BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

September 6, 2005

IN RE:	)	
	)	
AUDIT OF NASHVILLE GAS COMPANY'S	)	**DOCKET NO.**
INCENTIVE PLAN ACCOUNT FOR THE PLAN	)	**04-00290**
YEAR ENDED JUNE 30, 2004	)	

ORDER ADOPTING INCENTIVE PLAN ACCOUNT FILING OF NASHVILLE GAS COMPANY FOR YEAR ENDED JUNE 30, 2004

This matter came before Chairman Pat Miller, Director Sara Kyle and Director Ron Jones and of Tennessee Regulatory Authority (the "Authority" or "TRA"), the voting panel assigned to this Docket, at a regularly scheduled Authority Conference held on June 13, 2005 for consideration of the September 1, 2004 Incentive Plan Account filing (the "IPA filing") of Nashville Gas Company ("Nashville Gas" or the "Company") for the year ended June 30, 2004. The Compliance Audit Report ("Report") by TRA Utilities Division ("Audit Staff") regarding the IPA filing is included as Exhibit A, which is attached hereto and incorporated into this document as if fully rewritten herein.

On September 1, 2004, Nashville Gas made its IPA filing for the year ended June 30, 2004. On March 4, 2005, the Audit Staff filed its Report of the Company's IPA filing. Audit Staff made two findings based on its audit. The first finding was that Nashville Gas over-stated the amount available for sharing between the Company and its ratepayers under the Capacity Release Incentive Mechanism, because the Company included $1,987,437 in asset management fees. Thus, Audit Staff found that the Company's share of "savings" was over-stated by $600,400. The inclusion of asset management fees into the Company's Incentive Plan Account

("IPA") was also an issue in the Company's IPA filing for the year ended June 30, 2003.[1] Audit Staff's second finding was that Nashville Gas over-stated the amount of interest owed by ratepayers by $20,002, which represents an over-recovery from customers. Audit Staff explained that the second finding was a result of the first finding. Based on the foregoing, Audit Staff concluded that, except for the findings noted, the Company had correctly calculated its share of savings under its IPA.

Audit Staff issued two recommendations with regard to the Company's IPA filing. First, Audit Staff recommended that the Authority suspend the Company's Incentive Plan ("Plan") pending the outcome of a separate docket opened to address the inclusion of asset management fees in the Company's tariff. Second, Audit Staff recommended that the Authority consider engaging a consultant (paid for by the Company) to assist Audit Staff with the audit process going forward.

On April 19, 2005, the Company filed *Nashville Gas Company's Response to the Utilities Division's Incentive Plan Account Audit Report* ("*Response*"). In its *Response*, the Company urged the Authority to authorize it to continue to operate under its approved Plan, including the incorporation of fees from asset management arrangements in the IPA. The Company argued that inclusion of those fees is authorized by the plain language of the Company's Plan and inclusion of such fees is supported by a number of prior recommendations by Audit Staff and rulings by the Authority. Additionally, the Company asserted that the Audit Staff's Report was based on several misperceptions of the character of asset management arrangements and the proper scope of the Audit Staff's audit authority.[2] The Company argued that the Audit Staff was

[1] *See In re Audit of Nashville Gas Company's Incentive Plan Account for the Plan Year Ended June 30, 2003*, Docket No 03-00489, *Notice of Filing by Energy and Water Division of the Tennessee Regulatory Authority*, p 13 (March 29, 2004)
[2] *Nashville Gas Company's Response to the Utilities Division's Incentive Plan Account Report*, p 10 (April 19, 2005)

inappropriately questioning the provisions within the Plan, rather than limiting the audit to testing compliance with those provisions.

On May 18, 2005, the Audit Staff filed the *Staff Reply to Nashville Gas Company's Response to the Utility Division's Incentive Plan Account Audit Report* ("*Staff Reply*"). In the *Staff Reply,* Audit Staff addressed the Company's arguments contained in the *Response.* The Audit Staff argued that, even if inclusion of asset management fees into the Company's IPA is authorized by the plain language of the Company's Plan, the Authority has reserved the right to "modify, extend or terminate" the Company's Plan at any time it deems necessary.[3] Additionally, the Audit Staff maintained that the objective of the audit is to determine if the balance in the Company's IPA is in conformance with the Company's Plan. Audit Staff asserted that this objective includes determining whether a transaction should be covered under the terms of the Plan.

On May 26, 2005, the Company filed *Nashville Gas Company's Response to the Staff's Reply.* Nashville Gas filed this document to address a new assertion contained in the *Staff's Reply.* The new assertion was that the maximum ratepayer/shareholder sharing ratio applicable to capacity management savings under the Company's approved Plan is not in conformance with capacity release sharing ratios in effect in the other two states where Piedmont Natural Gas Company, Inc.[4] provides regulated natural gas service. The Company stated that, while Audit Staff's assertion is correct, the gas cost recovery mechanisms in those two states justify the differential.

