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February 24, 2005

Ms. Beth A. O'Donnell, Executive Director
Public Service Commission of Kentucky
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602

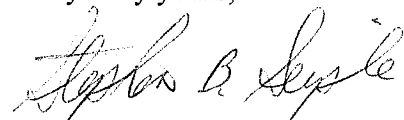
RECEIVED
FEB 24 2005
PUBLIC SERVICE
COMMISSION

Re: **PSC Case No. 2004-00462**

Dear Ms. O'Donnell,

Enclosed for filing with the Commission are the original and nine copies of Columbia Gas of Kentucky's Reply Comments in Case No. 2004-00462. Please call me at (614) 460-4648 should you have any questions about this matter.

Very truly yours,



Stephen B. Seiple
Lead Counsel

Enclosures

cc: Richard S. Taylor
Parties of Record

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:)
)
THE APPLICATION OF COLUMBIA GAS) OF KENTUCKY, INC. TO IMPLEMENT A) NEW SMALL VOLUME GAS TRANSPOR-) TATION SERVICE, A GAS PRICE HEDG-) ING PLAN, AN OFF-SYSTEM SALES AND) CAPACITY RELEASE REVENUE SHARING) MECHANISM, AND A GAS COST INCEN-) TIVE MECHANISM.)

Case No. 2004-00462

REPLY COMMENTS OF
COLUMBIA GAS OF KENTUCKY, INC.

Columbia Gas of Kentucky, Inc. ("Columbia") filed its Application in this docket on November 30, 2004. By Order dated February 4, 2005, the Commission provided interested parties with the opportunity to file Comments on Columbia's Application by February 14, 2005. The Entry further provided Columbia with the opportunity to file Reply Comments by February 24, 2005.

The Lexington-Fayette Urban County Government, Interstate Gas Supply, Inc., MxEnergy, Inc. and the Attorney General filed comments. Columbia hereby files these Reply Comments to address issues raised by the Comments of the Attorney General and MxEnergy.

Off-System Sales and Capacity Release Revenue Sharing

Columbia requested that its proposed Off-System Sales and Capacity Release Revenue Sharing Mechanism be approved on a permanent basis. The Attorney General argues that no incentive program should be made permanent, including Columbia's proposed Off-System Sales

and Capacity Release Revenue Sharing Mechanism. (Attorney General Comments at 3.) Columbia requested that the proposed Off-System Sales and Capacity Release Revenue Sharing Mechanism be approved on a permanent basis because Columbia has, in two previous pilot programs (*see* the Application filed in this docket at 2-3, 7), demonstrated the benefits that an Off-System Sales and Capacity Release Revenue Sharing Mechanism can provide. Columbia was, in fact, the first LDC to propose an incentive program of any type. Because similar incentive mechanisms have been effective, on a pilot basis, for approximately eight years, there is no need to continue the incentive program on a "pilot" basis. The proposed Off-System Sales and Capacity Release Revenue Sharing Mechanism should be approved on an ongoing basis so that Columbia and other parties will not need to unnecessarily burden the Commission with repeated requests for renewal of a program that benefits both Columbia and its customers. However, approval of the incentive program on a permanent or ongoing basis does not mean that the Commission relinquishes its oversight responsibilities nor that the Commission may not modify or terminate the program if it believes good cause exists to take such action. The Commission would, of course, maintain its authority over Columbia's incentive program, just as it does over all of Columbia's other tariffs.[1]

The Attorney General suggests that Columbia has been unable to demonstrate that the previous pilot programs provided customer benefits, and in so doing makes reference to Columbia's response to Attorney General Data Request Set 1 number 25. (Attorney General Comments at 3-4.) Columbia notes that Attorney General Data Request Set 1 number 25 dealt solely with capacity releases, and not off-system sales. Nonetheless, Columbia responded that even when

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The Attorney General has also questioned Columbia's ability to measure benefits of incentives based largely upon Columbia's responses to Attorney General Data Request Set 1 numbers 21-25, all of which dealt only with Capacity Release issues. In effect, the Attorney General asked Columbia to project future demand requirements that define the future availability of unutilized capacity, future market place characteristics such as pricing differentials that contribute to the value of the unutilized capacity, and revenue results of a future Capacity Release program, both with and without the proposed incentive mechanism. A specific response would, of necessity, require speculation. However, as Columbia responded to the Attorney General, no one can accurately forecast the future market dynamics that will control the actual savings that will result; but given the proper incentive and opportunity to lower gas costs by following and optimizing dynamic market conditions Columbia believes it can create value.

During any given time frame, a utility can measure the results of its actions given the tools it had available. Either the utility had an incentive, and can measure the results, or the utility did not have an incentive, and can measure the results. What a utility cannot do, however, is to measure the results under an actual environment, but then try to assume what the results might have been had the utility been operating in a different environment. As noted in Columbia's response to the Attorney General's data requests, it is impossible to make that kind of determination. Nevertheless, given the proper incentives to monitor market conditions and optimize the

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value of non-utilized capacity, the opportunity exists to lower gas costs by capturing the value for non-utilized capacity.

