

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

June 23, 2006

IN RE:

**CHATTANOOGA GAS COMPANY
ACTUAL COST ADJUSTMENT AUDIT**

)
)
)
) **Docket No. 05-00321**

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

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 for Chattanooga Gas Company in this docket and would respectfully state as follows:

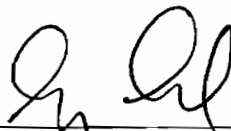
1. The present docket was opened by the Authority to hear matters arising out of the ACA audit of Chattanooga Gas Company (the "Company").
2. The Company's ACA filing was received on December 1, 2005, and the Audit Staff completed its audit of same on June 12, 2006. The original 180-day deadline for the Staff's completion of the audit was extended to July 10, 2006 by mutual consent of Chattanooga Gas Company and the TRA Audit Staff as provided for in the Purchased Gas Adjustment Rule (1220-4-7-.03 (2)).

3. On June 14, 2006, the Utilities Division issued its preliminary ACA and IPA audit findings to the Company, and on June 16, 2006, the Company responded thereto.

4. The preliminary ACA audit report was modified to reflect the Company's responses and a final ACA 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:

A handwritten signature in black ink, appearing to read "G. Lamb", is written over a horizontal line.

Gary Lamb
Utilities Division of the
Tennessee Regulatory Authority

CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of June 2006, 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:

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Gary Lamb

**COMPLIANCE AUDIT REPORT
of the
ACTUAL COST ADJUSTMENT COMPONENT
of the
PURCHASED GAS ADJUSTMENT RULE
for
CHATTANOOGA GAS COMPANY**

Docket No. 05-00321

Prepared by:

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

JUNE 2006

EXHIBIT A

**COMPLIANCE AUDIT REPORT
of the
ACTUAL COST ADJUSTMENT COMPONENT
of the
PURCHASED GAS ADJUSTMENT RULE
for
CHATTANOOGA GAS COMPANY
for the Year ended June 30, 2005**

Docket No. 05-00321

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I. INTRODUCTION

The subject of this audit 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"). The objective of the 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, 2005, are calculated correctly in accordance with all TRA rules, orders, and directives applicable to Chattanooga and are supported by appropriate source documentation.

II. AUDIT OPINION

The Staff concludes that except for the findings noted herein, the Purchased Gas Adjustment mechanism, as calculated in the Actual Cost Adjustment, appears to be working properly and in accordance with the TRA rules for Chattanooga Gas Company.

III. SUMMARY OF COMPANY FILING

The Company made its Actual Cost Adjustment filing for its Tennessee service area on December 1, 2005. This ACA filing showed \$71,550,123 in total gas costs, with \$70,724,402 being recovered from customers through rates. Adding a beginning balance in the Deferred Gas Cost account ("ACA account") of negative \$2,132,756 in over-recovered gas costs from the preceding ACA period and interest owed to customers for the current period of \$132,907 resulted in an ACA balance at June 30, 2005 of **negative \$1,439,943** in **over-recovered** gas costs. The Company's filing is summarized on the following page.

CHATTANOOGA GAS COMPANY
ACA FILING FOR PERIOD JULY 2004-JUNE 2005

Line

1	Beginning Balance (July 2004)	\$ (2,132,756.24)
2	Purchased Gas Costs (July 2004 – June 2005)	71,550,122.71
3	Gas Costs recovered through rates (July 2004 – June 2005)	70,724,402.09
4	Interest on monthly ACA Account balances	<u>(132,907.00)</u>
5	Ending Balance (June 2005) (Line 1 + Line 2 – Line 3 + Line 4)	<u>\$ (1,439,942.62)</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, 2006, to begin refunding the balance in the ACA account as of June 30, 2005. The Staff's findings resulting from this audit are described in detail in Section VIII of this report.

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., 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 from various suppliers and transported via three natural gas pipelines in accordance with separate and individual tariffs approved by the Federal Energy Regulatory Commission (FERC). The three interstate pipelines are Tennessee Gas Pipeline (TGP), East Tennessee Natural Gas (ETNG), and Southern Natural Gas (SNG).

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

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. Gary Lamb and Pat Murphy of the Utilities Division conducted this audit.

VI. DESCRIPTION OF PURCHASED GAS ADJUSTMENT RULE

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 customers 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 these Rules. 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 No. 01-00619). The mechanism affects all plan years ending after June 30, 2000, and 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 are waived.

VII. SCOPE OF ACA AUDIT

The ACA audit is a compliance audit of the Company's ACA account. The audit goal is to verify that the Company's calculations of gas costs incurred and recovered are materially correct,¹ and that the Company is following 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, 2006. Refer to the ACA Account detail provided in Section III, Summary of Company Filing.

To accomplish the audit goal, Staff reviewed gas supply invoices, as well as supplemental schedules and other source documentation provided by Chattanooga. Where appropriate, Staff requested additional information to clarify the filing.

¹ 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.

VIII. ACA FINDINGS

Staff's audit resulted in findings totaling a **net over-recovery of \$36,059.77**. This amount is the net total of five (5) findings and represents an additional over-recovered amount, which when added to the Company's calculated balance, results in an ending balance in the ACA account of a **negative \$1,476,002.39 in over-recovered gas costs**. A summary of the ACA account as filed by the Company and as adjusted by the Staff is shown below, followed by a description of each finding.

