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BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

June 27, 2006

IN RE:)
)
CHATTANOOGA GAS COMPANY)
PERFORMANCE-BASED RATEMAKING)
TARIFF ("INCENTIVE PLAN") AUDIT) **Docket No. 05-00322**

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

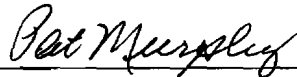
Pursuant to Tenn. Code Ann. §§65-4-104, 65-4-111 and 65-3-108, the Utilities Division of the Tennessee Regulatory Authority hereby gives notice of its filing of the Compliance Audit Report of the Performance-Based Ratemaking Tariff (hereafter "Incentive Plan") for Chattanooga Gas Company in this docket and would respectfully state as follows:

1. The present docket was opened by the Authority to hear matters arising out of the Incentive Plan audit of Chattanooga Gas Company (the "Company").
2. The Company's Incentive Plan filing was received on December 1, 2005, and the Audit Staff completed its audit of same on June 20, 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 in conjunction with the ACA audit (Docket 05-00321) as provided for in the Purchased Gas Adjustment Rule (1220-4-7-.03 (2)).
3. There were no material findings during the course of the Incentive Plan Audit.

4. 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 cursive script, reading "Pat Murphy", is written over a horizontal line.

Pat Murphy, Manager
Utilities Division of the
Tennessee Regulatory Authority

CERTIFICATE OF SERVICE

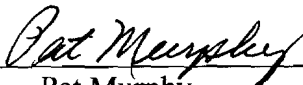
I hereby certify that on this 27th day of June 2006, a true and exact copy of the foregoing has been either hand-delivered or delivered via U.S. Mail, postage pre-paid, to the following persons:

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Pat Murphy

**COMPLIANCE AUDIT REPORT
of the
PERFORMANCE-BASED RATEMAKING TARIFF
(hereafter “INCENTIVE PLAN”)
for
CHATTANOOGA GAS COMPANY**

Docket No. 05-00322

Prepared by:

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

JUNE 2006

EXHIBIT A

COMPLIANCE AUDIT REPORT
of the
PERFORMANCE-BASED RATEMAKING TARIFF
(hereafter “INCENTIVE PLAN”)

for
CHATTANOOGA GAS COMPANY
for the Year ended June 30, 2005

Docket No. 05-00322

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I. INTRODUCTION AND AUDIT OPINION

The subject of this compliance audit is the Performance-Based Ratemaking tariff (“PBR,” “Incentive Plan,” or “IPA”) of Chattanooga Gas Company (“Chattanooga,” “CGC,” or the “Company”). The audit objective was to determine whether the Company had complied with the terms and conditions of its IPA tariff as of June 30, 2005. 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, 2005, 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.

II. BACKGROUND AND DESCRIPTION OF INCENTIVE PLAN

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, 2001.¹ 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.² 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.”

¹ 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.

² TRA Rule 1220-4-7-.05.

The Incentive Plan automatically rolls over for an additional plan year on each July 1st, 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.

III. ACTUAL PLAN YEAR RESULTS

On December 1, 2005, Chattanooga filed an annual report as specified in its tariff, showing the actual cost of gas invoiced by its affiliate Sequent Energy Management ("Sequent" or "SEM") and other suppliers and the applicable benchmark index for each month of the plan year ending June 30, 2005. The Staff reviewed Sequent invoices and other supplier invoices which were filed as part of the Company's ACA audit, and the indexes used to calculate the benchmark each month. Below is a table summarizing the Company's monthly purchases as compared to the calculated monthly benchmarks.

Month	Actual Purchase Cost	Benchmark Cost	Percentage Over/(Under) Benchmark
July 2004	\$5,696,193	\$5,707,531	-0.1987%
August 2004	4,107,410	4,104,043	0.0821%
September 2004	1,102,327	1,103,027	-0.0635%
October 2004	2,374,000	2,372,169	0.0772%
November 2004	2,238,462	2,231,203	0.3254%
December 2004	9,894,484	9,946,188	-0.5198%
January 2005	7,011,458	6,980,228	0.4474%
February 2005	5,318,783	5,309,841	0.1684%
March 2005	5,326,515	5,168,003	3.0672%
April 2005	4,922,458	4,997,251	-1.4967%
May 2005	4,497,729	4,522,872	-0.5559%
June 2005	5,876,421	5,705,990	2.9869%
Annual Cost	\$58,366,240	\$58,148,345	0.3747%