Had the Attorney General specifically inquired about the benefits of Columbia's Off-System sales incentive programs, Columbia would have responded that Columbia's Off System Sales efforts have impacted customers in a much more measurable way, because without an incentive mechanism, it is doubtful that Columbia (or other similarly situated local gas distribution companies) would be participants in the upstream sales market. Therefore, all results from Off-System Sales can be used to measure the impact of the incentive. Since Columbia's Off-System Sales incentive was first approved, the program has netted the following proceeds that, in the earlier stages were shared between Columbia and the GCA, and in the last few years were shared between Columbia and the CHOICE Program stranded cost pool.

(Proceeds Provided in Thousands of Dollars)

Year	CKY Share of Off System Sales	Off System Sales Benchmark	Off System Sales Proceeds	Capacity Release Benchmark	Capacity Release Proceeds
1996	35%	0	1,345	(see 1997)	368
1997	35%	0	4,502	462	238
1998	35%	0	5,062	379	160
1999	35%	0	6,593	253	192
2000	35%	0	7,103	233	197
2001	25%	0	7,548	N/A	352
2002	25%	0	3,842	N/A	254
2003	25%	0	2,890	N/A	183
2004	25%	0	1,285	N/A	70

As the above summary demonstrates, Off-System Sales were a much larger part of the proceeds potential than were Capacity Releases. Columbia has requested in this docket that it be permitted to retain fifty percent of future Off-System Sales proceeds in order to recognize that the higher sharing percentage is more of an incentive to participate in a segment of the energy

business that is not a core segment of an LDC's regulated business. Capacity release, though arguably more of a core part of an LDC's business, has been combined with Off-System Sales in this proposal in order to simplify the process by developing a consistent approach to measuring the value of the products.

The Attorney General objects to the sharing ratios proposed by Columbia, and characterizes the sharing ratios as "inappropriate and punitive" toward customers. (Attorney General Comments at 4.) Such a negative attitude about incentives on the part of the Attorney General, and about Off-System Sales in particular, is indicative of a mistaken belief that: (1) sales in mid-market streams to non-customers is a core part of an LDC's business; and, (2) that incentives do not impact results. Aggressively pursuing Off-System Sales opportunities is not a core part of an LDC's business, and the table above illustrates that incentives do yield results. The Attorney General states that Columbia's GCA customers will be "penalized" if the sharing ratios proposed by Columbia are approved. (Attorney General Comments at 4.) However, Columbia's proposal will greatly increase revenue credits to the GCA customers because under the current program, the GCA receives all of the capacity release revenue, but none of the more valuable Off-System Sales revenue that is currently credited to fund CHOICE Program stranded costs. Increasing the incentives for Columbia to pursue Off-System Sales and Capacity Releases has the potential to further increase the total revenues to be shared by Columbia and its customers.

The Attorney General notes that Columbia's proposed sharing percentage is higher than those recently approved for Atmos Energy and Louisville Gas & Electric. (Attorney General Comments at 4.) While the sharing mechanisms approved for those companies may be lower than what has been proposed by Columbia, it is Columbia's understanding that those companies' incentives included the sharing of reductions in demand costs from pipelines, such as through

flexed rates. That element, and how to deal with those flexed charges over time, is significantly different than what Columbia has proposed. These companies were rewarded for activity that Columbia has not even suggested, that being that they would receive credits for discounts received on their transportation contracts with interstate pipelines. This is a far different approach than that which Columbia has proposed and does not call for the same type of adjustment to sharing during latter phases of the incentive program that were deemed necessary by the Commission for those other programs.

Columbia received no sharing of the benefits of its recent reductions in contract demand costs obtained as part of its capacity contract renegotiations or for other discounts obtained on capacity in recent years. The benefits of these reductions are reflected entirely in Columbia's demand cost. In the proposed CHOICE Program, sales and CHOICE Program customers pay the same demand cost through the GCA or the Balancing Service Charge to marketers, and receive the entire benefit of demand cost reductions. Though higher than the initial sharing bands of the most recently approved sharing percentages for Atmos and Louisville Gas & Electric, Columbia's proposed sharing percentage is equivalent to that previously approved for both companies, and the second sharing bands of the most recently approved sharing bands for both companies. In comparison to the other recently approved programs, Columbia has fewer elements of eligible activity and the activity must be managed and generated while CHOICE marketers are also operating on its system. It is, therefore, appropriate that Columbia's sharing be established as proposed.

The Attorney General claims that benchmarks should not be eliminated. (Attorney General Comments at 5.) There are no benchmarks in Columbia's current program, so it is not clear to what benchmark the Attorney General is referring. Originally, Columbia had a Capacity Re-

lease benchmark and that may be to what the Attorney General refers. Columbia believes it is appropriate that no benchmark be applied to Capacity Releases because the combined benefit for the customers from 50% of both Off-System Sales revenue and Capacity Release revenue under Columbia's proposal will far exceed all of the Capacity Release revenue that Columbia's customers receive under the current program.

Off-System Sales and Capacity Release Adjustment

As part of its Application, Columbia proposed to include the Off-System Sales and Capacity Release Adjustment ("OSCRA") in the GCA rate for sales customers, but included it as a separate item for CHOICE Program customers. MxEnergy commented that the OSCRA should instead be passed on to CHOICE Program suppliers, and could then be reflected in the suppliers' rates. (MxEnergy Comments at 1-2.)

