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JUN 20 2005

PUBLIC SERVICE
COMMISSION

VIA OVERNIGHT-DELIVERY

June 17, 2005

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615

Re: In the Matter of the Application of The Union Light, Heat and Power Company to Implement a Hedging Program to Mitigate Price Volatility in the Procurement of Natural Gas
Case No. 2005-00191

Dear Ms. O'Donnell:

I have enclosed an original and seven copies of The Union Light, Heat and Power Company's responses to the Staff's first set of data requests in the above-referenced case.

Please date stamp and return the two enclosed copies of this cover letter in the self-addressed envelope.

If you have any questions, please do not hesitate to contact me at (513) 287-3601.

Sincerely,

John J. Finnigan, Jr.
Senior Counsel

JJF/sew

cc: The Hon. Elizabeth Blackford (w/enc.)

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KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-001

REQUEST:

1. Refer to page 2 of Attachment B, Amount of ULH&P's Gas Supply Subject to the Hedging Plan. ULH&P states that base supply is the sum of its estimated minimum daily natural gas purchases, plus daily storage injection capabilities. For clarification, is it also correct to describe base gas as the gas requirements that are not dependent on weather conditions? Explain the response.

RESPONSE:

Yes, since the base gas is the amount of natural gas required for load on a minimum day plus the maximum amount that can be injected into storage, this volume can be delivered every day regardless of weather conditions. The amount of base gas changes month to month as the minimum day requirements and the maximum storage injection rights change.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-002

REQUEST:

2. Refer to page 3 of Attachment B, Schedule for Purchase of Hedging Instruments.
 - a. ULH&P states that by including minimum quantities to be hedged it will gain the advantages of a mechanistic feature while preserving management discretion as to the timing of gas supply purchases. Identify the advantages of a mechanistic hedging feature.
 - b. Provide the derivation of the minimum and maximum hedged volume percentages.

RESPONSE:

- a. The advantage of a mechanistic hedging feature is that it will assure an adequate level of hedging in an uncertain market. If all indications are that prices should drop, an analyst would most likely decide not to hedge at that time. However, unforeseen circumstances, such as a Hurricane or an error in EIA's weekly storage report, could cause prices to climb dramatically. Since it is difficult to predict such occurrences, a mechanistic approach will assure a minimum level of hedging and thereby reduce volatility more than if all hedging was left up the discretion of the Hedging Committee.
- b. The minimum and maximum hedged volume percentages are a product of trial and error rather than a formula or calculation. ULH&P's first year hedging strategy called for a range of 50-75%. In the second year, the range was reduced to 0-65%, and in the most recent approved plan the range was 20-75%. ULH&P feels that a range of 25-75% hedging for base winter supply will assure that an adequate level of hedging while still allowing for a sufficient quantity of base gas to be priced out at a monthly index in order to maintain a balanced supply portfolio.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-003

REQUEST:

3. Refer to page 6 of Attachment B, Price Caps. ULH&P states that it utilizes price caps as part of its hedging instruments. Provide the current premium for a price cap.

RESPONSE:

ULH&P has no price caps as part of its current hedging strategy, but included it in the 2005 Hedging Strategy to allow for their use in the future, depending on market conditions. The premium is dependent of the current market and desired cap, and changes day to day as the market changes. On June 10, 2005 a \$9.00 price cap for November 2005 through March 2006 could be acquired for a premium of \$0.78/dth. A similar price cap at \$10.00 would cost \$0.54/dth. In keeping with ULH&P's strategy to use physical rather than financial hedging, the cost of the cap would be included in the price paid once the gas is delivered, rather than paying a premium upfront when the price cap is set.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-004

REQUEST:

4. Refer to page 7 of Attachment B, Fixed Price Contracts. ULH&P states that fixed priced contracts will be set between the highest and the lowest price that NYMEX trades on the strike date. Explain how ULH&P and the supplier will determine the price for these contracts.

