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April 18, 2005

HAND DELIVER

Mr. Pat Miller, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

Re: Nashville Gas Company's Response to the Utilities Division's Incentive Plan Account Audit Report--TRA Docket No. 04-00290

Dear Mr. Miller:

Enclosed are an original and thirteen copies of Nashville Gas Company's Response to the Utilities Division's Incentive Plan Account Audit Report.

Please contact me if you have any question concerning these responses.

Very truly yours,

George H. Masterson

GHM:ch
Enclosure
cc: Hon. Sara Kyle (w/o enclosure)
Hon. Ron Jones (w/o enclosure)
Hon. Debi Tate (w/o enclosure)
Randal Gilliam, Esq. (w/o enclosure)
Timothy C. Phillips, Esq. (w/ enclosure)
Richard Collier, Esq. (w/o enclosure)
Darlene Stanley (w/o enclosure)
James H Jeffries, IV, Esq. (w/ enclosure)
R. Dale Grimes, Esq. (w/ enclosure)

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BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

IN RE:	)	
	)	
NASHVILLE GAS COMPANY, A	)	
DIVISION OF PIEDMONT NATURAL	)	**DOCKET NO. 04-00290**
GAS COMPANY, INC. INCENTIVE	)	
PLAN ACCOUNT (IPA) AUDIT	)	

NASHVILLE GAS COMPANY'S RESPONSE TO THE UTILITIES DIVISION'S INCENTIVE PLAN ACCOUNT AUDIT REPORT

Nashville Gas Company, a division of Piedmont Natural Gas Company, Inc ("Nashville Gas" or the "Company"), respectfully submits the following response to the March 4, 2005 *Notice of Filing By Utilities Division of the Tennessee Regulatory Authority* ("Staff Audit Report" or "Report") in the above-captioned docket. The purpose of this response is to address the findings, conclusions and recommendations of the Utilities Division ("Staff") related to the propriety of including asset management fees under the Capacity Management Incentive Mechanism of the Company's Service Schedule No 316[1] and related issues, and the Staff's proposal to hire a consultant to assist Staff with future Incentive Plan audits

For the reasons described herein, Nashville Gas respectfully requests that the Tennessee Regulatory Authority ("Authority") disallow Staff's proposed adjustment to the Company's Incentive Plan Account and authorize the Company to continue to operate under its approved Incentive Plan, including the incorporation of fees from asset management arrangements in the Incentive Plan Account, as it has operated with Authority approval for several years In the alternative, and to the extent the Authority finds it necessary or proper, the Company requests that the Authority approve its revised Service Schedule No. 316 attached hereto as Exhibit A in order to clarify that asset management arrangements are authorized

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[1] Staff refers to Nashville Gas' Incentive Plan mechanism as Service Schedule No 14 That numbering has been superceded and the current approved number for the Company's Plan is Service Schedule No 316

transactions under the Capacity Management Incentive Mechanism of the Company's Plan.[2] The Company takes no position on the Staff's proposal to hire an outside consultant to assist in the audit of the Company's Incentive Plan except to note that under the Company's view of the proper scope of such an audit, such assistance may not be necessary

EXECUTIVE SUMMARY

In its Report, Staff recommends that the Authority (1) disallow the inclusion of $620,402 in asset management fees and related interest attributable to the twelve-month period ending June 30, 2004 in the Company's Incentive Plan Account, (2) suspend the operation of Nashville Gas' Incentive Plan pending the outcome of a separate docket to investigate whether asset management fees should be included under the Company's Plan or other changes should be made to the Plan; and (3) consider engaging a consultant to assist Staff in its audit of the Company's Incentive Plan Account going forward Staff's first and second recommendations are based on its conclusion that the Company's existing Incentive Plan does not provide for the inclusion of asset management fees in the Incentive Plan Account and concerns over the scale, transparency, and allocation of risk associated with asset management transactions

Nashville Gas disagrees with Staff's principal recommendations and submits that the inclusion of asset management fees in the Company's Incentive Plan Account is appropriate on a number of grounds and does not require further investigation. First, the inclusion of these fees in the Incentive Plan Account is authorized by the language of the Company's Plan because the underlying asset management transactions constitute a form of bulk capacity release and are consistent with both current market practices and the goals of Nashville Gas' approved Plan. Second, inclusion of these fees in the Incentive Plan Account is supported by a number of prior recommendations by Staff and rulings by the Authority which have authorized

