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

February 21, 2005

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

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PUBLIC SERVICE COMMISSION

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 eight copies of the Response of Louisville Gas and Electric Company to the Attorney General's Initial Request for Information dated February 9, 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

A SUBSIDIARY OF
LG&E ENERGY

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

RECEIVED
FEB 21 2005
PUBLIC SERVICE COMMISSION

In the Matter of:

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

LOUISVILLE GAS AND ELECTRIC COMPANY'S
RESPONSE TO THE
ATTORNEY GENERAL'S
INITIAL REQUEST FOR INFORMATION
DATED
FEBRUARY 9, 2005

FILED: FEBRUARY 21, 2005

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to Attorney General's First Set of Data Requests Dated February 9, 2005

Question No. 1

Responding Witness: Clay Murphy

Q-1. Who was responsible for the following risks under gas supply purchasing conducted before the first LG&E gas supply PBR was approved:

a. Contracting risks,
b. storage management risks,
c. supply management risks,
d. transportation management risks, and
e. credit risks.

A-1. LG&E discusses in detail the risks enumerated above and information related to its activities under the PBR mechanism in its response to Commission Staff Question No. 1.

Before LG&E's gas supply cost Performance-Based Ratemaking ("PBR") mechanism was first approved, customers assumed the risks associated with gas supply purchasing to the extent that gas supply purchases met the tests of reasonableness and prudence.

After the PBR mechanism was approved, LG&E assumed 50% of such risks during the first four years of the PBR mechanism and 25% of such risks during the most recent three years of the PBR mechanism.

It is important to note that prior to the approval of the PBR mechanism, LG&E did not enter into many of the kinds of transactions described in response to Commission Staff Question No. 1. For example, prior to the implementation of the PBR mechanism in 1997, no significant credit risks existed because LG&E did not make off-system sales. Prior to the implementation of the PBR mechanism in 1997, no significant storage management risks existed because LG&E was not provided an incentive to deviate from its planned withdrawal and storage injection schedules. Additionally, contracting risks, supply management risks, and transportation management risks were lower because there was no incentive for LG&E to adopt strategies and enter into transactions that might increase those risks.

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Question No. 2

Responding Witness: Clay Murphy

Q-2. For each of the risks specified in the preceding question, please give the specifics of the nature and extent of the risk LG&E has assumed under the PBR mechanism that did not previously reside with it under standard/traditional gas supply regulation.

A-2. See LG&E's response to Commission Staff Question No. 1.

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Question No. 3

Responding Witness: Clay Murphy

Q-3. At page 5 of the report it states that "the benchmarks incorporated in the PBR mechanism are presumed to be the results that LG&E would have achieved in the absence of the incentives the PBR provides." Please explain in detail why it is appropriate to "presume" that the benchmarks are the results that LG&E would have achieved absent incentives.

A-3. As LG&E has explained in both Case No. 97-171 and Case No. 2001-00017, benchmarks are used because it is not possible to determine what gas supply costs might have been incurred in the absence of the PBR mechanism or under a differently constructed PBR mechanism.

The purpose of the PBR mechanism itself is to set the benchmarks (and thus the behavior that is to be incented under the PBR mechanism) and the risks and/or rewards for achieving or failing to achieve savings under the mechanism. LG&E's PBR mechanism is intended to align the interests of LG&E and its customers in such a way that LG&E outperforms the benchmarks in order to further the least cost acquisition standard for gas supplies established by the Commission and discussed in its Orders in Administrative Case Nos. 297 and 384.

The goal of least cost acquisition is one of the most important reasons to encourage the use of gas supply cost PBR mechanisms in general, and LG&E's PBR mechanism specifically. LG&E's gas supply cost PBR mechanism incorporates a "least cost acquisition" standard in purchasing natural gas supplies and pipeline transportation services. The sharing mechanism of LG&E's PBR mechanism encourages it to purchase the lowest cost gas supplies and reliable pipeline transportation services from among all the supplies and pipeline transportation services available to LG&E.

LG&E's PBR mechanism incorporates its own cost/benefit test to determine the effectiveness of LG&E's procurement activity. The benchmarks, which are objective, meaningful, and inclusive, were established prior to the beginning of the operation of the PBR mechanism, and provide a meaningful standard for measuring and reviewing performance. LG&E's performance is measured by

comparing actual costs to benchmark costs to determine the savings or expenses resulting under the PBR mechanism.

