Louisville Gas and Electric Company
220 West Main Street (40202)
P.O. Box 32010
Louisville, Kentucky 40232

April 11, 2005

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APR 1 1 2005

PUBLIC SERVICE
COMMISSION

Elizabeth O'Donnell, Executive Director
Public Service Commission
211 Sower Boulevard
P. O. Box 615
Frankfort, Kentucky 40602

RE: Modifications to Louisville Gas and Electric Company's Gas Supply Clause to Incorporate an Experimental Performance-Based Ratemaking Mechanism - Case No. 2005-00031

Dear Ms. O'Donnell:

Please find enclosed an original and ten copies of the Reply Comments of Louisville Gas and Electric Company in response to the Comments of the Attorney General filed March 28, 2005, in the above-referenced case.

Please contact me if you have any questions regarding this filing.

Sincerely,

Robert M. Conroy
Manager, Rates

Enclosures

cc: Honorable Elizabeth E. Blackford

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND	)	
AND ELECTRIC COMPANY FOR	)	
PERFORMANCE-BASED GAS RATE	)	**CASE NO. 2005-00031**
BASED GAS RATES	)	

REPLY COMMENTS OF LOUISVILLE GAS AND ELECTRIC COMPANY

On December 30, 2004, Louisville Gas and Electric Company ("LG&E") filed with the Kentucky Public Service Commission ("Commission") its Report on its gas supply cost Performance-Based Ratemaking ("PBR") mechanism. LG&E's Report was filed in accordance with the Order in Case No. 2001-00017 dated October 26, 2001, directing the company to file its assessment and recommendation for modification or termination of the PBR mechanism. In the Report, LG&E recommended the continuation, with certain modifications, of its PBR mechanism. The Commission docketed the Report as Case No. 2005-00031. LG&E responded to two rounds of discovery totaling 15 questions from the Commission and a single round of 14 questions from the Attorney General ("AG"). LG&E has requested that the Commission issue its Order in this case by June 1, 2005.

DESCRIPTION OF LG&E's GAS SUPPLY COST PBR MECHANISM

LG&E's gas supply cost PBR mechanism is an incentive mechanism that uses a risk/reward structure to encourage the company to reduce gas supply costs without negatively impacting reliability. LG&E's gas supply cost PBR mechanism is comprehensive with every dollar of gas supply cost benchmarked.

LG&E's gas supply PBR mechanism first went into effect on November 1, 1997, pursuant to the Commission's Order in Case No. 97-171 dated September 25, 1997, and was renewed for a subsequent term of four years pursuant to the Commission's Order in Case No. 2001-00017 dated October 26, 2001. That Order approved the gas supply PBR mechanism for a second experimental term effective November 1, 2001, with certain modifications. One of those modifications was to eliminate the 50/50 sharing of savings and expenses and to substitute sharing percentages based on a sliding scale. The sliding scale allocates 25% of savings or expenses, up to 4.5% of benchmarked gas costs, to the company and 75% of savings or expenses to customers. Savings or expenses in excess of 4.5% of benchmarked costs are shared on a 50/50 basis.

LG&E's PBR mechanism measures performance against established and appropriate benchmarks that meaningfully encourage it to focus on promoting efficiency and innovation in the acquisition of gas supplies. LG&E's PBR mechanism has encouraged it to pursue, develop, and manage creative supply arrangements, increase risk-taking, and to negotiate aggressively to improve cost performance, while maintaining reliability. The PBR mechanism thus encourages least cost acquisition. As a result, LG&E actively responds to changing market conditions and explores gas supply and pipeline transportation purchase and sales opportunities in an effort to outperform the PBR benchmarks.

LG&E's PBR mechanism benefits both customers and shareholders by encouraging least cost acquisition of gas. The PBR mechanism encourages LG&E to outperform benchmarks resulting in low cost and reliable service to customers. The PBR mechanism subjects LG&E to a risk/reward sharing mechanism (which was not the case before the implementation of LG&E's gas supply cost PBR mechanism).[1] While LG&E has assumed certain risks in order to achieve savings under its PBR mechanism, these risks have been manageable. These risks include, but are not limited to, contracting risks, storage management risks, supply management risks, transportation management risks, and credit risks. LG&E has described each of these risks at length and has provided

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[1] LG&E's Response to Attorney General's First Data Request No. 1.

specific examples that illustrate how LG&E is exposed to each risk.[2] The PBR provides a balanced risk/reward structure that proportionally encourages the company to take on risks in order to achieve benefits for both the utility and its customers.