[2] Nashville Gas does not request an evidentiary hearing in this docket as it believes that this Response and the accompanying documentation provides a clear and convincing record upon which the Authority can resolve this matter To the extent the Authority establishes a separate docket for the investigation of Staff's concerns, as Staff has requested, Nashville Gas reserves its right to participate fully in that

both the inclusion and sharing of these revenues under the Capacity Management Incentive Mechanism of the Company's Plan Third, the Staff's concerns over the transparency, allocation of risk, and scale of asset management transactions are based on misperceptions of how the market for natural gas capacity operates and what can (and cannot) be known about that market and the effect of asset management arrangements under the Company's Plan For these reasons, the Staff's recommendation to disallow inclusion of asset management fees in the IPA and to initiate an investigation of these fees in a separate proceeding should be declined.

In the event that the Authority finds that some ambiguity exists in the Company's Incentive Plan, and further finds that resolution of that ambiguity would be in the public interest, the Company requests that the Authority approve revised Service Schedule No. 316 attached hereto as Exhibit A which adds language to expressly reference asset management transactions Such action would eliminate the basis for Staff's concerns by expressly providing for the inclusion of asset management fees in the Company's Incentive Plan Account and would resolve the issues raised by Staff in its recent audit report and the similar concerns raised in last year's annual audit report.

The Company takes no substantive position as to whether Staff should be permitted to hire an independent consultant to assist in future Incentive Plan Account audits

BACKGROUND

Nashville Gas filed its request for approval of a natural gas Performance Incentive Plan on April 22, 1996. The purpose of the Plan was to replace the annual gas cost prudence review process with an incentive plan designed to align the Company's interests with those of its ratepayers by giving the Company an economic incentive to minimize gas costs. Nashville Gas' Incentive Plan proposal was approved on a two-year experimental basis by the Tennessee Public Service Commission by Order dated May 31, 1996. In the Commission's Order

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proceeding including the right to take discovery, present evidence and cross-examine witnesses approving the Plan, the Commission directed Nashville Gas and the Staff to recommend a qualified independent consultant to review the progress of the Plan and to report to the Commission annually on their conclusions. The Company and Staff selected Andersen Consulting to analyze the results of the Plan for the two-year experimental period.

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

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

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

Since the date of the Authority's *Order Approving Performance Incentive Plan*, Nashville Gas has operated that Plan in accordance with its terms During this period, Nashville and its customers have both benefited from the more than $17 million in gas cost savings generated under the Plan. For the last several years, Nashville Gas has utilized asset management arrangements in order to secure additional savings under the Plan. Under these asset management arrangements, marketing companies provide guaranteed payment to Nashville Gas for the right to manage Nashville's capacity portfolio for a specified period of time and simultaneously agree to provide Nashville's citygate delivery needs up to the Company's maximum daily quantity rights

Since 1999, the Staff has conducted an annual audit of Nashville Gas' Incentive Plan to determine if the amounts recorded under the Plan were correct While these audits have resulted in some relatively minor adjustments in various account balances, they have not sought to examine or change any fundamental aspect of the Plan or to raise issues about the underlying public interest of the Plan. In these audits, Staff has specifically approved Nashville Gas' use of asset management arrangements and have credited such arrangements with substantial increases in ratepayer savings under the Plan [3]

In its audit of the twelve-month period ending June 30, 2003, in Docket No 03-00489, Staff changed its approach and recommended that the Company's Plan be suspended based on concerns over issues related to asset management transactions The factors underlying the Staff's recommendations included concerns over documentation of minor aspects of the asset management request for proposal ("RFP") process and the propriety of including the asset management fee in the Incentive Plan. Nashville Gas opposed the recommendation to suspend its Plan and after several filings by the parties in that docket, the Authority ultimately ordered the Company to make proposals to cure several perceived weaknesses in the Company's administration of its Incentive Plan, including procedures related to the utilization of asset managers. The Company subsequently filed its corrective proposals on June 17, 2004. In that filing, the Company did not propose any change in its accounting of asset management fees nor did it propose to fund a consultant to assist Staff in its audit of the Company's Plan. The Company's proposals were accepted by the Staff in a filing made on August 5, 2004, however, Staff continued to assert in that filing that a further investigation was needed to determine whether asset management fees should be included in the Company's Incentive Plan Account and whether a consultant should be hired to assist Staff in future Incentive Plan audits. The Company responded on August 13, 2004 arguing that no further proceedings were necessary to

