BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

August 16, 1999

IN RE:	)	
APPLICATION OF UNITED CITIES GAS	)	
COMPANY TO ESTABLISH AN	)	**DOCKET NO. 95-01134**
EXPERIMENTAL PERFORMANCE-BASED	)	**now DOCKET NO. 97-01364**
RATEMAKING MECHANISM	)	

FINAL ORDER ON PHASE TWO

MELVIN J. MALONE
CHAIRMAN

H. LYNN GREER, JR.
DIRECTOR

SARA KYLE
DIRECTOR

This matter came before the Tennessee Regulatory Authority (hereafter the "Authority" or "TRA") on February 16, 1999, for decision on the Phase Two issues of the petition of United Cities Gas Company (hereafter the "Company" or "United Cities") to continue, on a permanent basis, its experimental performance based ratemaking mechanism. This matter was heard by the Authority on March 26, 27, and 31, 1998. The Order reflecting the Authority's decisions on the Phase One issues was entered on January 14, 1999. The findings of fact and conclusions of law rendered by the Authority on February 16, 1999, on the Phase Two issues are set forth herein.

I. PROCEDURAL BACKGROUND

On January 20, 1995, United Cities filed an application with the Tennessee Public Service Commission ("TPSC") requesting that it be authorized to conduct a two-year experiment wherein the TPSC would use a different method to determine whether the Company was performing reasonably in managing and acquiring its gas supply. Instead of reviewing United Cities' performance after-the-fact by way of a prudency review,[1] as had been traditionally done, United Cities proposed that the TPSC review its performance on an ongoing basis. Under the proposal, United Cities' performance would be measured against pre-defined benchmarks that would act as surrogates for the market price of gas.

The proposal was designed to create an incentive for United Cities to perform better than (or "out-perform") the market and to penalize the Company if its acquisition of gas supplies

[1] Under the Purchased Gas Adjustment (PGA) Rules (TRA Rule Section 1220-4-7-.05) an audit of the prudence of gas purchases applies to any gas company with operating revenues of $2,500,000 or more. The Rule states that a qualified consultant, hired by the TRA, is to evaluate and report annually to the TRA on the prudence of all gas costs which were incurred by the gas company during the previous year.

resulted in a price of gas above the pre-defined benchmarks. United Cities contended that under its performance-based proposal, the Company would become more accountable to customers for its management and acquisition of gas supplies. If the Company out-performs the market, both the Company and the customers would benefit by sharing equally in the savings. If, on the other hand, United Cities' performance resulted in the Company paying a price for gas above the pre-defined benchmark, the Company would absorb half of the costs in excess of an established deadband.

On May 12, 1995, after conducting a hearing on United Cities' application and after considering the evidence presented at the hearing by United Cities and the Consumer Advocate Division of the Office of the Tennessee Attorney General (hereafter the "Consumer Advocate"), the TPSC issued an order setting forth its unanimous decision approving the proposal with modifications. The TPSC stated that changes in the natural gas industry prompted it to look "to incentive programs and more streamlined regulation to improve efficiency and hold down costs to consumers."[2]

In approving United Cities' proposal, the TPSC adopted the following modifications and incorporated them into the Company's proposal.[3]

1. United Cities would be limited to a maximum of $25,000 per month on gains and losses for all of the approved PGA mechanisms.

2. The Gas Procurement Mechanism would be modified to include a 2% reasonableness zone that applies to both sides of the market. The Company would share equally with its customers all gas costs savings below 98% of the market and would also bear a share of the costs in excess of 102% of the market. In regard to the other mechanisms, 90% of all gains or losses would go to the consumers and 10% would go to the Company.

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2 Tennessee Public Service Commission Order dated May 12, 1995, page 4, paragraph 3.
3 Tennessee Public Service Commission Order dated May 12, 1995, pages 4 and 5.

3. The Company would be required to contract with an independent consulting firm to review this mechanism and report to the TPSC annually during the two-year experimental period. This review would not be an audit or a substitute for the current prudence review, which would not be required during the experimental period, but would be for the purpose of informing the TPSC if the proper incentives were in place and what, if any, further modifications should be made to the program.

4. The TPSC would review the initiative in one (1) year and consider any proposed adjustments filed by the parties.

5. Any proposed adjustments requested by the parties would be required to be filed not less than thirty (30) days nor more than sixty (60) days before the anniversary date of the program which would be April 1.

6. The TPSC would again review this matter in two (2) years to consider any further adjustments and whether the program should be made permanent.

There was no appeal of the TPSC's May 12, 1995, Order establishing the two-year experiment.

At a regularly scheduled conference held on November 7, 1995, the TPSC approved the selection of the independent consultant. This action was memorialized in a TPSC Order dated May 3, 1996. On February 2, 1996, the consultant's first report, containing a review of the Company's performance as it related to the approved mechanism was provided to the TPSC. The consultant's report recommended certain modifications to the mechanism for the second year. After the consultant's report was filed, the TPSC received pre-filed testimony from United Cities and the Consumer Advocate and conducted a hearing on the matter on March 5, 1996. Over the objections of the Consumer Advocate, the TPSC took administrative notice of the consultant's report. In addition the TPSC did not permit the Consumer Advocate to cross-examine the consultant, Mr. Frank Creamer. On May 3, 1996, the TPSC issued an order modifying the mechanism/program in accordance with the consultant's report and directing the consultant to file a second report addressing the results from the second year of the experiment.

On June 27, 1996, the Consumer Advocate filed a petition for review of the May 3, 1996, Order in the Tennessee Court of Appeals. In the petition, the Consumer Advocate requested that the Court also review the TPSC's May 12, 1995, Order. On October 3, 1996, the Court issued an Order denying the request for a review of the May 12, 1995, Order on the grounds that such request was not timely. With respect to the May 3, 1996, Order, the Consumer Advocate argued before the Court that it was denied due process when, during the hearing giving rise to the May 3, 1996, Order, the TPSC took official notice of Frank Creamer's consulting report without permitting the Consumer Advocate to effectively challenge the report. On March 5, 1997, the Court issued an Order in which it found that the TPSC had violated the Consumer Advocate's due process rights by denying the Consumer Advocate access to all evidence considered by the TPSC and by failing to afford the Consumer Advocate an opportunity to impeach the same by cross-examination. On June 30, 1996, the TPSC was dissolved by act of the Tennessee General Assembly.

In a March 5, 1997, opinion, the Court of Appeals vacated the May 3, 1996, Order of the TPSC and remanded the case to the Authority "for such further proceedings and actions as it may deem appropriate including a reconsideration of the subject of the May 3, 1996, Order of the Public Service Commission."[4]

[4] *Tennessee Consumer Advocate v. Tennessee Regulatory Authority and United Cities Gas Company,* Court of Appeals, Middle District, No. 01A01-9606-BC-00286, March 5, 1997, page 7.

On February 28, 1997, the consultant filed his second report, which contained a review of the Company's performance during the second year of the mechanism. Among other things, the consultant recommended the implementation of a permanent performance-based ratemaking mechanism. In the consultant's judgment, the experimental mechanism provided demonstrable benefits to the Company's customers.