LG&E's gas supply cost PBR mechanism benchmarks all the costs which LG&E incurs in gas purchasing. For gas commodity costs, the PBR mechanism establishes objective monthly, weekly, and daily pricing benchmarks which reflect all the zones in which LG&E is able to purchase gas. For pipeline transportation costs, the PBR mechanism establishes the just and reasonable tariff rates approved by the Federal Energy Regulatory Commission ("FERC") as the objective rates under which LG&E is able to purchase transportation and related services. For off-system sales, the benchmark is the cost that LG&E pays for the gas which is being sold. These benchmarks are reasonable and are the presumed results that would have been achieved in the absence of the PBR mechanism. See LG&E's response to Attorney General Question No. 8 for a detailed discussion of the continued reasonableness of each of the benchmarks included in LG&E's PBR mechanism.

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Question No. 4

Responding Witness: Clay Murphy

Q-4. At page 6 of the report it states that "a narrow, rigidly constructed PBR mechanism could ultimately result in higher gas costs and the diminishment of reliability." Absent the ability to determine whether the gas costs paid by consumers inclusive of the portion paid to shareholders under the PBR mechanism plan are less than would have been paid absent a PBR, how can the consumers be assured that a PBR that in some way incorporates all gas supply costs is still not too narrow in any of its given aspects or that it does not benchmark against standards that do not result in the lowest and most reliable possible gas cost?

A-4. LG&E disagrees with the premise of the question. As LG&E has explained in its response to Attorney General Question No. 3, a benchmarking mechanism is established because it is not possible to determine what gas supply costs might have been incurred in the absence of the PBR mechanism or under a differently constructed PBR mechanism. It is simply not feasible to reconstruct what might have happened or what actions LG&E might have taken in the absence of the PBR mechanism. The purpose of the PBR mechanism itself is to set the benchmarks (and thus the behavior that is to be incented under the PBR mechanism), and the framework for sharing the risks and/or rewards for achieving (or failing to achieve) savings under the mechanism. These risk/reward incentives must be established at the same time as the benchmarks in order to establish a meaningful framework for the behavior to be incented. Once the benchmarks are established, they should be accepted as the presumptive measure of what would have occurred in the absence of the PBR mechanism. It would be pure conjecture to speculate about what LG&E might have done had there been no PBR mechanism or if the mechanism incorporated a different set of benchmarks.

As explained in detail in LG&E's response to Attorney General Question No. 8, each of the benchmarks included in LG&E's PBR mechanism is a reasonable standard against which to measure LG&E's performance. These benchmarks provide an incentive to LG&E to purchase natural gas and pipeline transportation at the lowest price available to LG&E for supplies or transportation services that meet LG&E's reliability, volume, flexibility, creditworthiness, and other requirements. There are circumstances when LG&E is not willing to purchase a

low cost supply when that supply is likely to be unreliable. An explanation of how the PBR mechanism serves to improve or maintain reliability can be found in LG&E's response to Commission Staff Question No. 1.

Furthermore, LG&E's PBR mechanism is not narrowly or rigidly constructed because: (i) it incorporates all of LG&E's gas supply costs; (ii) it does not encourage one objective (such as least cost) to the detriment of other equally important objectives (such as reliability); and (iii) it does not encourage savings under one component of the mechanism more heavily than another component of the mechanism. Additionally, the benchmarks incorporated in the PBR mechanism are not constructed in a manner that discourages LG&E from exploring and taking advantage of the wide variety of gas supply and pipeline transportation purchase and sales opportunities available in the market.

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Question No. 5

Responding Witness: Clay Murphy

Q-5. At page 9 of the report the FERC-approved rates for pipeline transportation services are mentioned as the benchmark. Are the FERC-approved rates the buy-without-negotiation-rates?

a. Do the FERC-approved rates allow for lesser negotiated rates?

b. Do the FERC-approved rates allow for higher rates than those approved?

c. Does common industry practice negotiate rates that are lower than the FERC-approved rates?

