COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

CITIPOWER, L.L.C.	)	
	)	CASE NO. 2004-00101
	)	
ALLEGED FAILURE TO COMPLY WITH KRS 278.300, KRS 278.020(1) AND THE COMMISSION'S ORDER IN CASE NO. 1999-00225	)	

O R D E R

Citipower, L.L.C. ("Citipower") is a limited liability company organized under the laws of the State of Delaware with its principal offices located at 2122 Enterprise Road, Greensboro, North Carolina. Citipower also maintains an office in Whitley City, Kentucky. Citipower engages in the distribution of gas to the public for compensation for lights, heat, power, and other uses, and is a utility subject to Commission jurisdiction. KRS 278.010.

This Commission is mandated by KRS 278.040 to regulate utilities and enforce the provisions of KRS Chapter 278.

KRS 278.300(1) provides that "[n]o utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission."

KRS 278.300(8) provides an express exemption from this statute if a note issued by the utility is for a proper purpose, is not in violation of law and is payable not more

than 2 years from the date of issuance or not renewed for a period in excess of 6 years from the date of issue of the original note.

KRS 278.020(1) prohibits any person, partnership or private corporation, or combination thereof from beginning construction of any plant, equipment, property, or facility for furnishing to the public any of the services enumerated in KRS 278.010 until such person has obtained from the Commission a certificate that public convenience and necessity require such construction.

On January 10, 2003, staff members from the Commission's Financial Audit Branch issued a Report of Financial Examination ("Report") of Citipower for the year ended December 31, 2001, which is attached as Appendix A. Since several deficiencies were noted in that Report, Commission Staff conducted a follow-up examination on December 10 and 11, 2003, at Citipower's office in Whitley City, Kentucky. Commission Staff prepared a Report of Follow-up Examination ("Follow-up Report") and sent it to Citipower on February 27, 2004. The Follow-up Report is attached hereto as Appendix B. Citipower filed Responses to the Report and the Follow-up Report ("Responses") on February 14, 2003 and March 26, 2004, respectively, which are attached as Appendix C.

Commission Staff alleges in the Report and Follow-up Report that:

1. On December 31, 2001, Citipower had debt on its books that consisted of three renewable loans, all of which had a maturity date of two years or less, that had been renewed several times. Staff noted that, in December 2003, Citipower combined the three notes into one loan, which included a note that had initially been issued on November 11, 1997. Citipower did not seek Commission approval of the new loan.

2. Citipower issued securities every year since 1997 and did not seek Commission approval to make such issuances.

3. Citipower assumed the debt of Lick Branch Unit, L.L.C ("LBU") to Oneida Gas in the amount of $445,000 without Commission approval.

4. Citipower extended a pipeline to Stearns, Kentucky without seeking a Certificate of Public Convenience and Necessity ("CPCN").

5. Citipower did not comply with the Commission's directive in its March 31, 2000 Order in Case No. 1999-00225[1] to file a compliance plan and to file quarterly reports.

Citipower acknowledged in its Responses that it violated KRS 278.300 when it failed to obtain approval from the Commission before it renewed the November 11, 1997 note, assumed the debt of LBU, and issued securities as set forth above.

After reviewing the Report and Follow-up Report prepared by Commission Staff and the Responses filed by Citipower, the Commission finds that a prima facie showing has been made that Citipower has violated KRS 278.300 by its failure to seek and obtain Commission approval for its renewal of the November 11, 1997 note, its assumption of the debt of LBU, and its issuance of securities annually from 1997 through 2003. The Commission further finds that a prima facie showing has been made that Citipower has violated KRS 278.020(1) by its failure to obtain a CPCN for the Stearns pipeline extension and violated the Commission's Order dated March 31, 2000 in Case No. 1999-00225 by its failure to comply with the directives therein.

[1]Case No. 1999-00225, The Application of Citipower, LLC for an Adjustment of Rates Pursuant to the Alternative Rate Filing Procedure for Small Utilities.

IT IS THEREFORE ORDERED that:

1. Citipower shall appear before the Commission on July 8, 2004, at 9:00 a.m., Eastern Daylight Time, in Hearing Room 1 of the Commission's offices at 211 Sower Boulevard, Frankfort, Kentucky, for the purpose of presenting evidence concerning the alleged violations of KRS 278.300 and KRS 278.020 and of showing cause why it should not be subject to the penalties prescribed in KRS 278.990(1) for the alleged willful violations. The official record of the proceeding shall be by video only, unless otherwise requested by a party to this proceeding.

2. Citipower shall submit to the Commission, within 20 days of the date of this Order, a written response to the allegations contained herein.

3. The Report and Follow-up Report of Commission Staff are attached as Appendix A and B, respectively, and are made a part of the record in this proceeding.

4. The Responses filed by Citipower are attached as Appendix C and are made a part of the record in this proceeding

5. Any motion requesting an informal conference with Commission Staff to consider any matter which would aid in the handling or disposition of this proceeding shall be filed with the Commission no later than 20 days from the date of this Order.

Done at Frankfort, Kentucky, this 1st day of June, 2004.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00101 DATED JUNE 1, 2004.

Paul E. Patton, Governor

Janie A. Miller, Secretary
Public Protection and
Regulation Cabinet

Thomas M. Dorman
Executive Director
Public Service Commission

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Robert E. Spurlin
Commissioner

January 10, 2003

David Hutchinson, Chief Financial Officer
Citipower, L.L.C.
2122 Enterprise Road
Greensboro, North Carolina 27408

Dear Mr. Hutchinson:

Enclosed is the final report of the Commission's financial examination of Citipower, L.L.C. for the year ended December 31, 2001. As discussed with you, the difference between this report and the draft report are changes made to page 2.

The utility has 30 days from the date of this letter to respond to the deficiencies noted in the report. If you have any questions, please call me at (502) 564-3940, ext. 233.

Very truly yours,

Chris Whelan

M. Christina Whelan, CPA
Audit Reviewer
Division of Financial Analysis

Enclosure

EDUCATION PAYS

Citipower, L.L.C.

January, 2003

Introduction

Citipower, L.L.C. ("Citipower") is a natural gas local distribution company which serves approximately 450 customers in McCreary County, Kentucky. Citipower became regulated as a local distribution company in 1996 when it purchased McCreary Natural Gas Systems, Inc. ("McCreary Gas"), a farm tap system, and began connecting customers in addition to those served under farm tap regulations. Citipower purchases its gas from an affiliated company, Forexco, Inc. ("Forexco"). Forsberg Oil Company, Inc. ("Forsberg Oil") owns the largest percentage of Citipower at 10% and through its subsidiary Forexco, performs management and bookkeeping services for Citipower. Forsberg Oil and Forexco are both based in Greensboro, North Carolina.

Scope

In July and August 2002, Beverly Davis and Chris Whelan visited Citipower's office in Whitley City, Kentucky, to perform a financial examination. The examination included an evaluation of tariff compliance, recordkeeping practices, compliance with the Uniform System of Accounts Prescribed for Natural Gas Companies ("USoA"), and compliance with certain statutes and regulations.

Nonregulated Activity

Citipower has invested approximately $1 million in a compressor station and 4-inch steel pipeline that connects its system to a high-pressure pipeline in Tennessee owned by Citizens Gas Utility District ("Citizens"). Citipower sells gas to Citizens through this pipeline by contract. Because Citipower sells gas to Citizens at the same rate at which it purchases from Forexco, the utility does not receive a profit from the

sale transactions. However, Citipower does receive transportation revenue from these sales. The sale and transportation of gas to Citizens are nonjursdictional to the Commission because they are interstate sales.

