Expected net margin per mmbtu = ($5.00-4.00-.40) = $.60

e Expected net margin = $ 60 x 10,000 = $6,000

Q. How are these financial transactions valued?

A. In accordance with Financial Accounting Standards Board Statement No. 133 (SFAS 133), these financial hedges are classified as derivatives and valued using Marked-to-Market accounting which requires that changes in value be reflected in SEM's income statement Due to the rescission of EITF (Emerging Issues Task Force) 98-10, physical inventory cannot be valued using Marked-to-Market accounting As a result, inventory is valued using a weighted average cost of gas (WACOG) in accordance with traditional accrual accounting (refer to *Key Terms and Concepts* for the definition of WACOG). Accordingly, due to SEM's required accounting treatment of hedges, there is a timing difference in the recognition of losses associated with these hedges compared to the gains associated with the physical inventory As my testimony will illustrate, this timing difference is eliminated once all the related transactions, including the physical withdrawal of inventory, are settled.

Q. How do SEM's activities create value for sharing with CGC's ratepayers?

A As stated earlier, at the time that SEM plans to optimize CGC's unused capacity, SEM executes several transactions at market prices (same as index prices) to lock-in an expected profit margin that will be shared with CGC once all related

transactions are settled over time. Upon completion of the over-all transaction, the profit margin locked in by SEM is the basis for sharing profits with CGC. SEM manages all transactions and revalues these transactions daily based on market prices as required by governing accounting rules. Tracking shareable profits over time requires aggregating all settled and unsettled components of the deal at any given point in time. Once all legs of the deal are settled, the profit margin is shared fully with CGC.

Q. Is it possible for an over-all transaction to result in a loss?

A. No.

Q. Can you please provide an example of how SEM shares this value with CGC's rate-payers over time?

A Yes

CGC Sharing Example

In September, SEM plans to inject gas into storage and withdraw gas from this facility in December. SEM executes several deals to hedge the economic value identified in these transactions.

Summary of Transactions:

- Total Economic Value of Example #1: $6,920

- Total Economic Value of Example #2: $5,425
- Economic Value of Examples #1 & #2: $12,345

Shareable Value to CGC - $12,345 x 50% = $6,173[1] – This value will be fully recognized and shared once all components of the deals are settled.

[1] Rounded to nearest dollar

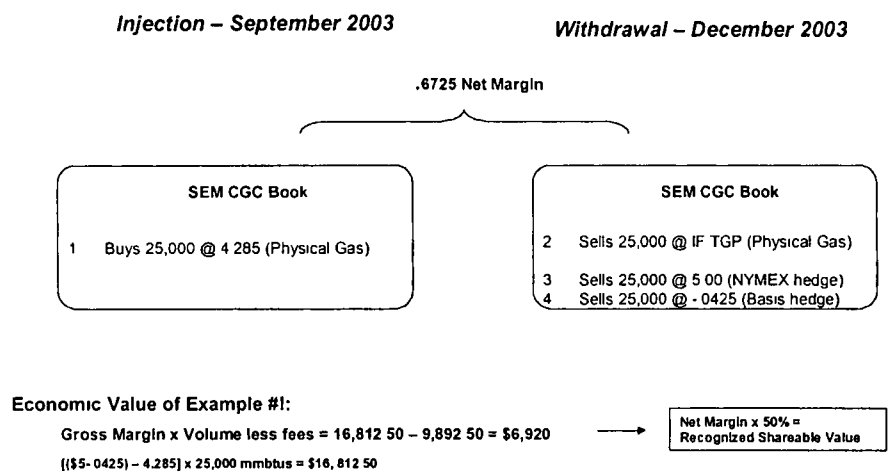
Q. Can you please explain the first example?

A. Yes. The expected economic value of Example 1 is $6,920 on September 19, 2003.

Example #1 Details

- Trade Date – 9/19/03
- Storage Deal Type – Firm Storage Service
- September 2003 Injection
- December 2003 Withdrawal
- SEM buys and injects 25,000 mmbtus at $4.285
- SEM sells a NYMEX Swap – 25,000 at $5 for December
- SEM sells a Basis Swap - 25,000 at $(0425) for December
- SEM will withdraw the physical gas and sell the gas at index in December
- Total fees = $9,892 50

Example # 1



The net margin of the actual injection and planned withdrawal transactions for Example #1 is $6,920 before sharing.

Q. Please elaborate on how SEM values each leg of the deal at different points in time.

A. As noted in this example, SEM identifies and hedges the planned economic value of a transaction immediately. The deals are valued over time and all legs of each deal are settled by December. Here's how Example #1 is valued at different points in time. The economic value of Example #1 is $6,920 on September 19th. The Marked-to-Market value of the financial hedges is zero on this date since the hedges are executed at market prices.

