

**BEFORE THE TENNESSEE REGULATORY AUTHORITY**

**NASHVILLE, TENNESSEE**

**March 14, 2006**

<b>IN RE:</b>	)	
	)	
<b>SUMMARY OF THE TRANSACTIONS IN</b>	)	<b>DOCKET NO.</b>
<b>CHATTANOOGA GAS COMPANY'S DEFERRED</b>	)	<b>04-00402</b>
<b>GAS COST ACCOUNT FOR THE TWELVE MONTHS</b>	)	
<b>ENDED JUNE 30, 2004 AND THE COMPUTATION OF</b>	)	
<b>ACA FACTOR EFFECTIVE JANUARY 1, 2005</b>	)	
	)	
<b>CHATTANOOGA GAS COMPANY'S REPORT OF</b>	)	<b>DOCKET NO.</b>
<b>ACTUAL GAS COST AND THE APPLICABLE INDEX</b>	)	<b>04-00403</b>
<b>COST FOR EACH MONTH OF THE PLAN YEAR</b>	)	
<b>ENDED JUNE 30, 2004</b>	)	

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**ORDER**

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This matter came before Chairman Ron Jones, Director Pat Miller and Director Sara Kyle of the Tennessee Regulatory Authority (the "Authority"), the voting panel assigned to this docket, at the regularly scheduled Authority Conference held on November 7, 2005 for consideration of the *Compliance Audit Report of the Actual Cost Adjustment Component of the Purchased Gas Adjustment Rule and Performance-Based Ratemaking Tariff for Chattanooga Gas Company* ("Report") prepared by the Authority's Utility Division (the "Staff"). The Report, attached hereto as Exhibit 1, contains the audit findings of the Staff, the original responses thereto of Chattanooga Gas Company ("CGC" or the "Company"), and the recommendations of the Staff to the Company in addressing the findings.

CGC submitted its Actual Cost Adjustment (ACA) filing on November 15, 2004, and the Staff completed its audit of the Company's filing on August 25, 2005. On August 29, 2005, the Staff issued preliminary ACA audit findings to CGC, and the Company responded to the findings on

September 6, 2005. The Staff filed its Report with the Authority on September 9, 2005. CGC filed a response with the Authority on October 7, 2005.

The Report contains four findings. The net amount of these findings is an over-recovery of gas costs in the ACA account of \$29,557. Finding No. 1 is that Sequent Energy Management (“Sequent”) invoiced CGC monthly for gas purchases priced at index, rather than at the actual price paid by Sequent as represented by the Company to the TRA.<sup>1</sup> Sequent is the marketing arm of AGL Resources, the parent of CGC, and therefore is an affiliate of CGC. The Staff also noted that the Company entered into a new asset management agreement with Sequent that stipulates that all sales made by Sequent to CGC will be priced at the applicable indices without informing or seeking approval from the TRA. The Company did not concur with Finding No. 1 and responded that the use of indices is a standard industry practice and is appropriate under the Company’s tariff. The Company states that the new asset agreement with Sequent was effective April 1, 2004 and at that time, there were no rules, orders or policies that required CGC to obtain Authority approval prior to its commencement.

Finding No. 2 is that the Company’s failure to reduce the total uncollectible costs by the pro rata portion determined in Docket No. 97-00982 caused CGC’s over-recovery of uncollectible gas cost revenues. As a result of the recalculation based on Finding No. 2, Finding No. 4 is that the Company understated the amount of interest due to customers. Finding Nos. 2 and 4 together resulted in an over-recovery of \$29,557. The Company concurred with these findings.

Finding No. 3 is that the Company did not supply sufficient information for the Staff to verify the credits accruing to ratepayers as a result of transactions made by Sequent using CGC’s

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<sup>1</sup> *Compliance Audit Report of the Actual Cost Adjustment Component of the Purchased Gas Adjustment Rule and Performance-Based Ratemaking Tariff for Chattanooga Gas Company*, pp. 11-12 (September 9, 2005).

assets. Stemming from the audit results in Docket No. 03-00516,<sup>2</sup> Sequent had stated that it had in place a tracking mechanism to individually identify those transactions involving the use of the Company's assets. The Staff had requested documentation of the accounts credited in the Company's most recent Interruptible Margin Credit Rider filing. CGC's response to the Staff's request summarized the credits, but did not provide detailed documentation of the revenue realized from asset management sales on the various pipelines. Due to lack of time, the Staff accepted the amounts calculated by the Company, but indicated more details would be required in the next audit filing. The Company did not concur, stating it had responded to the Staff's data request in good faith and was unaware the response was insufficient until it received the draft finding. In addition, CGC disagreed that Sequent deployed its tracking system as the result of the audit in Docket No. 03-00516. Finally, the Company noted that it had not objected to any of the Staff's requests to waive the review period.

In the Report, the Staff also made the following recommendations:

1. The TRA should hire an independent consultant in the next audit of the Company's Actual Cost Adjustment filing and Incentive Plan filing.
2. Following receipt of the consultant's report, the TRA should render a decision on the appropriateness of all current affiliate agreements between CGC and Sequent or whether modifications should be made.
3. The TRA should adopt a set of affiliate rules for CGC in order to ensure affiliate transactions are appropriate and do not harm ratepayers.

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<sup>2</sup> *In re: Tennessee Regulatory Authority's Audit of Chattanooga Gas Company's Actual Cost Adjustment Filing (ACA) for the Period Ending June 30, 2003*, Docket No. 03-00516, *Order Adopting, in Part, ACA Audit Report of Tennessee Regulatory Authority's Energy and Water Division*, p. 10 (May 6, 2005).

4. The TRA should require the Company, going forward, to place all contracts out for bid using the request for proposal (“RFP”) process. This requirement should be enforced at the end of the current term of all affiliate agreements currently in place.

The Company took no position on the hiring of a consultant, but expressed concern over the additional costs to customers. However, the Company objected to a consultant participating in the IPA audit which, in the Company’s opinion, would negate the waiver of the prudence audit by an outside consultant if certain benchmarks were met. The Company also objected to the Staff’s recommendations to adopt affiliate rules for CGC and to require the Company to place all contracts out for bid using the RFP process. The Company argued that its current affiliate arrangement provides protections for its customers that exceed any potential benefits from affiliate rules, such as a bidding requirement. According to CGC, the open bidding process does not ensure that ratepayers will receive greater benefits than the Company has achieved under the current asset management agreement.

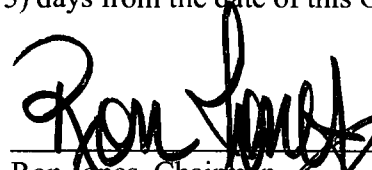
#### **NOVEMBER 7, 2005 AUTHORITY CONFERENCE**


At the regularly scheduled Authority Conference held on November 7, 2005, the panel voted unanimously to accept the audit findings as submitted. The panel voted unanimously to require CGC to submit to the TRA proposed guidelines for affiliate transactions to deter the risk of preferential treatment of an affiliate over a non-affiliate. These affiliate guidelines were ordered to be submitted by the Company as part of its performance ratemaking tariff no later than December 29, 2005. The panel also voted unanimously to require CGC to place all future asset management contracts out for bid using the RFP process and to uphold the findings in Docket No. 03-00516 requiring CGC to submit any asset management contract to the TRA for approval prior to the commencement of the

agreement. However, a majority<sup>3</sup> of the panel voted to reject the Staff's recommendation to hire an independent consultant.

