BEFORE THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

March 11, 1999

IN RE:	)	
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APPLICATION OF NASHVILLE GAS COMPANY, A DIVISION OF PIEDMONT NATURAL GAS COMPANY, TO ESTABLISH A PERFORMANCE INCENTIVE PLAN	))))	**DOCKET NO. 96-00805**

ORDER APPROVING PERFORMANCE INCENTIVE PLAN

On August 18, 1998, this matter came before the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA") for consideration of the Application of Nashville Gas Company (hereafter "Nashville" or "Company"), a division of Piedmont Natural Gas Company, to extend its previously-approved Performance Incentive Plan (hereafter the "Incentive Plan") on a permanent basis or until further order of the Authority. The Company also proposed to revise the Incentive Plan to clarify and/or simplify certain language in a manner that does not change any of its substantive or material provisions. In addition, the Company proposed to eliminate the requirement for an independent annual review.

I. BACKGROUND

On May 31, 1996, the Tennessee Public Service Commission (hereafter the "TPSC"), the predecessor to the Authority, issued an order approving the Incentive Plan for an experimental two-year period, beginning July 1, 1996. The Incentive Plan replaces the reasonableness or prudence review of Nashville's gas purchasing activities overseen by the Authority and is designed to produce rewards for Nashville's customers and its shareholders and to produce improvements in Nashville's gas procurement activities. The Incentive Plan approved by the TPSC was the result of an agreement between Nashville and the Consumer Advocate Division of the Office of the Tennessee Attorney General (hereafter "Consumer Advocate") and was not opposed by any party. The TPSC's order approving the Incentive Plan required Nashville and the TPSC's Staff to recommend a qualified independent consultant to review the progress of the Incentive Plan and to annually report the independent consultant's findings to the TPSC. The order also required Nashville to inform the TPSC by April 1, 1997, if it wished to continue the Incentive Plan for a second year.

On November 27, 1996, Nashville and the Authority's Staff submitted for the Authority's approval a contract for Andersen Consulting to perform annual reviews regarding the progress of the Incentive Plan. By Order dated January 2, 1997, the Authority determined that it was appropriate to accept the recommendation of the Company and the TRA's Staff that Andersen Consulting be employed as the independent consultant. The Authority approved the Andersen Consulting contract dated November 21, 1996.

By letter dated March 31, 1997, Nashville informed the Authority that it proposed to continue the plan for a second year, without modification. By letter dated April 7, 1997, Associated Valley Industries notified the Authority that it did not object to the Company's request. No party filed an objection to the Company's request. In accordance with its contract, Andersen Consulting filed its First Year Review of Performance Incentive Plan dated May 1, 1997, (hereafter the "First Report") and recommended that the Incentive Plan be continued for another year without modification. By Order dated June 30, 1997, the Authority authorized Nashville to continue the Incentive Plan for a second year, commencing July 1, 1997.

Andersen Consulting completed its Second Year Review of Performance Incentive Plan (hereafter the "Second Report") on March 23, 1998. By its Application dated March 31, 1998, Nashville requested that the Authority approve the Incentive Plan on a permanent basis, relying in large part upon the recommendations made by Andersen Consulting in its Second Report.

In the Second Report, Andersen Consulting found that:

> I. Based upon a review of Nashville's workpapers that were available following the publication of the First Report, the Incentive Plan's performance during the period July 1, 1996, through June 30, 1997, the first year of the Incentive Plan, was as follows:
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> 1. Net savings totaled $1,379,000, the amount available to be split between the ratepayers and Nashville, subject to the 1% deadband.
> 2. Ratepayers "earned" $925,000 in savings during the first full year of the plan or about 67% of the amount available from the sharing mechanism and the amount within the 1% deadband.
> 3. Nashville "earned" $455,000 during the first full year of the plan or about 33% of the amount available from the sharing mechanism and the amount within the 1% deadband.
> 4. Nashville's share of gains/losses for the first full year of the plan was approximately 1/3 of the $1.6 million gains/losses cap.
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> II. Based upon a review of Nashville's workpapers, the Incentive Plan's performance during the period July 1, 1997, through December 31, 1997, a period of six months into the second year of the Incentive Plan, was as follows:
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> 1. Net savings for the first six months of the second year of the Incentive Plan totaled $769,000, the amount available

to be split between the ratepayers and Nashville, subject to the 1% deadband.

2. Ratepayers "earned" $598,000 in savings during the first six months of the second year of the Incentive Plan or about 78% of the amount available from the sharing mechanism and the amount within the 1% deadband.

3. Nashville "earned" $171,000 during the first six months of the second year of the Incentive Plan or about 22% of the amount available from the sharing mechanism and the amount within the 1% deadband.

4. Nashville's share of gains/losses for the first six months of the second year of the Incentive Plan was less than 11% of the $1.6 million gains/losses cap.

5. Nashville's net gains during the first six months of the second year of the Incentive Plan was largely attributable to the Incentive Plan's Gas Procurement Mechanism, a reversal from the first year of the Incentive Plan.

