COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR MODIFICATION OF ITS PERFORMANCE-BASED RATEMAKING MECHANISM	))))	CASE NO. 2021-00028

O R D E R

On January 29, 2021, Louisville Gas and Electric Company (LG&E) applied to extend and modify its existing gas cost Performance-Based Ratemaking (PBR) mechanism. On February 9, 2021, the Commission issued an Order establishing a procedural schedule for this matter, suspending LG&E's proposed modifications to its PBR mechanism, and allowing LG&E to continue using its most recently approved PBR mechanism during the pendency of this matter. There were no requests for intervention in this matter. LG&E responded to two requests for information from Commission Staff. On June 25, 2021, LG&E filed notice, pursuant to the procedural schedule, indicating that it did not believe a hearing was necessary in this matter and that the case be submitted for a decision on the record. This case is now before the Commission for a decision on the record.

BACKGROUND

The Commission approved LG&E's current PBR mechanism in Case No. 2019-00437 through March 31, 2021.[1] When it extended LG&E's PBR mechanism, the

[1] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020). LG&E's PBR was first approved in Case No. 1997-00171, *Modifications to Louisville Gas and Electric*

Commission stated that it would review the PBR mechanisms of the three local distribution companies (LDCs) that have such mechanisms in their tariffs on the same schedule to be more consistent in its review of each utility's mechanism. The Commission ordered the same PBR expiration date for Columbia Gas of Kentucky, Inc. in its most recent PBR proceeding,[2] and Atmos Energy Corporation's PBR mechanism is currently under review.[3] The Commission also indicated that at the next review, it would consider the larger issue of PBR mechanisms as they apply to gas costs, the appropriateness of all gas-purchasing activities included in incentive mechanisms, the construction and consistency of all approved benchmarks, and best practices of sharing mechanisms between LDCs and their customers.[4]

LG&E's current PBR mechanism benchmarks its gas costs against three components: (1) the Gas Acquisition Index Factor (GAIF), which benchmarks actual commodity costs against prices published by *Platt's Inside FERC's Gas Market Report* for monthly purchases, *Natural Gas Week* for weekly purchases, and *Platt's Gas Daily* for daily purchases;[5] (2) the Transportation Index Factor (TIF), which benchmarks LG&E's

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Company's Gas Supply Clause to Incorporate an Experimental Performance-Based Ratemaking Mechanism (Ky. PSC Sept. 30, 1997).

[2] *See* Case No. 2017-00435, *Electronic Application of Columbia Gas of Kentucky, Inc. to Extend Its Gas Cost Adjustment Performance Based Rate Mechanism* (Ky. PSC July 24, 2020).

[3] Case No. 2020-00289, *Electronic Request of Atmos Energy Corporation for Modification and Extension of Its Gas Cost Adjustment Performance Based Ratemaking Mechanism* (filed Aug. 31, 2020).

[4] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order at 9–10.

[5] LG&E P.S.C. Gas No. 13, Original Sheet No. 87.2-87.5. Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (filed Dec. 27, 2019), Application, Testimony of J. Clay Murphy (Murphy Testimony), Report to the Kentucky Public Service Commission on Gas Supply Cost Performance-Based Ratemaking Mechanism (Report) at 8.

pipeline transportation costs against the Federal Energy Regulatory Commission (FERC) approved transportation rates of Texas Gas Transmission (Texas Gas) and Tennessee Gas Pipeline Company (Tennessee Gas);[6] and (3) the Off-System Sales Index Factor (OSSIF), which benchmarks sales of gas, transportation, and storage services against LG&E's out-of-pocket costs to make such sales.[7]

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 ranging from 0 to 4.6 percent of LG&E's total actual gas supply costs, as defined in the tariff, and is shared 70/30 between ratepayers and shareholders in favor of the ratepayers. The second band covers variances greater than 4.6 percent and is shared 50/50.[8] Before the final Order in Case No. 2019-00437, the first sharing band covered variances ranging from 0 to 3.0 percent of LG&E's total actual gas supply costs and the second band covered variances greater than 3.0 percent. However, the Commission raised the percentage at which the sharing switches from 70/30 to 50/50 in that case "[i]n recognition of the need to provide a meaningful incentive to LG&E that still provides the greatest possible gas cost savings to customers."[9]

LG&E proposed two modifications to the PBR mechanism approved in Case No. 2019-00437. First, LG&E proposed to extend its current PBR mechanism through

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[6] LG&E P.S.C. Gas No. 13, Original Sheet No. 87.6-87.8.

[7] LG&E P.S.C. Gas No. 13, Original Sheet No. 87.8-87.9.

[8] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order at 5–6.

[9] *Id.* at 7.