Following the entry of the Court of Appeals' March 5, 1997, Order, United Cities filed a petition on March 31, 1997, requesting the Authority to adopt the 1996 and 1997 reports of Frank Creamer and to permanently approve the mechanism. The Consumer Advocate opposed United Cities' petition and on May 20, 1997, the Authority convened a contested case in this matter and appointed a Pre-Hearing Officer to assist the parties in formulating the issues to be considered by the Authority. Thereafter, the parties engaged in extensive discovery which resulted in several pre-hearing conferences addressing discovery issues.

Prior to the beginning of the hearing, the Authority bifurcated this case to consider the issues arising from the remand by the Court of Appeals (Phase One) separate from the issues arising from United Cities' petition seeking approval of a permanent performance based ratemaking mechanism (Phase Two). In accordance with the Court of Appeals' decision, the Consumer Advocate was permitted ample time to take the deposition of Frank Creamer in advance of the hearings. Further during the hearings, the Consumer Advocate conducted cross-examination of Mr. Creamer and of other witnesses concerning Mr. Creamer's reports. The Phase One and Phase Two hearings took place on March 26, 27, and 31, 1998. The Consumer Advocate cross-examined

Frank Creamer on the Phase One issues on March 26, 1998,[5] and on the Phase Two issues on March 27, 1998.[6]

II. SUMMARY OF THRESHOLD AND PHASE ONE ISSUES

In bifurcating this proceeding, the TRA addressed certain threshold issues in Phase One. The Authority also considered, in Phase One, the issues associated with the remand of the 1996 proceeding, including the 1996 Creamer Report and whether to continue the mechanism for the second year. In Phase Two, the Authority addressed the issues raised in the 1997 petition filed by United Cities, including a review of the 1997 Creamer Report and a decision as to whether the mechanism should continue beyond its second year on a permanent basis. In order to adequately and properly address these issues, the Authority conducted separate hearings for each phase. The hearing on Phase One was held on March 26 and 27, 1998, and the hearing on Phase Two was held on March 27 and 31, 1998. At a regularly scheduled Authority Conference held on August 18, 1998, the Authority rendered its decision on the threshold and Phase One issues as follows:[7]

1. The Tennessee Regulatory Authority has the statutory power to approve a performance-based incentive mechanism which automatically penalizes or rewards the public utility for its performance in procuring the natural gas that it sells to customers;

2. The parties to this proceeding are not entitled to have access to staff information formulated for the Directors in preparation and final deliberation of this case;

[5] TRA Hearing, United Cities Gas, Volume 1, March 26, 1998, page 69 through page 98; page 101 through 161; and page 177 through 180.

[6] TRA Hearing, United Cities Gas, Volume II, March 27, 1998, pages 467 through page 503.

[7] A final Order reflecting the Authority's decisions was issued on January 14, 1999. A Petition for Reconsideration filed by United Cities was considered by the Authority at its February 16, 1999, Conference and denied at that time.

3. United Cities' performance-based ratemaking mechanism does not violate the PGA rules governing natural gas public utility companies;

4. The May 12, 1995, Order issued by the Tennessee Public Service Commission was not invalidated by the fact that the Court of Appeals vacated the Order issued by the Tennessee Public Service Commission on May 6, 1996. The May 12, 1995, Order of the Tennessee Public Service Commission is active subject to further consideration and modification as is deemed appropriate by the Authority in this docket;

5. United Cities has the burden to prove that any and all changes in rates are just and reasonable under T.C.A. §65-5-203(a);

6. The May 12, 1995, Order issued by the Tennessee Public Service Commission instituted a just and reasonable rate;

7. The May 12, 1995, Order issued by the Tennessee Public Service Commission did not constitute retroactive ratemaking;

8. The Authority declined to adopt the four recommendations made by Mr. Creamer in his report dated February 2, 1996, for the second year of the PBR experiment (April 1, 1996 – March 31, 1997);

9. The NYMEX index, which is one of the three basket of indices used to determine the benchmark price of natural gas in United Cities' PBR ratemaking mechanism shall not be excluded from the basket of indices;

10. Sufficient evidence existed in the record to show that United Cities' PBR ratemaking mechanism has improved United Cities' performance in purchasing natural gas and has benefited United Cities' customers;

11. The NORA contract is excluded from the United Cities' PBR plan because it predated the existence of said plan;

12. Gains and losses under the plan will be calculated on a monthly basis rather than on a transaction basis;

13. The lower end of the existing deadband around the benchmark price is set for the second year at 97.7% which is 1% below the level that existed prior to the initiation of United Cities' PBR plan. The high end of the deadband remains at 102%;

14. Affiliate party transactions were not present during the first year of the plan and will be considered during Phase Two; and

15. The Authority did not find with the Consumer Advocate that United Cities' PBR plan is too complex.

The above decisions by the Directors concluded Phase One of this docket. Subsequent to the Directors' decisions on Phase One, the Company submitted, on October 28, 1998, a revised compliance filing for the second year of the performance-based ratemaking mechanism incorporating the above applicable modifications to the calculation of incentive savings for the second year of the experimental period.[8]

III. PHASE TWO ISSUES

Phase Two of this proceeding encompasses a review of the second year results of the Company's incentive plan and a determination of whether the plan should continue on a permanent basis. Pursuant to the stipulation of the parties and the recommendation of the Pre-Hearing Officer, the following three issues were approved by the Authority for consideration during Phase Two of this proceeding:

1. Whether the TRA should adopt, in whole or in part, the recommendations made by the consultant in his report dated February 28, 1997, including:

    a. Whether the TRA should establish a fixed limit of five years for the plan;

[8] Whereas the Company's original filing, which was filed on September 9, 1997, indicated it had reached the cap of $300,000 during the second year of the plan, the revised filing indicated the Company's revised share of savings during the second year of the mechanism should have been $296,570.

b. Whether the TRA should establish an interim review period at the midpoint of the recommended five-year fixed term period;

c. Whether the TRA should establish automatic special trigger events, such as dramatic increase/decrease in gas prices, no activity in the gas purchasing mechanism for an extended period, or a fundamental change in the utility's marketplace including the potential of unbundling;

d. Whether the TRA should modify the basket of indices used to determine benchmark pricing, such as deleting the NYMEX index when it deviates more than $0.151 MMBtu from the average of the other two indices;

e. If the TRA decides to completely delete the NYMEX from the performance plan, should the historical band of 98-102% be recalculated;

f. Whether the TRA should increase the 1996 earnings cap from $600,000 per year to $1.25 million per year, or by some other amount;

g. Whether the TRA should establish an earnings cap on the NORA contract;

h. Whether the TRA should simplify the plan by collapsing the five incentive mechanisms (gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost, and storage capacity cost) into two mechanisms (gas commodity and capacity release sales);

i. Whether the TRA should establish a procedure to verify the utility's reserve margin to ensure the utility's level of contract demand is prudent; and

j. Whether the utility should establish internal feedback and reward systems which link individual or department performance to achievement of performance goals.

2. Whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the utility.

3. Whether United Cities' PBR plan has resulted in substantial benefits to its customers.

Issues 1(d), 1(e), 1(g), and 3 above were resolved by the Authority as a part of the Phase One deliberations. The remaining Phase Two issues and the question of whether the plan should be made permanent were deliberated by the Directors during a regularly scheduled Authority Conference on February 16, 1999. In addition, the Directors deliberated on affiliate transactions, an issue that materialized during discovery into Phase Two issues.

A. <u>Affiliate Transactions:</u>

In its Post-Hearing Brief the Consumer Advocate pinpointed the issue of affiliate transactions as significant to Phase Two of this proceeding:

> In general, most of the issues in the 1996/Phase One portion of the hearing are also issues in the 1997/Phase Two portion of the hearing. ...In the 1997/Phase Two portion of the hearing, however, the problems related to affiliate transactions became even clearer.[9]

Company representative, William Senter, stated "[d]uring the second year of the experiment United Cities beat the benchmark and saved $2.4 million in gas costs."[10] According to the Company's Post-Hearing Brief, these savings were derived from entering into and administering various gas purchase contracts including the gas purchase contract which United Cities entered into with its marketing affiliate, Woodward Marketing LLC (hereafter "WMLLC"), on April 1, 1996.[11]

WMLLC is a limited liability corporation of which Woodward Marketing, Inc., (hereafter "WMI") owns 55% and UCG Energy Corporation (hereafter "UCG Energy") owns 45%. WMI is

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[9] Consumer Advocate Division's Post-Hearing Brief, page 25 through page 26.

[10] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 573, lines 3 and 4.

a nonregulated gas marketing company which was formed in 1986.[12] It has bought and sold gas in Tennessee since 1987 and has, on occasion, sold spot market gas to United Cities Gas Company. During this time, United Cities owned a nonregulated gas marketing company, UCG Energy Corporation. In the latter half of 1993, WMI contacted UCG Energy regarding the possibility of merging the two companies. Negotiations lasted nearly twelve months and, on October 19, 1994, the two companies entered into a letter of intent to form Woodward Marketing LLC.[13] The purchase price paid by United Cities' for its 45% interest was $5.75 million in cash and stock with WMI having the right to earn an additional $1 million over a five-year period.[14] The $1 million "earnout schedule" was based upon projections of annual income derived from the Willamette Study.[15] Following regulatory approval, the LLC became effective May 1, 1995.[16]

The Consumer Advocate alleged that the gas sales contract between United Cities and WMLLC was not a direct response to the experimental PBR mechanism approved by the TPSC in 1995 but, was, in fact, anticipated when WMLLC was formed. Dr. Stephen Brown, the Consumer Advocate's economist, concluded that based upon the information provided by the Company, the Woodward contract predated the PBR and that the PBR appeared to be a response to the contract and to the formation of the merged company rather than the other way around.[17] Witnesses for the

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[11] United Cities Gas Company's Post-Hearing Brief, page 43.

[12] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 678, lines 8 and 9.

[13] Prepared Rebuttal Testimony of J.D. Woodward, March 16, 1998, page 2, line 8, through page 3, line 21.

[14] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 696, line 21, through page 697, line 11.

[15] The Willamette Study is an appraisal report dated July 28, 1994, prepared by Willamette Management Associates for United Cities Gas Energy Corporation the title of which is "Fair Market Value of the Common Stock of Woodward Marketing, Inc. on a Controlling Interest Basis." See also Exhibit JDW-1 to the Prepared rebuttal Testimony of J.D. Woodward.

[16] See Order of the Tennessee Public Service Commission dated December 16, 1994. See also TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 3 through 5.

[17] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 788, lines 6 through 11.

Company denied that there was any connection between the formation of the LLC in 1994 and the gas sales contract entered into in 1996. Ron McDowell testified that it was not until February of 1996 that he initiated negotiations with Mr. Woodward for a gas purchasing contract.[18] Mr. Woodward corroborated that account in his testimony and stated that the contract was negotiated to be effective April 1, 1996, with the price of gas tied to a basket of indices.[19] In his rebuttal testimony, Mr. Woodward also addressed this issue several times and stated that there were no discussions between United Cities and Woodward Marketing in 1993 or 1994 regarding WMLLC selling gas to United Cities.[20] James Harrington, United Cities' consultant, testified:

> Their [the Consumer Advocate's] conspiracy theory is groundless on a number of bases, including ...the Woodward contract was not in effect during the first year. I participated in the design and implementation of the PBR and never met or knew of Mr. Woodward during that period.[21]

The Consumer Advocate based its assertions concerning the affiliate transactions in part on the Willamette earnout schedule.[22] Dan McCormac, however, admitted during his testimony for the Consumer Advocate that he had no firm evidence to dispute United Cities' statement that the first time the Company approached WMLLC about being its sole supplier of gas in Tennessee was in 1996.[23]

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[18] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 638, lines 20 through 25.

[19] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 11 through 25 and page 680, lines 1 through 9.

[20] Prepared Rebuttal Testimony of J.D. Woodward dated March 16, 1998, page 4, lines 1 through 9, page 5, lines 7 through 22, page 6, lines 1 through 9 and page 9, lines 1 through 10.

[21] TRA Hearing - United Cities Gas Transcript, Volume II, March 27, 1998, page 513, lines 16 through 21.

[22] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 697 line 2 through page 698 line 6.

[23] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 737, line 17, through page 739, line 5.

The Authority received notice on September 6, 1996, of the execution of the gas sales agreement between WMLLC and United Cities. This notice, however, did not result from the Company's initiative but was received in response to a written inquiry by the Authority dated August 8, 1996. In the Company's response, Mark Thessin stated the Authority was not advised of this agreement because the Authority does not have any rules requiring approval of affiliate transactions.[24] The apparent discrepancy between Mr. Thessin's statement and the testimony of Company witness, Ron McDowell, that he knew if the Company used an affiliate that it would be examined,[25] was not reconciled at the hearing nor did the Company offer an adequate explanation as to why relevant information was not forthcoming from the Company.