SUMMARY OF THE ACA ACCOUNT:

	Company	Staff	Difference (Findings)
Adj. Beginning Balance at 7/1/04	\$ (2,132,756.24)	\$ (2,162,313.63)	\$ (29,557.38)
Plus Gas Costs	71,550,122.71	71,550,795.32	672.61
Minus Recoveries	<u>70,724,402.09</u>	<u>70,724,402.09</u>	<u>0.00</u>
Ending Balance before Interest	\$ (1,307,035.62)	\$ (1,335,920.40)	\$(28,884.77)
Plus Interest	<u>(132,907.00)</u>	<u>(140,082.00)</u>	<u>(7,175.00)</u>
Ending Balance at 6/30/05	<u>\$ (1,439,942.62)</u>	<u>\$ (1,476,002.39)</u>	<u>\$ (36,059.77)</u>

** Any variances are due to rounding.

SUMMARY OF FINDINGS:

				Page #
FINDING #1	Inventory Injections	\$54,902.76	Under-recovery	6
FINDING #2	Inventory Withdrawals	(54,905.42)	Over-recovery	7
FINDING #3	Uncollectible Gas Costs	675.27	Under-recovery	8
FINDING #4	03-04 ACA Audit Findings	(29,557.38)	Over-recovery	9
FINDING #5	Interest	<u>(7,175.00)</u>	Over-recovery	10
TOTAL		<u>\$(36,059.77)</u>	Over-recovery	

FINDING #1:**Exception:**

The Company's actual cost of storage inventory injections was less than reported in its ACA filing, resulting in an **under-recovery of \$54,902.76**.

Discussion:

The Company made a \$32.02 calculation error in recording the cost of inventory injections in August 2004, which resulted in an understatement of inventory injections for the month by that amount. Also, the Company did not record an adjustment made to the September 2004 inventory injections which resulted in an overstatement of the injection amount by \$54,934.78. The net result of these two errors is a net **under-recovery of \$54,902.76** in commodity gas costs.

Company Response:

The Company concurs that it made a \$32.02 calculation error in recording the cost of inventory injections in August 2004. The Company also agrees that the \$54,934.78 adjustment made to the Company's financial records to record for gas injected into storage in September 2004 was misclassified on the deferred gas cost schedule included in the ACA filing for the twelve months ended June 30, 2005 resulting in a net under-recovery of \$54,902.76.

FINDING #2:**Exception:**

The Company's actual cost of storage inventory withdrawals was understated in its ACA filing, resulting in an **over-recovery of \$54,905.42**.

Discussion:

The Company did record an adjustment made to September inventory withdrawals which resulted in an overstatement of September 2004 withdrawal amount by **\$54,905.42**, which represents an **over-recovery** of commodity gas costs.

Company Response:

Chattanooga Gas Company concurs that the deferred gas cost schedule included in its ACA filing for the twelve months ended June 30, 2005 reflected a \$54,905.42 stored gas inventory adjustment as a withdrawal that should have been identified as an injection. The incorrect classification resulted as over-recovery of \$54,905.42. The misclassification impacted only the deferred gas cost schedule included in the ACA filing but did not impact the Company's financial records.

FINDING #3:

Exception:

The Company recorded an incorrect amount of *net* uncollectible gas costs in the ACA filing for the month of February, 2005, resulting in an **under-recovery of \$675.27** in gas costs.

Discussion:

The Company recorded the full amount of *net* uncollectible write-offs (gas cost and margin) for the month instead of only the PGA (gas cost) portion. The total net write-off was a **negative** \$2,680.80 (higher payment amount than accounts written-off) versus the net gas cost portion of **negative** \$2,005.53. The difference of **\$675.27** represents an **under-recovery** of gas costs.

Company Response:

Chattanooga Gas Company concurs that in February 2005, \$675.27 of non gas cost (margin) recovered from customers whose accounts had previously been written-off was improperly credited as recovered gas cost resulting in a \$675.27 under-recovery of gas costs.

FINDING #4:**Exception:**

The Company did not adjust the beginning balance in the ACA account to reflect the 2003-04 ACA audit findings. This omission resulted in an **over-recovery of \$29,557.38** in commodity gas costs.

Discussion:

Adjustments were not made to this year's ACA filing for last year's ACA audit findings #2 and #3. This resulted in an **over-recovery of \$29,557.38** of commodity gas costs.

Company Response:

Chattanooga Gas Company concurs that the \$29,557.38 adjustments included in finding # 2 and #3 of the September 9, 2005 report of the ACA audit for the twelve months ended June 30, 2004 was not included on the deferred gas cost schedule in the Company's ACA filing for the twelve months ended June 30, 2005. The adjustments have been recorded in the Company's financial records and will be include in the ACA filing for the twelve months ending June 30, 2006.

FINDING #5:**Exception:**

The Company used an incorrect interest rate in the calculation of interest on account balance for the months January through March 2005. This error, combined with the Staff's recalculation of interest based on Findings 1 through 4, resulted in an **over-recovery of \$7,175.00** in gas costs.