[3] See April 4, 2001 *Notice of Filing by Energy and Water Division of the Tennessee Regulatory Authority* in Docket No 00-00759 at p 3

determine if the inclusion of asset management fees in the Incentive Plan Account was proper and indicating its belief that the issue of hiring a consultant was a matter for determination between Staff and the Authority On February 4, 2005, the Authority issued its *Order Accepting Company's Proposed Improvements to Company's IPA* in Docket No. 03-00489 in which it accepted Nashville Gas' proposed improvements to its Incentive Plan practices. In accepting these improvements, the Authority took no action on Staff's recommendations to initiate a further investigation into asset management fees or the hiring of a consultant to assist Staff in future audits [4]

Exactly one month later, on March 4, 2005, Staff issued its Report on Nashville Gas' 2004 Incentive Plan Audit in this docket. That Report found no mathematical discrepancies in the Company's Incentive Plan Account but resurrected the two Staff proposals the Authority declined to approve in Docket No. 03-00489. (1) suspension of the Incentive Plan and the initiation of a separate docket to investigate inclusion of asset management fees in the Company's Incentive Plan Account; and (2) the hiring of a consultant to assist Staff in future Incentive Plan audits The Report also proposed an adjustment in the Company's Incentive Plan Accounts to remove the Company's allocated share of asset management fees collected during the audit period The Company's responses to the Staff's renewed proposals in this regard are set forth below.

DISCUSSION

I. STAFF'S PROPOSAL TO INITIATE AN INVESTIGATION OF THE INCLUSION OF ASSET MANAGEMENT FEES IN THE COMPANY'S INCENTIVE PLAN ACCOUNT IS UNWARRANTED AND DUPLICATIVE OF STAFF'S POSITION IN DOCKET NO. O3-00489.

[4] While the Authority did not expressly reject Staff's asset management fee and consultant issues in Docket No 03-00489, a reasonable interpretation of the Authority's February 4, 2005 Order is that the Authority did not find those concerns sufficient to warrant the initiation of a separate investigation of those matters To the best of Nashville Gas' knowledge, nothing has occurred between February 4, 2005 and March 4, 2005 that would support a change in that conclusion

In its Report, Staff challenges the practice of including asset management payments received by the Company in the Incentive Plan Account and questions whether various aspects of the Company's Plan should be revisited by the Authority Staff further recommends that the Authority suspend Nashville Gas' Incentive Plan pending the completion of a separately docketed investigation into asset management fees and related issues Nashville Gas believes that adoption of the Staff's recommendations would be contrary to the Authority's prior findings regarding Nashville Gas' Incentive Plan including its recent Order in Docket No 03-00498, that the Staff's concerns over inclusion of asset management fees under the Incentive Plan mechanism are not well-founded, and that the Staff has failed to provide any evidence of actual or even potential ratepayer harm that could result from the Plan's operations. As such, Nashville Gas respectfully submits that the Staff's proposals in this regard should be dismissed and its approved Incentive Plan mechanism should be allowed to continue to operate to the benefit of ratepayers and the Company.

A. Staff's Recommendations Are Contrary to the Intent and Language of the Incentive Plan and Inconsistent with Prior Precedent and Findings of this Authority.

Staff argues that the Company's Plan does not make express reference to asset management arrangements and, therefore, the inclusion of fees from such arrangements in the sharing mechanism under the Plan is not permitted. This view is based on an overly restrictive reading of the Plan language and ignores substantial precedent that supports inclusion of these fees in the Incentive Plan Account.

While it is true that the words "asset management" do not appear in the Company's Service Schedule No 316, that tariff does provide that the purpose of the Capacity Management Incentive Mechanism under the tariff is "to encourage Nashville to actively market off-peak unutilized transportation and storage capacity on upstream pipelines in the secondary market" The tariff further provides that "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 . . . ." Under the Company's asset management practices to date, the Company has done exactly what was intended by and described in the tariff. Specifically, Nashville Gas has released upstream transportation and storage rights under the Federal Energy Regulatory Commission's capacity release regulations to a third-party for utilization in the secondary market and has received compensation in exchange.[5] In turn, Nashville Gas has credited that compensation to the Incentive Plan Account The fundamental difference between an asset management arrangement and a capacity release transaction with respect to the operation of the Incentive Plan is that asset management arrangements cover a broader spectrum of capacity rights and are tantamount to a bulk one-time release of upstream capacity into the secondary market for a specified period rather than smaller individual transactions. The "bulk" nature of this transaction makes the released capacity more valuable than it would be if the underlying capacity were released in individual transactions. It is for this reason that asset management arrangements result in higher payments to the Company than could be obtained under a series of individual releases The scale of the release of upstream capacity rights under an asset management arrangement does not change the essential character of the release, however, and that character is no different than that of a single capacity release transaction Accordingly, Nashville contends that asset management arrangements fall squarely within the purpose and intent of Special Schedule No. 316 and that the language of that tariff does not in any way prohibit inclusion of the fees from such arrangements in the sharing mechanism under the Incentive Plan notwithstanding the lack of a specific reference to "asset management" in the tariff.