Affiliated Companies

A brief description of Citipower's affiliated companies follows:

Forsberg Oil. Forsberg Oil owns 10% of Citipower, and 100% of Forexco. Forsberg Oil is designated the "tax matters partner" by the Citipower Operating Agreement and provides management and bookkeeping services to Citipower through its subsidiary Forexco. Forsberg Oil owns the leaseholds for the approximately 28 natural gas wells which supply gas to Citipower. In order to preserve its 10% ownership of Citipower, each time that additional membership units of Citipower are issued, additional equity is issued to Forsberg Oil.

Forexco. Forexco provides management and bookkeeping services to Citipower on behalf of Forsberg Oil. Although Forsberg Oil owns the leaseholds for the gas wells supplying Citipower, these wells are owned by working interest owners and royalty interest owners in programs sponsored by Forexco.

Lick Branch Unit, L.L.C. As of December 31, 2001, Citipower has invested $1.5 million in Lick Branch Unit, L.L.C. ("Lick Branch") by purchasing 87.52% of its membership units. Lick Branch has 49% ownership of Lick Branch Joint Venture which owns an underground storage field in Tennessee. The storage field is accessible to Citipower's distribution system through its steel pipeline to Citizens and a portion of Citizen's pipeline. As of the date of this report, Commission Staff is not aware of Citipower using this storage field. It should be noted that Lick Branch is a Kentucky

advised to implement a system of accounting for the costs of both regulated and nonregulated plant, to maintain a plant depreciation schedule, and to ensure that its annual report reconciles to its general ledger. Citipower was previously advised to improve its utility plant recordkeeping in the Staff Report ("Staff Report") in its most recent rate case, Case No. 1999-00225, Order issued March 17, 2000.

2. Utility Plant – Purchase of McCreary Gas. Citipower originally recorded the acquisition of McCreary Gas at the purchase price rather than the original cost as required by the USoA. The Staff Report recommended that Citipower conduct a study to determine the original cost of the assets purchased and record the transaction in accordance with the USoA. Citipower has not determined by study, or estimated, the original cost of the assets and has not adjusted its books to correct the original journal entry.

It appears that the purchase price of McCreary Gas was significantly in excess of the original cost. This difference should have been recorded, not in plant, but in a plant acquisition adjustment account and amortized over the remaining useful life of plant at the time of the transfer. Given the limited information available, Commission Staff has determined that Citipower should have made the following journal entry to record the purchase of McCreary Gas:

101	Gas Plant in Service	$175,772	
114	Gas Plant Acquisition Adjustment	$487,592	
108	Accumulated Depreciation		$7,364
131	Cash		$656,000

The entry to correct Citipower's books cannot be determined with certainty but to make no entry would leave Citipower's plant materially overstated. Therefore Staff is proposing that Citipower make the following adjusting journal entries:

114	Gas Plant Acquisition Adjustment	$487,592	
101	Gas Plant in Service		$487,592

To record a plant acquisition adjustment for the 1996 transfer and reduce plant by same

216	Unappropriated Retained Earnings	$69,429	
114	Gas Plant Acquisition Adjustment		$69,429

To record amortization of the plant acquisition adjustment from 9/24/96 through 12/31/01 using a 37 year amortization period

In addition, since plant is overstated on Citipower's books, depreciation has been overstated since Citipower purchased McCreary Gas. Citipower should make an adjustment to decrease accumulated depreciation for the overstatement from 1996 through 2001.

3. Nonregulated Activity – Cost Allocations. As stated previously, Citipower receives transportation revenue from the sale of gas to Citizens. Currently, over $1 million of plant is used solely for this nonregulated activity. The transportation service is provided by Citipower, not a subsidiary, and therefore costs associated with it should be recorded as transmission expenses in separate subaccounts designated for the nonregulated activity. In addition to the compressor station expenses recorded by Citipower for this activity, if work is conducted for this activity at Citipower's office or is performed by Citipower employees, a portion of labor, materials, office supplies and expenses, transportation, etc. should be allocated to the transmission expense

subaccounts. It should be noted that, in the future, this pipeline could be used to purchase gas from Citizens, sell to or purchase gas from another entity via the Citizens line, and transport gas to and from the Lick Branch storage field. Citipower should file a Cost Allocation Manual for its nonregulated activities in accordance with KRS 278.2205.

4. Affiliated Company Transactions.

a. Forexco. There is not a clear separation between the activities of Citipower and Forexco. In 2001, Citipower occasionally paid Forexco expenses and charged them to an accounts receivable account. A few instances were noted where Citipower paid Forexco expenses and charged its own expense accounts. Some of the records provided to Staff during the examination contained Forexco documents. In addition, for contractual services such as legal, accounting, and engineering, it was difficult to determine if the expense was Citipower's or Forexco's.

Furthermore, although plant records were not sufficient to determine with certainty, it appears that Citipower may be bearing the cost of connecting its system to Forexco's wells. It could be argued that Forexco is Citipower's source of supply and connecting to the wells is a cost of that supply; however, Citipower and Forexco are affiliated companies and therefore the negotiations between the two cannot be considered to be at arm's length. Part of the gas produced from Forexco's wells is sold to Citizens in Tennessee. By contract, this gas is sold by Citipower; however, in actuality, Citipower gets only a transportation fee for the sale of gas to Citizens. Therefore, the majority of the receipts from Citizens goes to Forexco. Citipower should pay only the cost of supply that reasonably contributes to its benefit. In addition, the contract between Citipower and Citizens does not specify a transportation rate. Staff

was informed that the rate was $.50 per Mcf but was unable to recalculate transportation revenue as reported in the annual report using this rate. The contract should be amended to specify the transportation rate. It should also be noted that Citipower employees change the charts on Forexco's wells each month although no salary is allocated to Forexco for this labor and transportation expense.

KRS 278.2201 prohibits a utility from subsidizing a nonregulated activity whether that activity is provided by an affiliate or the utility. This statute, along with KRS 278.2203 requires the utility to keep separate records and allocate costs. Citipower should pay expenses directly whenever possible and charge to its books only those costs that are incurred in its operations. Invoices and supporting documentation should be kept separately for each company. Citipower was cited for this deficiency in the Staff Report.

b. Lick Branch. In 2001 Citipower made unsupported disbursements for Lick Branch. Some of these disbursements were recorded in an account titled Investment in LBU while others were recorded in Accounts Receivable – Lick Branch. Several entries recorded in the investment account did not appear to be for equity purchases. Whether these disbursements are investments in Lick Branch or loans, all transactions should have supporting documentation providing the purpose and specifics such as term, payment requirements, and interest rates in the case of loans and number of ownership units purchased in the case of equity investments. Citipower should examine the entries in these accounts and make reclassifications if necessary and obtain supporting documentation for all transactions.

5. Natural Gas Purchases. In 2001, Forexco did not provide invoices to Citipower for gas purchases. There is no citygate from which gas enters Citipower's system as the gas comes from wells operated by Forexco connected at various sites. Although the gas is measured at the wells, some of this gas is sold to Citizens in Tennessee. Forexco bills Citipower based on the amount of gas sold by Citipower to its customers and since Forexco does the bookkeeping for Citipower, it makes journal entries in the utility's general ledger for the gas purchases.

