COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF COLUMBIA GAS OF KENTUCKY, INC. TO EXTEND ITS GAS COST INCENTIVE ADJUSTMENT PERFORMANCE BASED RATE MAKING MECHANISM	))))	CASE NO. 2020-00378

O R D E R

On November 30, 2020, Columbia Gas of Kentucky, Inc. (Columbia Kentucky) applied to extend its existing gas cost Performance-Based Ratemaking (PBR) mechanism. On January 27, 2021, the Commission issued an Order establishing a procedural schedule for this matter and allowing Columbia Kentucky to continue using its most recently approved PBR mechanism during the pendency of this matter. There were no requests for intervention in this matter. Columbia Kentucky responded to two requests for information from Commission Staff. On May 25, 2021, Columbia Kentucky filed a motion indicating that it did not believe a hearing was necessary in this matter and requesting that the case be submitted for a decision on the record. The Commission agrees that a hearing is not necessary in this matter and, therefore, grants Columbia Kentucky's request that this case be submitted for a decision on the record. This case is now before the Commission for a decision on the merits.

BACKGROUND

The Commission approved Columbia Kentucky's current PBR mechanism in Case No. 2017-00453 through March 31, 2021.[1] The Commission declined to extend Columbia Kentucky's PBR mechanism through 2023 as requested in that case and noted that in its next review that it would "evaluate PBR mechanisms for reasonableness and potentially realign and modify the PBR mechanisms of all Kentucky Local Distribution Companies (LDCs), or terminate the PBR mechanisms entirely."[2] The Commission stated that Columbia Kentucky should file testimony and any supporting documentation to assist the Commission in determining whether Columbia Kentucky's PBR should be continued, modified, or terminated as part of its next PBR case.[3] Columbia Kentucky now proposes to extend its PBR mechanism through March 31, 2024 without any modifications.

Columbia Kentucky's current PBR mechanism is broken into three components: (1) the Gas Cost Incentive Mechanism (GCI), (2) the Off System Sales Incentive (OSSI), and (3) the Transportation Cost Incentive (TCI).[4] Columbia's GCI benchmarks actual commodity costs of gas against prices published by *Platt's Inside FERC's Gas Market Report*, *Natural Gas Week*, and *Platt's Gas Daily* for purchases on the pipeline from which a particular gas purchase is made.[5] The OSSI in Columbia's PBR calls for sharing, based

[1] Case No. 2017-00453, *Electronic Application of Columbia Gas of Kentucky, Inc. to Extend its Gas Cost Adjustment Performance Based Rate* Mechanism (Ky. PSC Oct. 22, 2019), Order.

[2] Case No. 2017-00453, *Columbia Gas of Kentucky, Inc.* (Ky. PSC Oct. 22, 2019), Order at 3.

[3] Case No. 2017-00453, *Columbia Gas of Kentucky, Inc.* (Ky. PSC Oct. 22, 2019), Order at 3.

[4] Columbia Kentucky's Gas Tariff, P.S.C. KY No. 5., Ninth Revised Sheet No. 50.

[5] Columbia Kentucky's Gas Tariff, P.S.C. KY No. 5., Ninth Revised Sheet No. 50, Sixth Revised Sheet No. 50a, Original Sheet No. 50b.

on the percentages discussed below, of revenues net of costs from off systems sales, other than those revenues generated by operational sales.[6]

Columbia Kentucky's TCI generally benchmarks the demand costs at the Federal Energy Regulatory Commission (FERC) approved rates for the demand quantities contracted for and the volumetric costs at the FERC approved rates of the actual volumes delivered against the actual demand and volumetric costs of gas transportation on each pipeline.[7] However, in the Final Order in Case No. 2017-00453, the Commission stated that it expected Columbia Kentucky's transportation costs to continue improving and, therefore, set the benchmarks for transportation costs on the Columbia Gas Transmission pipeline and the Tennessee Gas Pipeline to discounted rates negotiated by Columbia Kentucky.[8] On rehearing, the Commission established the TCI benchmark for purchases made pursuant to the discounted rate on the Columbia Gas Transmission pipeline as the discounted rate, grossed up by the percentage increase in the FERC rate since the PBR mechanism was established.[9]

Variances between Columbia Kentucky'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 2 percent of Columbia Kentucky's Actual

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[6] Columbia Kentucky's Gas Tariff, P.S.C. KY No. 5., Second Revised Sheet No. 50c.

[7] *See* Columbia Kentucky's Gas Tariff, P.S.C. KY No. 5., Original Sheet No. 50b, Second Revised Sheet No. 50c.