Valuation on Trade Date

Example #1

September 19, 2003

Period	Volume	Price	Deal Type	Market Price	MTM Value	Status	Net Margin
9/20/03	25,000	$4 285	Physical[1]	$0 000	$0	Realized	$0
12/03	(25 000)	Wacog	Physical[1]	$4 958	$0	Unrealized	$0
12/03	(25,000)	$5 000	Fixed Price	$5 000	$0	Unrealized	$0
12/03	(25,000)	($0 0425)	Basis Swap	($0 0425)	$0	Unrealized	$0
							$0

1 Forward Physical Deals can not be valued using MTM due accounting rules

Q. How are these deals revalued over time?

A On September 30th, the financial hedges are revalued by SEM using Marked-to-Market accounting. The physical inventory cannot be valued using this accounting treatment. Therefore, SEM reports a loss at the end of this quarter. The loss of $2,050 on the financial hedge is an unrealized loss on September 30th. As noted in the *Key Terms and Concepts* section, SEM will carry this unrealized loss on the books until December when this hedge is settled. In December, this hedge will be revalued based on settlement prices and the MtM gain or loss associated with this hedge will be reported as a realized gain or loss. SEM carries inventory, the gas in storage, at a cost of $4.285 per mmbtu.

Although SEM records an unrealized loss of $2,050 on September 30th, 50% of

Valuation – end of the 3rd Quarter

Example #1

3rd Quarter Filing

September 19 2003				September 30 2003			
Period	**Volume**	**Price**	**Deal Type**	**Market Price**	**MTM Value**	**Status**	**Net Margin**
9/20/03	25 000	$4 285	Physical[1]	$0 000	$0	Realized	$0
12/03	(25 000)	Wacog	Physical[1]	$5 040	$0	Unrealized	$0
12/03	(25 000)	$5 000	Fixed Price	$5 082	($2 050)	Unrealized	($2 050)
12/03	(25 000)	($0 0425)	Basis Swap	($0 0425)	$0	Unrealized	$0
							($2,050)
						Unrealized Loss	($2 050)
						Total	($2 050)

1 Forward Physical Deals can not be valued using MTM due to accounting rules

this amount is not reported to CGC at this time since the filing is annual as of December 31st.

In December SEM sells 25,000 at index, $4.82. Financial hedges are settled based on published prices and SEM shares 50% of the economic value of Example #1 (50% x 6,920) with CGC.

Valuation on December 31st

Example #1

4th Quarter Filing 

September 19, 2003			September 30, 2003				December 31 ,2003
Period[1]	**Volume**	**Price**	**Deal Type**	**Market Price**	**MTM Value**	**Status**	**Net Margin**
9/20/03	25 000	$4 285	Physical[1]	$0 000	$0	Realized	$0
12/03	(25,000)	$4 285	Physical	$4 820	$13 375	Realized	$13,375
12/03	(25,000)	$5 000	Fixed Price	$4 860	$3,500	Realized	$3,500
12/03	(25 000)	($0 0425)	Basis Swap	($0 040)	($63)	Realized	($63)
							$16,813
						Realized	$16,813
						50% Share before fees	$8,406
						50% of Fees	($4,946)
						Net Shareable Amount	$3 460

1 Forward Physical Deals can not be valued using MTM due to accounting rules

Q. Can you please explain the second example?

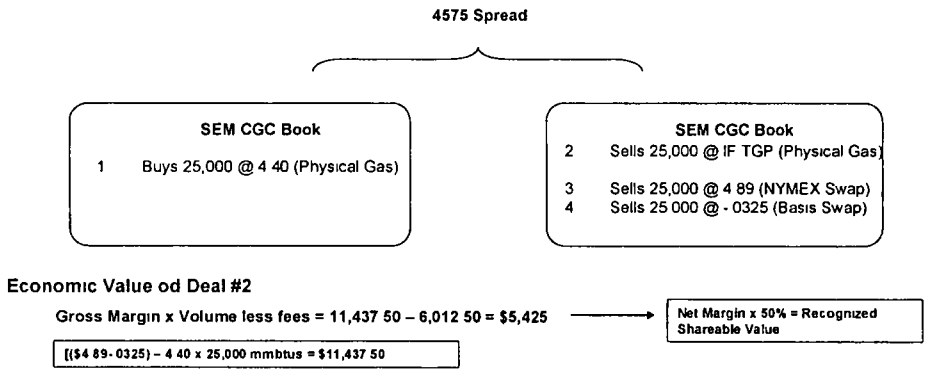
A Yes. The expected economic value of Example #2 is $5,425 on October 30th.

Example #2 Details

- o Trade Date – 10/30/03
- o Storage Deal Type – Firm Storage Service
- o October 2003 Injection
- o December 2003 Withdrawal
- o SEM buys and injects 25,000 mmbtus at $4.40
- o SEM sells a NYMEX Swap - 25,000 at $4.89 for December

- SEM sells a Basis Swap - 25,000 at $(.0325) for December
- SEM will withdraw the physical gas and sell the gas at index in December
- Totals fees = $6,012.50

Example # 2



As shown below, the Marked-to-Market value of Example #2 is $175 on the initial trade date. This unrealized gain is due to the fact that the end of day settlement prices for both the NYMEX and Basis Swaps were slightly different. The deals were executed earlier in the day and market price movements after execution of these transactions were minimal.