A-5. In the absence of negotiation, or the absence of a competitive situation from which to negotiate, FERC-approved rates are available to all qualifying pipeline transportation service customers.

a. Yes. Pipelines may enter into agreements with customers that include demand or commodity rates that are discounted to a level between the applicable minimum and maximum FERC-approved demand or commodity rate when customers have competitive alternatives. However, in the future, pipelines may be less likely to offer discounts depending upon FERC's treatment of pipeline revenues affected by gas-on-gas discounting. See LG&E's response to Commission Staff Question 1-1.

b. Yes. Pipelines may enter into agreements with customers that include "negotiated rates" which can result in demand or commodity rates that are higher than the otherwise applicable FERC-approved rates. Negotiated rates may be above or below the maximum tariff rate and are not bound by the pipeline's rate structure and may also differ from rates produced by Straight-Fixed Variable ("SFV") rate design. Pipelines are authorized to enter into such negotiated rates under FERC's Policy Statement entitled "Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, Regulation of Negotiated Transportation Services of Natural Gas Pipelines, Statement of Policy and Request for Comments", 74 FERC ¶ 61,076 (1996).

c. Yes. Pipeline customers with competitive alternatives are generally able to negotiate rates less than the FERC-approved maximum tariff rates. Customers that do not have access to competing transporting pipelines, or those customers that do not take advantage of a competitive situation, are not able to achieve rates that are lower than the FERC-approved rates. LG&E's PBR mechanism encourages LG&E to negotiate aggressively with its pipeline transporters to reduce rates and maximize savings generated under the mechanism.

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Question No. 6

Responding Witness: Clay Murphy

Q-6. At page 12 of the report it states that certain actions have been successful in the past but may be less valuable in the future given the evolving nature of the gas market.

a. If this is true, how is the relevance of the chosen benchmarks as appropriate measures of performance in that evolved market to be determined?

b. If this is true, how does retention of the same benchmarks accommodate the evolving nature of the market to produce the lowest cost gas for the consumer as opposed to gas costs that simply beat benchmarks that may be rendered irrelevant by an evolving market?

A-6. a. As more fully discussed in LG&E's response to Attorney General Question No. 8 the benchmarks in the PBR mechanism remain relevant. It is important to distinguish the difference between the relevance of the benchmarks and the relevance of the actions taken (and risks assumed) to outperform the benchmarks. The actions which enable LG&E to achieve savings, as measured by the benchmarks, may become irrelevant in that they may become unavailable or valueless, or too risky over time as the marketplace changes.

Because of the dynamic nature of the marketplace, actions taken to achieve savings which were successful in one period may not be successful at another time. The PBR mechanism incents LG&E to continually investigate and search for actions that will help it create savings that accrue to the benefit of both shareholders and customers. LG&E's strategies to create savings under the PBR mechanism are not static. LG&E must continually analyze, refine, and develop its gas supply strategies in order to ensure that it continues to outperform the benchmarks incorporated in the PBR mechanism.

b. See LG&E's response to Attorney General Question No. 6 (a) above.

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Question No. 7

Responding Witness: Clay Murphy

Q-7. If the market is evolving, why is it appropriate to retain benchmarks for a five year period as opposed to examining the propriety of the benchmarks on a more regular basis?

A-7. As described in detail in LG&E's response to Attorney General Question No. 8, LG&E's benchmarks are reasonable and are likely to continue to be reasonable standards against which to measure LG&E's performance.

Additionally, 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.

The mechanism is currently broadly enough constructed that certain changes in the marketplace can be reflected in the benchmarks themselves. For example, if LG&E interconnected with another pipeline, the mechanism provides for the addition of an appropriate benchmark. Likewise, if a price posting ceases publication, the current tariff includes a provision for LG&E to make an application to the Commission to replace that price posting with a substantially similar price posting.

See also LG&E's response to Commission Staff Question No. 5.

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Question No. 8

Responding Witness: Clay Murphy

Q-8. If the market is evolving, please explain in detail why each of the benchmarks established is appropriate on a going-forward basis.

A-8. LG&E's gas supply cost PBR mechanism is comprehensive and includes all of LG&E's gas supply costs. The three basic components of LG&E's PBR mechanism are the Gas Acquisition Index Factor ("GAIF"), the Transportation Index Factor ("TIF"), and the Off-System Sales Index Factor ("OSSIF"). The benchmarks included are reasonable on a going-forward basis because they continue to reflect the market for natural gas that is accessible to LG&E and the FERC price for natural gas transportation services. The benchmarks in combination with the PBR sharing mechanism encourage LG&E to purchase low cost, reliable gas supply and pipeline transportation services.