On May 31, 2005, Audit Staff filed the *Staff Reply to Nashville Gas Company's Response to the Staff's Reply.* There, Audit Staff asserted that, in addressing the discrepancy between the maximum ratepayer/shareholder sharing ratios in Tennessee and other states, they were merely

[3] Nashville Gas Company, Service Schedule No 316, *Performance Incentive Plan*, p 1
[4] Nashville Gas Company is a division of Piedmont Natural Gas Company

pointing out an omission made by the Company when referencing its asset management agreements in other states as support for including the agreement in Tennessee under the current Plan terms.[5]

At a regularly scheduled Authority Conference held on June 13, 2005 the panel considered the Report. The Directors noted that, in TRA Docket No. 03-00489, the panel voted to allow the continuation of the Company's IPA while both the Audit Staff and the Company worked together to resolve the issue regarding inclusion of asset management fees in the IPA.[6] Based on that ruling and the fact that Audit Staff and the Company have been unable to reach an agreement with regard to that issue, the panel determined that it would be improper to disallow the inclusion of asset management fees in this IPA filing. Thus, the panel voted unanimously to approve the Company's IPA filing in its entirety. However, the panel also voted unanimously to open a separate docket to resolve the issue regarding the inclusion of the asset management fees into the Company's IPA, including the structure of shared savings. Further, the panel ordered that the issue regarding whether the Authority should consider engaging a consultant (paid for by the Company) to assist Staff with the audit process be deferred until determinations are made regarding the inclusion of the asset management fee into the Company's IPA.

IT IS THEREFORE ORDERED THAT:

1. The September 1, 2004 Incentive Plan Account filing by Nashville Gas Company for the year ended June 30, 2004 is approved and adopted and is incorporated in this Order as if fully rewritten herein.

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[5] *Staff Reply to Nashville Gas Company's Response to the Staff's Reply*, pp 1-2 (May 31, 2005)

[6] *See In re Audit of Nashville Gas Company's Incentive Plan Account for the Plan Year Ended June 30, 2003*. TRA Docket No 03-00489, *See Order Accepting Company's Proposed Improvements to Company's IPA* (February 4, 2005), *Order Adopting, In Part, IPA Compliance Audit Report of Tennessee Regulatory Authority's Energy and Water Division* (October 1, 2004)

2. A new docket will be opened to resolve the issue regarding the inclusion of the asset management fees into Nashville Gas Company's Incentive Plan Account.

3. The issue regarding whether the Authority should consider engaging a consultant (paid for by the Company) to assist Staff with the audit process is deferred until determinations are made regarding the inclusion of the asset management fee into Nashville Gas Company's Incentive Plan Account.

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

Pat Miller, Chairman

Sara Kyle, Director

Ron Jones, Director

COMPLIANCE AUDIT REPORT
OF

NASHVILLE GAS COMPANY'S
INCENTIVE PLAN ACCOUNT

Docket No. 04-00290

PREPARED BY

TENNESSEE REGULATORY AUTHORITY

ENERGY AND WATER
UTILITIES DIVISION

MARCH 2005

EXHIBIT A

TENNESSEE REGULATORY AUTHORITY'S
COMPLIANCE AUDIT
of
NASHVILLE GAS COMPANY'S
INCENTIVE PLAN ACCOUNT
Docket No. 04-00290

TABLE OF CONTENTS

I. INTRODUCTION

The subject of this compliance audit is the Performance Incentive Plan (hereafter "Incentive Plan" or "IPA") of Nashville Gas Company (hereafter "Nashville Gas," "Nashville" or the "Company"), a division of Piedmont Natural Gas Company. The objective of the audit 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[1] and to verify that the factors utilized in the calculations were supported by appropriate source documentation. The IPA consists of two mechanisms, which are more fully described in *Section II.*

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

		Plan Year Ended 6/30/04
Total Actual City Gate Purchases	$	110,847,597
Total Annual Benchmark	$	111,355,274
Percentage Actual Purchases to Benchmark	$	99.54%
Total Incentive Savings (Losses) from:		
Gas Procurement	$	1,143,000
Capacity Management		2,360,655
Total Incentive Savings	$	3,503,655
Incentive Savings (Losses) Retained by Ratepayers:		
Gas Procurement	$	330,010
Capacity Management		1,573,645
Total Incentive Savings to Ratepayers	$	1,903,655
Incentive Savings (Losses) Retained by Company:		
Gas Procurement	$	812,990
Capacity Management		787,010
Total Incentive Savings to Company	$	1,600,000

Section III of this report further describes the actual results of the plan year and *Section V* details the Staff's findings.

[1] Service Schedule No. 14, Performance Incentive Plan (See Attachment 1)

II. BACKGROUND AND DESCRIPTION OF PERFORMANCE INCENTIVE PLAN

On May 31, 1996, the Tennessee Public Service Commission (hereafter the "TPSC"), the predecessor to the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA"), issued an Order in Docket 96-00805 approving the Incentive Plan on an experimental basis for Nashville Gas. The specific details of the Incentive Plan were included in Nashville Gas' Service Schedule No. 14 tariff entitled Performance Incentive Plan, which was issued on April 22, 1996, and was effective July 1, 1996. A copy of this tariff is attached to the report as Attachment 1.

The experimental period began July 1, 1996, and ended June 30, 1998. On March 31, 1998, the Company filed an Application for Extension of the Performance Incentive Plan, which would allow the plan to continue on an annual basis. The Authority issued an Order on March 11, 1999, authorizing the Company to continue under a modified Incentive Plan. The Incentive Plan automatically rolls over for an additional plan year on each July 1st, beginning July 1, 1998, and continues until the Incentive Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville Gas to the Authority or (b) modified, amended or terminated by the Authority.