**IT IS THEREFORE ORDERED THAT:**

1. With the exceptions noted in this Order, the Actual Cost Adjustment Audit Report of Chattanooga Gas Company's annual deferred gas cost account filing for the year ended June 30, 2004, a copy of which is attached to this Order as Exhibit 1, is approved, adopted and incorporated in this Order as if fully rewritten herein.
2. CGC is required to submit to the TRA proposed guidelines for affiliate transactions as part of its performance ratemaking tariff no later than December 29, 2005.
3. CGC is required to place all future asset management contracts out for bid using the RFP process.
4. CGC is required to submit an asset management contract for approval by the TRA prior to commencement of the agreement, as previously ordered in Docket No. 03-00516.
5. 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.

  
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Ron Jones, Chairman

  
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Pat Miller, Director

  
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Sara Kyle, Director

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<sup>3</sup> Chairman Jones did not vote with the majority and instead voted to hire a consultant as outlined in the Report. He stated that the front-line staff conducting the audit, who are requesting additional expertise to discharge their responsibilities, should be afforded the necessary tools to complete their charge.

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**BEFORE THE TENNESSEE REGULATORY AUTHORITY**

T.R.A. DOCKET ROOM

**NASHVILLE, TENNESSEE**

**September 9, 2005**

**IN RE:**

**CHATTANOOGA GAS COMPANY**

**ACTUAL COST ADJUSTMENT AUDIT AND**

**PERFORMANCE-BASED RATEMAKING TARIFF**

)

)

)

)Docket No. 04-00402

)Docket No. 04-00403

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**NOTICE OF FILING BY THE UTILITIES DIVISION OF THE TENNESSEE  
REGULATORY AUTHORITY**

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Pursuant to Tenn. Code Ann. §§65-4-104, 65-4-111 and 65-3-108, the Utilities Division of the Tennessee Regulatory Authority hereby gives notice of its filing of the Compliance Audit Report of the Actual Cost Adjustment Audit (hereafter "ACA") component of the Purchased Gas Adjustment Rule and the Performance-Based Ratemaking Tariff ("hereafter IPA") for Chattanooga Gas Company in these dockets and would respectfully state as follows:

1. The present dockets were opened by the Authority to hear matters arising out of the ACA audit and IPA audit of Chattanooga Gas Company (the "Company").

2. The Company's ACA filing and IPA filing were received on November 15, 2004, and the Staff completed its audit of same on August 25, 2005. The original 180-day deadline for the Staff's completion of the audit was extended to September 26, 2005 by

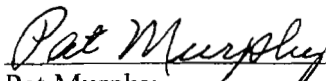
mutual consent of Chattanooga Gas Company and the TRA Staff as provided for in the Purchased Gas Adjustment Rule (1220-4-7-.03 (2)).

3. On August 29, 2005, the Utilities Division issued its preliminary ACA and IPA audit findings to the Company, and on September 6, 2005 the Company responded thereto.

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

5. The Utilities Division hereby files its Report with the Tennessee Regulatory Authority for deposit as a public record and approval of the recommendations and findings contained therein.

Respectfully Submitted:

  
Pat Murphy  
Utilities Division of the  
Tennessee Regulatory Authority

**CERTIFICATE OF SERVICE**

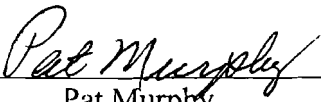
I hereby certify that on this 9th day of September, 2005, a true and exact copy of the foregoing has been either hand-delivered or delivered via U.S. Mail, postage pre-paid, to the following persons:

Ron Jones  
Chairman  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, TN 37243

Mr. Bryan E. Seas  
Vice President and Controller  
AGL Resources, Inc.  
Location 1686  
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Mr. Archie R. Hickerson  
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Ms. Amanda Hwang  
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\_\_\_\_\_  
Pat Murphy



**COMPLIANCE AUDIT REPORT  
of the  
ACTUAL COST ADJUSTMENT COMPONENT  
of the  
PURCHASED GAS ADJUSTMENT RULE  
and  
PERFORMANCE-BASED RATEMAKING TARIFF  
for  
CHATTANOOGA GAS COMPANY**

**Docket Nos. 04-00402 and 04-00403**

**Prepared by:**

**THE UTILITIES DIVISION  
of the  
TENNESSEE REGULATORY AUTHORITY**

**September 2005**

**EXHIBIT A**

**COMPLIANCE AUDIT REPORT  
of the  
ACTUAL COST ADJUSTMENT COMPONENT  
of the  
PURCHASED GAS ADJUSTMENT RULE  
and the  
PERFORMANCE-BASED RATEMAKING TARIFF  
for  
CHATTANOOGA GAS COMPANY  
for the Year Ended June 30, 2004**

**Docket Nos. 04-00402 and 04-00403**

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## **I. INTRODUCTION**

The subject of this compliance audit report is Chattanooga Gas Company's ("Company," "Chattanooga," or "CGC") compliance with the Actual Cost Adjustment and Refund Adjustment of the Purchased Gas Adjustment Rule ("PGA Rule") of the Tennessee Regulatory Authority ("TRA" or the "Authority") and the terms of its Performance-Based Ratemaking Tariff ("PBR," "Incentive Plan," or "IPA"). The objective of this compliance audit is to determine whether the purchased gas adjustments, which are encompassed by the Actual Cost Adjustment ("ACA"), as more fully described in section VI., for the year ended June 30, 2004, are calculated correctly, in conformance with all applicable TRA rules and orders, and are supported by appropriate source documentation and whether the Company has complied with the terms of its Incentive Plan as of June 30, 2004.

The gas purchasing activity reported in the Company's IPA filing is in part substantiated by invoices supplied in the course of its annual ACA audit. Since there is no incentive sharing mechanism in CGC's IPA, the audit conclusions for the IPA compliance audit are inexorably linked to the audit conclusions reached in the ACA compliance audit. Therefore, for this particular audit, the TRA Staff ("Audit Staff") has elected to combine its reporting of the compliance audits of Chattanooga's ACA and IPA filings for the year ended June 30, 2004.<sup>1</sup>

## **II. AUDIT OPINION**

The Staff concludes that except for the Audit Staff's findings noted herein (Section VIII), the Company's reporting of its gas purchases as compared to the benchmarks established in its Incentive Plan and the Purchased Gas Adjustment mechanism, as calculated in the Actual Cost Adjustment, appear to be working properly and in accordance with the TRA rules for Chattanooga Gas Company. While the monetary findings are not material, with respect to the Company's total gas costs, the Audit Staff continues to have concerns regarding the lack of transparency regarding affiliate transactions and the absence of affiliate rules for Chattanooga Gas. The Audit Staff also questions the Company's practice of charging CGC the index rate for purchases other than NORA purchases.<sup>2</sup> See Section XIX of this report for the Audit Staff's conclusions and recommendations.