The Staff's assertions are also contrary to the prevailing precedent and practice of the Authority. Nashville Gas has been engaging in asset management transactions since 1999.

[5] This release is conducted in exactly the same manner and subject to the same federal regulations that would apply to individual release transactions

Each such transaction has been included under the Incentive Plan sharing mechanism, reported to and approved by the Authority under the exact language currently set forth in Special Schedule No 316.[6] These transactions have dramatically increased the gains experienced by ratepayers (and the Company) under the Company's Incentive Plan.[7] In fact, in the Staff's report on Nashville Gas' Incentive Plan activities for the year ended June 30, 2000, the Staff stated:

> The capacity release portion of the Capacity Management Mechanism generated significantly greater savings this plan year as compared to last year Last year's savings was $11,510. The $1,650,000 savings for this year was the result of Nashville Gas assigning its pipeline capacity to an "asset manager".[8]

This use of asset management arrangements by the Company has been approved repeatedly by both the Staff and the Authority since 1999 and the Company's use of such arrangements this year does not vary materially from its past practices, except where modified to comply with Plan practice improvements authorized by the Authority in Docket No. 03-00498 Further, nothing in the Staff's Audit Report this year suggests that Nashville Gas has varied from the terms of its Incentive Plan or engaged in activities that have been harmful to ratepayers In fact, the total savings realized from the Incentive Plan for the audit period are higher than ever before and total in excess of $3 5 million.[9] Moreover, the Authority has recently declined to act on virtually identical recommendations made by Staff in Docket No. 03-00498 This history of approved asset management transactions by the Company establishes a significant hurdle for Staff to clear in order to establish that some other result should apply in this period than has applied in all prior periods where asset management fees were included under the Company's Incentive Plan Account. In the Company's view, Staff has not cleared this hurdle because it has

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[6] These transactions were also consistently approved by Staff until last year when Staff raised concerns over whether the Plan language covers such transactions

[7] This is illustrated by Exhibit K to the Affidavit of Keith P Maust filed in Docket No 03-00498 and incorporated herein by reference, as well as by the Staff Audit Report in this proceeding, which collectively show that gains under the Plan increased dramatically beginning in 2000 when Nashville Gas began to use such arrangements and have continued since that time

[8] *Notice Of Filing By Energy and Water Division of the Tennessee Regulatory Authority*, Docket No 00-00759 (April 4, 2001)

not offered any evidence in this proceeding that would provide a material basis for the Authority to reverse course on its treatment of asset management fees.

Based on these factors, Nashville Gas respectfully submits that the inclusion of asset management fees in the Company's Incentive Plan Account is authorized under the provisions of Service Schedule No. 316 and is consistent with the substantial and uniform precedent permitting the inclusion of these fees in the Company's Incentive Plan Account during prior periods

B. <u>The Staff's Concerns Over Operation of the Company's Plan Are Not Well-Founded</u>.

In its Report, Staff voices several concerns regarding the purported characteristics of asset management arrangements including assertions that: (1) utilization of an outside manager does not permit a determination of the savings obtained through utilization of an asset management arrangement, (2) incentive plans should entail risk and asset management arrangements do not; (3) asset management arrangements are not transparent and cannot be audited; and (4) asset management arrangements entail less accounting than individual capacity release transactions. Nashville Gas believes that Staff's positions on these points misperceive the character of asset management arrangements and the proper scope of the Staff's audit authority.