The Incentive Plan consists of two mechanisms: (1) the Gas Procurement Incentive Mechanism, and (2) the Capacity Management Incentive Mechanism. Under the Gas Procurement Incentive Mechanism, Nashville Gas retains 50% of the savings on gas purchased below 99% of a pre-determined benchmark. Should the Company purchase gas above 101% of the same pre-determined benchmark, the Company is penalized for 50% of the excess. The Capacity Management Incentive Mechanism is tied to the Company's total annual demand cost and the sharing ratio is a sliding scale, with Nashville Gas earning a larger percentage with a higher level of cost savings. Interest is accrued on the outstanding monthly balance in the IPA account using the same computation as is provided for in the Authority's Purchased Gas Adjustment Rule 1220-4-7-.03(vii). A more detailed explanation of each mechanism can be found in Attachment 1.

III. ACTUAL PLAN YEAR RESULTS

On September 1, 2004, Nashville Gas submitted its annual report to the TRA Compliance Staff, showing its calculation of the balance in the Incentive Plan Account ("IPA Account") as of June 30, 2004. According to the Company filing, the Incentive Plan generated $3,503,654 in total incentive savings. Of this amount, $1,903,654 benefited the ratepayer and $1,600,000 was retained by Nashville Gas.[2] Adding the under-recovered balance from the previous period and accrued interest on the monthly balances, and subtracting the surcharges recovered from customers, results in an **under-recovered balance** in the IPA Account at June 30, 2004 of **$1,761,712**. To recover this balance, the Company filed a PGA (tariff filing 2004-1216) with the TRA seeking permission to discontinue the previous year's surcharge and to implement a $0.00936 per therm surcharge, effective November 1, 2004.[3]

The Company was able to purchase gas at less than the benchmark in only one (1) month of the twelve (12) months in the audit period. In December 2003, the Company shared in the portion of the savings that fell below the 1% lower limit of the deadband.[4] Purchases for the remaining eleven (11) months of the plan year were higher than the calculated benchmark. In none of those months did the purchases exceed the 1% upper limit of the deadband. Therefore, the Company was not required to share in those calculated losses. Total actual city gate purchases for the year averaged 99.54% of the total annual benchmark. Of the $1,143,000 total net gain reported under the Gas Procurement Incentive Mechanism, the Company retained $812,990 and $330,010 benefited the ratepayers.[5]

Nashville reported savings under the Capacity Management Incentive Mechanism of $2,360,655, of which $373,218 was the result of off-system sales and capacity release and $1,987,437 was the payment received from its Asset Manager.[6] The Company's total actual demand costs for the year were $9,391,980. Therefore, the Company did not participate in any savings until the savings reach $93,920 (1% of the total demand costs), as provided for in the Incentive Plan. Of the total alleged savings achieved, the Company retained $787,010 and $1,573,645 benefited the ratepayers.[7]

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

[3] The balance calculated in the Company's PGA tariff filing (2004-1216) did not include the interest due from customers of $76,426 Any under-recovery will be trued up in the Company's next IPA filing

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

[5] The ratepayers' savings of **$965,378** in December 2003 were offset by **$635,369** in losses experienced in the remaining months of the plan year

[6] Under the Gas Asset Management agreement, Nashville Gas assigns its firm pipeline transportation (capacity), storage (excluding local LNG) and supply rights to the "Asset Manager " In return for this assignment, Nashville Gas receives a lump-sum payment from the asset manager for the assignment of these rights (Company's description of agreement)

[7] The Company's share was reduced by $282,561 because of the $1 6 million cap and the customers' share was increased by the same amount

IV. AUDIT SCOPE

The IPA audit is a compliance audit of the Company's Incentive Plan account.[8] The audit goal is to verify that the Company's calculations of incentive gains and losses are materially correct,[9] and that the Company is in compliance with the terms of its tariff and following all Authority orders and directives with respect to its calculation of the IPA account balance. Also included in this audit is the Company's PGA tariff filing implementing a customer surcharge to recover the balance in the IPA Account, which was effective November 1, 2004.[10]

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

The Authority's Utilities Division is responsible for auditing those companies under the Authority's jurisdiction to insure that each company is abiding by the rules and regulations of the TRA. This audit was performed by Pat Murphy of the Utilities Division.

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[8] Service Schedule No 14 tariff Performance Incentive Plan

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

[10] PGA/Tariff filing 2004-1216.

V. INCENTIVE PLAN (IPA) FINDINGS

The Compliance Staff reviewed the purchasing activities of Nashville Gas to determine whether the Company correctly calculated the amount of gains and losses under its Incentive Plan and whether it complied fully with the terms of its tariff. Staff's audit revealed no material findings with respect to the Company's mathematical calculations. However, Staff does take exception with the inclusion of the Asset Management Fee as part of the sharing mechanism. Based on the fact that the Panel of Directors assigned to the last audit (Docket 03-00489) declined to make a determination regarding whether the Asset Management Fee is included in Nashville's tariff as written or whether a modification to the tariff is necessary to include this type of savings,[11] Staff again presents its finding below.

