COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY TO IMPLEMENT A HEDGING PROGRAM TO MITIGATE PRICE VOLATILITY IN THE PROCUREMENT OF NATURAL GAS	)))))	CASE NO. 2005-00191

O R D E R

On May 13, 2005, The Union Light, Heat and Power Company ("ULH&P") filed its final report on its natural gas hedging activities for the 2004-2005 heating season and an application for approval of a natural gas hedging plan for the summer and winter seasons through March 31, 2008.[1] ULH&P has had a Commission approved hedging program in place since July 2001.[2] Its proposed plan consists of fixed price contracts with cost-averaging, fixed price contracts without cost averaging, contracts with price caps, and contracts with no-cost collars, and uses the same hedging instruments for its hedged transactions as in previously approved plans.

ULH&P also requests approval to negotiate contracts for gas purchases through October 31, 2010. In its last hedging case, the Commission granted ULH&P approval to enter into transactions with terms of up to 18 months from the time of the transaction. In

[1] See Case No. 2003-00151, The Application of the Union Light, Heat and Power Company for Approval of a Natural Gas Purchase Hedging Plan for the 2003-2004 Heating Season (Ky. PSC June 19, 2003) (where the Commission directed ULH&P to make such filing).

[2] See Case No. 2001-00128, 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 (Ky. PSC July 16, 2001).

support of its request, ULH&P asserts that a longer hedging time horizon will provide the Commission with information on the specific parameters of gas volumes and give ULH&P adequate management discretion to time the purchases at projected optimal points within the framework pre-approved by the Commission.

Under its proposal, ULH&P will perform all hedging through supplier contracts, thereby avoiding any transaction fees and reducing its hedging costs. It will not use any financial hedges, such as NYMEX futures. Under ULH&P's plan, ULH&P hedges a certain volume for each month covered by the plan, which is ultimately designed to hedge a percentage of its base gas within the plan's minimum and maximum volume.

ATTORNEY GENERAL'S POSITION

The Attorney General ("AG") filed comments on June 30, 2005. He objects to hedging on the grounds that all costs are assigned to the ratepayer and that a hedging plan allows a utility to substitute the plan for its own judgment in purchasing decisions. The AG also expressed concern with ULH&P's request to lengthen the period over which it can hedge gas purchases, comparing it to prior era purchasing practices which focused on long-term gas supply contracts. While agreeing that this practice will reduce volatility, he asserts that it also will prevent customers from realizing the advantages of least cost purchasing.

The AG contends that a hedging plan diminishes regulatory oversight of a utility's natural gas purchases. He argues that in the past, when a utility entered into a long-term contract, the Commission could review the contract and its specifics in order to review the prudence of the transaction. He contends that under ULH&P's proposal, the contract itself and the circumstances behind the contract would not be subject to direct regulatory oversight.

The AG also expresses the concern that ULH&P's renewed request to establish a minimum hedge volume results in a mechanistic approach. He asserts that ULH&P should be obligated and free to pursue the most prudent gas purchasing strategy for any given time period. He states that approving a hedging plan that contains a mechanistic approach, in lieu of using expertise to determine a purchasing plan, assigns all costs of gas purchasing to ratepayers, not just the cost of prudent purchases, and shifts all the risk away from the utility.

DISCUSSION

The AG opposes ULH&P's hedging plan because of the program's additional costs. Allowing ULH&P to negotiate contracts through October 31, 2010, he further argues, could increase the cost to the customer. The stated purpose of ULH&P's hedging plan is to reduce the volatility in purchased gas costs, not to purchase the hedged volume at the lowest costs.[3] The Commission remains of the opinion that reducing volatility is a proper goal for a hedging program We recognize that reducing volatility comes at a cost, which the customer should bear since he benefits from the hedging activity. ULH&P performed a customer survey in a previous hedging case,[4] which demonstrated that its customers are willing to incur additional cost in order to stabilize their bills. The AG has presented no evidence that customers' attitudes have changed. Therefore, the Commission does not believe that ULH&P's hedging program should be discontinued merely because there is the possibility of additional costs.

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[3] Case No. 2005-00191, ULH&P's Application, Attachment B at 1.

[4] See "ULH&P Gas Price Hedging Customer Survey Report," (filed in Case No. 2001-00128, Nov. 12, 2001).

The AG also expresses concern with reduced regulatory oversight because of the use of hedging contracts. He argues that contracts employing hedging agreements restrict the Commission's ability to review the contract for prudence and make the Commission's oversight more distant. We do not agree. Transactions conducted within the parameters of an approved hedging plan merely present a rebuttable presumption of reasonableness. If the Commission finds that a transaction merits review, that ULH&P made this transaction in accordance with an approved hedging plan will not prohibit the Commission from investigating it.

The AG's final concern involves ULH&P's request for a mandated minimum hedged volume. He stated that if a minimum is approved, ULH&P's purchasing expertise will be replaced by mechanistic purchasing. In ULH&P's last hedging case,[5] the Commission stated that it found little cause for concern about mechanistic purchasing that does not reflect market conditions, given the relatively small portion of ULH&P's total winter requirements subject to hedging and its small percentage of gas coming from storage. The Commission also considered the possible price effect of not having a minimum hedged amount. Without hedging at least a minimum volume, hedging activity has no significant effect on the customer's bill.

FINDINGS AND ORDERS

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

1. ULH&P's report on its natural gas hedging activities for the 2004-2005 heating season should be accepted.

[5] See supra note 1.

2. ULH&P's natural gas hedging plan should be approved through March 31, 2008 as proposed and ULH&P should be permitted as part of that plan to enter into contracts for gas purchases through October 31, 2010.

3. ULH&P should file interim and final reports on its hedging activities as required by the Commission in its approvals of ULH&P's previous hedging programs.

IT IS THEREFORE ORDERED that:

1. ULH&P's report on its natural gas hedging activities for the 2004-2005 heating season is accepted.

2. ULH&P's natural has hedging plan is approved as proposed through March 31, 2008 and ULH&P may, as part of that plan, enter into contracts for gas purchases through October 31, 2010.

3. ULH&P shall file interim and final reports as required by the Commission in its approvals of ULH&P's previous hedging programs.

Done at Frankfort, Kentucky, this 15th day of August, 2005.

By the Commission

ATTEST:

Executive Director