[8] Case No. 2017-00453, *Columbia Gas of Kentucky, Inc.* (Ky. PSC Oct. 22, 2019), Order at 1–3.

[9] Case No. 2017-00453, *Columbia Gas of Kentucky, Inc.* (Ky. PSC Jul. 24, 2020), Order. If the FERC rate increased by 11.3%, the benchmark rate for purchases made pursuant to the discount rate would be $4.6579 per Dth ($4.1850 per Dth x 111.3%). The total benchmark cost for purchases made pursuant to the discounted rate would be $4.6579 per Dth times the amount of gas purchased.

Gas Costs, as defined in the tariff, and is shared 70 percent to ratepayers and 30 percent to shareholders. The second band covers variances greater than 2 percent and is shared 50/50 between ratepayers and shareholders.[10]

Columbia Kentucky's witnesses argued that its PBR mechanism is providing a positive incentive that produces lower gas costs for customers and that it should be continued for that reason.[11] Columbia Kentucky reported the following PBR savings during the last 5 years of its PBR mechanism:

Year	GCI Savings	TCI Savings	OSSI Savings	Total Savings[12]	Total Actual Costs	Percentage
15/16	$604,558	$6,313,075	$691,363	$7,608,997		
16/17	$329,885	$6,336,959	$1,003,432	$7,670,275	$44,867,740	17.10%
17/18	$138,650	$6,849,990	$603,326	$7,591,967	$51,047,734	14.87%
18/19	$30,733	$6,878,778	$699,668	$7,609,179	$62,391,336	12.20%
19/20	$206,667	$3,881,115	$1,047,528	$5,135,310	$38,488,109	13.34%

Columbia Kentucky argued that those PBR savings are evidence that the PBR mechanism is resulting in lower gas costs for customers.[13]

Columbia Kentucky noted that the GCI component of the PBR mechanism is benchmarked against market indices that reflect the actual transactions of others and that the GCI savings reflect purchases that were lower than those published indices. It argued that "[i]t is reasonable to assume that if others were paying higher prices for the commodity during those periods the customers received an overall lower cost compared

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[10] Columbia Kentucky's Gas Tariff, P.S.C. KY No. 5., Ninth Revised Sheet No. 50, Original Sheet No. 50d.

[11] Direct Testimony of Judy Cooper (filed Nov. 30, 2020) (Cooper Testimony) at pg. 8, lines 4–12.

[12] Cooper Testimony at Attachment A.

[13] Columbia Kentucky's Response to Commission Staff's First Request for Information (filed Feb. 23, 2021) (Columbia Kentucky's Response to Staff's First Request), Item 1.

to a flat market based cost."[14] Columbia Kentucky similarly indicated that the transportation rates approved by FERC are the fair, just, and reasonable rates such that a savings is achieved to the extent that a utility obtains a transportation rate that is lower than the FERC approved rate.[15] Thus, Columbia Kentucky argued that the PBR savings reflected above support a finding that its PBR mechanism results in savings to customers.[16]

Columbia Kentucky acknowledged that there would be some incentive to lower gas costs in the absence of the PBR mechanism[17] and stated that "[a]bsent a PBR mechanism Columbia Kentucky would continue its least cost approach to purchase reliable gas supplies and pipeline transportation services."[18] However, it stated that the PBR mechanism provides an additional incentive "to devote resources to continually evaluate the market for opportunities to lower costs."[19] It further asserted that without the PBR mechanism "Kentucky customers may miss the opportunity for lower costs as several products in the PBR are available to other affiliates," and "[a]ll else being equal, rational economic and fiscally responsible behavior would seek to accomplish the transaction in the environment that provides the greatest opportunity between alternatives."[20]

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[14] Columbia Kentucky's Response to Staff's First Request, Item 1.

[15] *See* Cooper Testimony at page 6, line 14–page 7, line 19.

[16] Columbia Kentucky's Response to Commission Staff's Second Request for Information (filed March 23, 2021) (Columbia Kentucky's Response to Staff's Second Request), Item 11.

[17] Columbia Kentucky's Response to Staff's First Request, Item 7.

[18] Columbia Kentucky's Response to Staff's First Request, Item 8.

[19] Columbia Kentucky's Response to Staff's First Request, Item 8.

[20] Columbia Kentucky's Response to Staff's First Request, Item 7.