Forexco's method of billing Citipower based on Citipower's sales to its customers is problematic. There is no confirmation of the amount of gas sold by Citipower by comparison to purchased gas records. In addition, Citipower's line loss cannot be calculated under this method. Furthermore, during 2001 Citipower implemented a new billing system and experienced problems during the first months of the implementation. The dollar amount and volume of gas sold in February is uncertain, therefore the amount of gas purchased is uncertain.

Citipower should install a meter just south of its compressor station in northern Tennessee which is just south of all pipeline connections to Kentucky customers. Forexco should bill Citipower based on the gas measured at its wells minus the amount measured at this site and submit monthly invoices showing the amount of gas sold, the rate per unit of gas, previous balance (if any), total due and any other information pertinent to the transaction.

6. Credit Card Purchases. Invoices were not available to support credit card purchases. Invoices are necessary to ascertain the business purpose of the purchase. A review of the credit card statements indicates that many of the purchases were not for

Citipower business. Citipower should keep all invoices for credit card purchases and charge to regulated operations only those items that pertain to its regulated activities.

7. Segregation of Duties. Citipower has only one office employee and that employee receives customer payments, posts payments, writes and signs checks for the Bank of McCreary County account, and receives the bank statements each month. In addition, this employee controls the petty cash fund. This lack of segregation of duties and lack of supervision exposes the utility to financial loss. A similar situation exists for the First Union account in North Carolina in that one person writes checks, performs the bookkeeping and receives the bank statements. The McCreary County bank statements should be sent directly to Forexco for reconciliation. Monthly cash receipt reports, the monthly billing and billing adjustments, and petty cash invoices should be closely scrutinized by Forexco. The First Union account should be reconciled by someone not involved in the day to day bookkeeping.

8. Minutes of Meetings. Citipower does not have minutes of meetings for 2000, 2001, and 2002 to date. Annual meetings are provided for in the utility's Operating Agreement. Citipower should have annual meetings and keep minutes for those meetings.

9. Miscellaneous Recordkeeping.

a. Allowance for Doubtful Accounts. At December 31, 2001, the allowance for doubtful accounts had a debit balance. This account is a contra-asset account to accounts receivable and its purpose is to reduce accounts receivable for the amount estimated to be uncollectible. Recording a debit in allowance for doubtful accounts

overstates accounts receivable and shows inappropriate accounting practices. Citipower should use the allowance method for accounting for uncollectibles correctly.

b. Hookup Fees. In 2001, Citipower recorded hookup fees in a revenue account in its general ledger but credited the balance of this account to utility plant in the annual report. The fee is for service line installation and, as will be addressed later in this report, is an unregulated service. The revenues and expenses related to the installation of service lines should be recorded in accounts 415, Revenues from Merchandising, Jobbing, and Contract Work and 416, Costs and Expenses of Merchandising, Jobbing, and Contract Work, respectively.

c. Accounts Payable. Citipower is not recording accounts payable on its financial statements. The utility is required by the USoA to keep its books on the accrual basis. Staff performed a search for accounts payable at December 31, 2000 and determined the amount to be approximately $23,000. At year end, Citipower should determine the amount of accounts payable and, if material, record it on the financial statements.

d. Misclassifications. Some expenses were improperly classified in the annual report per the USoA. In addition to others previously discussed in this report, the following are examples of the misclassified items:

Description	Proper Account	Account Charged
Transportation expenses	Allocated to various accounts based on distribution of wages of employees that use vehicles	932 - Maintenace of General Plant
Private plane service	426 – Nonutility Expenses	930.2 – Miscellaneous General Expenses

Office utilities	921 – Office Supplies and Expenses	930.2 – Miscellaneous General Expenses
Securities - offering expense	Equity	927 – Franchise Requirements

In addition, the utility recorded $18,217 in Acct. 929 Duplicate Charges – Other. On the annual report, the utility marked through the account title and labeled the account Customer Service and Information Expense. The items in this account appeared to be general items of line maintenance and repair and customer connection costs, none of which should be recorded in a Customer Service and Information Expense account. The utility is advised to analyze expenses and consult the USoA before making classifications.

Laws and Rules

The utility's records were examined for compliance with its tariff and certain statutes and regulations. The following deviations were noted:

10. Fringe Benefits. During 2001 Citipower made loan payments for an employee's personal vehicle and paid for gasoline, taxes, and maintenance of the vehicle but did not include these payments as compensation to the employee. Under Internal Revenue Code Section 61, these payments are a fringe benefit and should be treated as wages subject to payroll tax withholding and the payment of employment taxes. In the future, the utility should treat such items as wages.

11. Customer Deposits.

a. Tariff. Citipower's tariff states that customer deposits will be retained for twelve months after which they will be refunded unless an additional deposit is required. Although a number of deposits were returned in 2001, some of those were held longer

than one year and some deposits currently being held are over one year old. In addition, Citipower's tariff provides for a calculated deposit and the utility is instead collecting a flat rate. Citipower should abide by its tariff or change its tariff to match its current practice.

b. Interest. For those customer deposits refunded in 2001, interest was paid for only one year when some deposits had been held between two and three years. For those deposits currently being held over one year, interest is not being paid annually. KRS 278.460 requires Citipower to pay interest on customer deposits at an annual rate of 6%, and KAR 5:006, Section 7, requires a utility to accrue interest from the date of the deposit and to pay interest annually. The utility is advised to pay accrued interest annually on customer deposits.

12. Unauthorized Rates and Charges. During 2001 Citipower charged rates for service that differed from those set forth in its tariff. In general, the utility charged less than its authorized rate by not charging its authorized gas cost adjustment. The Commission was made aware of this in Case No. 2002-00252, a gas cost adjustment filing. The rates approved in that case allows the utility to collect the undercharges over a 36-month period.

In addition, the utility was assessing the following untariffed charges:

- $100 tap fee to commercial customers
- $200 hookup fee to residential customers/$250 to commercial customers
- $75 meter set fee

The hookup and tap fees were addressed with Citipower by letter from Commission Staff dated July 31, 2002. According to Citipower personnel, the hook-up

fee is for the installation of the customer's service line up to 100 feet. Anything over 100 feet is an additional $1 per foot. Citipower was informed that if the customer is allowed to contract with a party other than the utility to install the service line, this is considered an unregulated service and the utility is not required to file the fee in its tariff. The tap fee is for the installation of the meter, meter stand, regulator, and connections. Citipower was informed that its tariff provides that the tap will be made at Citipower's expense and it should cease collection of that fee.

It should also be noted that Citipower's contract for service shows a $50 disconnect charge which is not included in its tariff. It does not appear that the utility collected this fee in 2001. Citipower should update its contract for service to delete this charge. Citipower should also delete reference to the $100 tap fee and language stating that the customer shall pay the cost of the meter and regulator. Citipower may request Commission approval of the disconnect charge.

There was one instance in 2001 where the utility charged a $75 meter set fee. Citipower is advised to cease collecting the unauthorized fee. Citipower may request approval of this charge.

13. Providing a Copy of Rate Schedule. The rate schedule under which bills are computed is not furnished to customers once a year by one of the four prescribed methods required by 807 KAR 5:006, Section 6. Those methods are: printing on the bill, publishing in a newspaper of general circulation, mailing to each customer, or providing a place on each bill where a customer may indicate his or her desire for a copy of the applicable rates. Citipower is advised to comply with this regulation.

14. Miscellaneous Tariff Item. Citipower has two rate schedules, one for residential and commercial and the other for industrial and institutional customers. However, on page 3 of its tariff, under Customer Classifications, Institutional is listed under the Commercial category. To clear up any confusion that might be caused by this, the utility should update page 3 of its tariff to show Institutional as a separate classification.