In recognition of the risks associated with the gas supply cost PBR mechanism, LG&E is requesting to realign the sliding scale sharing structure used in the mechanism to reflect more accurately and proportionately the risks of operating under the mechanism.[3]

<u>Components of PBR Mechanism:</u>

The components of LG&E's PBR mechanism are: (i) Gas Acquisition Index Factor ("GAIF"); (ii) Transportation Index Factor ("TIF"); and (iii) Off-System Sales Index Factor ("OSSIF"). The benchmarks incorporated in each component in combination with the PBR sharing mechanism encourage LG&E to purchase low cost, reliable gas supply and pipeline transportation services. Each of the components and the benchmarks incorporated therein are described in LG&E's data request responses[4] and are summarized below.

- <u>GAIF</u>: The GAIF component of the PBR mechanism benchmarks LG&E's actual commodity costs against a calculated benchmark representative of the market price of gas by using various industry-recognized price postings. This component includes LG&E's supply reservation fee costs which are benchmarked against an average of the historical reservation fees ("HRF") paid by LG&E during the previous two years. The GAIF benchmark is reflective of the fact that LG&E may purchase natural gas supplies from a variety of supply zones at various times during the month.

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[2] LG&E's Response to Commission Staff's First Data Request No. 1.
[3] LG&E's Response to Attorney General's First Data Request No. 9.
[4] LG&E's Response to Attorney General's First Data Request No. 8.

- TIF: The TIF includes pipeline transportation costs, which are benchmarked against LG&E's pipeline suppliers' transportation rates as approved by the Federal Energy Regulatory Commission ("FERC").[5] The TIF benchmark is reflective of the manner in which pipelines charge for firm pipeline transportation services. These FERC-approved rates provide a fair and objective benchmark against which to measure transportation cost savings achieved by LG&E and encouraged by the PBR mechanism. This benchmark continues to be effective in encouraging LG&E to aggressively negotiate contracts for low cost, reliable firm pipeline transportation services and to release pipeline capacity.

- OSSIF: The OSSIF reflects LG&E's net revenues from off-system sales transactions. Transactions related to sales of natural gas or storage-related services are reflected in this component. The OSSIF component of the PBR mechanism benchmarks LG&E's off-system sales against the out-of-pocket costs incurred to make such off-system sales. The OSSIF benchmark fairly and objectively measures savings achieved by LG&E.

In addition to providing reasonable and meaningful benchmarks, LG&E's gas supply cost PBR mechanism recognizes the importance of reliability in contracting for natural gas supplies. The benchmarks incorporated into LG&E's gas supply cost PBR mechanism support a gas supply and pipeline transportation portfolio that provides reliable and flexible supply management capabilities. LG&E's PBR mechanism does not include incentives that encourage it to take actions that reduce reliability in order to achieve lower costs.

Sharing Mechanism:

LG&E's PBR mechanism contains benchmarks that encourage and incent appropriate behavior in creating cost savings for customers. LG&E's PBR mechanism reflects an

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[5] LG&E's pipeline interstate pipeline transportation capacity providers are Texas Gas Transmission LLC and Tennessee Gas Pipeline Company.

integrated behavioral standard because it is well reasoned, comprehensive, and balanced. The PBR mechanism is designed to minimize all gas supply cost elements, not simply to reduce some discrete component, or components, of gas costs. LG&E's gas supply cost PBR mechanism is also balanced so that one objective (such as least cost) is not encouraged to the detriment of other equally important objectives (such as reliability).

PROPOSED MODIFICATIONS TO LG&E'S GAS SUPPLY COST PBR MECHANISM

LG&E has proposed to retain the existing benchmarks incorporated in the PBR mechanism and to extend the mechanism for a period of 5 years. It has also proposed to modify the current sliding scale applicable to the sharing of savings and expenses. As LG&E discussed in the Report in this case, LG&E continues to support the 50/50 sharing mechanism approved in Case No. 97-171 as appropriate.[6] Furthermore, LG&E demonstrated that a reduction in incentives has resulted in a reduction in risk-taking and resultant potential rewards.[7] However, in recognition of the fact that the Commission in Case No. 2001-017 implemented a sliding scale, LG&E has offered an alternative sliding scale which will better encourage, incent, and reward effective and innovative gas supply cost management. Specifically, LG&E proposed that for savings (and expenses) up to 2% of benchmarked gas costs, sharing will be 30%/70% in favor of customers; for savings (and expenses) greater than 2% and up to 3% of benchmarked gas costs, sharing will be 40%/60% in favor of customers; for savings (and expenses) greater than 3% and up to 4% of benchmarked gas costs, sharing will be 50%/50%; and for savings (and expenses) greater than 4% of benchmarked gas costs, sharing will be 60%/40% in favor of the Company.