This is an issue that Columbia discussed with the CHOICE Program marketers subsequent to the filing of the Application. Columbia and the CHOICE marketers agree that Off System Sales and Capacity Releases revenues are, in part, generated by services provided in common to both sales and CHOICE customers and that the most effective means of providing equal treatment to the sales and CHOICE customers is through a credit to the GCA, and therefore the balancing charge. As a result of those discussions, Columbia will file a Supplement to its Application in which it will propose a modification to address the concern addressed in MxEnergy's Comments. Columbia will propose to instead apply the OSCRA to the demand component of Columbia's GCA, and therefore will be credited to CHOICE Program customers as a credit within the charge to marketers for Balancing Services. This will enable a more accurate comparison for customers between Columbia's rate and marketer offers.

Gas Cost Incentive Mechanism

As part of its Application, Columbia also proposed to implement, on a pilot basis, a Gas Cost Incentive Mechanism ("GCIM"), associated with summer month purchases. The GCIM approach to measuring the effectiveness of gas purchasing efforts centers around defining a market standard, or price benchmark, and then trying to better that benchmark price, which if successful, will result in lower gas costs for system supply customers. A commodity component is an element of the incentive programs approved for other LDCs, and since 1998 the Commission has urged Columbia to expand its incentive program. While the demand elements of Columbia's incentive program are incorporated in its CHOICE Program, the commodity element, if approved by the Commission, will add another component to the overall effectiveness of Columbia's gas purchasing processes. Through a sharing of the net savings or costs, the GCIM rewards or penalizes Columbia based on the results of its gas supply acquisition efforts.

The Attorney General takes exception with the proposed GCIM because the proposal comes after "the highest summer gas costs ever." (Attorney General Comments at 6.) However, it is in part because of the current high price of gas that the implementation of a GCIM makes more sense than ever. As long as an appropriate benchmark is chosen a GCIM will provide an incentive to find supply that is cheaper than the benchmarked average price of gas. And if Columbia fails to meet the benchmark, under the proposed GCIM Columbia will be required to pay for half of the gas costs that fall above the benchmark.

The Attorney General also claims that the proposed benchmark is faulty because it does not represent an "apples to apples comparison" of Columbia's total summer purchasing practice and gas supply management. (Attorney General Comments at 6.). Columbia's proposal provides a benchmark of prices from the closing NYMEX contract and published indices to develop the

benchmark for the very same months at the very same locations at which Columbia is negotiating its purchases. The Attorney General's concern about an "apples to apples" comparison is misplaced, because Columbia's GCIM will use the very pricing locations and sources that it uses to price acquired supplies.

The Attorney General argues that in some manner, a benchmark should "clearly eliminates the impact of exogenous forces" from the GCIM. (Attorney General Comments at 6.) It is unclear what those exogenous forces are to which the Attorney General refers, but external forces acting on a commodity is what constitutes the market place, and the fact that exogenous forces exist does not change the goal of the GCIM – that being, to purchase gas at prices each month that are less than the defined acceptable market price, or benchmark.

The Attorney General also suggested that if the GCIM is approved by the Commission, that reports be required that demonstrate the overall GCIM benefit to customers. (Attorney General Comments at 6.) Columbia can provide an annual review after each summer that would compare the purchases it makes each month to the benchmarks created for each month. The report would include details of each purchase, the calculation of the benchmark for each location, and location details such that one could verify that appropriate comparison were being made, and record the cumulative effect on gas costs to the customers.

Marketer Charge

In its Application, Columbia proposed that Marketers participating in the CHOICE program pay a fee for each Mcf consumed by their CHOICE customers each month, based on the total number of Columbia customers participating in the CHOICE program each month. As proposed, the revenue generated by the marketer fees will be retained by Columbia to help offset the costs of administering the CHOICE program. However, the marketer charge is to be tiered, rang-

ing from $.10/Mcf up to $.14/Mcf, in order to provide an incentive for Columbia to promote the CHOICE program.

MxEnergy claims to support the incentive concept (MxEnergy Comments at 2), but the substance of its recommendation would, in fact, eliminate the incentive. MxEnergy suggests that "a significant portion of the increased Marketer Charge should be annually budgeted for customer education and marketing of the Choice program." (MxEnergy Comments at 2.)

The increased marketer charge is necessary to cover the costs of administering the CHOICE program, and these costs consist primarily of customer education costs and investments in programming necessary to provide billing information to customers, facilitate the exchange of information between Columbia and marketers for customer enrollments and maintain an accounting of marketer revenues. (*See,* Columbia's response to the Staff's Initial Data Request, Question Number 5.) However, unlike a traditional cost-based rate, the marketer fee is intended to recover Columbia's CHOICE Program administrative costs, and to also provide an incentive for Columbia to promote the CHOICE Program – i.e., Columbia has a financial incentive that is aligned with the success of the CHOICE Program.

By suggesting that all or most of the marketer fee revenue be earmarked for customer education and marketing MxEnergy ignores the fact that a substantial portion of Columbia's administrative costs consist of computer programming expenses. More disconcerting is the fact that MxEnergy apparently would have the marketer fee be primarily a cost-based charge. If MxEnergy's recommendation were to be adopted, the marketer fee would recover administration costs, but would provide no bottom line financial incentive for Columbia to promote the CHOICE Program. During discussions with the marketers, Columbia understood the marketers to state that they believed that providing incentives for Columbia to promote the CHOICE program is an es-

sential component necessary for the program's success. Columbia is dismayed that MxEnergy would apparently now seek to undermine this essential component of the proposed program, and if the Commission were to adopt MxEnergy's proposal Columbia would withdraw its application rather than going forward with a CHOICE Program.