15. Noncompliance with a Commission Order. In Case No. 1999-00225, Citipower was ordered to file a plan for compliance with the recommendations contained in the Staff Report within 60 days of the date of that Order and to file quarterly reports including a comparative balance sheet, income statement and statement of cash flows. The utility has not made these filings and is advised to do so.

16. Certificate of Public Convenience and Necessity. In July 2000, Citipower contacted the Commission by letter and requested guidance on whether a proposed project, the Stearns Extension estimated to cost $73,631, would require a certificate of public convenience and necessity ("certificate"). A Commission Staff Attorney responded by letter stating that it was the opinion of Staff that the construction project would require a certificate. The utility extended its pipeline to Stearns but did not request a certificate from the Commission. In the future Citipower should obtain a certificate prior to constructing facilities that are not extensions in the ordinary course of business.

17. KRS 278.300 Issuance or Assumption of Securities. KRS 278.300 states that, "[n]o utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any

other person until it has been authorized so to do by order of the commission." This statute does not apply to debt that has a term of two years or less that has not been renewed for more than an aggregate of six years.

a. Debt. At December 31, 2001, Citipower had $1,044,180 of debt on its books, the majority of which consisted of three different loans. The purpose of the loans and balances at December 31, 2001 are as follows:

- $500,000 – construction of a pipeline to Citizens in Tennessee
- $250,000 – invest in Cambridge Resources, Inc. which merged into Lick Branch
- $246,750 – working capital and infrastructure purposes

The loans are one-year renewable loans and have been renewed several times. The utility did not receive Commission approval for this debt. All three loans have a maturity of two years or less and have not been renewed for more than a total term of six years. However, the renewal of one of the $250,000 loans in 2002 will mark the fifth full year the loan has been outstanding. Any additional extensions of this loan will place the utility in violation of KRS 278.300 unless prior Commission approval is obtained.

b. Securities. During 2001, Citipower issued $1,848,712 of securities without obtaining prior Commission approval. A review of Citipower's annual reports indicates that the utility has issued securities every year since its purchase of McCreary Gas in 1996. Citipower is advised to obtain Commission approval prior to issuing securities pursuant to KRS 278.300.

Other

18. Financial Condition. Citipower has experienced large net losses since its purchase of McCreary Gas in 1996. The utility has approximately $1 million of short-

term debt that it has renewed a number of times. With the exception of one principal payment, Citipower has paid only interest on this debt. Given its large net losses and current debt, Staff questions Citipower's ability to remain a viable company. Citipower should address this issue with Staff.

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00101 DATED JUNE 1, 2004.

Ernie Fletcher
Governor

LaJuana S. Wilcher
Secretary

Commonwealth of Kentucky
Environmental and Public Protection Cabinet
Public Service Commission
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February 27, 2004

David Hutchinson, Chief Financial Officer
Citipower, L.L.C.
2122 Enterprise Road
Greensboro, North Carolina 27408

Dear David:

Enclosed is the Report of Follow-up Examination for the Commission's financial examination of Citipower, L.L.C. for the year ended December 31, 2001. Please review the report carefully.

The utility has 30 days from the date of this letter to respond to the outstanding deficiencies noted in the report. If you have any questions, please call me at (502) 564-3940, ext. 233.

Very truly yours,

Chris

M. Christina Whelan, CPA
Audit Reviewer
Division of Financial Analysis

Enclosure

Citipower, L.L.C.
Report of Follow-up Examination

Citipower, L.L.C. ("Citipower") is a natural gas local distribution company that serves approximately 450 customers in McCreary County in Kentucky. Citipower became regulated as a local distribution company in 1996 when it purchased McCreary Natural Gas Systems, Inc. ("McCreary Gas"), a farm tap system, and began connecting customers in addition to those served under farm tap regulations. Citipower is managed by its affiliated company and gas supplier, Forexco, Inc., based in Greensboro, N.C.

Scope

On January 10, 2003, the Commission's Financial Audit Branch issued a report of financial examination of the utility for the year ended December 31, 2001. The examination evaluated tariff compliance, recordkeeping practices, compliance with the Uniform System of Accounts Prescribed for Natural Gas Companies ("USoA"), and compliance with certain statutes and regulations. The examination report cited the utility for eighteen deficiencies. Citipower did not dispute any of the findings in the report. On February 14, 2003, the utility responded to the report by stating what actions had been taken, or would be taken, to correct the deficiencies. On December 10 and 11, 2003, Beverly Davis and Chris Whelan visited Citipower's office in Whitley City, Kentucky to perform a follow-up to the examination report to determine the status of the deficiencies.

Analysis

Following is the status and any current recommendation for each deficiency noted in the original report:

1. <u>Utility Plant - Recordkeeping</u>.

- The utility was not maintaining centralized, detailed plant records to support the book cost of plant, both regulated and nonregulated plant.

<u>Status</u>: Beginning in 2003, the utility is keeping centralized, detailed plant records; however, there were some misclassifications between regulated and nonregulated plant.

Recommendation: Citipower should take better care when recording plant additions. Items should be evaluated as either regulated or nonregulated and recorded as such.

- Citipower was not maintaining a depreciation schedule.

Status: The utility is now maintaining a depreciation schedule.

- Plant subaccounts on the annual report did not reconcile to the general ledger.

Status: Plant balances in the utility's 2002 general ledger do not reconcile to the annual report due to the general ledger being maintained on a tax basis. This is acceptable so long as the utility can provide journal entries to reconcile the general ledger to the annual report.

2. **Utility Plant – Purchase of McCreary Gas.** Citipower had recorded the acquisition of McCreary Gas at the purchase price rather than the original cost as required by the USoA.

Status: The utility made a journal entry correcting the initial purchase.

3. **Nonregulated Activity – Cost Allocations.** Citipower was not allocating costs to nonregulated accounts for the sale and transportation of gas to Citizens Gas Utility District ("Citizens") in Tennessee. In addition, the report advised Citipower to file a Cost Allocation Manual ("CAM") for its nonregulated activities in accordance with KRS 278.2205.

Status: The utility includes, in its general ledger, compressor maintenance and compressor rent accounts which are associated with the sale and transportation of gas to Tennessee; however, some expenses related to this activity are still being recorded in regulated accounts. For example, electric bills for the compressor station in Tennessee and some legal expenses related to the pipeline are being recorded in regulated accounts. In addition, the utility is not allocating expenses for work done by employees related to the nonregulated activity nor has the utility filed a CAM. During the follow-up, Citipower personnel indicated that a CAM would be filed by March 31, 2004.

Recommendation: Citipower should carefully evaluate transactions to insure that all nonregulated items are identified and properly recorded. Also, if work is conducted

for this activity at Citipower's office or is performed by Citipower employees, a portion of labor, materials, office supplies, transportation, etc. should be allocated to the nonregulated subaccounts. Citipower should file a CAM with the Commission.

4. Affiliated Company Transactions.

a. Forexco

- There was not a clear separation between the activities of Citipower and Forexco. Citipower occasionally paid Forexco expenses, usually charging a payable/receivable account but sometimes charging its own expense accounts. For contractual services such as legal, engineering and consulting, it was difficult to determine which company incurred the expense. Citipower was advised that expenses were to be paid directly whenever possible and it should charge to its books only those costs incurred in its operations. In addition, the utility was advised that invoices and supporting documentation were to be kept separately for each company.