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<sup>1</sup> The Audit Staff's combined report for Chattanooga Gas' Actual Cost Adjustment and Incentive Plan filings is unique to this reporting period only

<sup>2</sup> Company response to audit Finding #1.

### III. SUMMARY OF COMPANY FILINGS

The Company filed its annual ACA and IPA reports for its Tennessee service area on November 15, 2004.

#### Actual Cost Adjustment

The ACA filing showed \$59,682,386 in total gas costs, with \$61,093,210 being recovered from customers through rates. Adding a beginning balance in the Deferred Gas Cost Account ("ACA Account") of negative \$664,146 in over-recovered gas costs from the preceding ACA period and interest due to customers for the current period of \$57,786 resulted in an ACA balance at June 30, 2004 of **negative \$2,132,756 in over-recovered** gas costs. The Company's ACA filing is summarized below.

#### CHATTANOOGA GAS COMPANY ACA FILING FOR PERIOD JULY 2003-JUNE 2004

<u>Line</u>		
1	Beginning Balance (July 2003)	\$ (664,145.57)
2	Purchased Gas Costs	59,682,385.87
3	Gas Costs recovered through rates	61,093,210.53
4	Interest on monthly balances	<u>(57,786.00)</u>
5	Ending Balance (June 2004) (Line 1 + Line 2 – Line 3 + Line 4)	<u>\$ (2,132,756.23)</u>

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

The Company filed a PGA tariff, effective January 1, 2005, to begin refunding the balance in the ACA Account as of June 30, 2004. The Audit Staff's findings resulting from this audit are described in detail in Section VIII of this report.

#### Incentive Plan

The Company's IPA filing reported total gas purchases for the period of \$51,275,877.64 and a benchmark (based on indexes as stipulated under the terms of the Incentive Plan) of \$51,272,759.60. The difference of \$3,118.04 represents 0.0061% (61 ten-thousandths of a percent) above the benchmark. Based on its observations and the Company's responses to staff data requests, the Audit Staff is of the opinion that this

extremely close correlation is the result of the Company charging Chattanooga Gas at index for the majority of the purchases during the audit period.<sup>3</sup>

#### **IV. BACKGROUND INFORMATION ON COMPANY**

Chattanooga Gas Company, located at 6125 Preservation Drive in Chattanooga, Tennessee, is a wholly owned subsidiary of AGL Resources, Inc. ("AGL"), a holding company formed in 2000 in response to the Public Utility Holding Company Act (PUCHA) of 1935. AGL Resources, Inc. is located at Ten Peachtree Place, Atlanta, Georgia. As a local distribution company ("LDC"), Chattanooga Gas provides service to customers in Chattanooga and Cleveland, Tennessee, and environs in Hamilton and Bradley Counties in Tennessee, respectively. The natural gas used to serve these areas is purchased by Sequent Energy Management ("Sequent" or "SEM")<sup>4</sup> from various suppliers and transported by East Tennessee Natural Gas ("ETNG"), Tennessee Gas Pipeline ("TGP") and Southern Natural Gas ("SNG") under tariffs approved by the Federal Energy Regulatory Commission ("FERC").

#### **V. JURISDICTION OF THE TENNESSEE REGULATORY AUTHORITY**

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

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

Further, Tenn. Code Ann. § 65-4-105 grants the same power to the Authority with reference to all public utilities within its jurisdiction as Tenn. Code Ann., Title 65. Chapters 3 and 5 confer oversight of the railroads to the Department of Transportation or oversight of transportation companies to the Department of Safety. By virtue of Tenn. Code Ann. § 65-3-108 said power includes the right to audit:

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

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<sup>3</sup> While the Company states that it began charging index in April 2004 (Company response to staff Finding #1), it appears from the IPA filing that the majority of first of month ("FOM") purchases were charged at index during all twelve (12) months of the plan year

<sup>4</sup> Sequent is a marketing affiliate of CGC.

The Utilities Division of the TRA is responsible for auditing those companies under the Authority's jurisdiction to ensure that each company is abiding by Tennessee statutes as well as the Rules and Regulations of the Authority. Pat Murphy and Gary Lamb in the Energy and Water Section of the Utilities Division conducted this audit.

## **VI. DESCRIPTION OF PURCHASED GAS ADJUSTMENT (PGA) RULE AND CGC PERFORMANCE-BASED RATEMAKING TARIFF**

### **Actual Cost Adjustment Audits**

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

The PGA consists of three major components:

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

The ACA is the difference between the revenues billed customers by means of the GCA and the cost of gas invoiced the Company by suppliers plus margin loss (if allowed by order of the TRA in another docket) as reflected in the Deferred Gas Cost account. The ACA then "true-up" the difference between the actual gas costs and the gas costs recovered from the customer through a surcharge or a refund. The RA refunds the "true-up" along with other supplier refunds. For a more complete definition of the GCA and RA, please see the PGA Formula in Appendix A of this Report.

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

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

### **Prudence Audit of Gas Purchases**

Section 1220-4-7-.05 of the PGA Rule requires, unless otherwise ordered by the Authority, an "Audit of Prudence of Gas Purchases" by a qualified consultant. This specialized audit evaluates and reports annually on the prudence of any gas costs included in the PGA. At its September 11, 2001 Authority Conference, the Directors voted to approve a Performance-Based Ratemaking Mechanism for Chattanooga (Docket

continues each year unless terminated by the Company or the Authority. For each year that the mechanism is in effect, if CGC's total commodity gas purchases are less than 1% above the total annual benchmark, its purchases are deemed prudent and the requirements of Section 1220-4-7-.05 of the PGA Rule is waived.

### **Performance-Based Ratemaking Tariff**

On January 8, 2002, the Tennessee Regulatory Authority ("TRA" or "Authority") issued an Order in Docket Number 01-00619 approving a tariff to establish a performance-based ratemaking mechanism for Chattanooga Gas Company. The specific details of the mechanism are included in Chattanooga Gas' tariff entitled Performance-Based Ratemaking, which was issued on January 25, 2002, and was effective September 11, 2001.<sup>5</sup> A copy of this tariff is attached to the report as Attachment 1.

The tariff differs from traditional incentive plans in that the Company does not share in any profits or losses experienced when comparing its actual gas cost purchases against a predetermined benchmark. The "incentive" in Chattanooga Gas's case is a waiver of the prudence audit of gas purchases as required under the TRA's Purchased Gas Adjustment Rule.<sup>6</sup> The terms under which the prudence audit will be waived is found in the section Prudence Determination of the tariff.

"If Chattanooga's total commodity gas cost for the plan year does not exceed the total benchmark amount by one percentage point (1%) for a plan year ending after June 30, 2000, Chattanooga's gas cost will be deemed prudent and the audit required by Tennessee Regulatory Authority's Administrative Rule 1220-4-7-.05 is waived. If during any month of the plan year, the Company's commodity gas cost exceeds the benchmark amount by greater than two percentage points (2%), the Company shall file a report with the Authority fully explaining why the cost exceeded the benchmark."

The Incentive Plan automatically rolls over for an additional plan year on each July 1<sup>st</sup>, and continues until the Incentive Plan is either (a) terminated at the end of a plan year by not less than 90 days notice to the TRA by Chattanooga Gas or (b) modified, amended or terminated by the TRA.