LG&E has requested a modification to the current sliding scale sharing mechanism to more accurately reflect the level of the risks assumed by LG&E as it operates under a mechanism that requires it to share in expenses when it cannot outperform established

[6] LG&E's Report to the Kentucky Public Service Commission on Gas Supply Cost Performance-Based Ratemaking Mechanism (hereinafter "Report") dated December 30, 2004, at p. 13.

[7] LG&E's Response to Attorney General's First Data Request Nos. 12 and 13.

benchmarks. Additionally, LG&E assumes risks in its efforts to outperform the benchmarks including, but not limited to, the following risks: (i) credit risks related to off-system sales, (ii) regulatory risks related to potential policy changes by FERC that may affect LG&E's ability to negotiate pipeline discounts or release capacity, (iii) expenses occurring under the HRF due to rising reservation fees for longer-term supply contracts, (iv) operational and price risks associated with creative supply transactions, and (v) the risks of outperforming benchmarks in an ever-changing market. While LG&E undertakes measures to manage each of these risks, it would not assume or be exposed to these risks absent the PBR mechanism.

LG&E also requested that the Commission issue an order in this case by June 1, 2005, in order to allow LG&E adequate time to adjust its gas supply portfolio and supply strategies in response to the proposed modifications to the PBR mechanism prior to the new mechanism becoming effective November 1, 2005.[8]

OTHER PBR MECHANISMS APPROVED BY THE COMMISSION

In recent years, the Commission has approved other gas supply cost PBR mechanisms; the two most recent of which are discussed below. In determining the reasonableness of LG&E's PBR mechanism, it is useful to consider such mechanisms approved for other utilities.

Atmos Energy Corporation:

The Commission, in its Order in Case No. 2001-00317 dated March 25, 2002, approved an extension of the gas supply incentive mechanism of Western Kentucky Gas Company ("WKG"), now called Atmos Energy Corporation. In that Order, the Commission approved the following sharing mechanism:

[8] Report dated December 30, 2004, at p. 14.

> The sharing mechanism will include two bands: (1) 0 percent to 2 percent; and (2) over 2 percent. If Western contracts with a third party to manage its gas supply, the sharing ratio in the first band will be 70/30 in favor of the ratepayer and the sharing ratio for the second band will be 50/50. If Western manages its own gas supply, the sharing ratio for the first band will be 75/25 in favor of the ratepayers, and the sharing ratio for the second band will be 50/50.[9]

This level of sharing is more favorable than that currently in place for LG&E. The breakpoint in LG&E's sliding scale is 4.5%. If the WKG breakpoint of 2% was based on actual savings performance results for WKG, LG&E's shareholders are receiving less favorable incentives than those of WKG even though LG&E has consistently outperformed WKG since the 4.5% breakpoint in the sharing mechanism for LG&E was based on LG&E's actual savings performance results.

<u>Columbia Gas of Kentucky</u>:

More recently, the Commission has approved a summer-only gas cost incentive mechanism for Columbia Gas of Kentucky ("CGK") by Order dated March 29, 2005, in Case No. 2004-00462, that includes a 50/50 sharing mechanism. CGK added this summer-only gas acquisition incentive program to its previously identified and incentivized supply activities (off-system sales and capacity release). While formerly subject to a sharing mechanism for off-system sales of 65/35 and for capacity release of 75/25, in favor of the customer, CGK has proposed and the Commission has now approved a 50/50 sharing mechanism for those activities.[10]

LG&E's gas commodity purchases are benchmarked against a basket of price indices that prevent LG&E from knowing the benchmark until the end of the month. Conversely, CGK's gas commodity purchases are benchmarked against one price index that is known at the beginning of the month. The design of LG&E's gas commodity benchmark

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9 Order of the Kentucky Public Service Commission in Case No. 2001-00317 dated March 25, 2002, at p. 4.