Valuation on Trade Date

Example #2

October 30, 2003

Period	Volume	Price	Deal Type	Market Price	MTM Value	Status	Net Margin
10/30/03	25 000	$4 400	Physical[1]	$0 000	$0	Realized	$0
12/03	(25 000)	Wacog	Physical[1]	$4 851	$0	Unrealized	$0
12/03	(25 000)	$4 890	Fixed Price	$4 893	($75)	Unrealized	($75)
12/03	(25 000)	($0 0325)	Basis Swap	($0 0425)	$250	Unrealized	$250
							$175

1 Forward Physical Deals can not be valued using MTM discounting rules

Q. What is the cost of the physical gas used in Examples 1 and 2?

A Since SEM has bought more physical gas and injected this gas into storage on October 30th, the gas in inventory will be tracked at cost using a WACOG price (refer to *Key Terms and Concepts)*. Using this accounting methodology yields the following calculation for the cost of gas in storage as follows:

Portfolio Example
Examples #1 & #2

WACOG Calculation Example on October 30, 2003

	Volume	Price	Notional Value
Example #1	25,000	$4 285	$107,125
Example #2	25,000	$4 400	$110,000
Total	50,000		$217 125

Portfolio WACOG $4 343 [1]

[1] Rounded to three decimal places

Q. Can you please explain how this affects value generated in Examples 1 and 2?

A. In December SEM withdraws physical gas in the amount of 50,000 mmbtus. The cost of the gas withdrawn from inventory is $4.343 per mmbtu (refer to WACOG discussion in *Key Terms and Concepts).* SEM sells this gas at an index price of $4 82. The financial hedges are also settled in December based on published index prices. Since all gas has been withdrawn from storage and all hedges have been settled, SEM's books reflect realized physical and financial margins. SEM shares 50% of total realized margin with CGC, $6,173, upon settlement of all deals as follows:

Portfolio Example

Examples #1 & #2

December 31 ,2003

Period	Volume	Price	MTM Price	Type	Status	Net Margin	
12/03	50 000	$4 343		Inventory	Realized	($217,125)	
12/03	(25 000)	$4 820		Physical Sale	Realized	$120 500	
12/03	(25,000)	$4 820		Physical Sale	Realized	$120 500	
12/03	(25 000)	$5 000	$4 860	Fixed Price	Realized	$3 500	
12/03	(25 000)	$4 890	$4 860	Fixed Price	Realized	$750	
12/03	(25 000)	($0 0425)	($0 0400)	Basis Swap	Realized	($63)	
12/03	(25 000)	($0 0325)	($0 0400)	Basis Swap	Realized	$188	
						$28 250	Gross Margin brfore Fees

1 Forward Physical Deals can not be valued using MTM due to accounting rules

Portfolio Valuation at Settlement

Examples #1 & #2

December 31 ,2003

Realized Margin	$28,250	
	$28,250	
50% Share before Fees	$14,125	
50% of Fees (Examples 1 & 2)	($7 952)	
Net Shared Amount	$6,173	Note 1

Note 1 – Rounded to nearest dollar

As this portfolio example proves, SEM shares 50% of the economic value of executed deals with CGC. Marked-to-Market will always equal accrual accounting by the end of the settlement period of all deals.

Q. Please explain how these transactions and SEM's accounting practices sometimes cause CGC to report negative amounts even though the over-all transaction results in a gain.

A. As shown in this example, if SEM prepares and files an annual filing to CGC prior to settlement of all deal components, the reported values may reflect a negative amount for a given leg of a transaction. In addition, individual deal components must be analyzed in conjunction with all related transactions to derive the correct economic value at any given point in time.

Q **Does this explain why CGC's December 2003 IMCR Report reflected "Unrealized Losses, net of $2,257,061."**

A. Yes. As discussed earlier, based on accounting rules, SEM must value all financial derivatives using Marked-to-Market accounting (refer to *Key Terms and Concepts*). These unrealized losses, ($2,257,061), represent the net estimated market value of hedges for the months of January 2004 forward on December 31, 2003 Due to SEM's required accounting treatment of hedges, there is a timing difference in the recognition of losses associated with these hedges compared to the gains associated with the physical inventory This timing difference is eliminated once all the related transactions, including the physical withdrawal of inventory, are settled. As shown in these examples, all hedges are revalued using

current market prices. The value of hedges is based on the appropriate contract month of the transaction.

The net unrealized losses reported in December 2003 will be an add-back in the annual 2004 filing since this amount represents an estimate of all unsettled hedges. In the December 2004 filing, SEM will recognize and report actual gains and/or losses associated with financial hedges for January 2004 through December 2004.

Q. Does this conclude your testimony?

A. Yes