COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY TO IMPLEMENT A PILOT PROGRAM TO EVALUATE THE USE OF A HEDGING PROGRAM TO MITIGATE PRICE VOLATILITY IN THE PROCUREMENT OF NATURAL GAS	))))))	CASE NO. 2001-00128

O R D E R

On March 28, 2002, The Union Light, Heat and Power Company (ULH&P) filed a proposed natural gas hedging plan for the 2002-2003 winter season. ULH&P proposed continuing the plan implemented for the 2001-2002 winter season with two modifications: eliminating price caps as a hedging instrument and decreasing the volumes to be hedged. The modified plan would consist of fixed-price contracts, cost-averaging instruments based on the NYMEX strip price for a given period of time and no-cost collars. Portions of ULH&P s application were filed pursuant to a request for confidential treatment. By letter of the Commission s Executive Director dated April 18, 2002, the request was granted.

A procedural schedule has provided an opportunity for discovery, written comments by intervenors, and a public hearing, if requested. The sole intervenor in this proceeding is the Attorney General of the Commonwealth of Kentucky, through his Office of Rate Intervention (AG). On April 18, 2002, the AG filed a request for a formal hearing. However, on May 8, 2002, he filed a notice withdrawing that request.

PROPOSAL

ULH&P proposes to hedge a limited portion of its base gas supply for the months of November through March.[1] The percentage proposed to be hedged will be within a minimum and maximum range identified in the confidential portion of the application. The plan describes the volumes of gas to be hedged, the types of hedging instruments to be acquired, the lock-in price for the gas supplies, and a price tolerance range within which the instruments will be acquired.

On May 1, 2002, ULH&P filed its annual report on its hedging activity for the period November 1, 2001 March 31, 2002. ULH&P reported that its gas costs during the 2001-2002 heating season were $1.2 million, or $.10 per Mcf, higher than if the hedging plan had not been implemented. It also supplied an analysis of the hypothetical effect of the same hedging activity if such a plan had been implemented for the 2000-2001 heating season, which showed savings of $.39 per Mcf. ULH&P emphasized in its report that the stated goal of its hedging program was to reduce the volatility in gas prices and to provide some protection against the extremely high prices experienced during the 2000-2001 heating season. In the report on its hedging activities for the 2001-2002 winter season, ULH&P proposed to file the annual report on its hedging activities for the 2002-2003 winter season by May 1, 2003.

[1] Base gas is defined as the quantity of gas that is purchased each day of the month, regardless of weather or other factors. It is calculated by adding the historical minimum daily load to the maximum daily injections into interstate pipeline storage.

AG S COMMENTS

On May 8, 2002, the AG filed comments on ULH&P s proposed plan, stating his general objection to hedging plans as he did in the Commission s review of ULH&P s 2001-2002 hedging plan. The AG s specific arguments against ULH&P s proposed plan for the 2002-2003 winter season are: (1) All costs are assigned to ratepayers; (2) No effort has been made to ascertain whether ratepayers prefer price stability to least cost pricing; and (3) A pre-approved plan relieves ULH&P from using its own judgment in making gas purchasing decisions. The AG also expressed concern with ULH&P s reluctance to establish only a maximum limit, or cap, with no lower limit, on its hedged volumes, as opposed to establishing a range of volumes consisting of both upper and lower limits. The AG argues that ULH&P should be obligated, as well as free, to pursue the most prudent gas purchasing strategy available for a given time period. The plan should not encourage or permit ULH&P to constrain itself to implementing pre-approved purchasing practices that are unresponsive to the needs of the season the purchases will cover. The AG argues that if the Commission approves ULH&P s hedging plan, the volumes to be hedged should be reduced from what has been proposed. Furthermore, the AG contends that customers should be surveyed to determine the extent of their support for hedging activity.