10 While CGK distinguishes its incentive mechanism from that of LG&E and WKG in terms of the sharing in any negotiated pipeline discounts, it is important to note that CGK is served only by its pipeline affiliate.

subjects it to considerably more risk than CGK, yet LG&E's potential reward is substantially less.

LG&E does not object to the sharing mechanism approved for CGK, but notes that LG&E's PBR mechanism is a more comprehensive and balanced mechanism. Consequently, the mechanism exposes LG&E and its shareholders to risks and potential cost exposure that are not reflected in the less comprehensive program recently approved by the Commission for CGK. In addition to the supply activities included in CGK's mechanism, LG&E's PBR mechanism benchmarks its substantial winter supply purchases, supply reservation fees (which continue to rise), and pipeline transportation costs, although its current sharing mechanism is 25/75 in favor of the customer.

COMMENTS OF THE ATTORNEY GENERAL

Pursuant to the Order of March 15, 2005, in this case, the Office of the Attorney General has submitted comments dated March 28, 2005, on LG&E's Report. Many of the objections raised by the AG in his March 28, 2005, comments, are the same as those raised in response to LG&E's PBR mechanism approved in Case No. 2001-00017, as well as in response to the PBR mechanisms of other Kentucky gas utilities.[11] The Commission has rejected the arguments advanced by the AG and approved the PBR mechanism of each utility, including LG&E.

The AG has failed to offer any analyses or studies that support his arguments opposing LG&E's PBR mechanism or the modifications to the mechanisms proposed by the company. Furthermore, the AG has not offered any alternatives for consideration. LG&E, on the other hand, has submitted data demonstrating the relevance of the benchmarks, the objectivity of the benchmarks, and LG&E's performance under those

[11] Order of the Kentucky Public Service Commission in Case No. 2004-00462 dated March 29, 2005, at p. 4.

benchmarks.[12] LG&E has provided evidence to support modifying the sliding scale sharing mechanism[13] where the AG has merely asserted that "no increase is warranted,"[14] without offering any empirical data or other evidence supporting that position.

The AG initiates his argument stating that the PBR mechanism is "a creature of assumed rather than actual savings."[15] In Case No. 2001-00017, the AG made similar arguments about the ability to "prove" that costs were lower as a result of the PBR mechanism than they would have been absent the PBR mechanism. The Commission in its Order stated:

> We are not persuaded by the AG's argument that the costs incurred during the PBR pilot accurately reflect the costs that would have been incurred during that period had there been no PBR. Absent the PBR, LG&E would have had different incentives and would have engaged in different purchasing activities.[16]

The Commission in that Order went on to state:

> Because of the incentives built into the PBR, it is reasonable to conclude that LG&E's actual gas costs were less than what they would have been under traditional regulation.[17]

In his March 28, 2005, comments in this case, the AG asserts the following with respect to LG&E's PBR mechanism:

1. No increase in the incentive is warranted if the PBR mechanism is retained.
2. The undiscounted FERC rate is not an appropriate benchmark.
3. If the PBR is continued, the longer-term is acceptable if it presents savings opportunities resulting from longer-term purchases that are not available in a

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[12] LG&E's Response to Attorney General's First Data Request No. 8; LG&E's Response to Commission Staff's First Data Request Nos. 1, 2, and 5; and LG&E's Response to Commission Staff's Second Data Request Nos. 3, 6, and 7.

[13] LG&E's Response to Commission Staff's First Data Request No. 5

[14] Attorney General's Comments dated March 28, 2005, at p. 2.

[15] Attorney General's Comments dated March 28, 2005, at p. 1.

[16] Order of the Kentucky Public Service Commission in Case No. 2001-00017 dated October 26, 2001, at p. 4.

[17] Order of the Kentucky Public Service Commission in Case No. 2001-00017 dated October 26, 2001, at p. 4.

> shorter term program. Longer term purchases may render the short term market benchmark inappropriate.

The appropriateness of the proposed sharing mechanism.

The AG's March 28, 2005, comments claim that

> [i]n the absence of the performance based mechanism, the cost of gas resulting from any reasonably prudent purchasing practice would be solely at the risk of the consumer as the company is entitled to recover the cost of gas.[18]

LG&E agrees with the AG on this point. LG&E has stated that, absent the PBR mechanism,

> customers assumed the risks associated with gas supply purchasing to the extent that gas supply purchases met the tests of reasonableness and prudence.[19]

What the AG does not acknowledge is the fact that, as a result of the PBR mechanism (and irrespective of the fact that these risks are "self-imposed"[20]), LG&E does now bear some portion of the risks which previously were borne entirely by customers. If the PBR is discontinued, customers will once again assume all risks associated with reasonable supply purchasing with both incentives and associated levels of performance discontinued.

