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July 17, 2006

VIA HAND DELIVERY

Chairman Sara Kyle
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-00505

Re: Docket 05-00321 Chattanooga Gas Company Actual Cost Adjustment
Filing for 12 Months Ended June 30, 2006

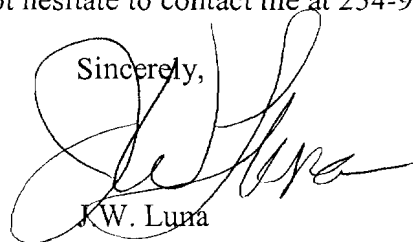
Docket 05-00322 Chattanooga Gas Company Annual Incentive Plan
Filing for 12 Months Ended June 30, 2006

Dear Chairman Kyle:

Enclosed please find the original and thirteen (13) copies of Chattanooga Gas Company's Response to the Utilities Division's Compliance Audit Report for filing in the above-referenced dockets.

If you have any questions, please do not hesitate to contact me at 254-9146.

Sincerely,



J.W. Luna

Enclosure

cc: Elizabeth Wade, Esq.
Archie Hickerson

**BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE**

July 17th, 2006

IN RE:)	
)	
CHATTANOOGA GAS COMPANY)	
ACTUAL COST ADJUSTMENT AUDIT AND)	Docket No. 05-00321
PERFORMANCE-BASED RATEMAKING TARIFF)	Docket No. 05-00322
("INCENTIVE PLAN") AUDIT)	
)	

**RESPONSE OF CHATTANOOGA GAS COMPANY TO THE
UTILITIES DIVISION'S COMPLIANCE AUDIT REPORTS**

Chattanooga Gas Company ("CGC" or "Company") respectfully submits the following response to the Compliance Audit Report of the Actual Cost Adjustment Component of the Purchased Gas Adjustment Rule ("Audit Report" or "Report") that was issued by the Utilities Division of the Tennessee Regulatory Authority ("TRA" or "Authority") on June 23, 2006.¹

The Staff has recommended the following: (1) that the Authority extend the timeframe for the Company to submit amendments to its Performance-Based Ratemaking ("PBR") Tariff to include a Request For Proposal ("RFP") bidding process; (2) that the Authority require the Company to bid its asset management and gas purchase agreements prior to the end of the initial term (March 31, 2007) of its current asset management and gas procurement agreements with Sequent Energy Management, L.P. ("Sequent") and

¹ In the Compliance Audit Report of the Performance-Based Ratemaking Tariff ("Incentive Plan") for Chattanooga Gas Company (Docket 05-00322) issued on June 27, 2006, the Staff has concluded that there are no material findings regarding the Incentive Plan audit. The Staff, however, has incorporated by reference into the Incentive Plan Audit Report the conclusions and recommendations set forth in the companion ACA Audit Report (Docket 05-00321) issued on June 23, 2006. Therefore, CGC intends, to the extent necessary, that its comments set forth herein address both Audit Reports.

require that the new contracts be brought before the TRA prior to their effective dates; and (3) that the Authority direct the Audit Staff to visit Sequent's offices in Houston, Texas, to review the asset management and gas purchase functions that Sequent provides to CGC.

The Company believes that its current asset management and gas procurement agreements with Sequent are working properly and are providing its firm customers great value. This is evident from the approximately \$4.4 million that CGC's firm customers received for the year ended December 31, 2005, and the \$0.5 million advance for the year ending December 31, 2006, as a credit against gas costs.² CGC, however, will continue to work with the Staff to revise its PBR Tariff to address an RFP process,³ and will work diligently toward bidding its asset management and gas procurement agreements according to that process. That being said, CGC has concerns about the proposed expedited timeframe for having the new asset management and gas procurement agreements in place by March 31, 2007. CGC also has concerns about the loss in value that this significant process change in asset management will have for its customers. CGC is committed to working to ensure that its firm customers receive the maximum benefits possible under its asset management and gas procurement agreements.

Whenever there is a disruption in an asset management arrangement, there is a loss of value for customers. While this is always the case, CGC wants to make sure that the loss of value is minimized during any transition process, particularly any loss of value

² For the year ended December 31, 2004, CGC credited \$1.8 million to its firm customers.

³ The Staff and the Company met on June 27, 2006, to discuss the RFP bidding process to include in CGC's PBR Tariff, as required by the Authority in the 2004 ACA and PBR Audit Dockets (04-00402 and 04-00403). The Company has filed in the 2004 Audit Dockets its proposed tariff revision addressing the RFP process which is based on its discussions with the Staff and on the language proposed by the Staff during the June 27th meeting.

resulting from the expedited timeframe for having a new asset management agreement in place by April 1, 2007. Given the current spreads (differential between the current price of gas and the price in the futures market), CGC has a unique opportunity to optimize the assets it holds to serve customers. However, given the uncertainty of not knowing whether it will continue as the asset manager past March 31, 2007, Sequent will not be able to capture value from the projected high spread in price differentials available today between March 2007 and any summer month in 2007. That is, without certainty the agreement will extend beyond March 2007, Sequent would be unable to enter into deals that terminated beyond that date. If the current agreements, that have been such an effective tool in providing credits to reduce gas costs, are either uncertain to be extended or terminated during this high volatility period, CGC faces the real possibility of not being able to return that value to its customers.

Significantly, before the new asset management and gas procurement agreements can commence on April 1, 2007, the Staff and CGC must agree on the RFP process and amend the Company's PBR tariff accordingly. Then, CGC must draft the RFP, and publish notice of the RFP thirty (30) days prior to issuing the RFP. Once the RFP is issued and responses are received, CGC must carefully evaluate the bids based on the selection criteria set forth in the RFP and select the winner(s). Upon finalizing the contracts with the winning bidder(s), the Company must submit the contracts to the TRA prior to their commencement. CGC recognizes that this is a very tight timeframe and is concerned that problems inherent within the process may delay the new contracts from commencing on April 1, 2007.

CGC believes that the Authority needs to maintain the flexibility to allow the Company's current asset management and gas procurement agreements with Sequent to continue past March 31, 2007 to prevent CGC's customers from losing value as a result of the proposed expedited timeframe for implementing new contracts. Throughout the process, CGC will monitor and alert the Staff and the Authority when a potential loss of value is occurring so that the Company and the Staff can work together to ensure that CGC's customers receive the most value from both the current and future asset management and gas procurement contracts. CGC appreciates the Authority's Order to bid the asset management agreement. Just as the Authority seeks to maximize the value of such activities for the ratepayers, CGC asks the Authority to ensure the process and transition is worked through in a manner that does not diminish value for ratepayers during the interim. The proposal CGC is setting forth is designed to ensure the impact of any change in asset management does not diminish the value ratepayers receive for those optimized assets.

CGC fully supports the Staff's request to visit Sequent's offices in Houston, Texas, and has previously made this invitation to the Staff. CGC and Sequent look forward to the opportunity to host such a Staff visit. CGC believes that an on-site visit will increase the Staff's first-hand knowledge and understanding of the transparency of CGC-affiliate transactions and will further develop the Staff's understanding and appreciation of the value and benefits that CGC's asset manager provides to its firm customers.

Respectfully submitted,

FARMER & LUNA, PLLC

By: 

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Attorneys for Chattanooga Gas Company

CERTIFICATE OF SERVICE

I hereby certify that a true and exact copy of the foregoing has been forwarded by hand delivery on this the 17th day of July, 2006, to the following:

Sara Kyle, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

J. Richard Collier, Esq.
General Counsel
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