October 31, 2025, which LG&E argued will allow it to more efficiently and effectively focus on achieving savings for customers.[10] Second, LG&E proposed to adjust its sharing percentages such that the current 4.6 percent threshold will be set at 2.0 percent to bring it in line with the sharing percentages of other Kentucky LDCs.[11]

LG&E also argued generally for maintaining its PBR mechanism. LG&E asserted that voluntary, well-constructed PBR mechanisms that benchmark gas costs in a transparent and objective way can produce results that are superior to the least cost acquisition standard.[12] LG&E argued that this is the case because PBR mechanisms include a risk/reward mechanism that incents the LDC to achieve superior results and places the LDC at risk if those results are not achieved.[13] LG&E argued that customers do not bear the risk associated with supply reliability and do not bear any incremental operating and maintenance costs to achieve those results.[14] Further, LG&E argued that customers ultimately pay lower gas supply costs with, rather than without, a PBR mechanism.[15]

During each of the last five years, LG&E achieved the following gas cost savings as compared to its benchmarks.

Year	GAIF Savings	TIF Savings	OSSIF Savings	Total Savings
2015/2016	$1,247,474	$2,586,483	$18,300	$3,852,257

[10] Supplemental Testimony of Clay Murphy (Supplemental Murphy Testimony) (filed Jan. 29, 2021) at 11.

[11] *Id.*

[12] *Id.* at 5.

[13] *Id.*

[14] *Id.* at 5–6.

[15] *Id.* at 6.

2016/2017	$1,747,156	$1,922,234	$196,921	$3,866,311
2017/2018	$3,560,780	$1,920,084	$381,716	$5,862,580
2018/2019	$4,539,225	$2,456,592	$149,500	$7,145,317[16]
2019/2020	$3,831,193	$2,201,208	$0	$6,032,401[17]

LG&E argued that it cannot fully evaluate the impact of the discontinuance or modification of its PBR mechanism, but it stated that optimization may cease or be eliminated under those circumstances.[18] It further argued that discontinuance of the PBR mechanism may have "unintended behavioral results that adversely impact benefits accruing to customers."[19]

DISCUSSION

Cost-based rates for investor owned utilities are set at a level to allow the utility to recover all of its reasonable expenses and provide its shareholders an opportunity to earn a fair return on invested capital.[20] The LDCs' purchased gas adjustment mechanisms provide for full recovery of the actual cost of gas, with the LDC retaining no profit and sustaining no financial losses on gas purchase transactions. The significance of LG&E's PBR mechanism, like those of the two other LDCs with such mechanisms, is that it allows LG&E to recover from its customers not only the actual gas costs incurred, but also a portion of calculated savings if gas costs are lower than defined benchmarks. It likewise

[16] Case No. 2019-00437, *Electronic Application, Report to the Kentucky Public Service Commission on Gas Supply Cost Performance-Based Ratemaking Mechanism* (filed Dec. 27, 2019), Appendix B.

[17] Supplemental Murphy Testimony, Appendix B.

[18] *Id.* at 8.

[19] *Id.* at 9–10.

[20] Case No. 2017-00481, *An Investigation of the Impact of the Tax Cuts and Job Act on the Rates of Atmos Energy Corporation, Delta Natural Gas Company, Inc., Columbia Gas of Kentucky, Inc., Kentucky-American Water Company, and Water Service Corporation of Kentucky* (Ky. PSC Dec. 27, 2017), Order at 1–2.

requires a utility to return to its customers a portion of calculated losses if gas costs exceed the benchmarks. The ultimate goal of the PBR mechanism is to reduce the overall rates paid by LG&E's customers while maintaining supply reliability, by incentivizing LG&E to lower the gas costs that are passed on to customers.[21] If the PBR mechanism does not result in lower customer costs than would have been paid in the absence of the PBR mechanism, then the PBR mechanism would not serve its intended purpose and, therefore, would not be justified.

LG&E argued that its PBR mechanism provides savings to customers, and there is some evidence to support LG&E's assertion. For instance, as argued by LG&E, its ability to share in savings is a form of positive reinforcement whereas the requirement that it share in costs is a form of negative reinforcement, both of which influence behavior in both persons and organizations.[22] Further, LG&E can show that it has outperformed its gas cost benchmarks, which are based on certain prices on the pipelines from which LG&E receives wholesale gas. However, there are several weaknesses in LG&E's evidence that its PBR mechanism results in lower costs to customers.

LG&E's primary basis for arguing that its PBR mechanism results in lower gas costs for customers is that it is beating the benchmarks, that the benchmarks of a well-constructed PBR mechanism are the market clearing prices, and that the market clearing prices are the least cost acquisition standard. If the PBR mechanism were eliminated, LG&E indicates, or at least implies, that it could then satisfy the least cost acquisition

[21] Case No. 2019-00437, *Electronic Application of Louisville Gas and Electric Company for Renewal and Proposed Modification of Its Performance-Based Ratemaking Mechanism* (Ky. PSC Oct. 26, 2020), Order at 8.