First, Nashville Gas submits that the calculation of savings under an asset management arrangement is identical to the calculation of savings under an individual capacity release transaction Savings in both circumstances are, quite simply, the amount a willing buyer in the marketplace is willing to pay for the Company's unutilized upstream capacity rights The difference between the two arrangements is the asset manager's capacity usage rights are secondary (after Nashville Gas' needs are met), but are primary under an individual capacity release transaction absent an asset management arrangement Under a competitive bid

[9] See Staff Audit Report at p 3

process such as that utilized by Nashville Gas, potential buyers are able to compete for the right to utilize the Company's unneeded upstream capacity on a secondary basis through the submission of bids during the RFP process. During this audit period, as was the case with prior audit periods, Nashville Gas contracted with the winning qualified bidder for the use of this capacity and the full amount of the proceeds obtained from the bidder were credited to the Company's Incentive Plan Account. As a result, the savings realized through the use of asset management arrangements during the audit period were market based and clearly discernible

Second, the risk to the Company under an asset management arrangement is not the appropriate test for whether the Company's Incentive Plan contains an element of risk. Instead, the risk justifying the adoption and continuation of the Incentive Plan is the Company's overall exposure to the absorption of commodity or capacity costs if the Company is unable to manage its aggregate capacity and commodity transactions such that end-of-period costs are at or below the index values utilized under the Plan. Presumably it is no surprise to the Authority that the Company seeks to engage in transactions under the Plan that will result in net savings (for its benefit and the benefit of its ratepayers) because that is the entire purpose of the Incentive Plan Further, it should not be a surprise that the Company would not knowingly enter into a transaction if it was clear that such transaction would result in net costs rather than net savings [10] Given these facts, it is not clear to the Company why Staff appears to believe that asset management arrangements must contain some degree of risk in order to come under the Plan.

Third, the Company does not agree that asset management transactions are not transparent and cannot be audited To the contrary, all phases of such transactions can be audited beginning with the list of bidders maintained by the Company and ending with the release of capacity by the Company. In between, the Staff can review the RFP issued by the

[10] This statement is as applicable to individual capacity release transactions as it is to asset management transactions

Company, all bids received in response to the RFP, the contract terms agreed to between the Company and the asset manager, the scope of capacity rights released, the duration of the release and the amount paid for such release. These are exactly the same types of information available in individual capacity release transactions without asset management arrangements The Staff appears to believe that it should also be able to discern to what purpose asset managers put the secondary capacity rights they purchase. This assertion is somewhat puzzling to the Company, however, because neither the Company nor the Staff are in a position to require disclosure of such information as it constitutes the proprietary business information of the purchaser This is true whether the transaction involved is a bulk asset management deal or an individual capacity release. Further, the Company is unaware of any circumstance in which a purchaser of upstream capacity rights is required to divulge the details of his use of such capacity In short, and in the Company's view, the Staff's audit inquiry properly ends at the moment the upstream capacity is released by the Company to a willing buyer in a competitive market. Under this view, the asset management transactions engaged in by the Company are entirely transparent and subject to audit

Finally, the Company does not perceive how the amount of accounting associated with a particular transaction is probative as to whether that transaction falls within the Company's Incentive Plan or whether the fees obtained from that transaction should be included in the Incentive Plan Account. In the absence of further support for this observation by the Staff, the Company submits that the accounting burden associated with any particular type of capacity release transaction is not relevant to a determination as to whether such a transaction should be included under the Company's Incentive Plan.

In sum, the individual concerns expressed by Staff with regard to the purported attributes of asset management transactions do not support exclusion of those arrangements from the Company's Incentive Plan or raise public interest concerns regarding the inclusion of fees attendant to those transactions in the Incentive Plan Account

C. The Staff Has Presented No Evidence That Supports Revisions to the Major Components of the Company's Incentive Plan.

In its Report, Staff suggests that it may be appropriate to re-examine major components of the Company's Incentive Plan including the savings sharing ratios between the Company and its customers and the cap on the Company's recovery of Plan savings The basis for this suggestion is the Staff's perception of changes in the natural gas wholesale markets The Company does not agree that the substantive components of its Incentive Plan should be revisited and perceives no evidence presented by the Staff that would raise a material issue with respect to the public interest inherent in the operation of the Plan. As such, Nashville Gas submits that no revisions to the Plan are necessary or should be entertained at this time

The current Incentive Plan was adopted by the Tennessee Public Service Commission on an experimental basis and ratified by this Authority on a permanent basis after substantial review and evaluation by both the interested regulatory authorities and outside consultants over a relatively protracted period. It represents a carefully balanced and intricate mechanism for aligning the economic interests of the Company and its ratepayers and of allocating risk and reward between these parties. Unexamined or casual modifications to the Plan could easily have dramatic impacts on performance and should not be made except where required by the public interest and where the need for modification is clearly demonstrated