Hedging

The Attorney General complains that Columbia "waited to propose a hedging plan until the Commission has shown such favor of hedging programs that there would be no chance the utility would bear any consequence if the program should fail to produce favorable results." (Attorney General Comments at 1.) Columbia does not agree with the Attorney General's characterization of Columbia's decision to recommend implementation of a Hedging Plan. As Columbia stated in its response to Attorney General Data Request Set 1 number 2:

> To this point, Columbia's strong storage position has had an influence on its decision regarding the necessity of proposing a hedging plan. Those supplies from storage are purchased at summer prices and as a result, serve as a hedge against winter period price spikes. In addition, it is very important that the regulatory environment is interested in and supportive of hedging. Without a clear understanding of the nature of the hedging program, and approval by the Commission, hedging programs create risk to the distribution company related to the full recovery of any costs after the fact. Therefore, in some regulated environments, hedging adds risk without any prospect of reward. Since there is no reward planned from a hedging program, it is important to minimize the risks. With the approval of shorter term hedge plans in Kentucky in recent years, and positive comments regarding hedging in the most recent Gas Management Audit, this interest and support for hedging appears to have grown to a level needed to make longer term plans successful. Finally, gas price volatility in the gas market has not dissipated. Based on the above, it appeared to Columbia that this would be an appropriate time to propose a hedging plan.

The Attorney General criticizes Columbia's proposed Hedging Plan because there is no measure of any actual volatility reduction. (Attorney General Comments at 1.) However, volatility reduction is the Attorney General's inferred intent of Columbia's Hedging Plan, and not Co-

lumbia's intent. As explained in Columbia's response to Attorney General Data Request Set 1 number 8-2:

> Columbia's stated objective in both the filing and in the Plan itself is that "Implementation of the Plan is intended to reduce the impact that potentially dramatic winter price spikes could have on the Gas Cost Adjustment price and to promote a level of price certainty and stability for Columbia's winter season gas supply." Columbia does not and has not measured the impact on price volatility.

Columbia considers the plan to be beneficial and effective if the Plan is accurately followed, and should result in greater certainty of future winter prices, and through that certainty, should reduce the impact of winter price spikes. Certainly, other Columbia LDCs with Hedging Plans have detailed descriptions of their results, which undergo regulatory scrutiny on a regular basis. Columbia is willing to provide appropriate summaries from which the Commission and interested parties will be able to determine whether they believe the Hedging Program is meeting its objectives.

It is a matter of fact that for each dekatherm hedged by the plan, a known price is developed for that portion of Columbia's supply. As the percentage of supply that has a fixed price grows, the more certainty there will be in Columbia's overall price of gas and the less prone the portfolio will be to price spikes. However, if price volatility is an important issue for the Attorney General, and if a definition of volatility can be agreed upon or set forth by the Commission, Columbia is certainly willing to provide such volatility measurements as part of the proposed reporting process for the hedging program, to the extent it is possible to supply the information requested.

In criticizing the costs associated with hedging programs, the Attorney General compares hedging to insurance. (Attorney General Comments at 2.) Columbia does not believe that the comparison to insurance is entirely accurate. With insurance, one must make payments to the

insurance company whether or not a claim upon a policy is ever made. Under Columbia's proposed Hedging Plan, Columbia simply will contract for a more balanced price portfolio with a greater percentage of the portfolio being fixed (through storage and hedging) as opposed to floating with winter real-time pricing. In effect, Columbia is simply pricing gas months ahead of time instead of hours or days ahead of time. With regard to its comments about insurance, it may be that the Attorney General is referencing some other hedging programs in which financial call options are purchased to effectively cap the price of gas. In those cases, the purchase of the call option would result in a definite cost (the option premium) while the option may or may not ever be exercised to effectuate the ceiling price. In those hedging programs, the efforts are more similar to purchasing insurance.

The Attorney General avers that hedging represents an "absolute cost" to the consumer. (Attorney General Comments at 2.) Columbia disagrees with this assertion. As stated earlier, Columbia is entering into contracts in order to set the price on certain volumes of gas instead of waiting until the day that gas for that day trades in the cash market. It is not a matter of paying more for gas; it is a matter of determining the price of gas at different times.

Under Columbia's proposed Hedging Plan, the results of the plan accrue entirely to customers. When costs of gas hedged by the Plan are lower than current market, customers receive those lower costs. If costs of gas hedged by the Plan are higher than the ultimate market that winter, then customers assume those higher costs. However, Columbia has been careful to develop controls and Trigger Price definitions in the Plan, which are likely to result in hedged prices that are more apt to be considered moderate, because the Trigger Prices are based upon history and averages.