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.[21] 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 Columbia Kentucky's PBR mechanism, like those of the two other LDCs with such mechanisms, is that it allows Columbia Kentucky 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 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 Columbia Kentucky's customers, while maintaining supply reliability, by incentivizing Columbia Kentucky to lower the gas costs that are passed on to customers.[22]

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. Further, using the PBR mechanism to share savings that Columbia Kentucky would have realized in the absence

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[21] 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; *see also Com. ex. rel. Stephens v. South Central Bell Tel. Co.*, 545 S.W.2d 927, 931 (Ky. 1976) ("Rates are non-confiscatory, just and reasonable so long as they enable the utility to operate successfully, to maintain its financial integrity, to attract capital and to compensate its investors for the risks assumed.").

[22] 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.

of the PBR mechanism would not be justified by the purpose of the mechanism. In fact, even savings actually arising from the PBR mechanism should only be shared with the utility to the extent necessary to incent the desired behavior. Additional sharing of gas cost savings would not serve the purpose of the PBR mechanism and would not be reasonable.

Columbia Kentucky argued that its ability to share in the PBR savings creates an incentive for it to generate gas cost savings and that its PBR savings demonstrate that it actually has generated savings as compared to the market. The Commission agrees that the ability to share in the PBR savings provides an incentive for Columbia Kentucky to generate savings and that Columbia Kentucky has been able to beat prices paid by others for both gas and transportation services, so there is some evidence to support the argument that Columbia Kentucky's PBR mechanism actually results in savings for customers. However, Columbia Kentucky, like the other LDCs, has trouble establishing whether and the extent to which the incentives offered by the PBR mechanism actually result in the PBR savings recorded.

Certain savings likely arise from a utility's position in the market, such as its ability to obtain multiple bids for large, long term gas supply contracts at indexed prices below the first of the month prices or its ability to use storage assets funded by customers to obtain gas when prices are more favorable.[23] A utility would also have at least some incentive to take advantage of opportunities in the market to reduce gas costs below

[23] *See* Columbia Kentucky's Response to Staff's Second Request, Item 6 (in which Columbia Kentucky discusses how it looks at the benefits of long term contracts each season to determine their benefits, if any, and how it may opt to utilize storage and procure supplies on an as needed basis if long term contracts are priced at a premium).

benchmark prices even if the PBR mechanism were eliminated, because the Commission has the authority to review and disallow gas costs that are found to be unreasonable. Further, even if Columbia Kentucky's PBR mechanism encourages cost saving behavior, 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 Columbia Kentucky's share of the PBR savings under its PBR mechanism. Thus, the fact that the PBR mechanism provides an incentive and that Columbia Kentucky does obtain gas and transportation services below costs paid by others does not necessarily establish that the PBR mechanism results in savings for customers.

In fact, there is evidence that the expansion of Columbia Kentucky's PBR mechanism in 2015 actually increased customer costs. The bulk of the PBR savings shared with Columbia Kentucky in its 2015/2016 PBR year, about $6.29 million dollars, and most years thereafter arose from discounted transportation rates that were in effect before the PBR mechanism was expanded to include the TCI component in 2015.[24] While Columbia Kentucky has claimed that the PBR mechanism encouraged it to work to maintain that lower rate in the face of increases in the tariffed rate,[25] the fact that the discounted rates were in place before they were shared through the PBR mechanism is strong evidence that the incentive provided by the PBR mechanism was not necessary to encourage Columbia Kentucky to obtain or maintain that rate. Further, the total PBR

[24] *See* Case No. 2017-00473, *Columbia Kentucky's Response to Staff's First Rehearing Request for Information, Item 6, Attachment A* (filed January 16, 2020) (showing the extent to which savings was generated from the discounted Columbia Gas Transmission, LLC SST rate and the Tennessee Gas Pipeline FT-A rate from February 2014 through January 2020).

[25] *See* Direct Testimony of Brad Stuck at page 6, line 12–page 9, line 14 (in which Columbia Kentucky's witness discusses its efforts to maintain the discounted rates).

savings from the GCI and OSSI components of the mechanism in Columbia Kentucky's 2015/2016 PBR year was only about $1.3 million. Thus, even assuming that all of the GCI and OSSI savings actually arose from the incentives provided by the PBR mechanism, the mechanism would have resulted in a net cost to customers in Columbia Kentucky's 2015/2016 PBR year due to the sharing of about $6.29 million in TCI savings that preexisted the mechanism.[26]

The Commission eliminated much of the transportation cost savings that preexisted the expansion of the PBR mechanism when it adjusted the benchmarks for TCI component in Case No. 2017-00453 to base them on the discounted rates. However, Columbia Kentucky did not provide any analysis to examine the extent to which its other gas costs beat market rates before as compared to after it expanded its PBR mechanism.[27] Columbia Kentucky was also unable 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.[28] Thus, while Columbia Kentucky argues that its PBR mechanism results in customer savings, its assertions are not