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<sup>5</sup> September 11, 2001 was the date of the Authority Conference during which the Directors voted to approve the Company's tariff petition with certain modifications.

<sup>6</sup> TRA Rule 1220-4-7-05

## **VII. SCOPE OF ACA AND IPA AUDIT**

The ACA audit is a limited compliance audit of the Company's ACA Account. The audit objective is to verify that the Company's calculations of gas costs incurred and recovered are materially correct,<sup>7</sup> and that the Company is following its tariff and all Authority rules, orders and directives with respect to its calculation of the ACA Account balance. Also included in this audit is the Company's PGA filing implementing a customer refund of the ACA Account balance, effective January 1, 2005, and a PGA filing to refund the balance in the Company's Interruptible Margin Credit Rider ("IMCR"), effective April 1, 2004. Refer to the ACA Account detail provided in Section III, Summary of Company Filings.

The IPA audit is also a limited compliance audit. The audit objective is to determine whether the Company has complied with the terms of its Incentive Plan for the twelve (12) months ended June 30, 2004. After reviewing the Company's gas purchases activity, along with the applicable benchmark indexes each month, Staff found no material errors. Staff concludes that, during the plan year under review, the Company's gas purchases have met the criteria as specified in its tariff. Therefore, for the plan year ended June 30, 2004, the Company is released from the prudence audit requirements encompassed in the Purchased Gas Adjustment Rule ("PGA Rule") 1220-4-7-.05. Section III of this report further describes the actual results of the plan year.

To accomplish the audit objectives, the Audit Staff reviewed gas supply invoices, as well as supplemental schedules and other source documentation provided by Chattanooga. Where appropriate, the Audit Staff requested additional information to clarify the filing.<sup>8</sup> The Audit Staff also reviewed the indexes published by Gas Daily and Inside FERC to determine if the benchmarks reported by CGC were accurate.

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<sup>7</sup> 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.

<sup>8</sup> Staff's request for Sequent's unredacted 3<sup>rd</sup> party supplier invoices and copies of purchase and asset management agreements between Sequent and CGC were provided only after the TRA convened a contested case and issued a protective order in this docket.



## VIII. STAFF AUDIT FINDINGS

The Audit Staff's audit resulted in findings totaling a **negative \$29,557.39**. This amount is the net total of two (2) findings and represents a credit or additional over-recovery in the ACA Account, which when added to the Company's calculated balance, results in a **negative** (over-recovered) balance in the ACA Account of **\$2,162,313.62**. A summary of the ACA Account as filed by the Company and as adjusted by the Audit Staff is shown below, followed by a description of each finding.

### SUMMARY OF THE ACA ACCOUNT:

Line		Company	Staff	Difference (Findings)
1	Beginning Balance at 7/1/03	\$ (664,145.57)	\$ (664,145.57)	\$ 0.00
2	Gas Purchases	59,682,385.87	59,653,024.48	(29,361.39)
3	Gas Costs Recovered thru Rates	<u>61,093,210.53</u>	<u>61,093,210.53</u>	<u>0.00</u>
4	Ending Balance before Interest (line 1 plus line 2 minus line 3)	\$ (2,074,970.23)	\$ (2,104,331.62)	\$ (29,361.39)
5	Interest on Account Balance	<u>(57,786.00)</u>	<u>(57,982.00)</u>	<u>(196.00)</u>
6	Ending Balance at 6/30/04 (line 4 plus line 5)	<u>\$ (2,132,756.23)</u>	<u>\$ (2,162,313.62)</u>	<u>\$ (29,557.39)</u>

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

### SUMMARY OF FINDINGS:

Page No.

FINDING #1	Index Billing	N/A	No \$ Effect	8
FINDING #2	Uncollectible Gas Costs	\$ 29,361.39	Over-recovery	14
FINDING #3	Asset Management	N/A	No \$ Effect	17
FINDING #4	Interest on Account Balance	<u>196.00</u>	Over-recovery	19
TOTAL		<u>\$ 29,557.39</u>	Over-recovery	

## **FINDING #1:**

### **Exception:**

Sequent Energy Management invoiced Chattanooga Gas monthly for gas purchases priced at index<sup>9</sup>, rather than at Sequent's cost as represented by the Company to the TRA.

### **Discussion:**

Sequent is the marketing arm of AGL Resources and, as such, is an affiliate of Chattanooga Gas. Through an agreement with its affiliate, Sequent began purchasing gas on behalf of CGC in April 2001. Sequent invoices CGC monthly for the cost of the gas. From the onset of this agreement, Sequent and CGC have represented to the TRA Audit Staff that the gas costs Sequent invoices to CGC are the actual costs incurred by Sequent.

**Docket 01-01010** Actual Cost Adjustment Filing ("ACA") for July 2000 through June 2001.

CGC response to Staff Data Request dated 12/04/01.

- Q.3 The following invoices payable to Sequent Energy Management do not have a payment stamp showing authorization, date and coding of the payment. Please supply proof of payment of these invoices.

Also, AGL has represented to our Staff that Sequent is passing through only its cost to the ratepayers of Chattanooga. With this in mind, please provide Sequent's invoices supporting the price of gas charged to Chattanooga each month. For each invoice show how the price compares to market for that month.

- CGC Since these transactions are settled through inter-company transfers, these invoices are not routinely stamped and coded as are third party invoices.

Because the final third-party invoices for gas purchases are often delayed for a number of months, Sequent bills CGC the monthly index price for gas deliveries. After Sequent has determined that all CGC gas invoices have been received, an adjusting entry is made on both Sequent and CGC's books to "true-up" the index price to the final invoice rate.

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<sup>9</sup> National indexes established by the voluntary reporting of actual transactions in the market by various companies. Chattanooga Gas uses Inside FERC and Gas Daily indexes as published in Platts publications: Index prices are by definition "after the fact" and reflect averages of the actual transactions that took place in the market place at a specific point in time.

**Docket 02-00929** Actual Cost Adjustment Filing for July 2001 through June 2002.

CGC response to Staff Data Request dated 11/06/02.

Q.1 It appears that Sequent bills Chattanooga Gas for the gas purchased based on the Inside FERC index for that month. Then, when the 3<sup>rd</sup> party invoices are received, Sequent trues up Chattanooga's account based on its actual cost. For the record, please provide a narrative describing Sequent's billing procedures regarding gas purchases for Chattanooga Gas.

CGC Sequent can be considered to be the "gas purchasing department" for Chattanooga Gas Company. In this role, Sequent purchases the gas for delivery to Chattanooga Gas' city gate and then transfers this gas to the Utility at Sequent's 3<sup>rd</sup> party cost. Sequent purchases a base level of gas for CGC at rates that are tied to the Inside FERC index. However, Sequent also purchases other additional "swing" gas for CGC throughout the month that is based on the market rate quoted on each particular day. For accounting purposes, CGC books an estimated liability at the end of each month for gas it purchases through Sequent. When Sequent actually invoices CGC for the gas it purchases the following month, it includes the actual third-party gas cost and CGC reverses its estimated liability.