[22] LG&E's Response to Commission Staff's First Request for Information (Response to Staff's First Request) (filed Mar. 17, 2021), Item 4.

standard by simply obtaining gas at the benchmark prices and that it would be incentivized to do so to eliminate the risk associated with a potential prudency review.[23] Under that scenario, the entirety of the savings under the PBR mechanism would be eliminated if the PBR mechanism were eliminated.

However, the Commission has the ability to review the reasonableness of a utility's gas costs in the absence of the PBR mechanism and would have the authority to disallow costs that are found to be unreasonable. Further, the absence of any effort to reduce the cost of gas below current benchmarks, especially when utilities have demonstrated that it is possible to do so consistently for years, would raise questions regarding the reasonableness of a utility's activities. There would also be potential operations and maintenance savings that could be passed on to customers if a utility took no action to reduce costs. Thus, the Commission disagrees with the contention that a utility would have no incentive to reduce gas costs below benchmark prices if the PBR mechanism were eliminated.

Further, even if LG&E's PBR mechanism encourages cost saving behavior it would not otherwise engage in without the mechanism, the PBR mechanism would only serve its purpose of reducing customer costs if the amount of the actual savings generated by the change in behavior exceeded LG&E's share of the PBR savings under its PBR mechanism. LG&E was not able to identify any economic or scientific studies that demonstrate that PBR mechanisms change utilities' behavior in a way that reduces gas costs for customers of LDCs generally.[24] Similarly, LG&E indicated that it has never

[23] Supplemental Murphy Testimony at 6-7.

[24] *See* Response to Staff's First Request, Item 4.

performed an analysis to examine the extent to which its gas purchase and transportation costs beat market rates before it adopted the PBR mechanism as opposed to after it adopted the mechanism.[25] Thus, while LG&E indicated that eliminating the PBR mechanism could result in increased costs to customers, its assertions are not supported by any studies or analysis that establish that LG&E's PBR mechanism changed its behavior in a way that results in lower gas costs for customers.

Despite the weaknesses in LG&E's evidence, the Commission does not find that its PBR mechanism should be eliminated in its entirety at this time. Rather, the Commission believes that those weaknesses weigh in favor of maintaining the reduced level of savings shared with LG&E as approved in Case No. 2019-00437, because the Commission is not convinced all of the savings can be attributed to actions taken as a result of LG&E's PBR mechanism. Continuing the current scaled back savings shared under the PBR mechanism, the effects of which are not yet clear, also allows the Commission to observe the impact of eliminating a portion of the incentives offered by the PBR mechanism without risking unforeseen consequences of eliminating the PBR mechanism outright. Thus, while the Commission rejects LG&E's proposal to adjust its sharing band to allow it to share in 50 percent of the savings over 2 percent of total gas costs, the Commission finds that LG&E's PBR mechanism should be extended without any additional substantive modifications.

However, for the reasons discussed above and because the Commission wants to more closely follow the impact of the reduced incentives, the Commission finds that LG&E's PBR mechanism should only be extended through October 31, 2024. When the

[25] See Response to Staff's First Request, Item 3.

mechanism is next reviewed, the Commission will consider further reducing the amounts shared or eliminating the PBR mechanism entirely, among other things.

IT IS THEREFORE ORDERED that:

1. LG&E's proposed modification to the gas cost sharing calculation is denied.

2. LG&E's PBR mechanism, without any substantive modification, is extended through October 31, 2024.

3. Within 60 days after October 31, 2023, LG&E shall file an evaluation report on the results of the PBR mechanism for the PBR years ending in 2021 through 2023. This report shall be considered in any proceeding established to continue, modify, or terminate the PBR mechanism.

4. LG&E shall file annual reports of its activity under the extended PBR mechanism including the same information it provided during the PBR period that ended October 31, 2020.

5. Within 20 days of the date of this Order, LG&E shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the PBR tariff revision approved herein and reflecting that they were approved pursuant to this Order.

6. All documents filed in the future pursuant to ordering paragraphs 3 and 4 herein shall reference this case number and shall be retained in the post-case correspondence file.

7. This case is closed and removed from the Commission's docket.

By the Commission

Commissioner Marianne Butler did not participate in the deliberations or decision concerning this case.

ENTERED

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KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Linda C. Bridwell

Executive Director

*Honorable Allyson K Sturgeon
Managing Senior Counsel - Regulatory &
LG&E and KU Energy LLC
220 West Main Street
Louisville, KENTUCKY 40202

*Andrea M. Fackler
Manager, Revenue Requirement
LG&E and KU Energy LLC
220 West Main Street
Louisville, KENTUCKY 40202

*Robert Conroy
Vice President, State Regulation and Rates
LG&E and KU Energy LLC
220 West Main Street
Louisville, KENTUCKY 40202

*Louisville Gas and Electric Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40232-2010