In four (4) months, amounts invoiced by Sequent and other suppliers were below the calculated benchmark for the month. In six (6) months amounts invoiced by Sequent and other suppliers were above the calculated benchmark, but within the 1% upper limit of the tariff. The total gas costs invoiced for the year were 0.3747% above the annual benchmark amount. For the two (2) months that gas costs exceeded 2% above the benchmark, the Company explained that there is no published index for the NORA delivery point. Therefore, CGC computed a surrogate index using a procedure consistent with the procedure for computing an index for city gate purchases. This resulted in an index that the Company maintains is artificially low, since it doesn't include a component

for the TGP 1-1 capacity. The Company states it intends to file a tariff change for the Authority's consideration to propose a more appropriate procedure to compute an index for NORA purchases. Therefore, Audit Staff opines that Chattanooga Gas has satisfied the criteria as set forth in its tariff and is released from the prudence audit for the plan year ended June 30, 2005.

IV. JURISDICTION OF THE TENNESSEE REGULATORY AUTHORITY

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

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

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

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

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

V. IPA FINDINGS

After reviewing the Company's filing, the Staff concludes that there are no material findings.³

³ 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.

VI. CONCLUSIONS AND RECOMMENDATIONS

The Incentive Plan audit is closely related to the ACA audit since the gas costs examined as part of this audit are audited for accuracy in the ACA audit. Any conclusions and recommendations resulting from the ACA audit are relevant to the IPA audit as well.

Therefore, the Compliance Audit Staff adopts the conclusions and recommendations set forth in the companion ACA Audit (Docket 05-00321) issued on June 23, 2006 and these conclusions and recommendations are fully incorporated herein by this reference.

CHATTANOOGA GAS COMPANY
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.

AFFILIATE TRANSACTION GUIDELINES

Terms used in these affiliate transaction guidelines have the following meanings:

1. Affiliate, when used in reference to any person in this standard, means another entity who controls, is controlled by, or is under common control with, the first entity.
2. Control (including the terms "controlling", "controlled by", and "under common control with") as used in the affiliate transaction guidelines, includes, but is not limited to, the possession, directly or indirectly and whether acting alone or in conjunction with others, of the authority to direct or cause the direction of the management or policies of an entity. Under all circumstances, beneficial ownership of more than ten percent (10%) of voting securities or partnership interest of an entity shall be deemed to confer control for purposes of these affiliate transaction guidelines.
3. Gas supplier is any person who sells or otherwise provides gas to the Company. It does not include customers who transport their gas and as a result of an imbalance in the amount consumed and the amount delivered to the city gate sell gas to the Company in compliance with the Company's approved tariff provisions.

Standards of Conduct

The Company must conduct its business to conform to the following standards:

1. All purchases from an affiliated gas supplier of gas for system supply or storage shall be at the price and in accordance with the terms provided in a fully executed contract between the Company and the affiliated gas supplier.
2. The Company and the affiliated gas supplier shall maintain records to show that such purchases are not at a price greater than the market price at the time of the transaction.
3. All sales of gas by the Company to an affiliated gas supplier shall be in accordance with the provisions of the Company's approved tariff or at the price and in accordance with the terms provided in a fully executed contract between the Company and the affiliated gas supplier. Any sale of gas to an affiliate not in accordance with an approved tariff provision shall be at a price that is not less than the market price at the time of the transaction.
4. The Company shall maintain records to show that sales to an affiliated supplier are in accordance with the applicable tariff provision or, if not provided under an approved tariff provision, the price is not less than the market price at the time of the transaction.
5. An affiliated gas supplier shall not make sales to any customer's premise that is connected to the Company's distribution facilities without the prior approval of the Company.
6. The Company shall not disclose to any affiliated gas supplier any information that the Company receives from a non-affiliated gas supplier that the non-affiliated gas supplier has identified as confidential unless the prior consent of the parties to which the information relates has been voluntarily given.
7. To the maximum extent practicable, the Company's operating employees and the operating employees of an affiliated gas supplier must function independently of each other.
8. The Company must maintain its books of accounts and records separately from those of an affiliated gas supplier.
9. The Company shall maintain sufficiently detailed records of all transactions with any affiliated gas supplier.