While there were no separate rules in place governing affiliate transactions, TRA Rule 1220-4-7-.03-(5)(iii) of the Purchased Gas Adjustment ("PGA") Rules anticipates the possibility of affiliate transactions:

> If the Company proposes to recover any Gas Costs relating to (1) **any payments to an affiliate** or (2) any payments to a nonaffiliate for emergency gas, over-run charges, or (3) the payment of any demand or fixed charges in connection with an increase in contract demand, **the Company must file with the Commission a statement setting forth the reasons why such charges were incurred and sufficient information to permit the Commission to determine if such payments were prudently made under the conditions which existed at the time the purchase decisions were made.** [Emphasis added]

The Company failed to comply with the above rule when it did not notify the Authority of its contract and subsequent purchases with WMLLC since the Company retains a 45% interest in

[24] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 633, line 22, through page 634, line 2.
[25] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 630, lines 15 through 19.

this limited liability corporation. The Woodward contract[26] is a three-year contract, with the initial date of expiration of March 31, 1999. The Woodward contract is automatically extended for three (3) year periods in the absence of a ninety (90) day notice of termination by either party. Under the terms of the contract, United Cities purchases all of its daily purchase volumes from Woodward for a price equal to $.08 below the basket of indices used in the "United Cities' gas purchase incentive mechanism currently in effect in the state of Tennessee."[27] The gas is to be transported according to United Cities' Summer and Winter operational plans. The contract is considered an "all requirements" contract since Woodward is responsible for making all nominations, scheduling volumes, and releasing capacity.[28]

Pursuant to PGA rule 1220-4-7-.03-(5)(iii), the TRA has the authority to review the Company's purchases from an affiliate and to determine the prudency of such purchases. In this instance, the TRA was prevented from doing so due to the Company's failure to notify the TRA of its contract with WMLLC.[29] Although Dan McCormac of the Consumer Advocate's office acknowledged that, all other things being equal, the eight cents below the basket of indices is a good deal,[30] the Consumer Advocate contended that it was not provided the necessary information to properly analyze the contract. Mr. McCormac testified:

> And I think they did what they felt was best for their stockholders. I have no doubt about that. And it may be that they did what was best for the ratepayers. But I do have some doubts about that because of the

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[26] A copy of the Woodward contract was provided by Company witness, J.D. Woodward, as Exhibit JDW-2 to his Prepared Rebuttal Testimony dated March 16, 1998.

[27] Exhibit JDW-2 of J.D. Woodward's Prepared Rebuttal Testimony dated March 16, 1998, page 7.

[28] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 679, lines 16 through 24.

[29] The Authority recognizes that absent more specific affiliate rules or guidelines for Tennessee, it would have been more complicated and time consuming, even with notification of the contract from the Company, to determine whether preferential treatment had been afforded the affiliate.

[30] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 761 lines 10 through 13.

> unanswered questions. We simply do not know what the total costs to consumers are after the Woodward contract started. We don't have the full picture. [31]

The Consumer Advocate further explained that "the TRA does not have the full picture because United Cities' affiliate, Woodward Marketing L.L.C., does not bill United Cities according to the cost and source of Woodward's supply of gas."[32] The Consumer Advocate contends that WMLLC switched pipelines in the winter months of 1996-1997 from a lower cost (Tennessee Gas Pipeline) to a higher cost (Columbia Gulf) pipeline. This shift, according to the Consumer Advocate, permitted WMLLC to earn substantial profits at the expense of the Tennessee consumers.[33] Dan McCormac testified that United Cities' consumers were charged rates based on a benchmark price of gas on a pipeline other than that on which the gas was actually purchased.[34] In its Post-Hearing Brief, the Consumer Advocate asserted:

> . . . United Cities, and its consumers, are forced to purchase gas from wherever Woodward chooses to buy it. Woodward pretends to buy it from the source specified by United Cities, but United Cities and the consumers are billed for the transportation costs associated with the purchase point determined by Woodward.[35]

The Consumer Advocate, however, never produced any evidence to support its theory that pipelines were switched.[36]

The United Cities' contract with WMLLC contains a Purchase Agreement (Exhibit A to the contract) detailing the purchase price and the manner in which WMLLC invoices United Cities for

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[31] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 726 line24 through page 727 line 7.

[32] Consumer Advocate's Post Hearing Brief, page 27.

[33] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 708, lines 12 through 21.

[34] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 710, lines 7 through 10.

[35] Consumer Advocate Division's Post-Hearing Brief, page 28.

its gas purchases. Within the Agreement, the parties agreed to a definition of "purchase price" as set forth at Section #2 (Purchase Price/MMBtu) of the Purchase Agreement:

> The basket of indices used to determine benchmark pricing for monthly baseload spot purchases described in United Cities' gas purchase incentive mechanism currently in effect in the state of Tennessee minus 8 cents plus other pass-through charges described below under 'Service Provisions'.

The Agreement further states in Section #3 (Daily Purchase Volume) that WMLLC will provide "full United Cities Gas Company requirements in the states of Tennessee and Virginia pursuant to Summer Operational and Winter Operational Plans." Each of these operational plans is detailed under the Service Provisions section (Section #6) on page 2 of the Purchase Agreement. WMLLC must invoice United Cities based on the Summer and Winter Plans. WMLLC is allowed to deviate from the plan only if "such deviation will not cause any operational or economic degradation to its services." The Purchase Agreement also specifies, under paragraph H of Section #6, that WMLLC is the Agent for managing United Cities' contracts. And as such:

> Buyer and Seller recognize that as consideration for selling gas at the purchase price agreed upon in this agreement, Seller has the right to manage and to use for its own purposes, subject to certain conditions which protect Buyer, all components of Buyer's upstream pipeline(s) supplier's services. Absent this consideration to Seller, the parties recognize that the purchase price would be at a rate different than that set forth in paragraph 2 of this purchase agreement.

Based on the terms of the gas purchase agreement and the testimony as presented, the Authority concludes that Woodward has been billing United Cities appropriately pursuant to the contract agreement. United Cities' witnesses testified repeatedly that United Cities did not care how Woodward sourced its gas as long as it met the requirements of United Cities' customers as

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[36] The Consumer Advocate referred to page 847 of the transcript to support this statement. This citation does not

outlined in the Summer and Winter operational plans.[37] During the hearing, Consumer Advocate witness Dr. Brown acknowledged that as a result of FERC Order 636,[38] United Cities is assigned capacity on specific pipelines which require United Cities to pay reservation and demand charges. Dr. Brown testified that he did not review those assignment contracts.[39] Dr. Brown further acknowledged that United Cities developed their Summer and Winter operational plans within the constraints of transportation capacity contracts and the Company's storage capacity. Dr. Brown did not study, however, how the plans were developed or form any opinion as to the reasonableness of the plans.[40]

Dr. Stephen Brown's testimony indicates that, even though the contract is quite specific, the Consumer Advocate may not have understood the operation of this gas sales contract going into this Hearing.[41] The Consumer Advocate alleged that WMLLC switched pipelines in order to maximize its profits at the expense of Tennessee consumers,[42] implying that consumers were forced to pay more under the contract than they would have without the contract when the "full costs" of delivery were considered.[43] Transportation costs were cited as a major issue,[44] even though Dr.

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refer to any discussion on the testimony of this subject.

[37] Prepared Rebuttal Testimony of Ron W. McDowell, page 5, lines 9 through 23 and Prepared Rebuttal Testimony of J. D. Woodward, page 11, lines 3 through 12 and lines 18 through 22.

[38] Following the deregulation of sales at the wellhead by Congress, Order 636 of the Federal Energy Regulatory Commission (FERC) unbundled the sale of gas from the transportation services which had been previously provided by interstate pipelines.

[39] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 791, lines 5 through 19.

[40] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 802 line 19 through page 803 line 12; and page 805, lines 1 through 18.

[41] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 810, lines 15 through 22 and page 815 line 5 through page 817 line 15.

[42] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 708, lines 11 through 21.

[43] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, at page 714, lines 16 through 20 and page 819, lines 10 through 21.