Status: It appears the practice of Citipower paying certain Forexco expenses and Forexco paying certain Citipower expenses and recording them to a payable/receivable account is still occurring. As before, a few instances were noted where Citipower paid Forexco expenses and charged its own expense accounts. In addition, it is still difficult to determine which company incurred consulting and engineering expenses paid by Citipower.

Recommendation: Citipower and Forexco should pay expenses directly. Citipower should cease expensing affiliated company costs on its books. Contractual service invoices should be marked to indicate for what project and which company the expense was incurred.

- In 2001, it appeared that Citipower was bearing the full cost of connecting to Forexco's wells although not all of Forexco's gas was sold to Citipower for regulated purposes.

Status: According to Citipower personnel, there have been no new well connections since the financial examination.

- The contract between Citipower and Citizens did not specify a transportation rate. The utility was advised to amend the contract to include the transportation rate.

Status: The contract was not amended to include the transportation rate.

Recommendation: The utility should amend the contract.

- Citipower employees were changing the charts on Forexco's wells each month but salary and transportation expenses were not being billed to Forexco.

Status: Citipower employees continue to change the charts on Forexco's wells, though Forexco is not billed for the salary and transportation expenses incurred.

Recommendation: Time spent on Forexco activities by Citipower employees should be charged to Forexco. During the follow-up visit, Staff was informed that a contract between the affiliates would be written to account for these types of transactions.

b. Lick Branch Unit, L.L.C ("Lick Branch").

Citipower made unsupported disbursements for Lick Branch, a subsidiary. Some of the disbursements were recorded in an account titled Investment in LBU while others were recorded in Accounts Receivable – Lick Branch. The utility was advised that all transactions should have supporting documentation providing the purpose and specifics such as term, payment requirements, and interest rates in the case of loans and number of ownership units purchased in the case of equity investments

Status: The utility is still making entries to investment in affiliated company accounts and affiliated company payable/receivable accounts without appropriate documentation.

Recommendation: Citipower is again advised to ensure that all transactions have supporting documentation providing the purpose and specifics of the transactions. In addition, Citipower is advised to cease recording affiliated company activity on its books. Each subsidiary, Citigas L.L.C. ("Citigas") and Lick Branch, should have its own set of books in order to reduce the number of transactions being recorded on Citipower's books unrelated to its operations as a local distribution company.

5. Natural Gas Purchases. Forexco did not provide invoices to Citipower for gas purchases. In addition, because gas enters Citipower's system from various wells and some of that gas is sold to Citizens, Forexco bills Citipower based on the amount of gas sold by Citipower to its customers. It was recommended that Citipower install a meter just south of its compressor station in northern Tennessee which is just south of all

pipeline connections to Kentucky customers. This would allow Forexco to bill Citipower based on the gas measured at its wells minus the amount measured at this site and submit to Citipower monthly invoices showing the amount of gas sold, the rate per unit of gas, previous balance (if any), total due and any other information pertinent to the transaction.

Status: Forexco provides invoices to Citipower; however, the utility has not installed a meter south of its compressor station. During the follow-up visit, utility personnel stated that there was a meter just north of the compressor station that could be used for this purpose. Although there is a line from one of Citipower's Kentucky customers to the compressor station, it is not being used to supply the customer at present.

Recommendation: Citipower should determine if the meter north of the compressor station can be used to determine the amount of gas sold to Citipower for resale to its regulated customers. If so, this amount should be used to bill Citipower rather than using the amount Citipower sells to its customers.

6. **Credit Card Purchases.** Invoices were not available to support credit card purchases.

Status: Invoices are still not available to support credit card purchases.

Recommendation: Citipower should keep all invoices to verify its expenses.

7. **Segregation of Duties.** Citipower had a risk of loss due to having only one employee at the Whitley City office who handled all financial transactions and Forexco having only one employee to handle all financial transactions originating in North Carolina.

Status: The bank statements for the Bank of McCreary County are now opened and reconciled by the CFO in North Carolina. According to the CFO, he closely reviews monthly cash receipt reports, the monthly billing and adjustments, and petty cash invoices. There is no change in the segregation of duties for transactions originating in North Carolina.

8. **Minutes of Meetings.** Citipower did not have minutes of meetings for 2000, 2001, and 2002 as provided for in the utility's Operating Agreement.

Status: According to the utility's CFO, Citipower is now keeping minutes of meetings.

9. **Miscellaneous Recordkeeping.**

a. Allowance for Doubtful Accounts. Citipower was not correctly using the allowance for doubtful accounts method to account for uncollectible accounts.

Status: It appears the utility is now correctly using the allowance method.

b. Hookup Fees. Citipower recorded hookup fees in a revenue account in its general ledger but credited the balance of this account to utility plant in the annual report. The fee was for service line installation, an unregulated service, and the revenues and expenses associated with the activity should have been recorded in accounts 415 and 416.

Status: The utility is still not using accounts 415 and 416 to record this activity.

Recommendation: Citipower should record service line installation revenue in account 415 and related expenses in account 416 in its annual report to the Commission.

c. Accounts Payable. Citipower was not recording accounts payable on its books.

Status: The utility now records accounts payable.

d. Misclassifications. Some expenses were improperly classified in the 2001 annual report per the USoA.

Status: Although Citipower has improved in this area, it is still misclassifying some expenses on the annual report. In 2002, it reported $38,201 in miscellaneous general expenses. The majority of these expenses should have been classified in other accounts.

Recommendations: The utility should consult the USoA or Commission Staff when completing its annual report if there is uncertainty as to expense classification.

10. **Fringe Benefits.** During 2001 Citipower made loan payments for an employee's personal vehicle and paid for gasoline, taxes, and maintenance of the vehicle but did not include these payments as compensation to the employee.

Status: The utility does not currently pay personal vehicle expenses for its employees.

11. Customer Deposits.

a. Tariff. The utility was not returning deposits after one year as provided for in its tariff. In addition, the utility was collecting a flat rate deposit while its tariff provided for a calculated deposit.

Status: Citipower has amended its tariff to provide for a flat rate deposit; however, the utility is still holding some deposits more than one year.

Recommendation: The utility should abide by its tariff or change the tariff to match its current practice.

b. Interest. Interest was not being calculated correctly for deposits that were refunded and for those being held by the utility, interest was not being paid annually.

Status: The utility is still not calculating interest correctly for deposits refunded or paying interest annually.

Recommendation: Citipower should refund or credit accrued interest on customer deposits through December 31, 2003 and refund or credit interest annually hereafter. The utility should prorate interest for customer deposits that are refunded prior to the utility's annual payment of interest. Commission Staff is available to assist with the interest calculations.

12. Unauthorized Rates and Charges. The utility was assessing the following untariffed charges:

- $100 tap fee to commercial customers
- $200 hookup fee to residential customers/$250 to commercial customers
- $75 meter set fee

In addition, Citipower was instructed to delete the following from its contract for service:

- a disconnect charge of $50 which is not included in its tariff
- a $100 tap fee and language stating that the customer shall pay for the meter and regulator

Status: A review of the Citipower's cash receipt records indicated that the utility had ceased collecting the tap fee and meter set fee. The utility was informed that if customers were not required to use Citipower to install the service line, then the hookup fee was unregulated and not required to be in the tariff. Regarding the contract for service, the utility deleted only the tap fee amount from the contract.

Recommendation: Commission Staff is working with Citipower on updating its contract for service.

13. **Providing a Copy of Rate Schedule.** The rate schedule under which bills are computed was not furnished to customers once a year by one of the four prescribed methods required by 807 KAR 5:006, Section 6.