Q.2 In July 2001, Chattanooga billed Sequent for recovery of its overpayment of April – June 2001 invoices. There are no true-up payments/credits during the current audit period (July 2001 – June 2002). Based on our analysis of the Sequent invoices for this time period, Chattanooga has a net under-payment of \$33,572. When will this amount be billed? Has Sequent and/or Chattanooga established a schedule for addressing this true-up process?

CGC Sequent has charged CGC an additional \$33,572 for the trued-up difference between the actual 3<sup>rd</sup> party cost of gas and the costs invoiced to CGC for the period July 1, 2001 through June 30, 2002. This charge, which is due to rounding, was booked in November 2002.

On July 13, 2001, CGC filed a petition requesting approval of a Performance-Based Ratemaking plan (Docket 01-00619). In response to the TRA Staff's data request, dated July 16, questions 1, 3 and 5, CGC indicated that all gas savings below the benchmark would flow back to ratepayers (question 1), that the Company must continue to improve and to purchase gas at or below the established benchmark (question 3) and Chattanooga Gas must continue to minimize the cost of gas (question 5).

The Consumer Advocate and Protection Division of the Attorney General's Office ("CAPD") intervened in this docket expressing its concern that without a prudence audit, the true price paid by Chattanooga's affiliate could not be determined and the ratepayer might not receive the full benefit of any cost savings. During the Authority Conference held on September 11, 2001, the CAPD reported that the parties had met and the Company had assured the CAPD that Sequent "will purchase gas at the lowest cost possible, and that it will not profit in its sales to Chattanooga Gas." Billye Sanders, attorney for Chattanooga Gas, confirmed this understanding, "...Chattanooga Gas...will continue to make those invoices available, and that same cost that is incurred by Sequent to purchase the gas would be the same cost that would be passed on to the consumer by Chattanooga Gas."<sup>10</sup> Based on this representation by the Company, the CAPD withdrew its intervention and the Directors of the Authority voted to approve CGC's petition with modifications. Comments filed by the Attorney General's Office on September 11, 2001 stated that "It is the understanding of the Attorney General based on representations by officials of CGC that such a "mark-up" will not occur. Specifically, Sequent, or any affiliate of CGC, will purchase gas at the **lowest possible market price**. Sequent will pass this price on to CGC at no additional cost, which will then flow directly to the rate payer at the same price Sequent makes its purchase." [Emphasis added]<sup>11</sup>

In the current audit (Docket 04-00402), CGC confirmed what the Audit Staff surmised. Sequent is now billing CGC for gas purchases based on the index price for the month. Staff data request dated March 24, 2005, question no. 2 asked:

Q.2 Are variances between Sequent's invoices and their corresponding 3<sup>rd</sup> party invoices adjusted ("trued-up") in the Company's ACA filing? If so, at what intervals?

CGC Variances between Sequent's invoices to Chattanooga Gas Company and their corresponding 3<sup>rd</sup> party invoices are not adjusted, or trued-up, in the Company's ACA filing. The Gas Purchase and Sales Agreement between CGC and Sequent Energy Management, L.P provides for gas to be purchased at index or at a negotiated price. The use of recognized indices for pricing the gas provides assurance that CGC and its customers are provided gas at no more than market price.

Index prices are only made available after the fact (after transactions in the market place are reported to the national index database). So, at the time Sequent is making purchases to fulfill CGC's gas requirements, it doesn't know what the index will be. Only after the index prices are published can Sequent then bill CGC the index price. Sequent has now memorialized this agreement with CGC effective April 1, 2004.<sup>12</sup>

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<sup>10</sup> Transcript of TRA Directors Conference, page 26 (September 11, 2001).

<sup>11</sup> Attorney General's Comments Regarding the Petition to Intervene, page 2, paragraph 2. (September 11, 2001)

<sup>12</sup> Gas Purchase and Sale Agreement between Chattanooga Gas Company and Sequent Energy Management, L.P. provided under Protective Order (July 18, 2005).

In the preceding filing period for CGC for the twelve (12) months ended June 30, 2003 (Docket 03-00516), Staff attempted to obtain copies of Sequent's third party invoices to confirm that the price paid by Sequent was in fact the price passed on to Chattanooga Gas. In that docket, Staff was not able to obtain complete un-redacted invoices due to a lack of a protective order. Therefore, the Audit Staff could not assure the Authority that CGC customers were being charged appropriately. On June 27, 2005, CGC's request for a protective order was brought before the voting panel in this docket. The Directors voted to convene a contested case and a protective order was issued on July 5, 2005. After two data requests (on July 12 and August 1), the audit staff received the complete un-redacted invoices from the Company. Time did not permit a detailed analysis of the invoices. But a limited review confirmed that the Company is charging CGC the index price for gas each month. The invoices show that gas is being purchased at various prices through out each month, but CGC is being retroactively charged the index price.

In summary, the Company has represented to the TRA and its Staff that Sequent is purchasing gas on behalf of Chattanooga Gas and charging CGC its cost in the market place. While the Audit Staff cannot with certainty identify the point in time that Sequent's practice changed, we now know that its practice is to bill index prices to Chattanooga. By doing so, CGC is assured of avoiding the prudence audit requirements of the Purchased Gas Adjustment Rule (TRA 1220-4-7-.05), by buying gas at the benchmark as provided for in its Performance-Based Ratemaking tariff (Sheet 54, paragraph 1) each month.

**Company Response:** [Note: All footnotes in the Company's response were placed there by the Company.]

Effective April 1, 2004 a new Asset Management and Agency Agreement was entered into between Chattanooga Gas Company (CGC) and Sequent Energy Management, L.P. (Sequent). This agreement stipulates that all sales made by Sequent to CGC will be priced at the applicable indices, namely, "FOM Index price" as published by Platts in the "Inside FERC's Gas Market Report or "Gas Daily prices" as published by Platts in the "Gas Daily". Since there are no indices for the NORA receipt point on East Tennessee Natural Gas, purchases at this point are priced at Sequent's actual cost. Approximately 5,000 dkt per day are delivered at the NORA receipt point November-March.

Accordingly, sales to CGC at other than the NORA receipt point have been priced at these applicable indices effective April 2004. Prior to the effective date of the new agreement, Sequent invoiced CGC at the applicable indices. Subsequently, these invoiced amounts were to be adjusted based on representative 3<sup>rd</sup> party invoices. The following summarizes the differences between index and 3<sup>rd</sup> party invoices, the total commodity cost of gas, and the % variance from April 2001 though June 2004:

Period	Index Exceeds Third Party Invoice	Total Commodity Cost of Gas <sup>13</sup>	% Variance
April 2001 – June 2001	\$20,907.	\$8,004,778	0.261%
July 2001 – June 2002	(\$33,998.)	\$31,974,619	(0.106%)
July 2002 – June 2003	\$5,585.	\$44,366,276	0.013%
July 2003 – June 2004	\$3,756.	\$47,612,316	0.008%

In summary, utilization of monthly “FOM” or daily “Gas Daily” indices to price physical gas purchases and sales are a standard industry practice. Additionally, the above historical table that summarizes sales to CGC invoiced at index to 3<sup>rd</sup> party invoices demonstrates that Sequent’s purchases are primarily at index or index +/- a small differential. As shown the variance is a fraction of a per cent (sic) of the commodity cost of gas. Given the current market conditions, where a vast majority of transactions are being executed at an index plus a small premium (usually \$0.005 or \$0.01), pricing all sales to CGC at index flat is advantageous to the utility, and assures that CGC’s gas purchase are prudent.