[44] Consumer Advocate's Post-Hearing Brief dated May 4, 1998, page 30.

Brown testified that transportation costs were a small part of the overall costs.[45] United Cities presented testimony that if transportation costs are included, higher cost gas could actually result in a net lower cost of gas[46] at the city gate.[47] The Consumer Advocate witness, Dan McCormac, conceded this point in his testimony:

> To put things in perspective a minute, the NORA gas is probably the most expensive gas there is. That may surprise somebody, but the reason for that, it's here closer to Tennessee. So if you just look at the price of gas, it's almost meaningless. You have to consider where it is. ... Since it's here close to Tennessee, even though you're paying more for it, it's still cheaper than paying less for it and getting it in Texas and having to pay to move it to Tennessee.[48]

Further, Company witness, Ron McDowell, testified that the operational plans called for delivery at the least cost feasible, taking into consideration United Cities' transportation and storage contracts and other factors.[49]

The Consumer Advocate argued that, as an affiliate, WMLLC should only bill its costs to United Cities.[50] The Company countered that WMLLC was a supplier like any other and as such was entitled to make a profit.[51] The independent consultant, Frank Creamer,[52] and the Company's

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[45] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 799, lines 23 through 25.
[46] The total cost of the gas includes the commodity cost and the transportation cost to move the gas from its source to the city gate. In general, the closer the gas source is to the city gate, the higher the commodity cost, but, since the distance to be moved is less, the transportation cost is less. In contrast, the farther the gas is from the city gate, the cheaper the commodity cost, but the transportation cost to move it a greater distance is more. It is, therefore, possible that the total of commodity and transportation costs for the higher cost gas could be lower than the total costs (commodity plus transportation) for the cheaper gas.
[47] Prepared Rebuttal Testimony of J.D. Woodward, page 9, lines 11 through 21.
[48] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 713, line 22, through page 714, line 6.
[49] Prepared Rebuttal Testimony of Ron W. McDowell, page 1, lines 21 through 40, page 2, lines 1 through 19.
[50] Prepared Rebuttal Testimony of James R. Harrington, page 13, lines 9 through 14.
[51] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 656, line 16, through page 657, line 12.
[52] TRA Hearing - United Cities Gas Transcript, Volume II, March 28, 1998, page 456, lines 22 through 25.

consultant, Mr. Harrington,[53] both testified that WMLLC, even though a sole supplier, should be treated as any other gas supplier. Mr. Woodward testified that WMLLC could not afford to offer such a guaranteed low price to United Cities if it could not use United Cities' capacity to generate a profit.[54] Ron McDowell, who negotiated the Woodward contract for the Company, testified that the contract took the risk out of the Company's gas supply since WMLLC assumed all the penalties regarding scheduling.[55] Mr. McDowell also testified that as a gas aggregator, WMLLC was in a position to acquire gas from sources unavailable to United Cities which enabled WMLLC to acquire gas for less than United Cities could and thus make a profit.[56] Mr. Woodward's unrefuted testimony was that the price offered to United Cities was at least five cents ($0.05) below the price offered to any of WMLLC's other customers.[57]

Consumer Advocate witness, Mr. McCormac, while suggesting that consumers might be paying more under the contract, conceded that the agreement with WMLLC was a good contract.[58] He also acknowledged that, all things being equal, United Cities should contract for a guaranteed delivery at a good price, considering that WMLLC was assuming the risk for price volatility and scheduling penalties.[59] There was no evidence of collusion between WMLLC and United Cities regarding the gas sales contract.[60] Both consultants testified that the contract price was

[53] Prepared Rebuttal Testimony of James R. Harrington, page 13, lines 9 through 14.
[54] Prepared Rebuttal Testimony of J.D. Woodward, page 15, lines 1 through 13.
[55] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 630, lines 6 through 19.
[56] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 649 line 11 through page 650 line 2.
[57] Prepared Rebuttal Testimony of J.W. Woodward, page 8, lines 12 through 17.
[58] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 760, line 3 through 18.
[59] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 730 line 22 through page 731 line 4.
[60] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 721, line 20 through 25.

exceptional.[61] Based upon the record, the Authority concludes that the contract price is good, if not exceptional, and that the contract benefits Tennessee consumers, as well as United Cities.

The Consumer Advocate also raised the issue whether the TRA can look beyond the Woodward contract to Woodward's sources and Woodward's cost of the gas sold to United Cities, so that the profits earned by Woodward are shared with the ratepayers of Tennessee. Although the Authority does not believe that the profits of an affiliated supplier should be passed on to the ratepayers of the local distribution company, the Authority does conclude that Authority rules cannot go unenforced nor can affiliate party transactions go unmonitored if performance-based ratemaking mechanisms are to be considered on a basis which is honest, meaningful, fair, and beneficial to the Company and its ratepayers. Still, however, United Cities should have notified the TRA of the Company's intention to enter into an "all requirements" contract with an affiliate. To act in accordance with the PGA rule, the Company should have voluntarily submitted the Woodward contract to the Authority prior to the effective date of the contract as the Company had in Georgia.[62]

The evidentiary record of the Phase Two proceeding demonstrates that the gas sales contract with WMLLC was not anticipated at the time WMLLC was formed and was initiated by United Cities after the experimental PBR plan had been approved in Tennessee. The record further demonstrates that WMLLC has invoiced United Cities according to the provisions of the contract. In considering the record in this proceeding, the Authority concludes that, as a condition for

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[61] TRA Hearing - United Cities Gas Transcript, Volume II, March 27, 1998, page 446, lines 2 through 6; page 456, lines 19 through 21; page 516, lines 8 and 9.

[62] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 673, line 23, through page 674, line 2.

including affiliate transactions in any PBR mechanism, affiliate transactions must be subject to certain guidelines.

United Cities presented evidence that in a similar proceeding in Georgia, United Cities agreed to abide by certain affiliate guidelines, as a condition to implementing a PBR mechanism in Georgia.[63] In its Post-Hearing Brief, United Cities agreed to be bound in Tennessee by these same guidelines.[64] As a result of this proceeding, the Authority deems it necessary to expand these guidelines and concludes that before any affiliate transactions can be included in the computation of savings or losses from the Company's PBR mechanism in Tennessee, those specific transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, a copy of which is attached as Exhibit 1 hereto. Documentation of the Company's compliance with these guidelines is to be presented to the Authority during its annual audit of the Incentive Plan Account. A determination of compliance with all of the affiliate guidelines will be made at the conclusion of each annual audit.

B. Whether the PBR mechanism should be made permanent:

As to the issue of whether the PBR mechanism should be made permanent, the Authority considered the following sub-issues:

(a) Whether a fixed limit of five years should be set for the plan;

(b) Whether an interim review period at the midpoint of the fixed term should be established; and,

[63] TRA Hearing - United Cities Gas Transcript, Volume III, March 31, 1998, page 600 line 19 through page 601 line 11.
[64] United Cities Gas Company Post-Hearing Brief dated May 1, 1998, page 54.