Gas Acquisition Index Factor (GAIF):

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 actual reservation fees 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.

LG&E's purchases both longer- and shorter-term natural gas supplies. Purchases under longer-term commitments generally have two price components: (i) a commodity portion tied to an industry-accepted price index reflective of market prices during the month in question, and (ii) a supply reservation fee which ensures that the local distribution company ("LDC") will have access to adequate service flexibility designed to reliably meet system loads. Shorter-term gas supplies, on the other hand, are for terms generally of one month or less and ordinarily do not include supply reservation fees. Commodity prices for shorter-term purchases reflect the current market for such supplies at the time of the

transaction. The duration of the purchase (either short- or long-term) is not an indication that the purchase is either firm or interruptible.

LG&E's natural gas purchases for transportation by Texas Gas Transmission LLC ("Texas Gas") are generally purchased in two supply zones: Zone SL and Zone 1. It is in these zones that LG&E has firm pipeline receipt point entitlements. LG&E also has firm transportation capacity entitlements on Tennessee Gas Pipeline Company's ("Tennessee") system for delivery to LG&E. LG&E currently has firm pipeline receipt point entitlements in Tennessee's Zone 0 supply area, and Tennessee's Zone 1 supply area. However, LG&E can also buy natural gas volumes for delivery to its city gate in either Texas Gas's Zone 4 or Tennessee's Zone 2.

The indices used by LG&E in its PBR mechanism are published by *Natural Gas Week* ("NGW"), *Gas Daily* ("GD"), and *Inside F.E.R.C.'s -- Gas Market Report* ("IF"). These three publications represent some of the most authoritative and recognized sources of natural gas pricing information available in the industry and provide pricing data specifically related to the supply zones accessed by LG&E. LG&E does not provide any pricing information to these publications. Therefore, LG&E cannot influence the determination of these indices.

The factors that influence the natural gas market change daily causing prices to fluctuate, often significantly. Price movement is reflective of changes, or perceived changes, in natural gas supply and demand, as well as other factors. Therefore, the price of gas established during bid week for the upcoming month can be drastically different (either lower or higher) than the price of gas during the month. The indices used in the GAIF benchmark include first-of-month, mid-month, and daily price postings. This mix of indices reflects the fact that LG&E must purchase natural gas supplies to meet customer requirements at various times during the month due to weather variations and other factors.

The Historical Reservation Fee ("HRF") component of the GAIF benchmarks LG&E's reservation fees against an average of the actual reservation fees paid by LG&E during the previous two years. Unlike gas commodity prices, there is no industry publication which includes reservation fee postings that reflect what other market participants are paying for various types of term supply packages. The level of the reservation fee paid under a particular supply agreement is highly dependent on the credit-worthiness of the parties and the unique provisions of the agreement such as the volume, term, pricing mechanism, and volume change flexibility. In the absence of a published index, it is reasonable to continue to benchmark LG&E's reservation fees against an average of the actual reservation fees paid by LG&E from the previous two years. This benchmark reflects LG&E's unique contract requirements and contracting position, and encourages LG&E to seek opportunities to lower reservation fees, or at least mitigate the impact of rising reservation fees.

Transportation Index Factor ("TIF"):

The TIF component of the PBR mechanism benchmarks LG&E's actual pipeline transportation costs against the transportation rates filed with and approved by FERC for either Texas Gas or Tennessee, as applicable. The TIF benchmark is reflective of the manner in which pipelines charge for firm pipeline transportation services. The rates for the pipeline transportation services are established and likely to continue to be established and regulated by the FERC. These FERC-approved rates provide a fair and objective benchmark against which to measure savings achieved by LG&E as a result of 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.

Off-System Sales ("OSSIF"):

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 as a result of the PBR mechanism.

An off-system sale is the resale of natural gas supplies (or services) to non-traditional customers of natural gas and natural gas services other than LG&E's retail customers. Such parties could include marketers, producers, end-users not on LG&E's system, or other LDCs.