COMPARISON OF COMPANY FILING AND STAFF AUDIT RESULTS:

	Company Filing	Staff Audit	Difference
IPA Account Balance at 6/30/03	$ 1,438,293	$ 1,438,293	$ 0
Plus Gas Procurement Savings	812,990	812,990	0
Plus Off-System Sales Margin	186,610	186,610	0
Plus Asset Management Fees	600,400	0	-600,400
Subtract Customer Surcharges	1,353,007	1,353,007	0
Plus Interest on Account Balance	76,426	56,424	-20,002
Equals IPA Account Balance at 6/30/04	$ 1,761,712	$ 1,141,310	$ -620,402

SUMMARY OF FINDINGS:

				Page No.
FINDING #1	Capacity Release Savings Over-stated	$ -600,400	Over-recovery	6
FINDING #2	Interest on Account Balance Over-stated	-20,002	Over-recovery	10
	Net Result	**$ -620,402**	**Over-recovery**	

[11] Authority Order dated February 4, 2005 in Docket No 03-00489, page 3

FINDING #1:

Exception

The Company over-stated the amount available for sharing between the Company and its ratepayers under the Capacity Release Incentive Mechanism. The Company included $1,987,437 in Asset Management Fees. Therefore, the Company's share of "savings" was **overstated by $600,400.**

Background

In its audit report covering the Company's Incentive Plan for the year ended June 30, 2003, Compliance Staff ("Staff") brought this finding to the Authority's attention in the form of a recommendation. Rather than include the issue as a finding in that audit and recommend denial of the Company's alleged "share" of the Asset Management Fee, the Compliance Staff recommended exclusion of the Asset Management Fee from the Company's Incentive Plan on a going forward basis.[12] Also included in the report were other Staff concerns and recommendations.

The Staff's audit report was brought before the Panel of Directors at a regularly scheduled Authority Conference on April 26, 2004. The majority of the Panel voted that Staff and the Company should meet to discuss Staff's concerns and that the Company should file a proposal to remedy audit findings #1 and #2 and areas of concern identified in Section VI of the report.[13] The Company's proposed modifications were considered by the Panel at the regularly scheduled Authority Conference on September 13, 2004. By majority vote, the Panel accepted the proposed improvements to the IPA process. However, the Panel declined to make a determination regarding the unresolved issues of (1) *asset management fees* and (2) *outside consultants*.[14]

Discussion

As stated in the Compliance Staff's audit report in Docket No. 03-00489, Staff then believed and continues to believe that inclusion of the fees paid by asset managers is not provided for in the Company's current Incentive Plan tariff as crafted and written. The tariff reads:

> "To the extent Nashville is able to release transportation or storage capacity, or generate transportation or storage margin associated with off-system or wholesale sales-for-resale, the associated **cost savings** shall be shared by Nashville and customers according to the following sharing formula:"(Emphasis added.)[15]

The Capacity Management Incentive Mechanism permits the Company to share in profits generated from marketing any excess storage or pipeline capacity or gas that it has reserved for its

[12] Staff Audit Report in Docket No 03-00489, page 13 Staff at no time alleged purposeful wrongdoing by the Company

[13] Authority Order dated October 1, 2004 in Docket No 03-00489, page 3

[14] Authority Order dated February 4, 2005 in Docket No 03-00489, page 3

[15] NGC's Service Schedule No 14, Performance Incentive Plan, page 4 (See Attachment 1)

customers, but is not currently needed to serve those customers. The calculation of profits or "savings" is based on the comparison of the Company's cost and the sales price. If the sales price is greater than the Company's cost, then a profit results and is permitted to be included for sharing under the terms of the Incentive Plan. The wholesale gas markets are markedly different today than when the Company's Incentive Plan was first crafted in 1996. In 1996, the function of selling unused capacity or unused gas to help reimburse ratepayers for the amount they paid for gas and pipeline and storage capacity was recognized as beneficial for the ratepayers. By creating an incentive (i.e. rewarding) the Company for increasing this activity, resulted in benefits for both the Company and the ratepayer.

Starting in 1999, the Company began selecting an outside Asset Manager to deal with the capacity management function in exchange for a fee. The fee paid to Nashville gives the Asset Manager the right to remarket Nashville's assets (for its own gain) when they are not needed by Nashville's customers. The Company included this fee each plan year as part of the Capacity Management Incentive Mechanism. The Compliance Staff erroneously treated these fees as released capacity transactions for plan years 1999-2000, 2000-2001, and 2001-2002. In Docket 03-00489 for plan year 2002-2003, Staff realized that the language of the Incentive Plan did not provide for the outsourcing of this capacity release function. The concept of an asset manager separate from the utility was unheard of in 1996. Therefore, although Staff agrees that the intent of an incentive plan is to encompass all purchasing activities of a company, an asset manager was not addressed or even anticipated in Nashville's original Incentive Plan.[16]

Staff has several reasons for believing that the Incentive Plan as written does not include the concept of an outside asset manager. First, the language of the Incentive Plan tariff makes no mention of an outside asset manager. The terms of the tariff address efforts made by the Company. In fact, the asset manager concept was not even utilized in 1996. Second, use of an outside asset manager does not allow for *calculation of savings* as stipulated in the tariff language. "Profits" as such cannot be determined or audited by Staff. Transparency of transactions is very important since the Enron scandal and the enacting of the Sarbanes-Oxley Act of 2002 by Congress and does not exist in an asset management arrangement. Third, an incentive plan should provide an incentive for the Company to move *beyond its normal prudent purchasing activity* and incur some risk for doing so, in exchange for the possibility of rewards. In the Company's own words, "In short, the inclusion of Asset Management fees as savings under the Incentive Plan Account is consistent with the purpose of the plan, has been highly beneficial to ratepayers, and **presents no risk of any kind to ratepayers or the Company**." (Emphasis added)[17] The following table highlights some of the differences between Capacity Release executed by the Company and the use of an outside asset manager:

[16] A similar observation was made by Staff in the Atmos Docket 01-00704, where Staff maintains that transportation discounts were not anticipated in the original incentive plan and therefore, not specifically provided for

[17] Company letter addressed to Chairman Tate, dated June 17, 2004, page 3 (Docket No 03-00489)

Capacity Release by NGC	Asset Manager
Transparent – able to be audited	Not transparent – cannot be audited
Multiple transactions	Single transaction
Increased accounting	Decreased accounting
Savings as anticipated in tariff can be calculated.	Savings cannot be calculated.
Savings amount to thousands of dollars	Transaction can result in millions of dollars

When crafting the Incentive Plan, the Authority wisely included language in the tariff to permit the TRA to *suspend, amend or terminate* the Incentive Plan at any time. The tariff reads:

> "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." (Service Schedule No. 14, Performance Incentive Plan, page 1)

The tariff language obviously anticipates the possibility of market changes that could alter the plan's effectiveness. Therefore, Staff has the duty to report its observations to the Authority for its consideration. Considering the evolution of the wholesale gas markets, Staff believes that the time has come for the Authority to revisit the terms of the Incentive Plan as they relate to the Capacity Release Incentive Mechanism. If the Authority should decide that the inclusion of asset management fees is appropriate under the Incentive Plan, then a determination needs to be made on how those fees will be treated in the context of an incentive plan. For instance, since there appears on the surface to be no relationship between the amount of the management fees paid to Nashville and the profits that might have resulted had the Company performed the function itself, a different sharing percentage between the Company and the ratepayers may be fairer to the ratepayers. Perhaps the ratepayer deserves a higher percentage than 50%. Also, in light of the millions of dollars at stake in the unregulated asset management arena, perhaps the current cap of $1,600,000 should be revisited. Perhaps a higher cap would be appropriate. Staff believes that opening a separate docket to address Nashville's Asset Management Fees in the context of its incentive plan is the most appropriate and efficient method to address these issues.

In Docket No. 03-00489, the Company expressed several concerns regarding the TRA revisiting any aspect of the current Incentive Plan tariff. One concern is that the Staff intends to re-examine substantive aspects of the tariff in its annual audit process. According to the Company, this would represent a return to an annual prudence review.[18] The prudence audit is a retroactive review of a company's gas purchasing decisions. Staff fails to see how this relates to its review of Nashville's compliance with its Incentive Plan tariff. Staff has an obligation to review any relevant issue it discovers in the course of its audits in order to provide assurance to the Authority that ratepayers are being treated fairly. As noted in Section VII, TCA § 65-3-108 gives the TRA full audit authority. Therefore, the Company has no basis on which to attempt to limit the scope of Staff's audit. In the Company's words (when addressing an outside consultant), "...the Company

[18] Company letter addressed to Chairman Miller, dated August 12, 2004, page 3 (Docket No 03-00489)

questioned whether such additional expertise is necessary if the audit is **properly limited to the purpose of determining whether the Incentive Plan Account balance is correctly calculated.**" (Emphasis added)[19] Staff takes issue with this statement. In light of current and evolving market conditions, Staff has an obligation to ascertain whether the proper incentives are in place (and indeed would be remiss if it did not) and to report its recommendations to the TRA. Again, the tariff itself provides for the modification or termination of the incentive plan at any time by the TRA.[20]

A second concern is that ratepayers would be harmed should the TRA suspend the Incentive Plan and address the concerns of the Compliance Staff in another docket. The Company states that the ratepayer will lose substantial economic benefit.[21] Staff disagrees. Absent inclusion of asset management fees in the Incentive Plan, **100%** of the fees (versus 50% under the Incentive Plan) accrue to the ratepayer by means of the Actual Cost Adjustment. The Company's stockholders would be the only ones to lose economic benefit. It is entirely within the Company's purview to engage an unregulated marketer to manage its assets. However, to include that transaction within its Incentive Plan, in order to retain a portion of the fees for its stockholders, requires the approval of the Authority. Only by refusing to release the ratepayers' unused assets would the Company inflict economic harm on the ratepayers.

A third concern is that if anything changes with respect to their Incentive Plan, this would result in higher gas prices for the consumer. This concern was raised with respect to the TRA utilizing a consultant to aid Staff in the more complex and technical aspects of the evolving natural gas market.[22] Again Staff disagrees. The cost of a consultant spread over the Company's customer base within the Actual Cost Adjustment would amount to less than $1 per year per customer, perhaps even less than $0.50 per year. Staff fully believes that the potential savings to consumers is greater than any potential increase in costs.

In summary, Staff believes the Company's current Incentive Plan tariff contains no provision to address the sharing of fees received from an asset manager. Staff agrees that an effective incentive plan must encompass all aspects of a company's gas purchasing activities. To this end, the tariff language itself provides for the modification or amendment of the tariff at any time by the Authority. Therefore, the Staff respectfully requests that the Authority open a separate docket to address issues relating to the Company's Incentive Plan.

Company Response

Nashville Gas Company, through its attorney James H. Jeffries IV, responded to Staff's Findings in this audit. Please see a copy of the letter dated March 2, 2005, attached to this report as Attachment 2.