> (c) Whether there should be established automatic special trigger events such as a dramatic increase/decrease in gas prices, no activity in the gas purchasing mechanism for an extended period, or a fundamental change in the utility's marketplace including the potential of unbundling.

Based on the evidentiary record, the Authority unanimously approved United Cities' PBR plan as a permanent plan to commence April 1, 1999. Rather than set a fixed term limit of five years, an interim review period, or automatic special trigger events, the Authority determined that the plan could continue on an annual basis under the same terms and conditions as specified in this Order until the Authority is otherwise notified by the Company not less than ninety (90) days prior to the end of any plan year that the Company wishes to terminate the plan or the plan is either modified, amended, or terminated by the Authority.[65]

C. Adjustments to the deadband:

During the Phase One deliberations, the Authority decided that any savings or losses from the gas procurement mechanism of the Company's PBR would be subjected to a "deadband" of 97.7% to 102%.[66] The Authority decided to allow this deadband to remain fixed for the first three years of the permanent PBR.[67] Should the PBR continue beyond the first three (3) years of the permanent plan, the Authority decided that the deadband would be adjusted at the conclusion of the initial three (3) period, and every three (3) years thereafter, to one percent (1%) below the most recent annual audited results of the incentive plan. Adjusting the deadband every three (3) years

[65] By Order issued on March 11, 1999, the Tennessee Regulatory Authority approved a performance incentive plan for Nashville Gas Company which contains the same terms and conditions for continuance on an annual basis.

[66] Final Order on Phase One, Docket No. 97-01364 dated January 14, 1999, page 24.

[67] Chairman Malone dissented finding fault with the majority's reasoning in applying year-end 1994 data, when year-end 1997 is available, to a plan that commences in 1999. He opined that use of such data is inappropriate and poor policy.

assures the consumers that the Company must continue to use its best efforts to outpace the arithmetic mean of its historical performance while allowing the Company to participate in the savings generated by any long term contracts which it has negotiated.

D. **Whether the TRA should increase the earnings cap to $1.25 million per year, or by some other amount:**

During the two-year experimental phase of the PBR, the Company's earnings were limited to $300,000 per year on overall gains and losses.[68] Issue 1(f) addresses whether the TRA should increase this earnings cap to $1.25 million per year. The Authority found that the cap should be increased $1.25 million annually beginning April 1, 1999.[69] This increase in the earnings cap effective April 1, 1999, should provide the Company with the necessary incentives to continue to become more aggressive by assuming additional risk in the purchasing of natural gas and in managing its firm transportation capacity on the upstream pipelines.

E. **Whether the TRA should simplify the plan by collapsing the five incentive mechanisms into two mechanisms:**

Under Issue 1(h) the Authority considered whether the original five incentive mechanisms (gas procurement, seasonal pricing differential, storage gas commodity, transportation capacity cost, and storage capacity cost) should be collapsed into two mechanisms (gas commodity and capacity release sales). The record clearly demonstrates that during the two-year experimental period of the PBR, all of the savings were attributable exclusively to the gas commodity and

[68] During the Phase One deliberations, the Authority determined an increase in the cap to $600,000 was not warranted for the second year of the experimental plan and, therefore, decided not to accept the consultant's recommendation to increase the cap.

capacity release mechanisms. Based upon this finding, the Authority concludes that collapsing the five mechanisms into two would simplify the plan without having any adverse consequences to the ratepayers.

F. Whether the TRA should establish a procedure to verify the utility's reserve margin to ensure the utility's level of contract demand is prudent:

Issue 1(i) deals with whether a procedure should be established to enable the TRA to verify the Company's reserve margin requirements on an annual basis. This issue was addressed in Mr. Creamer's recommendation #10 in his second year review. The Authority has determined that such a procedure is necessary in order to ensure that the Company is properly managing its firm transportation capacity. Therefore, the Company will be required to submit to the Authority, on an annual basis, documentation to substantiate its reserve margin and the procedure the Company utilized in arriving at the same. This requirement will allow the Authority to ascertain that the Company's level of contract demand is prudent.

G. Whether the Company should establish internal feedback and reward systems which link individual or department performance to achievement of performance goals.

Issue 1(j) questions whether an internal feedback and reward system should be established by the Company to reward its employees for achievement of performance goals. The Authority finds support in the record for Frank Creamer's recommendation that a departmental and individual feedback and rewards system should be implemented to reinforce desired behaviors that support the

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[69] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting: April 1, 1995 - November 30, 1996, page 25.

business objective.[70] Contrary to the Company's statement in its Post-Hearing Brief that "UCG has sufficient feedback and reward systems in place to accomplish department performance goals and disagrees with the reward system that focuses merely on each individual employee," Mr. Creamer found, during his review of the second year of the experimental plan, "no evidence of a feedback and reward system that directly shares company rewards and penalties with the staff responsible through some type of pay-for-performance, gain-sharing, or salary-at-risk program."[71] Mr. Creamer further found that UCG's existing incentive practices may not be sustainable in the absence of a feedback and reward system that prompts individuals to adopt desired behaviors that support business goals and objectives.[72] The Authority concludes that a feedback and reward system for those employees involved in the activities detailed in the plan must be in place as long as the Company is operating under a PBR mechanism.

H. Whether the NYMEX index should remain in the basket of indices:

During Phase One the Authority considered the issue of whether to include or exclude NYMEX from the basket of indices and decided during those deliberations that the NYMEX should remain in the basket of indices to which the Company's gas purchases are to be compared. During the Phase Two deliberations, that issue was again considered by the Directors with the

[70] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting: April 1, 1995 - November 30, 1996, page 26.
[71] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting: April 1, 1995 - November 30, 1996, page 22.
[72] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting: April 1, 1995 - November 30, 1996, at page 22.

majority voting to continue to retain NYMEX as one of the three indices utilized in computing the benchmark.[73]

I. Whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the Company:

Issue 2 of the Pre-Hearing Officer's report was whether the TRA should modify the Capacity Release Incentive Mechanism to provide an additional incentive for the Company. During the first year of the experimental plan, the capacity release incentive mechanism accounted for only 35% of the gains realized. During the first eight months of the second year of the experimental plan, only 30% of the gains were attributable to capacity release.[74] Therefore, the Authority does not find it necessary to modify the Capacity Release Incentive Mechanism to provide additional incentive for the Company.

IT IS THEREFORE ORDERED THAT:

1. United Cities Gas Company is authorized to operate under the Performance-Based Ratemaking Mechanism, as modified herein, beginning April 1, 1999, and continuing each year thereafter until the mechanism is either (a) terminated at the end of a Plan Year by not less than ninety (90) days notice by United Cities to the Authority, or (b) the PBR mechanism is modified, amended, or terminated by the Authority;

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[73] Chairman Malone disagreed with the majority on this issue. It is his opinion that United Cities failed to carry the burden in demonstrating that NYMEX is representative of the other indices used in the mechanism. For any mechanism of this type to be truly effective and not result in unwarranted and unintended pricing behavior, aberrations must be normalized. According to the Chairman, it matters little whether the component to be normalized is a well-known national indicator, or an obscure formula misapplied. What is important is that any force or computational dynamics be normalized or removed to neutralize the ruinous effects of a skewed component.