Discussion:

The Company used an interest rate of 4.23% in their calculation of interest for the first quarter of 2005. The correct rate, however, was 4.75%. Staff's recalculation of interest for this error along with Findings 1 through 4, resulted in an **over-recovery of \$6,054.00** in **commodity** gas costs and an **over-recovery of \$1,121.00** in **demand** gas costs. This represents a **total over-recovery of gas costs of \$7,175.**

Company Response:

Chattanooga Gas Company does concur that it used an interest rate of 4.23% in our calculation of interest for the first quarter of 2005.

IX. STAFF AUDIT CONCLUSIONS AND RECOMMENDATIONS

As reported in the body of this report, Audit Staff concludes that the Purchased Gas Adjustment mechanism, as calculated in the Actual Cost Adjustment, appears to be working properly and in accordance with the TRA rules for Chattanooga Gas Company. Staff's audit procedures revealed five (5) monetary findings reported in Section VIII, with which the Company concurs.

With regard to Audit Staff's recommendations made in the last audit (Docket Nos. 04-00402 and 04-00403 combined), the Authority issued its Order on March 14, 2006 commemorating its decision at the November 7, 2005 Authority conference. The panel of Directors voted to uphold recommendations #3 and #4 which addressed affiliate rules and an RFP bidding process for asset management. The majority of the panel, however, declined to uphold recommendations #1 and #2 which addressed the need for an independent consultant to review the asset management function in place for CGC and for the Authority to render its decision regarding the appropriateness of current affiliate agreements between CGC and its affiliate Sequent Energy Management ("SEM").²

As a result of the Authority's decision in these prior audit dockets, CGC was directed to: (1) submit proposed guidelines for affiliate transactions no later than December 29, 2005 and (2) place all future asset management contracts out for bid using the RFP process. The Company was also reminded of the Authority's decision in Docket No. 03-00516 which ordered CGC to submit all future asset management contracts to the TRA for approval prior to the commencement of the agreement.³

On December 29, 2005, Chattanooga submitted a revised Performance-Based Ratemaking ("PBR") tariff which included new language ("Affiliate Transaction Guidelines").⁴ At the January 23, 2006 Authority conference, the panel of Directors voted to accept the revised tariff, but directed the Company to resubmit the tariff with further amendments addressing the RFP process and safeguards to ensure that its affiliate is not given preferential treatment. The revised tariff was to be submitted by March 15, 2006. The Order arising from this decision, however, was issued on April 24, 2006, which precluded the Company from meeting the March 15 deadline. In addition, Audit Staff has been auditing the current ACA and IPA filings of CGC. Therefore, Audit Staff and the Company have agreed to meet on June 27, 2006, following the issuance of this report, to address the affiliate issues that arose in the prior audit dockets. At the conclusion of this meeting, a newly revised tariff will be crafted and submitted to the TRA for its approval.

There is one *additional issue* that the Audit Staff wishes to bring to the attention of the Directors. The initial term of the current Asset Management and Agency Agreement and Gas Purchase and Sale Agreement between Chattanooga Gas Company and Sequent Energy Management, L.P. will expire on March 31, 2007. The terms of the contract,

² Chairman Jones did not vote with the majority on recommendations #1 and #2.

³ Authority Order (March 14, 2006) in Docket Nos. 04-00402 and 04-00403, page 5 (ordering paragraphs 2 through 4).

⁴ TRA No. 1, Second Revised Sheet 56A.

Energy Management, L.P. will expire on March 31, 2007. The terms of the contract, however, provide for *automatic* annual renewals unless either party gives the other at least ninety (90) days written notice of termination prior to the end of the initial term or each subsequent one-year term.⁵ Theoretically, these “agreements” could continue “forever”. Audit Staff is concerned that even if appropriate language is added to the Company’s PBR tariff regarding affiliate transactions and an RFP bidding process, CGC may not rebid the current contracts due to the automatic renewal clause.

Therefore, Audit Staff makes the following recommendations:

1. The Authority should extend the timeframe for submission of amendments to the PBR tariff related to affiliate transactions and the RFP bidding process until Audit Staff has met with the Company and a joint tariff revision is crafted for consideration by the Directors.
2. The Authority should order the Company to abide by the directives given in Docket Nos. 03-00516, 04-00402 and 04-00403. These directives should require the Company to rebid its asset management and gas purchase agreements prior to the end of the initial term (March 31, 2007). The new resulting contract between CGC and the winner of the bidding process should be brought before the TRA for its approval prior to the effective date.
3. The Authority should direct Audit Staff to visit Sequent’s offices in Houston, Texas for the purpose of reviewing the asset management and gas purchase function Sequent provides for CGC and reviewing the program in place to isolate and track individual transactions made using the assets of Chattanooga Gas Company.⁶

⁵ Asset Management and Agency Agreement, paragraph 11.

⁶ Profits derived from these individual transactions are summarized and reported under CGC’s Interruptible Margin Credit Rider (IMCR) for crediting 50% of such profits to Tennessee customers.

APPENDIX A

PGA FORMULA

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.

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.