[19] Company letter addressed to Chairman Tate, dated June 17, 2004, page 3 (Docket No 03-00489)
[20] Service Schedule No 14, Performance Incentive Plan, page 1 (See Attachment 1)
[21] Company's April 12, 2004 response to TRA Energy and Water's IPA audit report, page 3 (Docket No. 03-00489)
[22] Company letter addressed to Chairman Tate, dated June 17, 2004, page 4 (Docket No 03-00489)

FINDING #2:

Exception

The Company over-stated the amount of interest owed by ratepayers by **$20,002**. This represents an **over-recovery** from customers.

Discussion

The difference between the amount of interest calculated by Staff and the amount calculated by the Company is the result of the Staff's audit adjustment in Finding #1.

Company Response

Nashville Gas Company, through its attorney James H. Jeffries IV, responded to Staff's Findings in this audit. Please see a copy of the letter dated March 2, 2005, attached to this report as Attachment 2.

VI. AUDIT CONCLUSIONS AND RECOMMENDATIONS

Conclusions

Nashville Gas Company, **except for** the findings noted, has correctly calculated its share of savings under its Service Schedule No. 14, Performance Incentive Plan, for the plan year ended June 30, 2004. The net findings represent a material adjustment to the Company's filing. These findings stem from the Staff's interpretation of the Capacity Management Incentive Mechanism, which is a part of the Company's incentive tariff.

Staff addressed this issue in its last audit report.[23] Since the Company had no prior notification from Staff regarding its belief that the Asset Management payment had been allowed as part of the existing tariff in error in prior years, Staff did not recommend an adjustment to Nashville's share of the fee. Staff did recommend that the Incentive Plan be suspended to permit the Authority to explore the treatment of asset management fees, and make any modifications to the plan that it deemed appropriate going forward. However, the majority of the voting Panel of Directors assigned to the audit in Docket No. 03-00489 "...declined to make a determination regarding the remaining unresolved issues."[24] Those issues were (1) whether Staff should have additional oversight of the Company's RFP bid process, (2) whether the asset management fees should be included in the Company's incentive plan, and (3) whether Staff should be able to use an outside consultant on future IPA audits, with the cost recovered through customers via the Actual Cost Adjustment

Staff acknowledges in this audit that the improvements agreed to in the prior audit have been implemented by the Company. These include written documentation of the bid process, publishing a notice in *Gas Daily* regarding the RFP for Asset Manager, and continuation of its reporting of transactions to *Gas Daily* and *Inside FERC.*[25]

A review of Nashville's response[26] to the audit findings in this audit reveals three (3) areas of disagreement between Staff and the Company. One, the Company believes the asset management fees are properly included in its incentive plan. In support of its position, it points to decisions in prior audits and to the fact that the Authority was silent on this issue in Docket No. 03-00489. Staff contends that prior decisions of this agency can be reevaluated by the Directors if additional information is brought to their attention. Staff should never be precluded from recommending that prior errors should be remedied whenever errors are discovered. Staff fully admitted in the last audit report that it believed it had erred in its acceptance of the asset management fees in prior audits. Nashville was on notification at that time regarding Staff's position. Since no final determination was made at that time, Staff again brings this issue to the Directors' attention.

Two, Nashville and Staff disagree as to the scope of the audit. The Company's position is that the scope is limited to verifying the mathematical accuracy of its calculation of the IPA account

[23] Docket No 03-00489
[24] February 4, 2005 Authority Order in Docket No 03-00489, page 3
[25] Staff did not ask to see documentation to support this claim, however reserves the right to request this in future audits
[26] See Attachment 2 to this report

ending balance. Staff again points to the language of the tariff that allows the TRA to revisit or terminate the incentive plan at any time.[27] In addition to auditing the mechanics of the Company's annual report, Staff is responsible for monitoring the plan and advising the Directors whenever it believes a review is warranted.

Three, Nashville alleges that an outside consultant is not necessary in order for Staff to audit the incentive plan and that the cost would be a potential detriment to ratepayers. Staff maintains that it does not have the expertise regarding the wholesale gas market changes taking place, especially in the unregulated arena. Due diligence requires Staff to look at all aspects of the market as it potentially impacts Tennessee customers. Staff would question why the Company would argue against the TRA obtaining outside expertise when needed.

Recommendations

1. The Authority should suspend Nashville's Incentive Plan[28] going forward, pending the outcome of a separate docket opened to address the inclusion of asset management fees in the Company's tariff.

2. The Authority should consider engaging a consultant (fees paid for by the Company and recovered from its customers) to assist Staff with the audit process going forward. The complexity of the issue identified in this audit and other potential issues require expert knowledge of wholesale gas markets.

[27] Service Schedule No 14, Performance Incentive Plan, page 1. (See Attachment 1)
[28] Service Schedule No 14, Performance Incentive Plan, page 1 states, "The Plan will continue until the Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville to the Authority or (b) the Plan is modified, amended or terminated by the Authority"

VII. JURISDICTION OF THE TENNESSEE REGULATORY AUTHORITY

Tennessee Code Annotated (hereafter "T.C.A.") gave jurisdiction and control over public utilities to the Tennessee Regulatory Authority. T.C.A. § 65-4-104 states:

> The Authority has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter.