2. For each plan year in which this Performance-Based Ratemaking Mechanism is in effect, the requirements of Section 1220-4-7-.05 of the Purchased Gas Adjustment Rules of the Tennessee Regulatory Authority entitled "Audit of Prudence of Gas Purchases" are hereby waived;

3. The Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions, a copy of which is attached to this Order as Exhibit 1 are hereby adopted and are in effect as to United Cities' performance-based ratemaking mechanism;

4. Prior to any affiliate transactions being included in the computation of savings or losses from this performance-based ratemaking mechanism, said affiliate transactions must first comply with the Tennessee Guidelines for United Cities Gas Company's Affiliate Transactions. Documentation of compliance is to be presented by the Company to the Authority during the TRA's annual audit of the Incentive Plan Account. The Authority, at the conclusion of each annual audit, will make a determination of the Company's compliance with all of the affiliate guidelines;

5. The NYMEX index shall continue to be included as one of the three indices in the basket used to determine the benchmark price of natural gas in Unites Cities' PBR mechanism;

6. The lower end of the deadband around the benchmark price of 97.7%, which was set under Phase One, shall remain in effect for the first three (3) years of the PBR mechanism. Thereafter, as long as the PBR mechanism remains in effect, the deadband will be adjusted every three (3) years to one percent (1%) below the most recent annual audited results of the PBR mechanism;

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[74] Second-Year Review of Experimental Performance-Based Ratemaking Mechanism as prepared by Frank Creamer of Andersen Consulting: April 1, 1995 - November 30, 1996, at pages 12 and 13.

7. During a plan year, United Cities will be limited to an earnings cap for incentive gains and losses of $1.25 million;

8. The five incentive mechanisms of gas procurement, seasonal price differential, storage gas commodity, transportation capacity cost, and storage capacity cost are collapsed into two mechanisms - Gas Commodity and Capacity Release Sales;

9. United Cities will submit on an annual basis to the Authority, for the Authority's approval, a procedure to verify the Company's reserve margin to ensure that the Company's level of contract demand is prudent;

10. While the PBR mechanism is in effect, the Company will have in place a gas supply incentive and rewards program for its non-executive employees involved in the implementation of the PBR mechanism, the details of which will be provided to the Authority on an annual basis within sixty (60) days of the beginning for each plan year. Unless the Company is notified otherwise within sixty (60) days of the filing, said plan will become effective;

12. United Cities will file a separate tariff to be effective April 1, 1999, which clearly identifies the specific procedures of the performance-based ratemaking mechanism. The tariff should incorporate all the changes as ordered by the Tennessee Regulatory Authority, in addition to specifying that the gains and losses derived from the mechanism are to be accounted for in an incentive plan account with similar language, true-up attributes, audit, and filing requirements as the Actual Cost Adjustment clause of the existing Purchased Gas Adjustment rules;[75]

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[75] Tennessee Regulatory Authority Rule 1220-4-7-.03(c).

13. 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 and after the date of this Order; and

14. 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 and after the date of this Order.

Melvin J. Malone, Chairman

H. Lynn Greer, Jr., Director

Sara Kyle, Director

ATTEST:

K. David Waddell, Executive Secretary

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE

IN RE:	)	
	)	
Application of United Cities Gas to	)	**Docket No. 97-01364**
Establish an Experimental Performance -	)	
Based Ratemaking Mechanism	)	

OPINION OF CHAIRMAN MALONE CONCURRING IN PART AND DISSENTING IN PART TO THE FINAL ORDER ON PHASE II

While I concur in all respects with the majority on the Phase II decisions, with the exception of "C. Adjustments to the deadband" and "H. Whether the NYMEX index should remain in the basket of indices," it is the majority's decision on "C. Adjustments to the deadband" that compels me to write this dissent. The majority ignored a basic tenet of regulation by ordering the use of 1994 data, not reflective of the current environment, when 1997 data, was available. That decision is in error, is in poor judgment.

In setting rates and developing policy that is in the public interest, the cornerstone of regulation is the pursuit and use of the most recent data available. This bedrock of regulation and, no doubt, outside of regulation, is a fundamental principle that when ignored yields unintended financial consequences and creates questionable policy. The use of current data is particularly critical since regulatory decisions are *prospective* in nature, affecting consumers in future periods well beyond the point in time in which regulatory decisions are made. Additionally, the inevitability of regulatory lag,[1] inherent in virtually every decision, can render even the most timely data stale before the effects of its use are realized. The majority's decision here inexcusably exacerbates this problem. One fact is certain. The majority would find it impossible to convince a banker or a mortgage lender to make a loan, a contractor to build a house, a real estate agent to sell a house, or a broker to negotiate a deal based on stale data, more than five (5) years old. The majority's inconsistencies are equally troubling. They would be hard-pressed to identify a docket, major or not, where the agency has failed to insist upon cases being presented containing the most recently available data. I believe they know why. So do I. The public interest demands that it be so.

While not rising to the level of Secretary of State Alexander Haig's erroneous understanding of the line of succession - on that dark day in March 1981 when would-be assassin John Hinckley Jr. made an attempt on President Reagan's life – the majority's misstep has nonetheless exposed itself to be as flawed. Like Secretary Haig, the majority here took decisive action; and, like Secretary Haig, the majority, too, demonstrated that mastery of procedure, policy, and precedent can, indeed, prove elusive. On February 16, 1999, reason was effortlessly abandoned despite repeated urgings that a thoughtful and rational decision be sought.

Today, I must respectfully dissent from the majority's wisdom that allowed employment of stale financial data, in establishing UCG's PBR benchmarks, when the

[1] Generally speaking, this is the inevitable period of time that elapses between an event and the subsequent response or action to the event. This is distinguished from regulatory *delay* which, more often than not, is intended as a characterization of the disposition of adjudicatory proceedings.

majority possessed full knowledge that more recent audited financial data was available.[2] While it is with utmost courtesy that I accept the majority's contention that they have given this issue "great thought [and] study," the rationale presented for the conclusion reached in the majority decision amounts to no more than the fabrication of a regulatory universe that is in utter disharmony with logic and facts that easily lay beyond such universe's self-defined borders.

The record in this proceeding provides the sole insight and support upon which the majority decision is presumably based. To wit, the record confesses to the following "findings of fact" and nothing more:

1) "During the deliberations on Phase I of the plan, I was outvoted on this point. I wanted the deadband to remain at 98 to 102 percent respectively. Because of the set 97.7 deadband, I have been forced to rethink my strategy."

2) "[T]hat my strong feelings on this ties to the earnings cap."

And, finally:

3) "I believe if we set the cap as low as 95...it's going to be virtually impossible for the company to receive any benefits for the consumers."[3]

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[2] The Authority was in possession of year-ended June 30, 1997, audited financial operating data with which UCG's benchmarks should have been established, on an on-going basis, for a plan commencing April, 1999. The majority chose, instead, to order the use of financial data for the year-ended June 30, 1994. This data will be a decade old at the time the first benchmark review is conducted.