In its finding, the Staff indicated that a lack of time prevented it from completing additional analysis that it believed to be appropriate. The Company points out that in the course of this review, it did not objected (sic) to any of the Staff’s requests for waivers of the review period set fourth in TRA Rule 1220-4-7-.03.

#### **Audit Staff Response:**

The Company has attempted to justify its unilateral decision to change Sequent’s method for billing Chattanooga for gas purchased on its behalf. That is a decision that should have been made by this Authority. After hearing the Company’s arguments, the Directors would have had the option of approving or denying the request or perhaps requesting additional information from the Company or outside experts to determine if billing index prices is in the best interest of Chattanooga’s ratepayers. Instead the Company has, for whatever reason, began a new practice without bringing the new Asset Management and Agency Agreement (referenced above) and the Gas Purchase and Sale Agreement between Chattanooga Gas and its affiliate Sequent before the Authority for its approval.

Following the issuance of the Audit Staff’s report in Docket 03-00516, at the December 13, 2004 Authority Conference, the Directors ordered that any agreement between Chattanooga Gas and an asset manager should be brought before the TRA for approval prior to effective date.<sup>14</sup> Despite that order, the Company refused to provide the Authority’s Audit Staff with a copy of the above referenced agreements without a

<sup>13</sup> Total commodity cost pre ACA summaries.

<sup>14</sup> See In re: Tennessee Regulatory Authority’s Audit of Chattanooga Gas Company’s Actual Cost Adjustment Filing (ACA) for the Period Ending June 30, 2003, Docket No. 03-00513, Order Adopting, in Part, ACA Audit Report of Tennessee Regulatory Authority’s Energy and Water Division, p. 10 (May 6, 2005).

protective order in place, nor did the Company seek prior approval of the agreements by this agency.

As regards the Company's inference that it would not refuse a request for another extension of the audit deadline, the Audit Staff has decided that, since another audit period has concluded for both the ACA and IPA and the Company would not likely file these reports until a decision is reached relative to this audit period, further extension would not be in the best interest of all parties involved. Therefore, as the Audit Staff has indicated, further analysis of invoices and the Company's tracking system for asset management transactions will be deferred until the next audit.

## **FINDING #2:**

### **Exception:**

The Company overstated uncollectible gas cost revenue by \$29,361.39.

### **Discussion:**

The Company failed to reduce uncollectible gas costs by the pro rata portion of the total uncollectible cost of \$138,006 determined in Docket 97-00982. In its response to the Staff's Data Request dated April 11, 2005, the Company allocated \$88,062 of the total \$138,006 as the uncollectible gas cost portion.<sup>15</sup>

The total uncollectible gas costs to be recovered from ratepayers included in the Company's ACA filing is \$177,224.63 for the months March – June 2004. However, this amount must be reduced by the pro rata share of the \$88,062 included in the Company's last rate case. Since four months of uncollectible gas cost is reported during this audit period the uncollectible gas costs attributable to the audit period must be reduced by 4/12 of the annual gas cost already included in base rates from the last rate case. The pro rata share of the \$88,062 is calculated as 4/12 of \$88,062 yielding \$29,354 of uncollectible gas costs included in base rates.

An adjustment must be made to actual uncollectible gas cost for the months of July – September 2004 in the next ACA audit. This adjustment will reflect the last three months that uncollectible gas costs were included in base rates. Pursuant to Docket 04-00034, effective October 1, 2004, the gas cost portion of the actual uncollectible cost was removed from the uncollectible expense included in base rates and is to be recovered through the gas cost portion of the PGA. The pro rata share of the \$88,062 for this period is calculated as 3/12 of \$88,062 yielding \$22,015.50 of uncollectible gas cost.

The Company incorrectly reduced the PGA portion of subsequent payments on written-off accounts by collection fees before crediting to the ACA. Uncollectible gas costs must be reduced by \$7.39<sup>16</sup> of collection agency fees which the Company netted against payments prior to crediting to uncollectible gas costs. Total adjustment to the uncollectible portion of uncollected write-offs results in **\$29,361.39 over-recovery of gas costs.**

At the time of CGC's filing, there was no consensus between Nashville Gas, Atmos Energy and Chattanooga Gas regarding the implementation of the decision in Docket 03-00209. Staff informally requested the three gas companies to file a joint proposal. But this did not occur before the matter again came before the Panel at the April 4, 2005 Authority Conference. At that time, the three gas companies were instructed to file a joint proposal with the Authority by June 1, 2005. In her letter to then Chairman Miller dated June 1, 2005 CGC counsel, D. Billye Sanders, states:

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<sup>15</sup> Staff Request dated 4/11/05, Item 2.

<sup>16</sup> April 2004 Gas Portions of Bad Debts Accounts Recovered submitted by CGC.



“Fees paid to collection agencies are not considered in the allocation of partial payments on accounts previously written-off to uncollected margin and gas costs. The full amount collected from the customer will be recognized as payment on the account. Any fee paid to a collection agency will be treated as an operating expense and will not impact the PGA/ACA.”

Therefore, Chattanooga Gas must abide by the joint proposal even though it is being applied retroactively in its case. Nashville Gas and Atmos Energy have not yet filed for recovery of uncollectible gas costs.

**Company Response:** [Note: All footnotes in the Company’s response were placed there by the Company.]

Chattanooga Gas Company (CGC) concurs. On February 9, 2004 in Docket 03-00209 the TRA found “that the intent of the PGA rule is to allow recovery of all gas costs, including those that are billed and uncollectible” and allowed the utilities to recover the gas portion of bad debt expense in excess of the amount included in base rates for gas cost through the PGA/ACA mechanism. However the allocation of the uncollectible allowance included in base rates to gas and non-gas costs were not addressed at that time. No additional directives were provided, relative to the recovery of the gas portion of bad debts prior to the November 15, 2005 ACA filing by CGC.

After the order in Docket 03-00209 was issued on February 9, 2005, the Staff issued data requests to each of the three gas utilities seeking information concerning the procedure each was using to account for and recover the uncollectible costs.<sup>17</sup> As indicated above, the Company responded, providing the data requested.

On April 4, 2005 the TRA directed (CGC), Atmos Energy Corp, and Nashville Gas Company (NGC) to file a joint proposal setting forth detailed procedures for accounting for uncollectible gas cost recovery within the annual Actual Cost Adjustment (ACA) filing. On June 1, 2005 the three utilities made the joint filing.