Further, T.C.A. § 65-4-105 grants the same power to the Authority with reference to all public utilities within its jurisdiction as chapters 3 and 5 of Title 65 of the T.C.A. has conferred on the Department of Transportation's oversight of the railroads or the Department of Safety's oversight of transportation companies. By virtue of T.C.A § 65-3-108, said power includes the right to audit:

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

ATTACHMENT 1

SERVICE SCHEDULE NO. 14
Performance Incentive Plan

APPLICABILITY

The Performance Incentive Plan (the plan) replaces the reasonableness or prudence review of Nashville Gas Company's (Nashville or Company) gas purchasing activities overseen by the Tennessee Regulatory Authority (Authority). The plan is designed to provide incentives to Nashville in a manner that will produce rewards for its customers and its shareholders and improvements in Nashville's gas procurement activities. Each plan year will begin July 1. The annual provisions and filings herein would apply to this annual period. The Plan will continue until the Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville to the Authority or (b) the Plan is modified, amended or terminated by the Authority.

OVERVIEW OF STRUCTURE

Nashville's Performance Incentive Plan is comprised of two interrelated components.

- Gas Procurement Incentive Mechanism
- Capacity Management Incentive Mechanism

The Gas Procurement Incentive Mechanism establishes a predefined benchmark index to which Nashville's commodity cost of gas is compared. It also addresses the recovery of gas supply reservation fees, the treatment of off-system sales and wholesale interstate sale for resale transactions, and the use of financial or private contracts in managing gas costs. The net incentive benefits or costs will be shared between the Company's customers and the Company on a 50% / 50% basis.

The Capacity Management Incentive Mechanism is designed to encourage Nashville to actively market off-peak unutilized transportation and storage capacity on upstream pipelines in the secondary market. The net incentive benefits or costs will be shared between the Company's customers and the Company utilizing a graduated sharing formula, with sharing percentages for Nashville ranging between zero and fifty percent.

The Company is subject to a cap on overall incentive gains or losses of $1.6 million annually. In connection with the Performance Incentive Plan, Nashville shall file with the Authority Staff, and update each year a Three Year Supply Plan. Nashville will obtain additional firm capacity and/or gas supply pursuant to such plan.

GAS PROCUREMENT INCENTIVE MECHANISM

The Gas Procurement Incentive Mechanism addresses the following areas:

- Commodity Costs
- Gas Supply Reservation Fees
- Off-System Sales and Sale for Resale Transactions
- Use of Financial Instruments or Other Private Contracts

<u>COMMODITY COSTS</u>

Each month Nashville will compare its *total city gate commodity cost of gas*[1] to a benchmark dollar amount. The benchmark gas cost will be computed by multiplying total actual purchase quantities for the month by a price index. The monthly price index is defined as

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

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

I = the monthly city gate commodity gas cost index.

F_f = the fraction of gas supplies purchased in the first-of-the-month market which are transported to the city gate under Nashville's FT service agreements.

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

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1 Gas purchases under Nashville's existing supply contract on the Tetco system are excluded from the incentive mechanism. Nashville will continue to recover 100 percent of these costs through its PGA with no profit or loss potential. Extension or replacement of such contract shall be subject to the same competitive bidding procedures that will apply to other firm gas supply agreements. In addition, Nashville's gas procurement incentive mechanism will measure storage gas supplies against the benchmark index during the months such quantities are purchased for injection. For purposes of comparing such gas purchase costs against the monthly city gate index price, Nashville will exclude any commodity costs incurred downstream of the city gate to storage so that Nashville's actual costs and the benchmark index are calculated on the same basis.

subscribe in the future.[2] The commodity index prices will be adjusted to include the appropriate pipeline maximum firm transportation (FT) commodity transportation charges and fuel retention to the city gate under Nashville's FT service agreements.

K = the fraction (relative to total maximum daily contract entitlement) of Nashville's total firm transportation capacity under contract in a geographic pricing region, where the subscripts are as above.[3]

F_o = the fraction of gas supplies purchased in the first-of-the-month spot market which are delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts.

O = the weighted average of *Inside FERC Gas Market Report* first-of-the-month price indices, plus applicable maximum IT rates and fuel retention, from the source of the gas to the city gate, where the weights are computed based on actual purchases of gas supplies purchased by Nashville and delivered to Nashville's system using transportation arrangements other than Nashville's FT contracts.

F_d = the fraction of gas supplies purchased in the daily spot market.

D = the weighted average of daily average index commodity prices taken from *Gas Daily* for the appropriate geographic pricing regions, where the weights are computed based on actual purchases made during the month. The commodity index prices will be adjusted to include the appropriate maximum transportation commodity charges and fuel retention to the city gate.

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2 To the extent that Nashville renegotiates existing reservation fee supply contracts or executes new reservation fee supply contracts with commodity pricing provisions at a discount to the first-of-the-month price index, Nashville shall modify the monthly commodity price index to reflect such discount.

3 Because the aggregate maximum daily contract quantities in Nashville's FT contract portfolio vary by month over the course of the year, the weights will be recalculated each month to reflect actual contract demand quantities for such month. The contract weights, and potentially the price indices used, will also vary as Nashville renegotiates existing or adds new FT contracts As new contracts are negotiated, Nashville shall modify the index to reflect actual contract demand quantities and the commodity price indices appropriate for the supply regions reached by such FT agreements.