There are several types of off-system sales transactions possible under the PBR mechanism. They include, but are not limited to: (i) the sale of natural gas under contract to LG&E in the production area, (ii) the sale of natural gas in the production area using supplies not already under contract to LG&E, (iii) the sale of natural gas supplies on a delivered basis using LG&E's pipeline capacity, and (iv) the sale of natural gas supplies on a delivered basis using the capacity of a third party. Other types of off-system sales transactions include storage transfers and sales of storage gas.

The OSSIF benchmark ensures that off-system sales are correctly priced, particularly when considered in conjunction with the other parts of the PBR mechanism, which benchmark commodity and transportation costs respectively. LG&E is not motivated to sell less expensive gas off-system through this mechanism, because these same costs are benchmarked and savings shared under the commodity and transportation cost mechanisms. Using the same sharing percentages in all the components of the PBR mechanism ensures that LG&E pursues opportunities under each of the components of the mechanism with the same vigor. For example, LG&E would have the same incentive to pursue transportation capacity release under TIF as it would to pursue off-system sales under the OSSIF.

In addition to providing reasonable benchmarks, and as reflected in Commission Orders, 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 portfolio that provides reliable and flexible supply management capabilities. LG&E's PBR mechanism does not provide incentives that could encourage it to take actions that reduce reliability in order to achieve lower costs.

LG&E's PBR mechanism is constructed so as to ensure that it encourages and incents the appropriate behavior in creating cost savings for customers. LG&E's PBR mechanism reflects an 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 balanced so that one objective (such as least cost) is not encouraged to the detriment of other equally important objectives (such as reliability).

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CASE NO. 2005-00031

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Question No. 9

Responding Witness: Clay Murphy

Q-9. The only change proposed by LG&E for its PBR on a going-forward basis is to grant it a larger incentive at every level of gas supply purchasing, with no level as favorable to the consumer as that established by the Commission in Case No. 2001-00017. As all other benchmarks remain the same, on what basis can the Commission determine that it would be appropriate to pay the company more to continue to measure its performance against the same benchmarks?

A-9. LG&E has not proposed to modify the benchmarks included in the PBR mechanism because the benchmarks continue to be reasonable standards against which to measure LG&E's gas supply costs. See LG&E's response to Attorney General Question No. 8.

LG&E has requested a change to the sliding scale sharing mechanism. LG&E has requested this modification for two reasons. Firstly, LG&E has proposed a change in the sharing mechanism, in order to provide an adequate incentive to pursue activities (such as sales of gas supply or pipeline transportation services) that provide marginal revenue and that might not otherwise provide an adequate reward under the current sharing mechanism to compensate for the risk which might be assumed. These and other activities that would be encouraged by LG&E's requested change to the sharing mechanism are discussed in detail in LG&E's response to Attorney General Question No. 11. Secondly, LG&E has proposed a change in the sharing mechanism in order to more adequately compensate it for the risks it is currently assuming. As discussed in LG&E's response to Commission Question No. 1, the current mechanism includes a number of risks that LG&E has assumed and which are significant. PBR mechanisms are incentive mechanisms, that is, they are intended to incent a certain behavior and to reward the risk undertaken with a commensurate reward.

Therefore, LG&E has asked that the sharing mechanism be modified as requested because the current mechanism inadequately rewards risk, and because increasing the risk/reward incentive rewards risk-taking designed to lower gas costs. The sharing mechanism is not being altered in order "to pay the company more to continue to measure its performance against the same benchmarks," but to incent the company to achieve greater savings under those benchmarks and to reward the company and customer for the increased risks assumed.

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CASE NO. 2005-00031

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Question No. 10

Responding Witness: Clay Murphy

Q-10. Please explain the means by which the Commission will be able to determine objectively that giving the Company a larger incentive produces incremental savings to the consumer that are as great as or greater than the added cost to the consumer represented by raising the shareholders' incentive?

A-10. See LG&E's response to Attorney General Question No. 9.

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Question No. 11

Responding Witness: Clay Murphy

Q-11. Please specify the activities the company will perform differently if it is granted a greater share of savings as they are measured against the same performance benchmarks.

A-11. As LG&E explained in its response to Attorney General Question No. 6, the actions themselves are secondary to the benchmarks and the incentives provided by the sharing mechanism. As also explained by LG&E in its response to Attorney General Question No. 6, the actions which LG&E undertook in the past (and the associated risks) may or may not be relevant for the future. This is the case because the natural gas marketplace is not a stagnant one. That the benchmarks are reasonable is discussed in LG&E's response to Attorney General Question No. 8.