The AG correctly states (at least in part) that "[i]t is the incentive performance mechanism itself that creates risks that the Company is being paid to assume."[21] Not only is LG&E now exposed to risks that exist by virtue of the fact that it operates under a PBR mechanism, but LG&E is also now exposed to a variety of risks that exist as underlying features of the gas marketplace.[22] In addition to marketplace risk, LG&E is at risk because it must absorb its share of the expenses unless it outperforms the PBR

[18] Attorney General's Comments dated March 28, 2005, at p. 2.
[19] LG&E's Response to Attorney General's First Data Request No. 1.
[20] Attorney General's Comments dated March 28, 2005, at p. 2.
[21] Attorney General's Comments dated March 28, 2005, at p. 2.
[22] LG&E's Response to Commission Staff's First Data Request No. 1; and LG&E's Response to Commission Staff's Second Data Request No. 2.

mechanism benchmarks. Because the mechanism imposes risk on LG&E, LG&E should be rewarded for the assumption of such risks.

LG&E would not have undertaken such risks had there been no PBR mechanism. As the AG indicates, those risks would have been borne solely by the customers.[23] LG&E discussed a variety of risks to which it is exposed, such as contracting risks, storage management risks, supply management risks, transportation management risks, and credit risks.[24] Although the AG does not believe that LG&E should be rewarded for undertaking those risks, the AG has not refuted that those risks do exist – whether such risks are inherent in either the marketplace or through the mechanism itself. Furthermore, LG&E has undertaken efforts to manage those risks and recognizes that it may be penalized under the PBR mechanism for failing to manage such risks in a manner consistent with the least cost acquisition encouraged by the benchmarks under the PBR mechanism.

LG&E has demonstrated that the current risk levels are significant and likely to increase.[25] In order to reflect both current and projected risk exposure, LG&E has proposed a modification in the sliding scale sharing mechanism to more appropriately match risk and reward levels.[26] For example, LG&E has discussed in various data request responses (i) credit risks related to off-system sales,[27] (ii) regulatory risks related to potential policy changes by FERC that may affect LG&E's ability to negotiate pipeline discounts or release capacity,[28] (iii) expenses occurring under the HRF due to rising reservation fees for longer-term supply contracts,[29] (iv) operational and price risk

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[23] Attorney General's Comments dated March 28, 2005, at p. 2.

[24] LG&E's Response to Commission Staff's First Data Request No. 1.

[25] LG&E's Response to Commission Staff's Second Data Request Nos. 4, 7, and 9.

[26] LG&E's Response to Attorney General's First Data Request No. 9.

[27] LG&E's Response to Commission Staff's First Data Request No. 1.

[28] LG&E's Response to Commission Staff's First Data Request Nos. 1 and 3; and LG&E's Response to Commission Staff's Second Data Request Nos. 4.

[29] LG&E's Response to Commission Staff's First Data Request No. 1; and LG&E's Response to Commission Staff's Second Data Request No. 2.

associated with creative supply transactions,[30] and (v) the risks of outperforming benchmarks in an ever-changing market.[31] Of particular note, LG&E discussed the impact of increasing supply reservation fees benchmarked in the GAIF component of the PBR mechanism.[32] LG&E suggested an alternative method of benchmarking which would rely upon a contemporaneous market price for the reservation fees because there is no publicly available third-party data to act as a benchmark. Therefore, the benchmark level would be the costs actually paid by LG&E.

The AG erroneously states that LG&E "is unable to identify ways in which it would act differently were the incentive different from what it is now."[33] Such is not the case. In direct response to the AG, LG&E indicated "several actions which it could undertake if the risk/reward sharing mechanism more adequately compensated LG&E for assuming certain risks associated with its gas supply PBR mechanism."[34]

The AG goes on to indicate that LG&E "states and restates that strategies and practices that once worked may not work again and that there is no guarantee that any practice will produce savings."[35] As LG&E explained in data request responses, the market is constantly changing.[36] As LG&E also explained, the changing nature of the market means that LG&E must adjust, realign, and continually rethink its strategies and actions in pursuit of least cost acquisition as encouraged by the PBR.[37] The AG is correct; there is no "guarantee" that actions taken by LG&E to produce savings under the PBR will result in savings. Because there is no guarantee, there must therefore be risk. Because there is risk, there should be reward. That is the nature of an incentive mechanism. In

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[30] LG&E's Response to Commission Staff's First Data Request No. 1; and LG&E's Response to Commission Staff's Second Data Request No. 2, 5, 6, and 7.

