COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

MODIFICATIONS TO LOUISVILLE GAS AND ELECTRIC COMPANY'S GAS SUPPLY CLAUSE TO INCORPORATE AN EXPERIMENTAL PERFORMANCE-BASED RATEMAKING MECHANISM	)))))	CASE NO. 2005-00031

O R D E R

On December 30, 2004, Louisville Gas and Electric Company ("LG&E") applied to extend and modify its existing gas cost performance-based ratemaking mechanism ("PBR"). The Commission approved the current PBR mechanism in October 2001 for a four-year period expiring in October 2005.[1] The program benchmarks LG&E's gas costs against three components: (1) the Gas Acquisition Index Factor ("GAIF") which benchmarks actual commodity costs against prices published by Inside FERC for monthly purchases, Natural Gas Weekly for weekly purchases, and Gas Daily for daily purchases, and benchmarks supply reservation fees against LG&E's average reservation fees from the previous two years; (2) the Transportation Index Factor ("TIF") which benchmarks LG&E's pipeline transportation costs against the Federal Energy Regulatory Commission's ("FERC") approved transportation rates of Texas Gas Transmission and Tennessee Gas Pipeline Company; and (3) the Off-System Sales

[1] Case No. 2001-00017, Modification to Louisville Gas and Electric Company's Gas Supply Clause to Incorporate an Experimental Performance-Based Ratemaking Mechanism, Order dated October 26, 2001.

Index Factor ("OSSIF") which benchmarks sales of gas, transportation and storage services against LG&E's out-of-pocket costs to make such sales.

Variances between LG&E's actual costs and the benchmarks are shared between shareholders and ratepayers on a sliding scale consisting of two bands. The first band covers variances from the benchmark ranging from 0 to 4.5 percent and is shared 75:25 between ratepayers and shareholders in favor of the ratepayers. The second band covers variances greater than 4.5 percent and is shared 50:50. During the period covered by the current mechanism, LG&E achieved total savings of $28,545,894, with LG&E retaining $7,704,026 and the customers retaining $20,841,868.

LG&E responded to two data requests from Commission Staff and one data request from the Attorney General ("AG"), the only intervenor in this proceeding. The parties chose to file written comments in lieu of a public hearing. All comments have been filed and the case stands submitted for decision.

ISSUES

LG&E proposes to modify the current PBR mechanism by adjusting the sliding scale in the following manner: 70:30 in favor of customers for the 0 to 2 percent band, 60:40 in favor of customers for variances over 2 percent up to 3 percent, 50:50 for variances greater than 3 percent up to 4 percent, and 60:40 in favor of LG&E for savings or expenses greater than 4 percent. LG&E also proposes to extend the program an additional five years through October 31, 2010. LG&E proposes these changes in order to more accurately reflect the level of risks that it believes it assumes by operating under a mechanism that requires it to share in expenses when it cannot outperform the benchmarks. LG&E argues that its request is reasonable because other

PBR mechanisms approved by the Commission are more generous to shareholders than LG&E's current mechanism.

The AG filed his comments on March 28, 2005. He takes issue with several components of the PBR, namely the proposed changes in the sharing mechanism and the continued use of undiscounted FERC-approved rates as the benchmark for transportation costs. The AG does not support continuing the PBR; however, if the Commission decides to continue it, he prefers no change in the sharing mechanism.

The AG contends that an increase in LG&E's shared percentage of the variances from the benchmark is not warranted given that the risks that LG&E discusses as justification for increasing its share occur as a function of the mechanism. In addition, the AG argues that LG&E is unable to identify any added benefits for ratepayers or any ways in which it would behave differently if the sharing percentages were changed. He contends that as a result of "unduly high benchmarks," the savings are assumed rather than actual, which allows LG&E to earn a profit on purchased gas expense that previously has been precluded. The AG states that assumption, presumption, and guess work should not substitute for an actual showing of benefits to the customer in a time when gas costs are at an all time high.

The AG takes issue with the use of undiscounted FERC transportation rates as the benchmark for LG&E's transportation costs. He contends that since LG&E has access to more than one pipeline, it has an obligation to negotiate discounted rates and that in light of this obligation, it is inappropriate to reward LG&E for outperforming the benchmark. The AG believes that the customers should be awarded the full benefit of

the negotiated discounts since they are the ones that pay for the pipeline charges and the personnel who negotiate the charges.

Finally, while the AG objects to the continuation of the mechanism, if the Commission orders continuation, he does not object to the longer term proposed if it presents savings opportunities from longer term purchases that would not be available in a shorter term program. He does, however, argue that the extension might make the short-term benchmarks inappropriate for longer-term purchases. The AG believes that longer-term contracts should be pursued if this would result in lower costs regardless of the term of the PBR program, since there will be a point at which a contract entered into late in the program would extend beyond the expiration of the mechanism.