The wisdom exercised in crafting the existing parameters of the Plan is plainly evident in the highly beneficial nature of the Plan's operations since its inception. Those operations have resulted in overall gas cost and capacity savings in excess of $17 million dollars and net savings to customers of almost $10 million, with savings the last two years of approximately $3 5 million dollars per year. Ironically, it appears to be the recent success of the Plan that has prompted Staff to raise its concerns notwithstanding the fact that performance at the current level was clearly contemplated under the Plan. This is evidenced by the fact that the Company's recent performance is in the neighborhood of the sharing cap established in the Plan, which was established at a time when both the Company's customer count and the commodity cost of gas were substantially lower than they are today.

In its filing, the Staff has not cited any evidence that would support the conclusion that modification of the Incentive Plan is required at this time In the absence of such evidence and in light of both the careful and protracted process that resulted in the Plan's current terms and the excellent performance of the Plan since its inception, Nashville Gas respectfully submits that it would be inappropriate to explore modification of substantial components of its Incentive Plan at this time.

II. STAFF'S PROPOSAL TO MAKE AN ADJUSTMENT OF $620,402 IN THE COMPANY'S INCENTIVE PLAN ACCOUNT FOR THE TWELVE-MONTH PERIOD ENDED JUNE 30, 2004 SHOULD BE REJECTED.

Staff proposes that an adjustment to the Company's Incentive Plan Account be made to remove the Company's share of asset management fees collected during the audit period This proposal is entirely dependent upon the conclusion that such fees are not properly included under the Company's Incentive Plan mechanism; however, unlike Staff's proposal to investigate asset management fees in a new docket, this proposal to adjust the Company's Incentive Plan Account for the audit period would have effect in this docket if granted. The Company strongly disagrees with the notion that the Authority should make an after-the-fact adjustment to the Company's Incentive Plan Account to eliminate asset management fees allocable to Nashville Gas and included in that account for the period covered by Staff's audit.

As a regulated Tennessee natural gas utility, Nashville Gas is obligated to abide by the lawful decisions and policies of the Authority with respect to recovery of its gas costs and gas cost related expenses In this case, those policies are established in the Company's approved Incentive Plan and by the Authority's decisions approving prior period audits and practices (which have consistently permitted inclusion of asset management fees in the Company's Incentive Plan Account) Nashville Gas' operations under the Incentive Plan during the audit period in this proceeding were completely consistent with its approved Plan and with prior

Authority decisions allowing the inclusion of asset management fees in the Company's Incentive Plan Account.[11]

As such, it would be fundamentally unfair (and unlawful) for the Authority to change its policies after the end of the audit period and then apply those changes to the Company's prior conduct during the audit period Under such a regulatory approach, Nashville Gas would be effectively charged with responsibility for compliance with a policy that did not exist until after the relevant period was closed and which could not have been ascertained by the Company during the time action would have been required to comply with the policy. While Staff appears to argue that such an adjustment would be justified because the Company had notice of Staff's position on asset management fees during the review period, this argument ignores the fact that this Authority (and not Staff) is the ultimate arbiter of what can and cannot be done under the Company's Incentive Plan and that changes in Authority policy are not effective until adopted by the Authority It further ignores the fact that Staff squarely raised this exact issue in Docket No 03-00489 and the Authority declined to adopt Staff's position in that proceeding, and that the Commission approved certain measures in Docket No. 03-00489 specifically designed to improve the asset management RFP process (which begs the question as to why the Authority would expressly approve improvements to a practice that is not authorized under the Incentive Plan) It is patently unreasonable for Staff to contend that the Company should have anticipated that the Authority would subsequently conclude that asset management fees are not authorized by the Company's Incentive Plan and adjusted its behavior accordingly. It is also unreasonable to contend that the Company should bear the economic consequences of an *ex post facto* application of what is even now only a proposed change in Authority policy. In the Company's view, it is difficult to imagine a more unfair, arbitrary or capricious form of regulation than that

[11] Nashville Gas would note in this regard that the Authority has allowed the inclusion (and sharing) of asset management fees under the Company's Incentive Plan for at least the last 4 years and that the improvements to the Company's Incentive Plan practices approved by the Authority in Docket No 03-00489 included alterations of the Company's asset management RFP processes

which would result from acceptance of the Staff's proposed adjustment to Nashville Gas' Incentive Plan Account for the period ending June 30, 2004.