[31] LG&E's Response to Commission Staff's First Data Request Nos. 1 and 5.

[32] LG&E's Response to Commission Staff's First Data Request No. 1; and LG&E's Response to Commission Staff's Second Data Request No. 9.

[33] Attorney General's Comments dated March 28, 2005, at p. 2.

[34] LG&E's Response to Attorney General's First Data Request No. 11.

[35] Attorney General's Comments dated March 28, 2005, at p. 2.

[36] LG&E's Response to Commission Staff's First Data Request No. 1.

[37] LG&E's Response to Attorney General's First Data Request Nos. 5, 6, 11, 12, 13, and 14.

order to encourage the company to take on risk in pursuit of least cost acquisition strategies, the company is rewarded for the risk it undertakes as a part of the PBR mechanism.

The appropriateness of the FERC-approved rates as benchmarks.

The AG objects to the use of the pipeline rates approved by FERC as an appropriate benchmark for the transportation activities benchmarked under the TIF component of the PBR mechanism. The AG's argument is without merit, as partially evidenced by the fact that it offers no alternative benchmark. Pipeline rates are regulated by FERC. One of the purposes of regulation is to simulate a competitive market by establishing cost-based rates for regulated services. These tariffed rates are the appropriate benchmarks for pipeline transportation services, just as posted price indices are the appropriate benchmarks for gas commodity purchases. To the extent that LG&E can procure gas transportation services at less than the established cost for such services, it should be encouraged and rewarded for doing so.

In its Order in Case No. 2001-00017, the Commission stated with regard to benchmarking of pipeline transportation costs:

> We find the FERC-approved transportation rates to be the most objective benchmark for this component of costs.[38]

The AG has offered no evidence of changed conditions justifying a departure from that finding, while LG&E has shown that these FERC-approved transportation rates remain appropriate benchmarks for these costs.[39]

The AG advances a *non sequitur* to the effect that "customers are assigned an added burden [in general rates] due to the presence of [multiple] pipelines" and that customers

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[38] Order of the Kentucky Public Service Commission Order in Case No. 2001-00017 dated October 26, 2001, at p. 8.
[39] LG&E's Response to Attorney General's First Data Request No. 8.

should therefore reap the benefits arising from discounts. While it is true that the presence of multiple pipelines in LG&E's service territory contributes to its ability to negotiate rates lower than tariffed rates, those pipelines do not "burden" LG&E's customers. The AG is confused about the impact of the presence of more than one interstate pipeline on potential physical bypass by large customers. The presence of a single interstate pipeline is enough to allow large customers to bypass LG&E's system. Multiple interstate pipelines are not necessary for bypass to occur.

The AG appropriately recognizes, with respect to rates offered to prevent bypass, that "so long as variable costs are recovered and a contribution made to fixed costs, the rate is considered adequate even if it is below the rate indicated by a cost of service study."[40] However, the AG ignores the fact that, to the extent that special contracts are negotiated between rate cases, it is the shareholders, not customers, who bear the impact of the rate reduction designed to keep the customer on the system. The AG also ignores the fact that both shareholders and customers benefit to the extent that a potential bypass customer remains on the system and makes some contribution -- rather than exiting the system and making no contribution.

Therefore, LG&E is able to negotiate charges for pipeline transportation services lower than cost because there is more than one pipeline present from which it can receive service. The presence of more than one pipeline is not necessary for customers to be exposed to revenue shifting designed to curtail a potential bypass. Customers would be exposed to the potential risk of having revenues shifted from customers with bypass potential if only a <u>single</u> pipeline were present which was capable of directly serving certain large customers. The AG's argument is without merit.

Proposed term of the PBR mechanism.