The Attorney General claims, "consumers are required to pay for hedging programs to 'insure' against the price volatility of the markets the utilities are simultaneously being incented to pursue." (Attorney General Comments at 2.) However, the Hedging Plan and the GCIM have entirely different objectives. The Hedging Plan is designed to effectuate a more balanced portfolio by fixing prices on a greater portion of Columbia's supply needs. In contrast, the GCIM compares the price Columbia negotiates for its purchase of physical gas supplies in the physical cash market with prices widely reported as commonly used indices. Even if all of Columbia's supplies were hedged pursuant to the proposed Hedging Plan, there would still be negotiations to purchase the physical gas. Customers would continue to benefit to the extent Columbia can better the market averages.

Finally, the Attorney General criticizes Columbia's proposed Hedging Plan for being too "mechanistic," and recommends the elimination of minimum hedged volume aspect of the proposal. (Attorney General Comments at 3.) While Columbia's Hedging Plan may have some "mechanistic" characteristics, the Hedging Plan was designed to avoid speculation. Columbia does not propose to gamble with customers' money, but believes that through a well reasoned, "mechanistic" approach, Columbia's gas price portfolio might be diversified, resulting in more gas price certainty and less extreme winter price spikes.

In contrast, the Attorney General would have Columbia absorb all risks (costs) when there is no potential for reward. The Attorney General would further require the removal of the minimum volume hedged component of Columbia's Hedging Plan, presumably on the assumption that there should be no restrictions on hedge volumes when gas prices are "low." The problem with the Attorney General's assumption is that it requires one to guess about gas price

trends. The Attorney General's Data Request Set 1 number 14 and Columbia's response thereto illustrate Columbia's concern about the Attorney General's approach:

> Question No. 14
>
> At page 11 of the application it states that use of the two-year window provided "a much better chance that futures prices will drop to the point of allowing prices of be set using the Plan's Trigger prices than would a Plan with a shorter window in which to price supplies."
>
> a. Does this statement reflect an expectation that gas supply prices will be trending downward over the term of the pilot program?
>
> b. If it does not reflect an expectation that prices will trend downward, to what is the drop in futures prices two years out attributed?
>
> c. If a downward trend in pricing is expected, does the "rules based" approach of the plan allow Columbia Gas to take full advantage of prices lower than triggering prices or does the fact that the plan is buying two years out prevent adaptation to a downward market trend?
>
> d. Does the proposal allow Columbia Gas to reduce the volumes of gas hedged at trigger prices to allow it to take advantage of downward pricing trends?
>
> Response of Columbia Gas of Kentucky:
>
> a. No.
>
> b. Columbia has not said or indicated that there will be "a drop in prices two years out". Rather, we have indicated that over a two-year time frame in a market as volatile as the natural gas futures market, there is a greater opportunity that prices will drop below Trigger Prices during a two-year period than during a shorter period. This is based on viewing the price range of NYMEX contracts over time.
>
> c. When futures prices are below trigger prices, hedges will be placed pursuant to the Plan up to the limits provided by the Plan.
>
> d. The hedging program recognizes that Columbia does not run the program based on speculative opinions about whether there is a trend and whether that trend will continue.

As stated in the data request response, Columbia believes it is inaccurate to assume, as does the Attorney General, that the best results are based on hunches and trends in the market. Columbia maintains that a stricter approach to investing in gas is appropriate. If the Commission were to require that Columbia implement a speculative hedging program, subject to continuous

guesswork by Columbia, regulators and auditors, Columbia would withdraw its hedging proposal.

Program Changes

As stated earlier herein, Columbia is proposing a change to the OSCRA as a result of discussions with marketers subsequent to the filing of the Application in this case. Those same discussions have also resulted in Columbia's decision to permit CHOICE Program marketers to make additional billing rate changes each year before Columbia will assess a fee for billing rate changes. This change will also be addressed in Columbia's Supplement to its Application.

Critical Dates

Columbia appreciates the efforts of all parties to work toward a resolution of this case so that CHOICE customers may continue to receive transportation service without disruption. Columbia reiterates that April 1, 2005, is the critical proposed effective date of the proposed CHOICE program, which includes the Off System Sales and Capacity Release Sharing Mechanism. In order to provide an opportunity for benefits this summer to sales system customers, April 1, 2005 is also a critical date for implementation of Columbia's proposed Gas Cost Incentive Mechanism.

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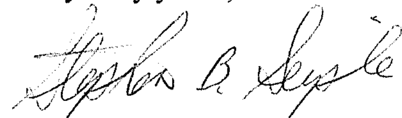

Stephen B. Seiple
Lead Counsel

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During any given time frame, a utility can measure the results of its actions given the tools it had available. Either the utility had an incentive, and can measure the results, or the utility did not have an incentive, and can measure the results. What a utility cannot do, however, is to measure the results under an actual environment, but then try to assume what the results might have been had the utility been operating in a different environment. As noted in Columbia's response to the Attorney General's data requests, it is impossible to make that kind of determination. Nevertheless, given the proper incentives to monitor market conditions and optimize the

[2] Columbia's response stated, "This is not a question that can be answered with certainty. Columbia considers the effect of incentives to be real and to have impact on results, and knows that the level of the incentive effects the investment in the effort and the results. Therefore, we believe that the benefit to customers will be a positive one, particularly when all parts of asset management are considered, including not only capacity release, but off system sales and the GCIM as package."

value of non-utilized capacity, the opportunity exists to lower gas costs by capturing the value for non-utilized capacity.