III. IN THE COMPANY'S VIEW, THE PROPER SCOPE OF THE STAFF'S AUDIT SHOULD BE LIMITED RATHER THAN OPEN-ENDED.

As was the case in Docket No. 03-00489, Staff and Nashville Gas have an apparent disagreement over the proper scope of an Incentive Plan audit. Nashville Gas believes that the fundamental purpose of an Incentive Plan audit should be to test the Company's accounting of gas and capacity costs and savings under its Incentive Plan.[12] Staff's description of the scope of its audit is consistent with the Company's view.

> The objective of the audit is to determine whether the balance in the Incentive Plan Account as of June 30, 2004 is calculated in conformance with the terms of the Company's Incentive Plan and to verify that the factors utilized in the calculations were supported by appropriate source documentation.[13]

Notwithstanding this limited description of the audit scope, Staff has raised issues in its Audit Report that go to the substantive terms of the Plan itself – such as whether terms and/or practices allowing inclusion of asset management fees, setting sharing percentages, or establishing sharing caps -- should be modified. In the Company's view, this type of recommendation is well beyond the scope of what could fairly be described as an audit because it challenges approved provisions of the Plan itself rather than testing compliance with those provisions.

Staff appears to believe that an audit should encompass all aspects of an Incentive Plan, including the right to challenge substantive aspects of the Plan itself In this case, Staff recommends that core terms such as the ratepayer/company sharing ratio and the cap on the Company's right to share in savings should be examined In defense of its position, Staff cites the Authority's right to modify, amend or terminate the Plan and argues that this right permits a wide-ranging investigation into all aspects of an approved Incentive Plan as part of the annual

[12] Webster's Ninth New Collegiate Dictionary (1987) defines "audit" as "a formal examination of an organization's or individual's accounts or financial situation "

audit process. Nashville Gas does not dispute that the Authority has jurisdiction to modify, amend or terminate the Company's Incentive Plan upon appropriate proceedings and evidence, nor does the Company dispute the Staff's right, acting in its advisory capacity, to recommend such a course The Company does dispute that such discretion is properly exercised in the course of annual audit proceedings, however, because in that circumstance, those annual proceedings become something akin to a yearly "prudence" type review of the Plan and its operations which is contrary to the express intent of the Plan [14]

In Nashville Gas' view, the Staff's proposed approach to an Incentive Plan audit is also inconsistent with the context in which the Company's Incentive Plan was adopted That context included adoption of the Plan after a two-year experimental period following evaluation and a positive recommendation by an outside consultant It also involved the purposeful abandonment of annual gas cost review proceedings in favor of a less regulated incentive type mechanism designed to align the interests of ratepayers and Nashville Gas This mechanism has performed well since its adoption and the Staff has presented no evidence in this proceeding that ratepayers have been harmed in any way by operation of the Plan during the period covered by its audit. Under the Staff's proposal, each and every term of the Company's approved Incentive Plan would be fair game each and every year in the audit proceeding thereby dramatically expanding both the historically limited scope of Staff audits and the burden associated with conducting such reviews. Staff's approach to annual review of the Incentive Plan's terms also creates potential for negative impacts on the Plan's performance and a corresponding potential detriment to Nashville Gas and its customers. Based upon these factors, the Company simply disagrees that the approved Incentive Plan reflected in Service

[13] Staff Audit Report at p 1

[14] The very first sentence of Nashville Gas' Incentive Plan states "The Performance Incentive Plan <u>replaces</u> the reasonableness or prudence review of Nashville Gas Company's gas purchasing activities overseen by the Tennessee Regulatory Authority "

Schedule No 316 should be subject to a substantive review of its core terms in each and every annual audit conducted by the Staff.

IV. THE COMPANY TAKES NO POSITION ON STAFF'S PROPOSAL TO HIRE A CONSULTANT.

As was the case in Docket No. 03-00489, Nashville Gas takes no substantive position on Staff's proposal to hire an independent consultant to assist in future audits of the Company's Incentive Plan. In this regard, however, Nashville Gas would note that the Staff's request for additional expert help in conducting future Incentive Plan audits appears to be reflective of their view of an expanded audit role. It may be that no additional expert knowledge would be needed to simply determine if the balances in the Incentive Plan Account are correctly calculated consistent with the terms of the Incentive Plan Inasmuch as Staff proposes that expenses associated with a consultant would be collected from ratepayers, the Company has no direct economic interest in this issue and believes that the issue is primarily a matter between the Authority and its Staff In making its determination on this matter, however, the Company believes that the Authority should consider both the proper scope of a Staff audit and the additional economic burden placed on customers under the Staff's proposal.