LG&E filed its reply comments on April 11, 2005, in which it reiterates many of the arguments included in its application. LG&E points out that the AG raises the same arguments he has raised in LG&E's previous PBR case and in other PBR cases filed with the Commission. LG&E states that the AG failed to offer any analysis or studies to support his position or any alternatives. LG&E states, on the other hand, that it has provided evidence to support its proposed modification of the sharing mechanism. LG&E points out that, under the PBR, it bears a portion of the risk that was previously borne entirely by customers. It states that without the PBR, customers would once again bear all the risks associated with reasonable gas supply purchases.

LG&E states that the AG's argument against using undiscounted FERC rates as the benchmark for transportation costs is without merit since he does not propose an alternative benchmark. LG&E states that one purpose of regulation is to simulate competition, which makes FERC-approved rates an appropriate benchmark. Therefore,

LG&E believes that if it is able to procure gas for less than the FERC rate by negotiating a discount, it should be rewarded for doing so.

LG&E states that the AG did not understand the purpose of its request to extend the mechanism an additional five years. LG&E reiterates that it supports a longer-term mechanism because this will allow for a longer-term focus on performance, not because it will enter into longer-term gas supply agreements only with a longer-term mechanism. LG&E also opposes the AG's stance that it is inappropriate to measure longer-term purchases against the short-term benchmarks used in the mechanism. LG&E agrees that the benchmarks would be inappropriate if it purchased gas using fixed prices. However, since LG&E does not use fixed price contracts, it argues that the benchmarks are appropriate.

ANALYSIS

We agree with LG&E that it is impossible to reconstruct the purchasing decisions that LG&E would have made absent the PBR. Without such a reconstruction, as the AG points out, it is also impossible to determine with exact precision the amount of any savings or expenses realized under the mechanism. LG&E is, however, able to demonstrate that it has pursued more aggressive gas purchasing measures as a result of the mechanism. While the AG argues that LG&E cannot prove that the PBR has benefited ratepayers, we take note that the record does not indicate that the ratepayers have been harmed.

The mechanism was modified in LG&E's previous PBR case in part because the record showed that LG&E had consistently outperformed the benchmarks. As a result, the Commission determined that the sharing ratio should be adjusted. Similar results

appear in the latest report filed by LG&E on its PBR mechanism, which covers the 12 months ended October 31, 2004. For all 3 PBR components, LG&E experienced net savings. It did experience net costs on a monthly basis for one PBR component, the GAIF, during 3 of the 12 months.[2] While over 50 percent of the total savings resulted from the TIF, we continue to be persuaded that it is appropriate to benchmark the costs of all the components of LG&E's gas procurement activities, including its transportation costs and we continue to find FERC-approved pipeline transportation rates to be an objective and reasonable benchmark.

Another consideration is LG&E's incremental costs to implement the PBR program. During the Commission's review of the initial pilot, LG&E stated that it hired an additional employee to deal with the PBR; however, that employee did not devote all his time to the PBR. The allocated portion of the cost of this employee, for the initial pilot period, was approximately $50,000. During that initial pilot, LG&E retained $8.9 million as its share of the savings realized under the PBR. Under the revised sharing mechanism in effect during the latest pilot period, LG&E retained $7.7 million while incurring an additional $49,042 in costs to implement the program.[3] While the dollar amount of the savings and shared costs are more a function of the market price of natural gas than the sharing percentage, LG&E continues to realize savings under the PBR while incurring little additional cost.

[2] It should be noted that $2.0 million of the $2.7 million in savings under the GAIF was realized in one month, December of 2003.

[3] Item 1, LG&E response to Commission Staff's Second Data Request dated March 3, 2005.

SUMMARY

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

1. The current mechanism provides sufficient incentive for LG&E.

2. Modifying the mechanism as LG&E has proposed, to include four sharing bands, would unnecessarily complicate the mechanism.

3. The mechanism should be continued in its present form, including all the previously ordered reporting requirements, for 5 years through October 31, 2010.

IT IS THEREFORE ORDERED that:

1. LG&E's proposal to modify its current PBR is denied.

2. LG&E's current PBR mechanism, without modification, is extended for 5 years through October 31, 2010.

3. Within 60 days of the end of the fourth year of the 5-year extension, LG&E shall file an evaluation report on the results of the PBR for the first 4 years of the extension period, and the Commission shall review same for purposes of determining whether the PBR should be continued, modified, or terminated.

4. LG&E shall file quarterly reports of its activity under the extended PBR in the same manner as it has done during the previous PBR period.

5. LG&E shall file its revised tariff sheets setting out the revisions to its PBR tariff, approved herein, within 20 days from the date of this Order.

Done at Frankfort, Kentucky, this 27th day of May, 2005.

By the Commission

ATTEST:

Executive Director