Based on LG&E's assessment of the current market, there are 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. These could include the following activities, either on a firm or interruptible basis:

- selling more gas in the off-system market;
- releasing greater quantities of pipeline capacity;
- providing off-system sales of storage services;
- undertaking currently marginal activities to generate greater savings;
- exerting greater leverage to negotiate steeper pipeline capacity discounts; and
- investigate the market for other actions which LG&E is either currently unaware or which do not currently exist.

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Question No. 12

Responding Witness: Clay Murphy

Q-12. Please specify the activities the company plans to discontinue if it is not granted a greater share of savings as they are measured against the same performance benchmarks.

A-12. As discussed in LG&E's response to Attorney General Question No. 6, the relevance of the benchmarks should not be confused with the relevance of the activities undertaken to achieve savings under the PBR mechanism.

Even if the benchmarks and sharing mechanism remain unaltered, LG&E may discontinue certain activities (or initiate new activities) depending upon their value in the marketplace relative to the risk (and cost) required to achieve savings through those activities. For example, LG&E may not make certain off-system sales depending upon the associated risk/reward levels.

It is important to note that if LG&E is not granted a greater share of savings, LG&E will be less likely to pursue the activities outlined in LG&E's response to Attorney General Question No. 11, or other activities, when it determines that the potential risk is not worth the potential reward.

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Question No. 13

Responding Witness: Clay Murphy

Q-13. Please enumerate in detail and explain all reductions in effort, performance, and/or savings achieved from November 1, 2001, forward that would have been achieved had the Commission not reduced the incentive share of savings it allowed LG&E to retain [in] Case No. 2001-00017.

A-13. In approving the extension of LG&E's gas supply cost PBR mechanism in Case No. 2001-00017, the Commission made four changes in the PBR mechanism approved in Case No. 97-171. Firstly, the Commission modified the previously symmetrical 50%/50% sharing mechanism by substituting a sliding scale which shared savings or expenses on a 75%/25% basis between Customer and Company up to 4.5% of benchmarked gas costs, above which point the sharing mechanism returned to the symmetrical 50%/50% sharing mechanism. Secondly, the Commission deleted the *NYMEX* settled price from the benchmarked calculation under the GAIF component of the PBR mechanism. Thirdly, the Commission eliminated the Capacity Release Threshold ("CRT"). Fourthly, the Commission approved the addition of the sale of storage services in the off-system market to the OSSIF component of the PBR mechanism.

In response to the changes in the benchmarks and the incentives to pursue least-cost acquisition strategies, LG&E made several changes in its gas supply portfolio and gas supply strategies:

Modification of Gas Supply Portfolio:

LG&E modified its gas supply portfolio to decrease the number of gas supply contracts which were priced at a first-of-the-month index (since the *NYMEX* benchmark was eliminated as a first-of-month ("FOM") index.) Instead, LG&E substituted gas supply arrangements which included mid-month pricing mechanisms, that is, they reflected prices which occurred after the first-of-month price was established.

This change to LG&E's supply portfolio had two results which impacted LG&E's performance under the gas supply cost PBR mechanism. Firstly, it reduced LG&E's ability to take advantage of opportunities to make additional sales of gas

supplies in the off-system market. This reduced LG&E's ability to take advantage of opportunities which might have increased savings under the OSSIF component of the PBR mechanism. However, such savings are not quantifiable. Secondly, that change in LG&E's gas supply portfolio also reduced LG&E's ability to purchase gas at a first-of-month index price when such purchases would have resulted in lower costs to LG&E's customers when compared to mid-month pricing alternatives. While it is possible to illustrate that opportunities to create savings were reduced, the savings that may have been generated cannot be quantified. LG&E's past purchasing decisions and resulting costs cannot be re-determined for a PBR Year with the assumption that these opportunities may or may not have been available to LG&E.