Status: According to utility personnel, the rate is published in the paper each time there is a change, even for a gas cost adjustment which is not required to be published.

14. **Miscellaneous Tariff Item.** Citipower has two rates, one for residential and commercial customers and the other for industrial and institutional customers. However, on page 3 of its tariff, under Customer Classifications, Institutional was listed under the Commercial category. The utility was advised to correct the classification language in its tariff.

Status: The utility has filed to update its tariff as directed.

15. **Noncompliance with a Commission Order.** Citipower had not filed a plan for compliance with the recommendations contained in the Staff Report in Case No. 1999-00225. In addition, Citipower had not filed quarterly reports as required in that case.

Status: The utility still has not filed a plan for compliance with the recommendations made in that case or quarterly reports.

Recommendation: Failure to comply with a Commission order is a serious matter that may subject the utility to civil penalties; therefore, the Commission is considering legal action. In any case, Citipower is advised to file the required information as soon as possible.

16. **Certificate of Public Convenience and Necessity.** The utility extended its pipeline to Stearns but did not request a certificate from the Commission as recommended to the utility by letter from Commission Staff. Citipower was advised to obtain a certificate prior to constructing facilities that are not extensions in the ordinary course of business.

Status: It appears there has been no major construction since the financial examination.

17. **KRS 278.300 Issuance or Assumption of Securities.**

a. At December 31, 2001, Citipower had $1,044,180 of debt on its books which consisted of three, one-year renewable loans that had been renewed several times. The utility did not receive Commission approval for the loans. All of the loans had a maturity of two years or less and, at the time of the financial examination, had not been renewed for more than a total term of six years. However, the renewal of one of the loans in 2003 would place the utility in violation of KRS 278.300 unless prior Commission approval was obtained.

Status: Citipower combined all three loans in November 2002 into one loan with a one-year term. The debt was renewed in December 2003. Therefore, it appears the utility is in violation of KRS 278.300. In addition, the following should be noted:

- In 2003, Citipower set up a line of credit with a bank in North Carolina for operations related to its subsidiary Citigas. According to the CFO, there have been no draws on this credit line.
- In its 2002 annual report, Citipower reported debt of $445,000 to Oneida Gas that was issued in January 2001 with a four-year term. This debt was not on the 2001 annual report and it was not in the Report of Examination as Commission Staff was not aware of it. During the follow-up visit, the CFO said that he was new to Citipower at the time of the financial examination and not aware of it. According to the CFO, it was LBU's debt originally but Citipower assumed it as an investment in LBU. This appears to be in violation of KRS 278.300.

Recommendation: Failure to request Commission approval for issuance of long-term debt is a violation of KRS 278.300; therefore, the Commission is considering legal action. The utility should contact the Executive Director's office to discuss this issue.

b. During 2001, Citipower issued $1,848,712 of securities without obtaining prior Commission approval. A review of Citipower's annual reports indicated that the utility had issued securities every year since its purchase of McCreary Gas in 1996 without Commission approval. The utility was advised to obtain Commission approval prior to issuing securities.

Status: Citipower has continued to issue equity units since the Report of Financial Examination was issued.

Recommendation: Failure to request Commission approval for issuance of securities is a violation of KRS 278.300; therefore, the Commission is considering legal action. The utility should contact the Executive Director's office to discuss this issue.

Other Items

18. Financial Condition. During the examination, it was noted that Citipower had experienced large net losses since its purchase of McCreary Gas in 1996. In addition, the utility had approximately $1 million of debt on its books for which it was making only interest payments. Staff questioned Citipower's ability to remain a viable company.

Status: Citipower has continued to experience large net losses and carry substantial debt on its books for which it makes only interest payments. Staff continues to question the utility's ability to remain a viable company.

Recommendation: Citipower should address this concern with Commission Staff.

Additional Information

Citigas. At the time of the Financial Examination, there was no activity for this Citipower subsidiary. Since that time, Citigas has begun operations. The subsidiary has built a 6-inch pipeline in California to transport gas from Forexco's wells to an 8-inch pipeline owned by Pacific Gas and Electric. At December 31, 2003, Citipower had a $1,620,083.94 receivable from Citigas on its books as well as an investment in Citigas of $33,914.01.

Removal of Affiliated Company Activity from Citipower's Books. According to the CFO, there is a desire to remove all LBU and Citigas activity from Citipower's books – in essence, to back out all related transactions so that Citipower's books would be as they would if only its regulated operations had been recorded. He also stated that it was his intention to remove Citigas as a subsidiary of Citipower and move the debt on Citipower's books to the books established for Citigas. The company gave no specific information on when this process would be initiated.

Transportation Rate. Commission Staff was informed that the transportation rate charged by Citipower to Citizens is currently $.25 per Mcf. During the financial examination year it was $.50 per Mcf. For the over $1 million Citipower has invested for plant related to this nonregulated activity, its only source of revenue from the activity is transportation revenue. This is due to the fact that it charges Citizens the same rate it pays to Forexco for the gas. Commission Staff has concerns about whether Citipower is pricing this service at a rate that allows the utility to recover its annual costs associated with the activity and provide a return on its investment.

Test of Tariff. During the follow-up visit, Staff performed a test of the utility's tariff. Thirty-nine customer billings were selected to be tested. The test indicated several problems as follows:

- Ten of the billings for service did not match Staff's recalculation but differed by only 8 cents or less. One account was overbilled by 80 cents while another account was overbilled one month by $6.98 and underbilled several months later by $7.14. In addition, Citipower's rate per Mcf extends to four digits past the decimal point. For some accounts it appeared the utility used all four digits in calculating the bill and at other times used only two. Citipower should be consistent in its billing practices and ensure that its billing system is charging the correct rate for all customers.
- Two accounts that appeared to be commercial accounts were not being billed for sales tax. The utility should charge sales tax to all non-residential accounts unless the utility is provided with an exemption certificate.

- Citipower was charging sales tax on gas service only. Citipower should include school tax as well as gas service when calculating sales tax for non-residential accounts.

Conclusion

Citipower has cured very few of the deficiencies noted in the Report of Financial Examination. This appears to be a pattern given the company's lack of response to the Commission's Order in Case No. 1999-00225. Commission Staff is concerned that Citipower's principals do not understand the importance of separating its regulated and nonregulated activities; the importance of maintaining supporting documentation for affiliated company transactions and keeping separate books for each affiliate; nor the importance of complying with applicable statutes and regulations and Commission orders.

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2004-00101 DATED JUNE 1, 2004.

Citipower

Forexco Inc.

RECEIVED
FEB 14 2003
PSC
FINANCIAL ANALYSIS

February 10, 2003

Thomas M. Dorman, Executive Director
Commonwealth of Kentucky
Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602
(502) 564-3940

Re: Citipower L.L.C. Response to 2001 Audit Report

Dear Mr. Dorman:

Please accept the enclosed Citipower, L.L.C. response to the Public Service Commission's report, issued January 10, 2003, on the financial examination of Citipower, L.L.C. for the year ended December 31, 2001. We will work diligently, to the best of our abilities, to correct the deficiencies and to implement the recommendations in the Commission's report.

Sincerely,

David J. Hutchinson
Chief Financial Officer

Citipower, LLC
2122 Enterprise Road
Greensboro, NC 27408

Voice 336-379-0800
Fax 336-379-0881

Response to Public Service Commission Report, issued January 10, 2003, on the Financial Examination of Citipower, LLC for the Year Ended December 31, 2001

1. Utility Plant – Recordkeeping. Citipower will begin keeping detailed plant records and a depreciation schedule in accordance with the PSC's instructions, beginning with the year 2002. Due to changes in personnel, the passage of time, and condition of the existing records, it is not feasible to create the recommended detailed records for previous years. However, there was and still exists a record of each addition and disposal of plant in the general ledger for those previous years.