RESPONSE:

Prices for fixed price contracts are set in one of two ways. In the first, ULH&P calls a supplier with a particular price, volume and delivery point. The desired price is set lower than where the market is currently trading. The supplier will put an order in with its trading operation, and notify ULH&P when or if they were able to secure that price. It is possible that the price will not be "hit," and ULH&P would have to revise its target price or decide not to hedge at that time.

The alternate method is when ULH&P calls a supplier and asks for a current price quote for a particular volume and delivery point. The quote will be accepted if ULH&P determines that it is reasonable based on real time NYMEX and basis pricing. Otherwise, ULH&P will attempt to negotiate with the supplier or simply call a different supplier.

The first method can sometimes result in a slightly lower price, but could also result in missed opportunities if the price begins to rise again within a fraction of a cent from the desired price. The first method would be used on days of increased volatility, and the second when the market is more stable. In either case, the fixed price will be between the minimum and maximum price traded on that day.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-005

REQUEST:

5. Refer to page 9 of Attachment B, No-Cost Collars. Describe ULH&P's method for determining the floor price for collars.

RESPONSE:

ULH&P contacts multiple suppliers to determine the best possible floor for a given ceiling when utilizing no-cost collars. Each supplier is told ULH&P's desired ceiling price, volume and delivery point. ULH&P will acquire the no-cost collar from the supplier who is willing to provide the lowest floor. If ULH&P determines that all offered floors are unreasonable, it would simply not enter into a no-cost collar at that time.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-006

REQUEST:

6. Describe how ULH&P determines which hedging method to use and how it determines which supplier it will use to execute a given hedge transaction.

RESPONSE:

The hedging method is determined by the Hedging Committee, based on current market conditions and the consensus of the most likely market direction. In general, fixed prices are used when the market seems to be at a low point and a collar or cap when the group believes that there is a likelihood that the price will decline. In periods of high uncertainty, ULH&P is more likely to utilize a cost averaging approach.

For a delivery month in which ULH&P has firm base contracts with various suppliers, the supplier for a fixed price transaction will be based on matching the desired volume to be hedged with the firm base volumes. For example, if ULH&P has firm base supply with Supplier A for 2,000 dth/day and with Supplier B for 1,000 dth/day, and wants to hedge 1,500 dth/day, then it would obviously need to enter into the hedging transaction with Supplier A. If more than one firm base contract is large enough to accommodate the hedging transaction, or there are no firm base contracts for the delivery month, the decision will be based on past experience with each supplier, and their familiarity with the desired hedging option. Further, as described in Staff Data Requests #4 and #5, the decision may be based on which supplier offers the lowest floor or a reasonable fixed price.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-007

REQUEST:

7. Provide the typical and maximum terms for a supplier contract that ULH&P uses as a hedge instrument.

RESPONSE:

Since the pilot hedging strategy for the winter of 2001-02, ULH&P has typically hedged for volumes of around 2,000 dth/day for the following winter or summer season. In some instances a single month was hedged, but most hedging was done for entire seasons or the three winter peak months of December through February. The maximum volume hedged during the four years that ULH&P had an official hedging strategy was 5,500 dth/day. In the filed 2005 Hedging Strategy, ULH&P contemplates similar typical volumes, with terms up to 30 months into the future.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
Response Due Date: June 20 2005

KyPSC-DR-01-008

REQUEST:

8. Provide the expiration date of ULH&P's current asset management agreement with Cinergy Marketing & Trading.

RESPONSE:

ULH&P's current asset management agreement with Cinergy Marketing & Trading expires on October 31, 2006.

WITNESS RESPONSIBLE: Jeff Kern

KyPSC Staff First Set Data Requests
ULH&P Case No. 2005-00191
Date Received: June 10 2005
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KyPSC-DR-01-009

REQUEST:

9. Explain how ULH&P executes its hedging arrangements through its asset manager.

RESPONSE:

Once ULH&P has negotiated a hedging arrangement with a supplier, it assigns the transaction to its asset manager by sending an assignment letter to the supplier with a copy to the asset manager. ULH&P pays the hedged price to the asset manager after the month of delivery and the asset manager then pays the supplier.

WITNESS RESPONSIBLE: Jeff Kern