Had the Attorney General specifically inquired about the benefits of Columbia's Off-System sales incentive programs, Columbia would have responded that Columbia's Off System Sales efforts have impacted customers in a much more measurable way, because without an incentive mechanism, it is doubtful that Columbia (or other similarly situated local gas distribution companies) would be participants in the upstream sales market. Therefore, all results from Off-System Sales can be used to measure the impact of the incentive. Since Columbia's Off-System Sales incentive was first approved, the program has netted the following proceeds that, in the earlier stages were shared between Columbia and the GCA, and in the last few years were shared between Columbia and the CHOICE Program stranded cost pool.

(Proceeds Provided in Thousands of Dollars)

Year	CKY Share of Off System Sales	Off System Sales Benchmark	Off System Sales Proceeds	Capacity Release Benchmark	Capacity Release Proceeds
1996	35%	0	1,345	(see 1997)	368
1997	35%	0	4,502	462	238
1998	35%	0	5,062	379	160
1999	35%	0	6,593	253	192
2000	35%	0	7,103	233	197
2001	25%	0	7,548	N/A	352
2002	25%	0	3,842	N/A	254
2003	25%	0	2,890	N/A	183
2004	25%	0	1,285	N/A	70

As the above summary demonstrates, Off-System Sales were a much larger part of the proceeds potential than were Capacity Releases. Columbia has requested in this docket that it be permitted to retain fifty percent of future Off-System Sales proceeds in order to recognize that the higher sharing percentage is more of an incentive to participate in a segment of the energy

business that is not a core segment of an LDC's regulated business. Capacity release, though arguably more of a core part of an LDC's business, has been combined with Off-System Sales in this proposal in order to simplify the process by developing a consistent approach to measuring the value of the products.

The Attorney General objects to the sharing ratios proposed by Columbia, and characterizes the sharing ratios as "inappropriate and punitive" toward customers. (Attorney General Comments at 4.) Such a negative attitude about incentives on the part of the Attorney General, and about Off-System Sales in particular, is indicative of a mistaken belief that: (1) sales in mid-market streams to non-customers is a core part of an LDC's business; and, (2) that incentives do not impact results. Aggressively pursuing Off-System Sales opportunities is not a core part of an LDC's business, and the table above illustrates that incentives do yield results. The Attorney General states that Columbia's GCA customers will be "penalized" if the sharing ratios proposed by Columbia are approved. (Attorney General Comments at 4.) However, Columbia's proposal will greatly increase revenue credits to the GCA customers because under the current program, the GCA receives all of the capacity release revenue, but none of the more valuable Off-System Sales revenue that is currently credited to fund CHOICE Program stranded costs. Increasing the incentives for Columbia to pursue Off-System Sales and Capacity Releases has the potential to further increase the total revenues to be shared by Columbia and its customers.

The Attorney General notes that Columbia's proposed sharing percentage is higher than those recently approved for Atmos Energy and Louisville Gas & Electric. (Attorney General Comments at 4.) While the sharing mechanisms approved for those companies may be lower than what has been proposed by Columbia, it is Columbia's understanding that those companies' incentives included the sharing of reductions in demand costs from pipelines, such as through

flexed rates. That element, and how to deal with those flexed charges over time, is significantly different than what Columbia has proposed. These companies were rewarded for activity that Columbia has not even suggested, that being that they would receive credits for discounts received on their transportation contracts with interstate pipelines. This is a far different approach than that which Columbia has proposed and does not call for the same type of adjustment to sharing during latter phases of the incentive program that were deemed necessary by the Commission for those other programs.

Columbia received no sharing of the benefits of its recent reductions in contract demand costs obtained as part of its capacity contract renegotiations or for other discounts obtained on capacity in recent years. The benefits of these reductions are reflected entirely in Columbia's demand cost. In the proposed CHOICE Program, sales and CHOICE Program customers pay the same demand cost through the GCA or the Balancing Service Charge to marketers, and receive the entire benefit of demand cost reductions. Though higher than the initial sharing bands of the most recently approved sharing percentages for Atmos and Louisville Gas & Electric, Columbia's proposed sharing percentage is equivalent to that previously approved for both companies, and the second sharing bands of the most recently approved sharing bands for both companies. In comparison to the other recently approved programs, Columbia has fewer elements of eligible activity and the activity must be managed and generated while CHOICE marketers are also operating on its system. It is, therefore, appropriate that Columbia's sharing be established as proposed.

The Attorney General claims that benchmarks should not be eliminated. (Attorney General Comments at 5.) There are no benchmarks in Columbia's current program, so it is not clear to what benchmark the Attorney General is referring. Originally, Columbia had a Capacity Re-

lease benchmark and that may be to what the Attorney General refers. Columbia believes it is appropriate that no benchmark be applied to Capacity Releases because the combined benefit for the customers from 50% of both Off-System Sales revenue and Capacity Release revenue under Columbia's proposal will far exceed all of the Capacity Release revenue that Columbia's customers receive under the current program.

Off-System Sales and Capacity Release Adjustment

As part of its Application, Columbia proposed to include the Off-System Sales and Capacity Release Adjustment ("OSCRA") in the GCA rate for sales customers, but included it as a separate item for CHOICE Program customers. MxEnergy commented that the OSCRA should instead be passed on to CHOICE Program suppliers, and could then be reflected in the suppliers' rates. (MxEnergy Comments at 1-2.)