If the actual total commodity gas purchase cost in a month is within one percent of the benchmark dollar amount, there will be no incentive gains or losses. If the actual total commodity gas purchase cost varies from the benchmark dollar allowance by more than one percent, the variance in excess of the one percent threshold shall be deemed incentive gains or losses under the plan. Such gains or losses will be shared 50/50 between the Company and the ratepayers.

Gas Supply Reservation Fees

Nashville will continue to recover 100% of gas supply reservation fee costs through its PGA with no profit or loss potential. For new contracts and/or contracts subject to renegotiation during the Plan year, Nashville will solicit bids for gas supply contracts containing a reservation fee.

Off-System Sales And Sale For Resale Transactions

Margin on off-system sales and wholesale sale-for-resale transactions using Nashville's firm transportation and capacity entitlements (the costs of which are recovered from Nashville's ratepayers) shall be credited to the commodity gas cost component of the Gas Procurement Incentive Mechanism and will be shared with ratepayers. Margin on such sales will be defined as the difference between the sales proceeds and the total variable costs incurred by Nashville in connection with the transaction, including transportation and gas costs, taxes, fuel, or other costs. For purposes of gas costs, Nashville will impute such costs for its related supply purchases at the benchmark first-of-the-month or daily index, as appropriate, on the pipeline and in the zone in which the sale takes place. The difference between Nashville's actual costs and such index price is taken into account under the Gas Procurement Incentive Mechanism. As to transportation costs, Nashville will impute such costs up to the transporting pipeline's maximum interruptible transportation (IT) rate. The difference between the maximum IT rate and Nashville's actual transportation commodity costs will be treated as capacity release margin under the Capacity Management Incentive Mechanism. After deducting the total transaction costs from the sales proceeds, any remaining margin will be credited to commodity gas costs and shared on a 50/50 basis with ratepayers

Use Of Financial Instruments Or Other Private Contracts

To the extent Nashville uses futures contracts, financial derivative products, storage swap arrangements, or other private agreements to hedge, manage or reduce gas costs, any gains or losses will flow through the commodity cost component of the Gas Procurement Incentive Mechanism.

CAPACITY MANAGEMENT INCENTIVE MECHANISM

To the extent Nashville is able to release transportation or storage capacity, or generate transportation or storage margin associated with off-system or wholesale sales-for-resale, the associated cost savings shall be shared by Nashville and customers according to the following sharing formula:

Capacity Management Incentive cost savings as a percent of Nashville's annual transportation and storage demand costs.	Sharing percentages Nashville/Customers. (Percent)
Less than or equal to 1 percent	0/100
Greater than 1 percent but less than or equal to 2 percent	10/90
Greater than 2 percent but less than or equal to 3 percent	25/75
Greater than 3 percent	50/50

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

DETERMINATION OF SHARED SAVINGS

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

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

Each year, effective November 1, the rates for all customers, excluding interruptible transportation customers who receive no direct benefit from any gas cost reductions resulting from the plan, will be increased or decreased by a separate rate increment or decrement designed to amortize the collection or refund of the June 30 IPA balance 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 twelve month 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.

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MAR 3 2004

ENERGY & WATER DIVISION

ATTACHMENT 2

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March 2, 2005

VIA UPS EXPRESS

Ms Pat Murphy
Manager – Energy and Water, Utilities Division
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

Re 2004 Nashville Gas Company Incentive Plan Account Audit Findings

Dear Ms. Murphy

Thank you for sharing Staff's draft findings on the 2004 audit of Nashville Gas Company's Incentive Plan Account We have reviewed your draft report and have several comments

First, it appears to us that the primary substantive finding of the Staff relates to its continuing concern over inclusion of asset management fees under the sharing mechanism in the incentive plan account This concern appears to have led Staff to propose an adjustment of roughly $600,000 in the review period IPA balance We have reviewed Staff's contentions and respectfully disagree As Nashville Gas Company has previously indicated, entering into asset management transactions constitutes a form of capacity release, the proceeds of which have been uniformly and repeatedly included in Nashville Gas' IPA for several years to the substantial benefit of ratepayers While Staff has recently changed its mind about the propriety of including these fees in the sharing mechanism under the IPA, Nashville Gas is very troubled by Staff's suggestion that a <u>retroactive</u> adjustment to the Company's IPA balance should be made in these circumstances, particularly where the Authority has only recently declined to adopt Staff's position on this matter

Second, it is apparent that Nashville Gas and the Staff have a disagreement about the proper scope of an IPA audit In the Company's view, and given the substantial history of TRA oversight of the Incentive Plan mechanism, an annual IPA audit should be for the purpose of verifying the proper accounting of incentive plan costs and revenues and not for the purpose of pursuing open-ended revisions/amendments to the Incentive Plan Staff appears to have a much broader view of the scope of an IPA audit.

Third, Staff continues to argue that it needs to hire consultants to help review the Company's Incentive Plan in the audit process. Nashville Gas does not have a substantive position on the need for Staff to engage independent consultants with respect to IPA audits except to note (1) that under the Company's position as to the proper scope of an IPA audit, an outside consultant may not be necessary, and (2) any increase in the Company's cost to provide gas service is potentially detrimental to the Company and its customers

We appreciate the opportunity to provide feedback to the Staff on these issues and hope these comments are useful to you in understanding Nashville Gas Company's position

Sincerely,

James H Jeffries IV

c Mr Randal Gilliam
Mr David Carpenter
Mr Bill Morris