DISCUSSION

Risk management procedures, such as hedging programs, are designed to guard against unwanted outcomes. Hedging provides a measure of protection against price volatility, both extreme volatility, such as that experienced in the winter of 2000-2001, and the less extreme volatility experienced in prior heating seasons. Wholesale natural gas prices are again acting in an uncharacteristic fashion. Prices have increased for the last several months despite the warmer than normal 2001-2002 winter, the higher-than-normal storage levels and the lower forecasts for summer demand. Articles in industry publications indicate analysts are struggling to explain the recent increases in natural gas prices. Adding to the difficulty of predicting future gas prices is the recent release of information concerning alleged manipulation of the California electric market. It appears that, regardless of the available information, forecasters will have limited success in predicting the level of energy prices over the next several months.

Hedging will not produce the lowest cost under all conditions, but it can limit the exposure to the financial impact of excessively high prices. Obviously, customers are financially impacted when prices increase. In addition, while utilities may pass through to customers the cost of their gas purchases, they can incur additional costs when prices increase due to related increases in uncollectible accounts. Hedging programs should attempt to strike a balance between the cost of hedging and the benefits of protecting customers against extreme price swings.

In its attempt to balance costs and benefits, the Commission considered the AG s concern regarding the level of volumes hedged. In response to Staff s information request, ULH&P replied that it believes a minimum hedged volume is necessary over the long run to ensure that a minimum level of savings will be captured when market prices turn out higher than the hedged prices. Given that this past heating season represents only one period from which to review the results of ULH&P s hedging activity, we are not persuaded by the AG s arguments to reduce the level of volumes that will be covered by ULH&P s hedging plan. Therefore, we will approve the upper limit of ULH&P s proposed winter supply requirement as the ceiling on the volumes to be included in the hedging plan. As to setting a minimum volume to hedge, we find that the range should contain no lower limit, or floor, on the volumes that may be hedged under the hedging plan. This will inject a greater degree of judgment and decision-making into the hedging plan than was included in the plan approved for the 2001-2002 heating season and provide greater flexibility to ULH&P in the event market prices experience a decline similar to that experienced in the summer and fall of 2001.

The Commission appreciates the AG s concern regarding public support for hedged gas prices and the potential for incurring additional costs. In response to a Staff information request, ULH&P indicated it has conducted no customer surveys to determine the level of understanding or support for its hedging activities or the additional cost passed through its Gas Cost Adjustment (GCA) mechanism. ULH&P further stated that conducting a scientifically valid survey of customers who had little knowledge of gas price trends, GCAs, or hedging would be difficult. The Commission understands that it will not be an easy task to draft and conduct a survey of this nature; however, it agrees with the AG that public support for hedging activity should be ascertained. The Commission believes that with input from the AG and Commission Staff, ULH&P can construct a survey that will satisfy all parties and derive the necessary information.

The Commission also has concerns about the lack of written policies and procedures for ULH&P s hedging program. In response to a Staff information request, ULH&P stated that since its hedging activity did not originate any risk, did not create tax, cash flow, accounting, value at risk, or market to market implications (sic), it does not follow its corporate "Integrated Risk Management Policies" for its hedging activity.[2] Instead, ULH&P holds regular meetings involving four employees, its Vice President of Gas Operations, its Manager of Gas Resources, a gas supply analyst and a gas buyer. These individuals review market conditions and determine whether or not to lock in either a fixed price or no-cost collar.

While its hedging activity may not create risk for ULH&P, the program is a form of risk management designed to mitigate the risk of volatility in gas prices. As such, the Commission concludes that it is appropriate to require ULH&P to develop specific guidelines for its hedging activity that, at a minimum, will provide continuity in the event of personnel changes.