This is an issue that Columbia discussed with the CHOICE Program marketers subsequent to the filing of the Application. Columbia and the CHOICE marketers agree that Off System Sales and Capacity Releases revenues are, in part, generated by services provided in common to both sales and CHOICE customers and that the most effective means of providing equal treatment to the sales and CHOICE customers is through a credit to the GCA, and therefore the balancing charge. As a result of those discussions, Columbia will file a Supplement to its Application in which it will propose a modification to address the concern addressed in MxEnergy's Comments. Columbia will propose to instead apply the OSCRA to the demand component of Columbia's GCA, and therefore will be credited to CHOICE Program customers as a credit within the charge to marketers for Balancing Services. This will enable a more accurate comparison for customers between Columbia's rate and marketer offers.

Gas Cost Incentive Mechanism

As part of its Application, Columbia also proposed to implement, on a pilot basis, a Gas Cost Incentive Mechanism ("GCIM"), associated with summer month purchases. The GCIM approach to measuring the effectiveness of gas purchasing efforts centers around defining a market standard, or price benchmark, and then trying to better that benchmark price, which if successful, will result in lower gas costs for system supply customers. A commodity component is an element of the incentive programs approved for other LDCs, and since 1998 the Commission has urged Columbia to expand its incentive program. While the demand elements of Columbia's incentive program are incorporated in its CHOICE Program, the commodity element, if approved by the Commission, will add another component to the overall effectiveness of Columbia's gas purchasing processes. Through a sharing of the net savings or costs, the GCIM rewards or penalizes Columbia based on the results of its gas supply acquisition efforts.

The Attorney General takes exception with the proposed GCIM because the proposal comes after "the highest summer gas costs ever." (Attorney General Comments at 6.) However, it is in part because of the current high price of gas that the implementation of a GCIM makes more sense than ever. As long as an appropriate benchmark is chosen a GCIM will provide an incentive to find supply that is cheaper than the benchmarked average price of gas. And if Columbia fails to meet the benchmark, under the proposed GCIM Columbia will be required to pay for half of the gas costs that fall above the benchmark.

The Attorney General also claims that the proposed benchmark is faulty because it does not represent an "apples to apples comparison" of Columbia's total summer purchasing practice and gas supply management. (Attorney General Comments at 6.). Columbia's proposal provides a benchmark of prices from the closing NYMEX contract and published indices to develop the

benchmark for the very same months at the very same locations at which Columbia is negotiating its purchases. The Attorney General's concern about an "apples to apples" comparison is misplaced, because Columbia's GCIM will use the very pricing locations and sources that it uses to price acquired supplies.

The Attorney General argues that in some manner, a benchmark should "clearly eliminates the impact of exogenous forces" from the GCIM. (Attorney General Comments at 6.) It is unclear what those exogenous forces are to which the Attorney General refers, but external forces acting on a commodity is what constitutes the market place, and the fact that exogenous forces exist does not change the goal of the GCIM – that being, to purchase gas at prices each month that are less than the defined acceptable market price, or benchmark.

The Attorney General also suggested that if the GCIM is approved by the Commission, that reports be required that demonstrate the overall GCIM benefit to customers. (Attorney General Comments at 6.) Columbia can provide an annual review after each summer that would compare the purchases it makes each month to the benchmarks created for each month. The report would include details of each purchase, the calculation of the benchmark for each location, and location details such that one could verify that appropriate comparison were being made, and record the cumulative effect on gas costs to the customers.

Marketer Charge

In its Application, Columbia proposed that Marketers participating in the CHOICE program pay a fee for each Mcf consumed by their CHOICE customers each month, based on the total number of Columbia customers participating in the CHOICE program each month. As proposed, the revenue generated by the marketer fees will be retained by Columbia to help offset the costs of administering the CHOICE program. However, the marketer charge is to be tiered, rang-

ing from $.10/Mcf up to $.14/Mcf, in order to provide an incentive for Columbia to promote the CHOICE program.

MxEnergy claims to support the incentive concept (MxEnergy Comments at 2), but the substance of its recommendation would, in fact, eliminate the incentive. MxEnergy suggests that "a significant portion of the increased Marketer Charge should be annually budgeted for customer education and marketing of the Choice program." (MxEnergy Comments at 2.)

The increased marketer charge is necessary to cover the costs of administering the CHOICE program, and these costs consist primarily of customer education costs and investments in programming necessary to provide billing information to customers, facilitate the exchange of information between Columbia and marketers for customer enrollments and maintain an accounting of marketer revenues. (*See,* Columbia's response to the Staff's Initial Data Request, Question Number 5.) However, unlike a traditional cost-based rate, the marketer fee is intended to recover Columbia's CHOICE Program administrative costs, and to also provide an incentive for Columbia to promote the CHOICE Program – i.e., Columbia has a financial incentive that is aligned with the success of the CHOICE Program.