After summarizing the activity in the Gas Procurement Incentive Mechanism and Capacity Management Incentive Mechanism for the period July 1, 1997, through December 31, 1997, as well as evaluating Nashville's organizational policies and practices, Andersen Consulting made the following recommendations in the Second Report:[1]

1. Implement a permanent performance based ratemaking mechanism, based upon the merits of the Incentive Plan.[2]

2. Rollover the permanent plan automatically each year, unless Nashville gives advance notice of its need to either withdraw or change the Incentive Plan, or the Authority elects to modify, amend, or terminate the Incentive Plan.

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[1] The Second Report also pointed out that "[t]he existence or absence of an incentive plan similar to [Nashville] is not, in itself, a confirmation or an indictment of [Nashville's] plan. Instead the case studies demonstrated the various plans used by other utilities operating in other jurisdictions and that [Nashville's] performance incentive plan was generally consistent with those industry practices." Second Year Review, dated March 23, 1998, at page 15.

[2] This recommendation was based, in part, upon the judgment of Andersen Consulting that the objectives of the two year period of the Incentive Plan were satisfied and the Incentive Plan resulted in benefits to both the ratepayers and Nashville. Id. at page 16.

3. Retain the employee incentive compensation plan that links reward with performance to ensure alignment of behavior and risk-taking with results.

4. Retain the primary features of the Incentive Plan, without modifications. A summary of those features include:

   A. Gas Procurement Mechanism:[3] 50/50 sharing arrangement, with a performance indicator of 99% of Index for Gains, and 101% of Index for Penalties.

   B. Capacity Management Mechanism:[4] Sliding scale from 100/0 to 50/50 as the sharing arrangement,[5] using the demand costs for transportation and storage capacity as the performance indicator.

5. Retain, without modifications, the "monthly price index" composite formula, as defined in the Appendix to the Second Report, that serves to compare Nashville's total city gate commodity cost of gas to a benchmark amount.

6. Having concluded the experimental period, remove the need for the permanent plan to be independently reviewed by a consultant, consistent with the Incentive Plan's objective of streamlining regulation and lowering regulatory costs.

At a regularly scheduled Authority Conference held on April 21, 1998, the Directors unanimously appointed the General Counsel or his designee to act as Hearing Officer to hear certain preliminary matters and to set a procedural schedule. A Pre-Hearing Conference was publicly noticed on June 4, 1998, and held on June 15, 1998, at 10:00 a.m. before Authority counsel, Dennis McNamee. Prior to the Pre-Hearing Conference, no party sought intervention in

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[3] The Gas Procurement Mechanism includes the primary elements of commodity costs, gas supply reservation fees, off-system sales and sale for resale transactions, use of financial instruments, both public and private contracts, hedges and swaps.

[4] The Capacity Management Mechanism includes the primary elements of release of transportation capacity, release of storage capacity, transportation of storage margin associated with off-system or wholesale sales-for-resale.

[5] As outlined in the Second Report, Nashville's share of the associated cost savings is calculated based on the actual capacity demand charges incurred by Nashville. Thus, the lower the demand charges and the greater the savings, the higher Nashville's sharing percentage. Id.

this proceeding. No interested parties, other than Nashville, appeared at the Pre-Hearing Conference. On June 15, 1998, the Hearing Officer filed his Report and Recommendation.

At a regularly scheduled Authority Conference held on June 30, 1998, the Directors considered the Hearing Officer's Report and Recommendation which recommended that the Application of Nashville Gas be brought before the Directors for consideration without a hearing since no parties had intervened nor had any objections to the Application been filed with the Authority. After reviewing the Report and Recommendation, and other relevant portions of the record, the Directors unanimously approved and adopted the Report and Recommendation of the Hearing Officer. This matter was scheduled for the Directors' consideration in July and, since the experimental period of the Incentive Plan expired on June 30, 1998, the Directors unanimously voted to allow the Company to continue operating under the incentive plan as it existed on June 30, 1998, until such time as the Authority further deliberated upon the matter and rendered a final decision on Nashville's Application.

On July 17, 1998, the Authority issued two Requests for Clarification to Nashville, the first of which outlined three (3) issues affecting Nashville's proposed Tariff Service Schedule No. 14. The Company responded to this first request by submitting, on July 23, 1998, a revised proposed tariff which incorporated the following new language:

1. Applicability Section: The Plan will continue until the Plan is either (a) terminated at the end of a plan year by not less than 90 days notice by Nashville to the Authority or (b) the Plan is modified, amended or terminated by the Authority.

2. Filing with the Authority Section: Unless the Authority provides written notification to the Company within 180 days of such reports, the Incentive Plan Account shall be deemed in compliance with the provisions of this Service Schedule.

3. Periodic Index Revisions Section: Unless the Authority provides written justification to the Company within 30 days of such notice, the price indices shall be deemed approved as proposed by the Company.