The Commission believes that valuable experience was gained from the hedging activities that were approved for the 2001-2002 winter season. We continue to believe that no one method can be applied to all utilities that opt to pursue hedging as part of their gas procurement processes. The Commission wishes to emphasize that while it encourages utilities to explore different purchasing practices, it still expects them to be responsible for making prudent gas procurement decisions. ULH&P should seek to obtain its natural gas supplies at the lowest reasonable cost, within a gas supply portfolio that balances the objectives of obtaining low cost supplies, minimizing price volatility and maintaining reliability of supply.

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[2] Response to Commission Staff's First Set of Data Requests filed April 22, 2002.

OTHER ISSUES

Accounting and Reporting Requirements

ULH&P did not propose to change any of the accounting and reporting requirements imposed upon it by our Order approving its 2001-2002 hedging plan.[3] The Commission believes the information provided by ULH&P in both its interim and final hedging reports was beneficial in our monitoring the activities of that plan. In order to retain those benefits, we will require that ULH&P comply with the same accounting requirements and reporting requirements for this hedging plan. The Commission will, however, require a change in the time when a final report on ULH&P s 2002-2003 hedging plan is to be filed relative to a filing for approval of any future hedging plan. ULH&P will continue to be required to file its final report no later than May 1, 2003. It will also be required to make such filing concurrent with or prior to filing an application for approval of a hedging plan for a subsequent heating season.

Administrative Case 384 Focused Management Audit

A focused management audit of the gas procurement practices of the Commonwealth s major jurisdictional gas distribution utilities, including ULH&P, is currently being conducted for the Commission by The Liberty Consulting Group (Liberty). The fairly broad scope of the audit covers many issues, including hedging programs. The Commission expects to gain a great deal of beneficial information from the audit. However, given that Liberty s final report is not due until several weeks after the date of this Order, that information will not be available when a decision is required

[3] Case No. 2001-00128, Order of July 16, 2001.

in this proceeding. Therefore, while the decision rendered herein does not have the benefit of Liberty s findings and recommendations on hedging, the Commission intends to take full consideration of those findings and recommendations in any future review of ULH&P s hedging program.

FINDINGS AND ORDERS

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. ULH&P s interim and final reports on its 2001-2002 hedging plan should be accepted.

2. ULH&P s request to implement a hedging plan for 2002-2003 should be approved, subject to the modification that there be no lower limit on the volumes that may be hedged.

3. ULH&P should file its interim report on its 2002-2003 hedging plan under the same requirements as it filed its interim report on its 2001-2002 hedging plan.

4. ULH&P should file its final hedging report on its 2002-2003 hedging plan concurrent with or prior to filing its next hedging plan. If it does not file a hedging plan for the following winter season, ULH&P should file its final report in the same manner as it filed its report on its 2001-2002 hedging plan.

5. ULH&P should prepare and file risk management policies and procedures governing its hedging activities within 60 days of the date of this Order.

6. ULH&P should contact the Commission within 60 days to schedule an informal conference with Commission Staff and the AG to discuss designing a customer survey as described herein.

IT IS THEREFORE ORDERED that:

1. ULH&P s proposed hedging plan for the 2002-2003 heating season is approved as modified herein.

2. ULH&P shall file with the Commission an interim hedging report on its 2002-2003 hedging plan, containing the same type of information as its interim report on its 2001-2002 hedging plan, no later than November 30, 2002.

3. ULH&P shall file with the Commission a final hedging report on its 2002-2003 hedging plan, containing the same type of information as its final report on its 2001-2002 hedging plan, no later than May 1, 2003.

4. Should it seek approval of a hedging plan for the 2003-2004 heating season, ULH&P shall file an application for such approval concurrent with or prior to filing its final report on its 2002-2003 hedging plan.

5. ULH&P shall file with the Commission written policies and procedures for its hedging activity within 60 days of the date of this Order.

6. ULH&P shall contact the Commission for the purpose of scheduling an informal conference with Commission Staff and the AG to discuss conducting a customer survey regarding its hedging activities.

Done at Frankfort, Kentucky, this 7th day of June, 2002.

By the Commission

ATTEST:

Executive Director