V. STAFF'S RECOMMENDATION THAT NASHVILLE GAS' INCENTIVE PLAN BE SUSPENDED SHOULD BE REJECTED.

Nashville Gas' Performance Incentive Plan has been in place for more than eight years. During that period it has generated more than $17 million in savings, almost $10 million of which has been credited directly to ratepayers. It has been evaluated by an independent consultant, by the Tennessee Public Service Commission and by the Tennessee Regulatory Authority. In each case, it has been found to be prudent, operationally efficient and in the public interest. During the last eight years, it has been a significant contributor to maintaining the affordability of natural gas service within Nashville Gas' service area Staff's primary issue in this docket hinges on what appears to be an issue of semantics – whether the existing tariff language covers fees derived from asset management transactions The Company believes that it does whereas the Staff questions that conclusion If the Plan is suspended pending an investigation of asset management fees and related issues, ratepayers and the Company will suffer substantial and unrecoverable economic loss through higher rates for natural gas service because of the inability to rely on the Plan to engage in asset management transactions in the interim No one will benefit from such a suspension. The Staff has presented no evidence that such a result is necessary to protect ratepayer interests. In light of these factors, as discussed more fully above, Nashville Gas submits that it would be unreasonable and contrary to the public interest to suspend the operation of the Company's Incentive Plan in these circumstances. As such, Nashville Gas urges the Authority to reject the Staff's recommendation to this effect To the extent the Authority believes it is necessary or appropriate to clarify the Company's Incentive Plan in order to resolve Staff's concerns, Nashville Gas requests that the Authority approve the revised Service Schedule No 316 attached hereto as Exhibit A

CONCLUSION

For the reasons set forth above, Nashville Gas respectfully requests that the Authority reject the findings, conclusions and recommendations contained in the Staff Audit Report and discussed above and approve the continuation of Nashville Gas' Performance Incentive Plan in accordance with its tariff. In the alternative, Nashville Gas requests that the Authority approve the revised Service Schedule No. 316 attached hereto as Exhibit A.

This the 18th day of April, 2005

George Masterson

R Dale Grimes
George Masterson

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CERTIFICATE OF SERVICE

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

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

This the 18th day of April, 2005.

George Masterson

EXHIBIT A

SERVICE SCHEDULE NO. 316

SERVICE SCHEDULE NO. 316
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

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

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

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

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.

P = the *Inside FERC Gas Market Report* price index for the first-of-the-month edition for a geographic pricing region, where subscript 0 denotes Tennessee Gas Pipeline (TGP) Rate Zone 0; subscript 1 denotes TGP Rate Zone 1; subscript C denotes Columbia Gas Transmission (CGT), Louisiana, plus applicable transportation and fuel charges in CGT's FT tariff to Rayne, and subscript $\propto$ denotes new incremental firm services to which Nashville may 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_0 = 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.

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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.

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.

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

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

To the extent Nashville is able to release transportation or storage capacity (including through asset management arrangements), 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·

The sharing percentages shall be determined based on the actual demand costs incurred by Nashville (exclusive of credits for capacity release) for transportation and storage capacity during the plan year, as such costs may be adjusted due to refunds or surcharges from pipeline and storage suppliers. Any incentive gains or losses resulting from adjustments to the sharing percentages caused by refunds or surcharges shall be recorded in the current Incentive Plan Account (IPA).

DETERMINATION OF SHARED SAVINGS

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

Gains or losses accruing to the Company under the Plan will form the basis for a rate increment or decrement to be filed and placed into effect separate from any other rate adjustments to recover or refund such amount over a prospective twelve-month period

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

FILING WITH THE AUTHORITY

The Company will file calculations of shared savings and shared costs quarterly with the Authority not later than 60 days after the end of each interim fiscal quarter and will file an annual report not later than 60 days following the end of each plan year Unless the Authority provides written notification to the Company within 180 days of such reports, the Incentive Plan Account shall be deemed in compliance with the provisions of this Service Schedule.

PERIODIC INDEX REVISIONS

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

GAS SUPPLY INCENTIVE COMPENSATION PROGRAM

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

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