2. Utility Plant – Purchase of McCreary Gas. Citipower will post the PSC's proposed adjusting journal entries. Citipower believes that the proposed adjusting journal entries represent the best estimate of adjustments which need to be made to correct the accounting for the purchase of assets from McCreary Gas.

3. Nonregulated Activity – Cost Allocations. Citipower will file a Cost Allocation Manual for its nonregulated activities in accordance with KRS 278.2205. Citipower anticipates preparing and filing the Cost Allocation Manual by June 30, 2002.

4. Afilliated Company Transactions. Citipower will negotiate a contract or contracts with Forexco which clearly document and separate the activies of Citipower and Forexco. Wherever possible, Citipower will pay its expenses directly and will allocate costs between regulated and non-regulated activities.

Citipower will examine all disbursements for Lick Branch and will reclassify these disbursements where necessary. Any required documentation will be prepared to support and clarify the disbursements.

5. Natural Gas Purchases. Citipower's current method of purchasing natural gas ensures that the economic loss from line loss is borne by the producers of the natural gas, not Citipower or its customers. Citipower will study the PSC's recommendation and determine if it is readily feasible to install an additional meter or meters and to purchase natural gas as recommended by the PSC. If so, it will reflect the revised methodology in the contract or contracts to be negotiated with Forexco.

6. Credit Card Purchases. Citipower will cease making purchases using credit cards, and will instead pay invoices by check.

7. Segregation of Duties. Citipower will direct the bank to send bank statements to the Greensboro office, and the statements will be reconciled by Greensboro office personnel. The segregation of duties issue cannot be completely resolved, due to the small size of the staff. However, the transactions initiated by the office employee in Whitley City will be reviewed by Greensboro Office personnel, and the bank statement will be reconciled by Greensboro Office personnel. The transactions initiated by the Greensboro office personnel will be reviewed by Dan Forsberg, President, and at year end by an outside CPA firm.

8. Minutes of Meetings. Citipower has and will continue to conduct annual meetings. Citipower will keep minutes of those meetings in the future.

9. Miscellaneous Recordkeeping. Citipower will examine and adjust the allowance for doubtful accounts.

Citipower will record hookup fees in the correct accounts.

Citipower will keep its records on an accrual basis and maintain accounts payable.

Citipower will do its best to properly classify expenses in the annual report per the USoA.

10. Fringe Benefits. Citipower no longer pays expenses related to an employee's personal vehicle, and has no plans to do so in the future. However, if it does it will treat those payments as wages.

11. Customer Deposits. Citipower will request permission to change its tariff to match its current practice with regard to deposits.

Citipower will pay interest on customer deposits annually at a rate of 6%.

12. Unauthorized Rates and Charges. Citipower has charged its customers rates authorized by the PSC since September 1, 2002, and those rates have included an adjustment to recover previous net undercharges as required by the PSC's Order in Case No. 2002-00252. Citipower will continue to timely file Gas Cost Adjustment Filings and will charge its customers rates authorized by the PSC.

Citipower has ceased collection of the fees not authorized by its tariff, and has changed its contract for service to delete the unauthorized fees.

13. Providing a Copy of Rate Schedule. Citipower will annually furnish its customers a copy of the rate schedule under which bills are computed.

14. Miscellaneous Tariff Item. Citipower will request the suggested technical change to page 3 of its tariff to show Institutional as a separate classification.

15. Noncompliance with a Commission Order. Citipower will file a plan of compliance with the recommendations contained in the Staff Report issued in Case No. 1999-00225, and will file quarterly reports including a comparative balance sheet, income statement and statement of cash flows. Citipower is in the process of taking actions in response to the Report of the PSC's financial examination of Citipower, LLC for the year ended December 31, 2001, which was issued January 10, 2003. Many of the recommendations in the Staff Report issued in Case No. 1999-00225 have been brought forward and/or updated in the Report issued January 10, 2003. Citipower will act first to respond to the more recent Report, and then act to respond to the remaining recommendations from the Staff Report issued in Case No. 1999-00225.

16. Certificate of Public Convenience and Necessity. Citipower will seek to obtain a Certificate of Public Necessity prior to constructing facilities that are not extensions in the ordinary course of business.

17. KRS 278.300 Issuance or Assumption of Securities. Citipower will seek authorization from the PSC prior to issuing securites and prior to issuing new debt or renewing its existing debt.

18. Financial Condition. Citipower has incurred significant losses since 1996 as it has built out its infrastructure. Citipower and its investors have been optimistic that this investment would benefit McCreary County and eventually become self-supporting. Citipower has increased its customer count each year, and has increased its revenues each year. The Federal Bureau of Prisons has constructed a large facility in McCreary County which began purchasing natural gas from Citipower in 2002, and which will be fully operational in late 2003 or early 2004. Our projections are that Citipower's operations will generate positive cash flow in 2004 and that the past investments in Citipower infrastructure will be good investments.

Citipower

RECEIVED

MAR 26 2004

PUBLIC SERVICE COMMISSION

March 19, 2004

Commonwealth of Kentucky
Public Service Commission
Attn: Office of Executive Director
211 Sower Blvd.
Frankfurt, Kentucky 40602

Subject: Citipower Responses and Applications

Gentlemen,

Enclosed you will find the following documents in response to notices from the Kentucky Public Service Commission to Citipower, L.L.C.:

1. Responses to Staff Report on Citipower, LLC Case No. 99-225
2. Responses to Report of Follow-up Examination received from the Commission on February 27, 2004.
3. Application for Note Renewal
4. Quarterly financial reports for 1999-2003

Citipower has expended a considerable amount of effort over the last several months in order to cure its previously outstanding deficiencies and to demonstrate that it is serious about complying with applicable statutes and regulations and Commission orders.

If you have any questions please contact Garland Shaw at 336-379-0800.

Sincerely,

Dan Forsberg
President

Enclosures

2122 Enterprise Road
Greensboro, NC 27408

Citipower's Responses to Issues in February 2004 PSC Report of Follow-up Examination

1. Utility Plant - Recordkeeping

Issue: Misclassifications between regulated and non-regulated plant

Response: The Commission has not provided us with the specific misclassifications so we cannot fully address this issue. Citipower will correctly classify all assets in the 2003 Annual Report to the best of its ability.

2. Utility Plant – Purchase of McCreary Gas

No noted deficiencies

3. Nonregulated Activity – Cost Allocations

Issue: Citipower was not allocating costs to nonregulated account

Response: The Commission has not provided us with the specific misclassifications so we cannot fully address this issue. Further, it is not at all clear in the USoA accounts how regulated and nonregulated activities are to be allocated. The word "nonregulated" does not appear in the USoA or its related instructions. However, Citipower has taken, or is taken, the following steps to improve in this area: Categorization of time spent on regulated and nonregulated activity in employee timesheets, revision of accounting system and procedures, and the preparation of a Cost Allocation Manual.

Issue: The report advised Citipower to file a Cost Allocation Manual

Response: Citipower is currently preparing a Cost Allocation Manual and anticipates filing it in April 2004.