Prior to the issuance of this draft report, the joint response filled on June 1, 2005 had not been officially addressed. As explained in the above finding, the Staff has adopted and is requiring that the recommended accounting and the recovery procedures proposed in the joint filing, with one exception, be followed in this and future ACA filings. The one exception is the methodology for allocating to the individual months the gas portion the uncollectible allowance included in base rates. As explained in the above finding, the Staff has allocated 1/12<sup>th</sup> of the annual allowance to each month. In the joint filing, CGC, Atmos Energy, and NGC recommended that the allowance be allocated

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<sup>17</sup> March 7, 2005 TRA Staff Data Request Docket 03-00209.

based on the ratio of net uncollectibles for the month to the total net uncollectibles for the twelve month period<sup>18</sup>.

Since no gas cost is included in the new base rates established for CGC effective October 1, 2004, the allocation of the uncollectible allowance to the individual months is applicable only to the period of March 2004 thorough September 2004. As a result, CGC accepts the Staff's modification of the methodology used to allocate the allowance in determining the adjustment in this review. The Company also agrees to adjust the deferred cost for the twelve months ended June 30, 2004 to include the \$7.39 collections fees consistent with the CGC, Atmos Energy, and NGC proposal filed June 1, 2005.

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<sup>18</sup> This procedure was also addressed in CGC's response to the TRA Staff's March 7, 2005 data request in Docket 03-00209 and the April 11, 2005 data request in docket 04-00402. Since the collection of the gas portion of the bad debts through the PGA had been in effect since March 2004, twelve months of such net write-offs under the new procedure was not available at the time of the filing of the ACA for the twelve months ended June 30, 2004.

### **FINDING #3:**

#### **Exception:**

The Company did not supply sufficient information for the Audit Staff to verify the credits accruing to ratepayers as a result of transactions made by Sequent using CGC's assets.

#### **Discussion:**

Stemming from the audit results in Docket 03-00516, Sequent stated that it now had in place a tracking mechanism to individually identify those transactions involving the use of CGC's assets. The Audit Staff requested in this audit documentation of the amounts credited in its most recent Interruptible Margin Credit Rider ("IMCR") filing. The response included documents summarizing the calculation of the credits; however, there was no detailed documentation of the revenue realized from Asset Management Sales on the various pipelines. Due to lack of time to pursue the details, the Audit Staff is accepting the amounts calculated by the Company. But in the next audit filing, we will request Sequent to provide more details of the tracking mechanism and to provide the Audit Staff with sufficient backup to support the numbers.

#### **Company Response:**

The Company does not concur with the finding relative to the request for documentation of the amounts of the credits for its most recent IMCR filing. The Company responded to the data request in good faith and both Chattanooga Gas Company and Sequent Energy Management were unaware that the Staff did not consider the response to be sufficient until the draft finding was provided on August 29, 2005. In the future, the Company asks that there be more open communications during such reviews that provides for discussion that may result in such issues being timely resolved prior to the preparation of the report. Chattanooga Gas Company and Sequent stand ready to provide the Staff with details of the system, the procedures used to track gains from transaction that involve the use of CGC's gas supply assets, and the documentation of the gain realized from the asset management agreement. Earlier this summer, the Company asked the Staff to schedule a meeting with representatives of CGC and Sequent to discuss asset management. The Company understands that this request was declined by the Staff because the TRA had opened a docket addressing Nashville Gas Company's asset management and the Staff was concerned that a meeting with Sequent and CGC representatives would be in conflict with the pending docket. The request for the meeting is a standing offer. The meeting can be scheduled once the Staff determines that such a meeting will not interfere with a pending docket.

In addition, CGC and Sequent do not agree that Sequent deployed its tracking system as the result of the audit in Docket 03-00516 as indicated in the finding. Sequent invested in the new end-to-end trading and risk management system in 2004 to support the growth and anticipated expansion of its business. Endur was implemented in October

2004 with the functionality to track and manage Sequent's trading and risk management activities associated with all proprietary and affiliate transactions. The system was configured to track financial hedging, inventory activities, affiliate sharing, commodity purchases and sales, transportation capacity and rates, and physical options.

Also in its findings, the Staff indicated that a lack of time prevented it from completing additional analysis that it believed to be appropriate. The Company points out that in the course of this review, it did not objected (sic) to any of the Staff's requests for waivers of the review period set fourth in TRA Rule 1220-4-7-.03.

**Audit Staff Response:**

Evidently a miscommunication has occurred in the Audit Staff's draft finding submitted to the Company. One, the new tracking system was brought to light in Docket 03-00516, even though the Company had already made plans to implement the system. Two, the Audit Staff is pointing out that it has not reviewed sufficient documentation to date to provide assurance to the Directors that amounts reported to the TRA are accurate. We are not assigning blame to anyone. We agree that the Company has expressed its desire to provide any additional information requested. As stated before, due to the need to finalize the audit as quickly as possible, the Audit Staff has elected to accept the Company's numbers and defer an in depth review until the next audit.

**FINDING #4:**

**Exception:**

The Company understated the amount of interest due to customers.

**Discussion:**

Staff recalculated the amount of interest due to customers on the ACA Account balance after making corrections for Finding #2. The result is an increase of interest due to customers in the amount of **\$196**. This represents an **over-recovery** of gas costs.

**Company Response:**

The Company concurs.

## IX. STAFF CONCLUSIONS AND RECOMMENDATIONS

This audit resulted in more questions than answers. The one apparent conclusion is that the agreements in place between affiliates Chattanooga Gas Company and Sequent Energy Management are not transparent and cannot be audited by the TRA's Audit Staff to the extent necessary to provide assurance to the TRA and to the Company's ratepayers that they are receiving all of the benefits to which they are entitled<sup>19</sup> and that they are not being harmed. What cannot be disputed is that Sequent is using CGC's assets<sup>20</sup> to create profits for itself and AGL's investors. What needs to be determined is whether those profits are fair, since they are obtained at the expense of Chattanooga's customers.

None of the agreements that have existed between CGC and Sequent have been brought before the TRA for prior review and approval. There has been no independent appraisal<sup>21</sup> of these agreements and the effect on Chattanooga customers. The Company basically says "trust us;" however, affiliate transactions always require more scrutiny than arms length transactions with third parties. Regardless of how the Company represents these agreements to the TRA, we must be cognizant of the profit motive, where it is possible to siphon off profits from regulated utilities and transfer them to the unregulated entities. The natural gas market has become very complicated and sophisticated in recent years. Hedging and arbitrage opportunities exist for the very knowledgeable traders at Sequent's level to make substantial profits for the unregulated companies. It is the Audit Staff's understanding that Sequent has these agreements in place for all of its regulated affiliates. The Virginia State Corporation Commission ("VSCC") is currently reviewing the Sequent agreement with Virginia Natural Gas (which was fairly recently acquired by AGL). VSCC Staff's report should be released the end of this month.

With the information that the Audit Staff has obtained since the approval of CGC's Incentive Plan, we now question the appropriateness of the terms of this plan. The plan is set up to provide Chattanooga the chance to waive the prudence audit requirement of the PGA Rule.<sup>22</sup> The effective date of the plan was September 11, 2001. By April 1, 2004, the Company had in place a formal agreement with Sequent to buy gas at index price.<sup>23</sup> This agreement now basically *guarantees* a waiver of the prudence audit requirement for CGC.

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<sup>19</sup> The Audit Staff cannot emphasize enough that the assets and commodities in question are fully paid for by the ratepayers. Chattanooga Gas and by extension AGL incur no risk in purchasing gas other than being found imprudent by this Authority

<sup>20</sup> Assets include pipeline capacity, transportation contracts and storage gas among others.