The AG incorrectly states that one of the reasons LG&E proposed increasing the term of the PBR mechanism from four to five years is "that this might allow savings from

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[40] Attorney General's Comments dated March 28, 2005, at p. 4.

purchases of longer term gas supply."[41] LG&E actually stated that it supports a longer term mechanism "because it will allow for a longer-term focus on performance."[42] LG&E further elaborated on its reason for requesting a longer term by stating that "a longer-term mechanism will enable LG&E to take risks or implement changes to reduce gas costs which may not be possible if the mechanism has a shorter term. For example, entering into a pipeline contract for a longer period may allow LG&E to achieve a larger discount."[43] LG&E has not stated the desire to enter longer-term gas supply agreements as a reason for lengthening the term of the mechanism.

The AG also raises the question of "whether it is appropriate to measure longer-term purchases against the short term benchmarks now in place."[44] It is possible and appropriate to benchmark longer-term gas supply purchases under the current GAIF benchmarks if such purchases are made at market prices and not fixed prices. The risk of creating potentially large expenses under the PBR mechanism, in combination with either the current or proposed sharing mechanism, would dissuade LG&E from entering into such longer-term gas supply purchases at fixed prices. LG&E explained that currently and during the term of the review period of the PBR mechanism, LG&E does not make purchases of gas at fixed prices.[45] Because longer-term gas supplies purchased at fixed-prices represent a "hedge", LG&E would make such purchases pursuant to a hedge plan and not under its PBR mechanism.

The AG continues that "there will be a point when longer term purchases would exceed the review period" and that this "raises a question as to whether the extension of the term to encourage cost saving longer term purchases is actually productive."[46] The AG raises this phantom issue, but neither explores nor suggests an alternative. LG&E continues to recommend a five year term for the reasons it has indicated.

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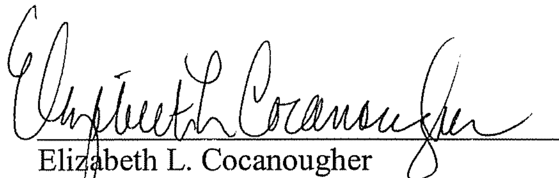
[41] Attorney General's Comments dated March 28, 2005, at p. 4.
[42] Report dated December 30, 2004, at p. 13.
[43] LG&E's Response to Attorney General's First Data Request No. 7.
[44] Attorney General's Comments dated March 28, 2005, at p. 4.
[45] LG&E's Response to Commission Staff's Second Data Request No. 3.
[46] Attorney General's Comments dated March 28, 2005, at pp. 4-5.

CONCLUSION

LG&E's PBR mechanism establishes meaningful and objective benchmarks against which to measure LG&E's performance. The benefits associated with LG&E's PBR mechanism are quantifiable, measurable, and verifiable. The PBR mechanism provides continued Commission oversight of LG&E's gas supply purchasing activities by enabling the Commission to objectively measure LG&E's performance and to review pertinent information. In addition, LG&E's proposed sharing percentages will provide a more proportionate realignment of the risk/reward structure of the mechanism and will encourage the company to achieve greater savings on behalf of customers.

WHEREFORE, Louisville Gas and Electric Company respectfully requests that the Commission approve the continuation of the PBR mechanism as modified in its December 30, 2004, Report herein, and that it issue its Order no later than June 1, 2005.

Respectfully submitted,



Elizabeth L. Cocanougher
Senior Regulatory Counsel
Louisville Gas and Electric Company
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40232
Telephone: (502) 627-4850

and

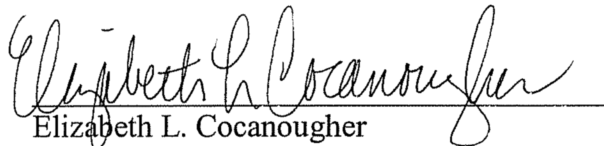
Robert M. Watt III
Stoll, Keenon & Park, LLP
300 West Vine Street, Suite 2100
Lexington, Kentucky 40507-1801
Telephone: (859) 231-3000

Counsel for Louisville Gas and Electric Company

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing pleading has been served by UPS Next Day delivery of same to the following person on this 11th day of April 2005:

Elizabeth E. Blackford, Esq.
Assistant Attorney General
Office of Rate Intervention
1024 Capital Center Drive, Suite 200
Frankfort, KY 40601-8204



Elizabeth L. Cocanougher
Senior Regulatory Counsel
Louisville Gas and Electric Company
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40232
Telephone: (502) 627-4850

and

Robert M. Watt III
Stoll, Keenon & Park, LLP
300 West Vine Street, Suite 2100
Lexington, Kentucky 40507-1801
Telephone: (859) 231-3000

Counsel for Louisville Gas and Electric Company