The second clarification request inquired as to the status of the Company's "feedback and reward system." The Company responded to this request by letter dated July 23, 1998, which further detailed Nashville's "feedback and reward system." Company representative, Bill R. Morris, executed an affidavit on July 31, 1998, attesting to his responses to each of these clarification requests. This affidavit, together with the clarification requests and responses thereto, was officially filed with the Authority and are part of the record considered in this matter.

This matter came before the Authority again at the regularly scheduled Authority Conference held on August 18, 1998. Having considered the First Report,[6] the Second Report,[7] the verified responses of Nashville to the Requests for Clarification, and other relevant portions of the record, the Authority unanimously approved Nashville's Application to extend its Incentive Plan, and directed Nashville to file a revision to its Service Schedule No. 14 Tariff, stating the following:

1. Nashville will continue to have in place the Gas Supply Incentive Compensation Program, as detailed to the Authority in its letter dated July 23, 1998; and,

2. Nashville will submit to the Authority, in writing, any proposed changes to the Gas Supply Incentive Compensation Program and, if the Authority elects to take no action concerning such proposed changes

[6] On July 31, 1998, Frank H. Creamer executed as affidavit, which is a part of the evidentiary record in this matter, stating that to the best of his knowledge his analysis, conclusions, and recommendations in his first and second year reports are true and accurate to the best of his knowledge and belief.
[7] Id.

> prior to the end of sixty (60) days after the same shall have been filed with the Authority, then such proposed changes shall become effective.

The Authority unanimously agreed to allow the Incentive Plan, as revised, to be automatically renewed on July 1st of each year, beginning July 1, 1998, unless and until the Incentive Plan is either (a) terminated at the end of a plan year by not less than ninety (90) days notice by Nashville to the Authority or (b) the Incentive Plan is modified, amended or terminated by the Authority.

The Authority also found it appropriate to eliminate the requirement for an independent review of the Incentive Plan. Based upon the independent consultant's analysis, the benefits of the Incentive Plan have now been demonstrated. Furthermore, Nashville will continue to submit quarterly and annual reports of the operations of the Incentive Plan and, if such reports or any other information should raise questions about the continued operations of the Incentive Plan, the Authority may take such action as it deems appropriate.

It is the opinion of the Directors of the Authority that incentive plans such as that proposed by Nashville can satisfy the public interest by providing net benefits to both ratepayers and the Company.[8] Such net benefits can be realized when an incentive plan is carefully evaluated and properly administered, consistent with state law. In Nashville's case, the Authority concludes that the Incentive Plan satisfies the public interest. The Authority further concludes that it is consistent with the goal of keeping expenses at a minimum to establish a Gas Supply Incentive Compensation Program to recognize selected Gas Supply non-executive employees

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[8] In formulating its decision in this matter, the Authority is mindful of the dicta offered by the Court of Appeals in its March 5, 1997, decision in Tennessee Consumer Advocate v. Tennessee Regulatory Authority, 1997 WL 92079, *4 (Tenn. Ct. App.), wherein the Court noted: "Of particular interest and concern are the propriety of . . . 'rewarding' [a] utility for keeping its expenses at the minimum, and of utilizing the services of an expert employed by the utility."

who are directly involved in managing such expenses. The public interest is served by performance measures for the Incentive Plan being established on an annual basis and by employees receiving incentive compensation as recognition for their contribution to the ratepayers and Nashville's shareholders through lower gas costs and gains related thereto.

IT IS THEREFORE ORDERED THAT:

1. Consideration of Nashville Gas Company's application for the extension of the Incentive Plan on a permanent basis does not require a hearing because no parties have intervened and no objections to Nashville's Application have been filed with the Authority;

2. Nashville Gas Company is authorized to continue to operate under the Incentive Plan, as modified herein, in such a manner that the Incentive Plan will automatically rollover for an additional plan year on each July 1st, beginning July 1, 1998, and will continue until the Incentive Plan is either (a) terminated at the end of a Plan Year by not less than 90 days notice by Nashville to the Authority or (b) the Incentive Plan is modified, amended or terminated by the Authority;

3. The requirement for an independent review of the Incentive Plan is eliminated;

4. The Company shall amend Service Schedule No. 14 of its Tariff by inserting a section entitled "Gas Supply Incentive Compensation Program" which provides that while the plan is in effect the Company will continue to have in place its "Gas Supply Incentive Compensation Program" as detailed in the Company's July 23, 1998, response to the Authority's second clarification request of July 17, 1998. This section of the tariff shall further provide that

the Company is required to notify the Authority in writing of any changes to the Gas Supply Incentive Compensation Program and, unless the Company is otherwise notified by the Authority within sixty (60) days, said changes will become effective.

5. Any party aggrieved with the Authority's decision in this matter may file a Petition for Reconsideration with the Authority within ten (10) days from the date of this Order; and

6. Any party aggrieved with the Authority's decision in this matter has the right of judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty (60) days from the date of this Order.

Melvin J. Malone, Chairman

H. Lynn Greer, Jr., Director

Sara Kyle, Director

ATTEST:

K. David Waddell, Executive Secretary