4. Affiliated Company Transactions

Issue: There was not a clear separation of duties between the activities of Citipower and Forexco

Response: The Commission has not provided us with the specific instances where Citipower paid Forexco invoices so we cannot fully address this issue. However, vendors are being instructed to bill the proper company for services. Care is being taken to ensure the proper company pays for their own costs.

Issue: The contract between Citipower and Citizens did not specify a transportation rate

Response: There is not a contract in force between Citipower and Citizens at this time. Citizens buys gas from Citipower at the same "posted" price they pay to other local producers. The gas is transported down Citipower's 11.5 mile 4" line to Citizens and no transportation is charged to Citizens.

Issue: Citipower employees were changing the charts on Forexco's wells, but no labor or transportation was billed to Forexco

Response: A contract for services between Citipower and Forexco has been created and will be executed in March, 2004. Citipower will charge Forexco for all well-related labor effective January 1, 2004.

Issue: The utility is making entries to investment in affiliated company accounts and affiliated company payable/receivable accounts without appropriate documentation
Response: Citigas, L.L.C. and LBU, L.L.C. each have their own set of books. The number of intercompany transactions is small (<20 in 2003) and they are documented.

5. Natural Gas Purchases
Issue: Forexco bills Citipower based on Citipower sales to customers, not a single metered volume
Response: There is not a single meter which the gas volumes pass through when Citipower takes custody of the gas. The vast majority of the gas goes straight from the producing wells to the customers. Therefore, the most accurate measure of how much gas is purchased by Citipower for its utility usage is the customers' meters.

6. Credit Card Purchases
Issue: Invoices are not available to support credit card purchases
Response: The Commission has not provided us with the specific instances where support was not available so we cannot fully address this issue. However, we have only found one instance where a credit card purchase was made in 2003 and it was supported by an invoice.

7. Segregation of Duties
Issue: There is no change in the segregation of duties for transactions originating in North Carolina
Response: Citipower has taken steps to improve the segregation of duties, including setting up a new bank account at the Bank of McCreary County that limits the amount of cash the utility staff can access. In North Carolina, the Controller's work is now being overseen by the CFO who reviews the monthly financial statements and accounts. This "compensating control" has strengthened the internal controls considerably.

8. Minutes of Meetings
No noted deficiencies

9. Miscellaneous Recordkeeping
Issue: The utility is still not using accounts 415 and 416 to record Hookup Fees
Response: This issue will be corrected in the 2003 Annual Report.

Issue: Citipower is still misclassifying some expenses in its annual report

Response: Since the Commission did not provide specific misclassification errors, we cannot fully address this issue. However, Citipower improved considerably in this area in 2002, and will make further improvements in 2003.

10. Fringe Benefits
No noted deficiencies

11. Customer Deposits
Issue: The utility is still holding some deposits for more than a year
Response: Most of the deposits for non-delinquent accounts were refunded in January 2004. The utility is reviewing the accounts and plans to refund the remainder in March 2004.

Issue: The utility is still not calculating interest correctly for deposits refunded or paying interest annually
Response: Interest is now being calculated correctly and was paid on refunded deposits.

12. Unauthorized Rates and Charges
Issue: Miscellaneous issues regarding gas service contract
Response: A revised Gas Service Contract has been approved by Chris Whelan of the Commission and is now being used by the utility.

13. Providing a Copy of Rate Schedule
No noted deficiencies

14. Miscellaneous Tariff Item
No noted deficiencies

15. Noncompliance with a Commission Order
Issue: Citipower had not filed a plan for compliance with recommendations in Staff Report in Case 1999-00225
Response: Citipower's responses to Case 1999-00225 have been enclosed with this document.

Issue: Citipower did not file quarterly reports as required in that case
Response: Please see enclosed quarterly financial statements.

16. Certificate of Public Convenience and Necessity
No noted deficiencies

17. KRS 278.300 Issuance or Assumption of Securities
Issue: Citipower renewed a one-year loan more than six times without PSC approval

Response: Citipower should have sought PSC approval for this loan in 2003 before renewing it in December, and regrets having failed to do so. Garland Shaw of Citipower spoke with Aaron Greenwell regarding this issue on February 18, 2004. Mr. Greenwell said that he would call the following week to discuss this issue, but he has not called as of this writing. As Citipower will not have the financial resources to repay this loan in 2004, we have enclosed an application seeking approval from the Commission for this debt.

Issue: Citipower assumed a loan of LBU, LLC without PSC approval
Response: Citipower should have sought PSC approval before assuming this loan, and regrets having failed to do so. It is anticipated that this loan will be fully repaid in 2004.

Issue: Citipower has issued securities without PSC approval
Response: Citipower should have sought PSC approval before issuing equities, and regrets having failed to do so. Citipower has now discontinued issuing equities and does not anticipate the need to raise equity again.

Since the Commission report of January 2003, any debt or equity financing taken by Citipower has been for non-regulated purposes. No new debt or equity is foreseen to be required by Citipower. However, in the event Citipower does wish to raise equity or borrow funds, it will seek Commission approval prior to doing so.

18. Financial Condition
Issue: Staff questions the utilities ability to remain a viable company considering past losses
Response: Citipower sales volumes and revenues grew considerably in 2003 due to the newly-constructed US Federal Prison in Pine Knot. Further volume growth is expected through 2005 as the prison is expected to begin housing inmates in mid-2004. As a result of the increased sales, as well as reduced costs, Citipower expects to generate net operating cash flows in excess of $500,000 per year for the foreseeable future. This should allow Citipower to pay off its outstanding loans within the next five years.

Citipower management will be glad to discuss this issue with the Commission if so desired.

Additional Items Discussed in Report
Issue: Citigas
Response: See comments below under "Removal of Affiliated Company Activity from Citipower's Books".

Issue: Removal of Affiliated Company Activity from Citipower's Books
Response: In Citipower's January Board of Directors meeting it was determined that a restructuring would be devised to split out the regulated and nonregulated

activities. This plan is still being pursued and Citipower is currently seeking the Commission's counsel on how to best proceed with its execution.

Issue: Transportation Rate
Response: Citipower is currently exploring other ways to utilize this pipeline in order to recover its investment.

Issue: Test of Tariff
Response: Citipower would appreciate the opportunity to see the specific problems identified by the Commission. Our system is programmed to consistently use two digits for billing calculations. We would also like to have clarification from the Commission regarding its proposed practice of calculating sales tax on school tax amounts.

Conclusion

Issue: Citipower has cured very few of the deficiencies noted in the Report of Financial Examination
Response: Citipower has indeed cured a large number of deficiencies noted in the report. However, we concede that not all of them have been sufficiently addressed and Citipower is now taking the action to do so. Additional financial staff and resources have been deployed in the first months of 2004 to this very task.

Issue: Lack of response to Commission's Order in Case No. 1999-00225
Response: Responses to this case are included in an enclosed document.

Issue: Citipower's principals do not understand the importance of separating its regulated and nonregulated activities
Response: Citipower has taken the following steps in regard to this issue:

1. Sought advice from Commission regarding restructuring of Citipower to separate regulated and nonregulated activities.
2. Preparing a Cost Allocation Manual.
3. Executed service contracts between affiliates in order to properly allocate costs.
4. Revised accounting system to account for regulated and nonregulated activities separately.

Issue: ... the importance of maintaining supporting documentation and separate books for each affiliate
Citipower does maintain documentation and separate books for each affiliate.

Issue: ... the importance of complying with applicable statutes and regulations and Commission orders

Citipower is now making a full-fledged effort to comply with the Commission rules and orders, and it is hoped that this effort is evidenced by the responses provided here and in the enclosed documents.