[26] PBR savings was shared with Columbia Kentucky at a rate of about 47.9 percent in the 2015/2016 PBR year. *See* Cooper Testimony at Exhibit A (showing the total PBR savings in that year and the company's share of the total savings from which the percentage can be calculated). If all of the $1.3 million in GCI and OSSI savings was generated by the incentives offered by the PBR mechanism, then customer costs would have been reduced by about $833,600 ($1.6 million x 52.1%). However, the 2015 expansion to the PBR mechanism resulted in 47.9 percent of the $6.29 million in transportation savings that preexisted the expansion, about $3.01 million, being shared with Columbia Kentucky. Thus, assuming all GCI and OSSI savings arose from expanding the mechanism, the net effect of the expansion was to increase the amount paid by customers by about $2.18 million in the 2015/2016 PBR year.

[27] *See* Columbia Kentucky's Response to Staff's Second Request, Item 11 (in which Columbia Kentucky referred to calculated savings under the mechanisms, including the savings under the TCI component that preexisted the expansion, to demonstrate that the expended PBR mechanism resulted in greater customer savings).

[28] Columbia Kentucky's Response to Staff's First Request, Item 4.

supported by any studies or analysis that establish that its PBR mechanism changed or will change its behavior in a way that ultimately lowers gas costs for customers.

Despite weaknesses in Columbia Kentucky's evidence, the Commission does not believe that it would be prudent to simply eliminate Columbia Kentucky's PBR mechanism in its entirety at this time due to potential unforeseen effects on customer costs.[29] However, as discussed above, Columbia Kentucky failed to establish that all of the savings shared through the PBR mechanism arose from the mechanism or that the extent of the sharing in the current PBR mechanism is necessary to serve the purpose of the PBR mechanism. Thus, the Commission finds that the PBR mechanism should be extended as requested by Columbia Kentucky but that savings shared with Columbia Kentucky through the mechanism should be reduced by adjusting the sharing bands to reduce the extent to which variances between actual and benchmark gas costs are shared with Columbia Kentucky.

Without any studies or analyses of the effects of PBR mechanisms on the costs to customers, it is difficult to establish the extent to which savings should be shared to serve the purpose of the mechanism. Further, while the Commission has previously adjusted the sharing band based on the extent to which past PBR savings compared to a utility's total gas costs,[30] it is difficult to make such an adjustment where, as here, the Commission

[29] The Commission recognizes that establishing whether and the extent to which a particular incentive influences behavior is not an easy task. Further, the Commission's ability to encourage lower costs in the absence of the PBR mechanism, through the threat of disallowing unreasonable costs, is limited by the number and complexity of gas procurement options and legal restrictions on its ability to disallow FERC approved costs. Thus, simply eliminating the incentives offered by the PBR mechanism in their entirety could have unforeseen consequences that increase the costs passed on to customers.

[30] 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 7.

has made significant changes to the benchmarks. Thus, the Commission will simply adjust the sharing band such that variances ranging from 0 to 4.5 percent of Columbia Kentucky's Actual Gas Costs will be shared 70 percent to ratepayers and 30 percent to shareholders and variances greater than 4.5 percent will be shared 50/50 between ratepayers and shareholders. This minor adjustment to the sharing band should allow the Commission to monitor the effects, if any, of reducing the incentives offered under the mechanism without risking unforeseen consequences of eliminating the PBR mechanism outright.

IT IS THEREFORE ORDERED that:

1. Columbia Kentucky's proposal to extend the PBR mechanism without modification is denied.

2. The current gas cost sharing calculation shall be modified as required herein, so that variances from 0 to 4.5 percent of Columbia Kentucky's Actual Gas Costs are shared 70 percent to ratepayers and 30 percent to shareholders, with sharing thereafter allocated 50/50 between Columbia Kentucky and its customers.

3. Columbia Kentucky's PBR mechanism, with the modification required herein, is extended through March 31, 2024.

4. Within 60 days after March 31, 2023, Columbia Kentucky 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.

5. Within 20 days of the date of this Order, Columbia Kentucky 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 paragraph 4 herein shall reference this case number and shall be retained in the post-case correspondence file, unless filed with a request to extend or modify the PBR mechanism.

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

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PUBLIC SERVICE COMMISSION

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Vice Chairman

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Commissioner

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