<sup>21</sup> Review by consultant with extensive experience in natural gas trading in today's market, which involves such strategies as hedging, arbitrage of storage, etc.

<sup>22</sup> TRA Rule 1220-4-7-.05.

<sup>23</sup> This is the date of the formal agreement, but the Audit Staff has evidence that suggests this practice of billing index existed prior to April 1, 2004. What started as billing index costs as an estimate and then truing up the transactions when actual third party invoices were received ended before the formal agreement was in place.

The agreement also takes away any incentive for Sequent to purchase gas below index for Chattanooga. The Audit Staff has determined from its limited review of Sequent's third party invoices that Sequent pays above and below index on a routine basis. But Chattanooga is charged index. The redacted invoices that the Company originally supplied to the Audit Staff always showed only the purchases that corresponded to the index price. From the representations given to this Authority and the CAPD, Sequent has an obligation to buy gas for Chattanooga at the least possible market price. Index is merely an indicator of the average price paid by traders during the month. Ergo gas is being routinely sold below index as well as above index. The Audit Staff does not believe that the index price always represents a prudent decision, since index is determined after the fact. The goal of the Incentive Plan is to compare CGC's (i.e. Sequent's) purchasing decisions against an objective measure to determine prudence. Chattanooga's agreement with Sequent eliminates any possibility that Chattanooga customers will benefit from the considerable knowledge and capabilities of Sequent's gas purchasing staff.

Based on the conclusions reached in this audit, the Audit Staff urges the Authority to adopt the following recommendations:

1. The TRA should hire an independent consultant in the next audit of Chattanooga Gas' Actual Cost Adjustment filing and Incentive Plan filing. The consultant would be charged with investigating (under the Audit Staff's direction) and reporting his findings regarding, at a minimum, the following:
  - a. Sequent's actual cost related to gas purchases earmarked for CGC.
  - b. Whether the benchmarks contained in CGC's Incentive Plan provide a fair measure of the prudence of Chattanooga's gas purchases.
  - c. Whether the terms of the Gas Purchase and Sale Agreement and Asset Management and Agency Agreement provide adequate safeguards for Chattanooga's ratepayers.
2. Following receipt of the consultant's report, the TRA should render a decision on the appropriateness of all current affiliate agreements between CGC and Sequent or whether modifications should be made.
3. The TRA should adopt a set of affiliate rules for CGC in order to ensure affiliate transactions are appropriate and do not harm ratepayers.
4. The TRA should require Chattanooga going forward to place all contracts out for bid using the RFP process. This requirement should be enforced at the end of the current term of all affiliate agreements currently in place. Nashville Gas uses the RFP process to obtain its asset manager. Atmos currently uses its affiliate Atmos Energy Marketing as its asset manager, but follows the affiliate rules in place for Atmos and puts the contract out for bid. The Audit Staff believes the TRA should be consistent in its regulation of natural gas companies.

APPENDIX A

**PGA FORMULA<sup>24</sup>**

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

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

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

where

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

D = The sum of all fixed Gas Costs.

DACA = The demand portion of the ACA.

P = The sum of all commodity/gas charges.

T = The sum of all transportation charges.

SR = The sum of all FERC approved surcharges.

CACA = The commodity portion of the ACA.

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

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

SF = Firm Sales.

<sup>24</sup> Pursuant to Docket 03-00209, the PGA Formula has been amended on an experimental basis to include the gas cost portion of uncollectible accounts.



ST = Total Sales.

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

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

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

where

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

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

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

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

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

CR3 = The residual balance of an expired Refund Adjustment.

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

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

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

# ATTACHMENT 1

CHATTANOOGA GAS COM. NY  
GAS TARIFF  
TRA NO.1

REVISED SHEET56

## PERFORMANCE-BASED RATEMAKING

### APPLICABILITY

This Performance-Based Ratemaking Mechanism (PBRM) is designed to encourage the utility to maximize its gas purchasing activities at minimum cost consistent with efficient operations and service reliability. Each plan year will begin July 1. The annual provision and filings herein will apply to this annual period. The PBRM will continue until it is either (a) terminated at the end of a plan year or by not less than 90 days notice by the Company to the Authority or (b) modified, amended or terminated by the Authority.

### OVERVIEW OF STRUCTURE

The Performance-Based Ratemaking Mechanism establishes predefined monthly benchmark indexes to which the Company's commodity cost is compared.

### BENCHMARK INDEX

Each month, Chattanooga Gas Company (Company / Chattanooga) will compare its actual commodity cost of gas to the appropriate benchmark amount. The benchmark gas cost will be computed by multiplying actual purchase quantities for the month, including quantities purchased for injection into storage, by the appropriate benchmark price index.

#### Spot Market Purchases:

The monthly spot market benchmark is the "Index" price published in the first issue of the delivery month of *Inside FERC's Gas Market Report* in the table titled "Price of Spot Gas Delivered to Pipelines," denoted in the column labeled "Index" and the row for the applicable "Pricing Point."

#### Swing Purchases

For swing purchases, the benchmark "Index" price for gas delivered on any day upon which *Gas Daily* is published, is equal to the Gas Daily-Midpoint price for the immediately following day under the heading "Daily Price Survey" For gas delivered on Saturday, Sunday, or any other day upon which *Gas Daily* is not published, the price index is equal to the Daily-Midpoint for the nearest subsequent day published by *Gas Daily*

#### Long-term purchases

For long term purchases, i.e., a term more than one month, the "Index" price published in the first issue of the delivery month of *Inside FERC's Gas Market Report* in the table titled "Price of Spot Gas Delivered to Pipelines" denoted in the column labeled "Index" and the row for the applicable "Pricing Point" will be adjusted for the Company's rolling three-year average premium paid to ensure long-term supply availability during peak periods.

#### City Gate Purchases

For city gate purchases where gas is delivered by the supplier to the local distribution company, the indexes will be adjusted for the avoided transportation costs that would have been paid if the upstream capacity were purchased versus the demand charges actually paid to the supplier.

PERFORMANCE-BASED RATEMAKING (Continued)

PRUDENCE DETERMINATION

If Chattanooga's total commodity gas cost for the plan year does not exceed the total benchmark amount by one percentage point (1%) for a plan year ending after June 30, 2000, Chattanooga's gas cost will be deemed prudent and the audit required by Tennessee Regulatory Authority's Administrative Rule 1220-4-7-. 05 is waived. If during any month of the plan year, the Company's commodity gas cost exceeds the benchmark amount by greater than two percentage points (2%), the Company shall file a report with the Authority fully explaining why the cost exceeded the benchmark.

FILING WITH THE AUTHORITY

The Company will file an annual report not later than 60 days following the end of each plan year identifying the actual cost of gas purchased and the applicable index for each month of the plan year.

Unless the Authority provides written notification to the Company within 180 days of such reports, the annual filing 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 used by Chattanooga and the composition of Chattanooga'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 notice to Chattanooga within 30 days of the Company's notice to the Authority, the price indices shall be deemed approved as proposed by the Company.