No Off-System Sales of Storage Services:

In response to the Commission including the potential to share in savings generated from the sale of off-system storage services to the OSSIF component of the PBR mechanism, LG&E began canvassing the marketplace for potential parties interested in such services. LG&E also requested and received an open-access certificate from FERC pursuant to its Order 63. That certificate permits LG&E to provide such services in the interstate marketplace at market-based rates. The legal and consulting fees associated with acquiring the certificate exceeded $49,000 and were paid by shareholders, not customers. In canvassing the marketplace, LG&E discovered that the type of storage services which LG&E was capable of offering (without diminishing reliability) were not valuable enough to overcome the costs and reliability considerations associated with providing such services given the sharing mechanism approved by the Commission in Case No. 2001-00017.

Reduced Emphasis on Marginal Activities:

In response to the reduced sharing mechanism approved by the Commission in Case No. 2001-00017, a number of activities also received reduced emphasis. These included, but are not limited to, pursuit of off-system sales activities when determined to be of only marginal value, release of pipeline capacity when determined to be of only marginal value, and contracting for gas supply arrangements with recall or re-put rights when determined to be of only marginal value. In the case of each of these activities, LG&E was not willing to take on the associated risks in exchange for the potential rewards.

As LG&E has discussed, the gas supply cost PBR mechanism is an incentive mechanism designed to encourage behavior by rewarding LG&E for assuming risks and achieving savings. When the reward is marginal, in light of either the risks assumed or the potential savings, the activity is not likely to be pursued.

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Question No. 14

Responding Witness: Clay Murphy

Q-14. At page 13 of the report the Company asks that the Commission authorize the extension and modification 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." Given that the only change sought is to increase the amount the Company keeps, what gas supply portfolio and supply strategies need to be adjusted?

A-14. LG&E disagrees with the premise of the question. LG&E is not proposing to alter the sharing mechanism simply in order to increase the amounts that it keeps, but, rather, to modify the risk/reward structure so that LG&E can be incented to undertake risks and activities to the benefit of both LG&E and its customers.

While LG&E has requested that the PBR mechanism's benchmarks remain the same and that only the sliding-scale sharing mechanism be modified, LG&E cannot foresee the final outcome of this proceeding. Any change that the Commission might order in LG&E's PBR mechanism will affect LG&E's natural gas supply strategies going forward. This is true whether the Commission changes the benchmarks, the sharing mechanism, or both the benchmarks and the sharing mechanism. This is also true if the Commission determines that the PBR mechanism should be discontinued. It is reasonable to assume that LG&E will modify its gas supply strategies affecting its gas commodity and transportation contracting practices in order to respond to the incentives established in an approved PBR mechanism or otherwise.

By being able to incorporate in its planning any changes in the construction of the PBR mechanism, LG&E can better determine, prior to the beginning of the next PBR Year (that is, prior to November 1, 2005), how best to modify its natural gas supply strategies in order to respond successfully to any new incentive provided by the PBR mechanism. LG&E commences its annual gas supply portfolio and strategy analysis in the spring of each year. How LG&E constructs that portfolio is dependent upon projected system loads, market conditions, storage inventory levels, Commission and FERC regulatory guidance, as well as other factors. All of these factors are evaluated in combination with the incentives provided under the PBR mechanism.

Once the supply and transportation portfolio and associated supply strategies are in place, LG&E must also manage its storage, transportation, and supply resources from day to day, not only to reliably serve customers' loads, but also in light of the incentives provided under the PBR mechanism. As discussed in LG&E's response to Commission Staff Question No. 2, LG&E was unable to adjust its gas supply portfolio for the PBR Year beginning November 1, 2001, in order to reflect the modifications to the PBR mechanism set forth in the Commission's October 26, 2001, Order in Case No. 2001-00017. Because LG&E was unable to adjust its strategies in a timely manner in response to the new PBR mechanism, LG&E's performance under the PBR mechanism was adversely affected for the remainder of that PBR Year. LG&E experienced a loss under the PBR mechanism for the month of November 2001, in excess of $850,000. Performance under the PBR mechanism remained poor for the remainder of that PBR Year until LG&E was able to modify its supply portfolio for the next PBR Year.

Therefore, LG&E has requested that the Commission approve the modification and extension of the PBR mechanism as proposed by LG&E by no later than June 1, 2005, or sooner, if possible, in order that LG&E can respond appropriately and successfully by November 1, 2005, to the incentives in the PBR mechanism becoming effective on that date. LG&E believes that such a time line provides a reasonable period for the review of the mechanism and also provides assurances to both LG&E and its customers that a least cost acquisition can be successfully pursued to the benefit of both.