[3] Director Greer offered the motion and sole rationale, and Director Kyle seconded the motion by stating that "I too have given this great thought, study, and I would at this time support Director Greer." Director Kyle, additionally, made it clear that her support was limited to the establishment of the deadband. *Transcript of Authority Conference, February 16, 1999, pp.28-29.*

There is general acknowledgement that the complexities and intricacies of regulatory issues can be, at times, formidable. This abrupt shift, however, in majority logic, so carefully crafted into our Phase I decisions, leaves one perplexed as to what mysterious force of persuasion caused so radical a shift in continuity and comprehension between the Phase I and Phase II decisions.

The rationale given that "I wanted the deadband to remain at 98 to 102 percent respectively. Because of the set 97.7 deadband, I have been forced to rethink my strategy," is inexplicable folly based on the majority support for the Phase I decisions. First, a *majority* decision was reached "that the existing deadband around the benchmark should be adjusted...to one percent below the level that existed prior to the initiation of the PBR mechanism in order to ensure...that the Company only benefits when appropriate, as opposed to benefiting for behavior that would have taken place absent the deadband."[4] Based on the above support for our Phase I decision, a Phase II majority decision *could not have logically* been cast based upon reliance in this point for support, without severely damaging the integrity of our Phase I deliberations. The final irony is that the Phase I decision to remove the NORA contract from the computation of the deadband was a *unanimous* decision. This decision alone was sufficient to require readjustment of the PSC established deadband.[5]

As compelling as the record is, thus far, in support of rejecting the majority's first line of justification, it is but a thread in this mis-woven tapestry of majority justification. The record additionally shows that in Phase I the Authority accepted the PSC established

[4] *Final Order On Phase One, January 14, 1999, p.23.*

benchmark that was set by analyzing historical purchases for the year ended June 30, 1994. This is key. The PSC developed UCG's benchmark using the most recently available historical data.[6] This fact is inseparable from the TRA's acceptance of the deadband in years one and two of the plan. The state of the evidentiary record leaves little doubt that had the PSC developed a deadband in 1995 using decade-old 1985 data our Phase I analysis and acceptance of UCG's plan for the experimental years would have been much different.

The Authority's professional consideration in evaluating this plan was not to guarantee that some numerical threshold be met; but, instead, to ensure that a sound methodological approach be developed and fairly applied. As has been historically demonstrated, sound methodology yields desirable, just, and logical results, with ensuing numerical values validated by virtue of their genesis. Our approval of the experimental plan *de facto* certified acceptance of a methodology – that being the establishment of a benchmark using the most recently available financial data as inputs.

Next, the majority decision[7] offers as a justifying "finding of fact" its strong "feelings" on the deadband somehow tying to the earnings cap. This rationale is the most difficult to understand of the three (3) bases of support presented. The only position that could begin to make sense is to hold that since the Phase I decision limited the company's earnings by instituting a cap,[8] sharing should be easily achievable and realized earnings

[5] The PSC deadband, 98 to 102 percent, was calculated taking into consideration the NORA contract.
[6] The PSC used data to develop UCG's benchmark for the year ended June 30, 1994. The PSC's Order establishing the two-year experiment issued May 12, 1995.
[7] *See footnote 2, supra.*
[8] Presumably, this position was held to be equally applicable to the Phase II decision on the earnings cap, which had not yet been deliberated when this motion was made.

unlimited. This belief, if correct, and no other was offered, ignores the stand-alone distinctions between a benchmark and an earnings cap. To be sure, the lower the sharing threshold, the sooner earnings can be realized. In reality, however, a deadband, properly developed, based on the most recently available historical data, constitutes a range where achievement of any point therein represents behavior that would have taken place absent any incentive to do so. The rational and logical development of this "range" bears no correlation, directly or indirectly, with a decision to "cap" earnings. While one may hold meritorious the argument that the more the company is free to earn, the greater is its incentive to do so, and the more consumers will save, this argument is not rationally sustainable as support for the establishment of the trigger point at which savings should commence. Yet, this is all that was offered, and the intellectual sacrifice is much too great to embrace its logic.

Lastly, the majority held firm with a "finding of fact" that suggested "if we set the cap as low as 95...it's going to be virtually impossible for the company to receive any benefits for the consumers." What remains remarkably obtuse about this statement is that it was offered and accepted without support. In fact, the record supported quite the opposite. As was discussed above and again here for additional clarity, *a deadband, properly developed, based on the most recently available historical data, constitutes a range where achievement of any point therein represents behavior that would have taken place absent any incentive to do so.* The Authority found this to be the case in Phase I, and accepted, as discussed earlier, a PSC deadband developed exactly in this manner. This strongly suggests that the majority's "finding of fact" is 100% incorrect, and if based, in law, on the evidentiary record, one is hard put to deny that it is 100%

unsupportable. In fact, with a lower end of the deadband accurately calculated at 95, using the most recently available historical data, and sharing not taking place until this level is bettered, the company is provided with a strong financial incentive to outperform its historical achievements. This is a much greater customer benefit than a threshold set artificially low. To suggest, as the majority does, that efficiency gains reach diminishing returns when the lower end of UCG's deadband is accurately calculated at 95, using the most recently available historical inputs, exposes itself suspect as a lack of objective trustworthiness. Admittedly, as a practical matter, few would deny that such a point indeed exists. The majority, however, in the absence of conclusive or even suggestive data, could do no more than prophetically peer into the future to identify the point of diminishing returns. The majority possesses no such gift.

Inexplicably, it is regrettable that the mental concentration required and demonstrated in making the Phase I decisions, *Nunc pro tunc*, based on the decision of the Tennessee Court of Appeals, so easily evaded discipline when called upon to establish thoughtful continuity between Phases I and II. Even this lapse is somewhat understandable. I hold not the majority's decision as the product of horrific judgment, vengeful emotion, or the precept of shortsightedness. It is infinitely more palatable to hold that this decision spontaneously erupted from a point of view where inadvertent misapplication and misunderstanding of our Phase I decisions temporarily joined forces to topple carefully concluded, well-considered, and empirically supportable decisions.

The final perplexity is that the majority seemingly *knew* right from wrong, but chose to ignore it here. Amidst and despite the mathematical folly and numerical shape-shifting in setting the deadband, the majority rallied its thoughts and voted that "at the end of each three-year period the deadband would be adjusted to 1 percent below ***the most recent annual audited results****....*" [emphasis added]. This is the correct result. This is what should have been ordered from the effective date of the plan, April 1, 1999, forward.

The unsupported inconsistencies discussed above are inexplicable, and the majority, in its order on this issue, does nothing to enlighten. I do, however, remain hopeful that this agency's decisions will once again be thoughtful, supportable, independent, take into account prior actions, and not fall prey to faulty logic. This hope springs forth without consideration for individual positions. It is my belief that if this Authority follows the road that is sound and well-reasoned, all majority decisions will be good decisions; and, more importantly, it is inevitable that those decisions will be in the public interest.

I so, respectfully, dissent.

Melvin J. Malone
Chairman

Attest:

David Waddell
Executive Secretary