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January 25, 2002

Mr. Carroll M. Redford, III
Miller, Griffin, & Marks, P.S.C.
271 West Short Street
600 Security Trust Building
Lexington, Kentucky 40507-1292

RE: Your January 14, 2002 letter
on Columbia Gas of Kentucky's
Weather Normal Adjustment ("WNA")

Dear Mr. Redford:

Columbia Gas of Kentucky's ("Columbia") WNA mechanism was presented to the Commission for approval as part of a unanimous settlement agreement in Columbia's most recent general rate case, Case No. 94-179, in 1994. The Commission approved the settlement, which was agreed to and filed by Columbia, the Office of the Attorney General, Lexington-Fayette Urban County Government, the Appalachian Research and Defense Fund and the Office of Kentucky Legal Services, effective November 1, 1994.

Rates set in a rate case for a gas distribution company are normally based on sales volumes that reflect normal weather conditions and temperatures for a "test year". However, actual weather conditions and temperatures during the period when rates are in effect seldom result in sales levels that match those on which the rates were based. A WNA, which is in effect only during the heating season, serves to mitigate the effect of weather on recovery of a gas utility's fixed costs, which account for nearly all costs except for the commodity cost of the gas itself. In the absence of a WNA, in a colder-than-normal winter, a gas utility will over-recover its fixed costs and customers' bills will be higher than with a WNA. Conversely, in a warmer-than-normal winter, the utility will under-recover its fixed costs and customers' bills will be lower than with a WNA. The intent is to stabilize customers' bills and utilities' cost recovery by mitigating the impacts of weather extremes. The WNA is not applicable to the utility's recovery of the cost of natural gas, just its non-gas costs.



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An underlying reason for a WNA is the significant level of costs associated with providing natural gas service, including a return on investment, that are fixed in nature. Sales volumes, however, are not fixed and many gas utilities typically make two-thirds of their annual sales during the months of December through March. Since a significant portion of a utility's fixed costs are recovered through the usage-based component of its rates, the volume of gas sold is of great importance. Hence the WNA, which adjusts the usage level to which the non-gas, or base commodity rate, is applied. In many states, the regulatory commissions have approved WNA mechanisms for gas utilities, as has been done in Kentucky, as a means of addressing this issue. Since the time when Columbia's WNA was implemented, the Commission has approved WNA mechanisms for three other large gas companies, Delta Natural Gas Company, Western Kentucky Gas Company, and the Louisville Gas and Electric Company.

A second approach to addressing the issue of fixed cost recovery has been attempted in past years, unsuccessfully, in other states. Under this approach, only the wholesale cost of gas, which is variable, is included in the commodity, or usage-based component of the utility's rates and the full amount of the fixed costs is included in a fixed monthly charge that is paid regardless of the amount of gas used. A portion of such costs are already recovered through this type of charge, which can be classified as either a customer charge or minimum bill, although such charges generally recover amounts equal to only somewhere between one-fourth and one-half of a utility's fixed costs. For most gas utilities in Kentucky, these partially compensatory charges are presently somewhere between \$6.00 and \$10.00 per month for residential customers. Increasing these to levels that fully recover fixed costs, while economically justifiable, would be expected to present a public relations problem similar to the unsuccessful experiences of others in years past in other parts of the country.

I hope this description and explanation is helpful. If you have further questions on this matter, please contact Mr. Jeff Shaw, of the Commission's Division of Financial Analysis, at 502-564-3940, extension 237.

Sincerely,



Thomas M. Dorman
Executive Director