By suggesting that all or most of the marketer fee revenue be earmarked for customer education and marketing MxEnergy ignores the fact that a substantial portion of Columbia's administrative costs consist of computer programming expenses. More disconcerting is the fact that MxEnergy apparently would have the marketer fee be primarily a cost-based charge. If MxEnergy's recommendation were to be adopted, the marketer fee would recover administration costs, but would provide no bottom line financial incentive for Columbia to promote the CHOICE Program. During discussions with the marketers, Columbia understood the marketers to state that they believed that providing incentives for Columbia to promote the CHOICE program is an es-

sential component necessary for the program's success. Columbia is dismayed that MxEnergy would apparently now seek to undermine this essential component of the proposed program, and if the Commission were to adopt MxEnergy's proposal Columbia would withdraw its application rather than going forward with a CHOICE Program.

Hedging

The Attorney General complains that Columbia "waited to propose a hedging plan until the Commission has shown such favor of hedging programs that there would be no chance the utility would bear any consequence if the program should fail to produce favorable results." (Attorney General Comments at 1.) Columbia does not agree with the Attorney General's characterization of Columbia's decision to recommend implementation of a Hedging Plan. As Columbia stated in its response to Attorney General Data Request Set 1 number 2:

> To this point, Columbia's strong storage position has had an influence on its decision regarding the necessity of proposing a hedging plan. Those supplies from storage are purchased at summer prices and as a result, serve as a hedge against winter period price spikes. In addition, it is very important that the regulatory environment is interested in and supportive of hedging. Without a clear understanding of the nature of the hedging program, and approval by the Commission, hedging programs create risk to the distribution company related to the full recovery of any costs after the fact. Therefore, in some regulated environments, hedging adds risk without any prospect of reward. Since there is no reward planned from a hedging program, it is important to minimize the risks. With the approval of shorter term hedge plans in Kentucky in recent years, and positive comments regarding hedging in the most recent Gas Management Audit, this interest and support for hedging appears to have grown to a level needed to make longer term plans successful. Finally, gas price volatility in the gas market has not dissipated. Based on the above, it appeared to Columbia that this would be an appropriate time to propose a hedging plan.

The Attorney General criticizes Columbia's proposed Hedging Plan because there is no measure of any actual volatility reduction. (Attorney General Comments at 1.) However, volatility reduction is the Attorney General's inferred intent of Columbia's Hedging Plan, and not Co-

lumbia's intent. As explained in Columbia's response to Attorney General Data Request Set 1 number 8-2:

> Columbia's stated objective in both the filing and in the Plan itself is that "Implementation of the Plan is intended to reduce the impact that potentially dramatic winter price spikes could have on the Gas Cost Adjustment price and to promote a level of price certainty and stability for Columbia's winter season gas supply." Columbia does not and has not measured the impact on price volatility.

Columbia considers the plan to be beneficial and effective if the Plan is accurately followed, and should result in greater certainty of future winter prices, and through that certainty, should reduce the impact of winter price spikes. Certainly, other Columbia LDCs with Hedging Plans have detailed descriptions of their results, which undergo regulatory scrutiny on a regular basis. Columbia is willing to provide appropriate summaries from which the Commission and interested parties will be able to determine whether they believe the Hedging Program is meeting its objectives.

It is a matter of fact that for each dekatherm hedged by the plan, a known price is developed for that portion of Columbia's supply. As the percentage of supply that has a fixed price grows, the more certainty there will be in Columbia's overall price of gas and the less prone the portfolio will be to price spikes. However, if price volatility is an important issue for the Attorney General, and if a definition of volatility can be agreed upon or set forth by the Commission, Columbia is certainly willing to provide such volatility measurements as part of the proposed reporting process for the hedging program, to the extent it is possible to supply the information requested.

In criticizing the costs associated with hedging programs, the Attorney General compares hedging to insurance. (Attorney General Comments at 2.) Columbia does not believe that the comparison to insurance is entirely accurate. With insurance, one must make payments to the

insurance company whether or not a claim upon a policy is ever made. Under Columbia's proposed Hedging Plan, Columbia simply will contract for a more balanced price portfolio with a greater percentage of the portfolio being fixed (through storage and hedging) as opposed to floating with winter real-time pricing. In effect, Columbia is simply pricing gas months ahead of time instead of hours or days ahead of time. With regard to its comments about insurance, it may be that the Attorney General is referencing some other hedging programs in which financial call options are purchased to effectively cap the price of gas. In those cases, the purchase of the call option would result in a definite cost (the option premium) while the option may or may not ever be exercised to effectuate the ceiling price. In those hedging programs, the efforts are more similar to purchasing insurance.

The Attorney General avers that hedging represents an "absolute cost" to the consumer. (Attorney General Comments at 2.) Columbia disagrees with this assertion. As stated earlier, Columbia is entering into contracts in order to set the price on certain volumes of gas instead of waiting until the day that gas for that day trades in the cash market. It is not a matter of paying more for gas; it is a matter of determining the price of gas at different times.

Under Columbia's proposed Hedging Plan, the results of the plan accrue entirely to customers. When costs of gas hedged by the Plan are lower than current market, customers receive those lower costs. If costs of gas hedged by the Plan are higher than the ultimate market that winter, then customers assume those higher costs. However, Columbia has been careful to develop controls and Trigger Price definitions in the Plan, which are likely to result in hedged prices that are more apt to be considered moderate, because the Trigger Prices are based upon history and averages.

The Attorney General claims, "consumers are required to pay for hedging programs to 'insure' against the price volatility of the markets the utilities are simultaneously being incented to pursue." (Attorney General Comments at 2.) However, the Hedging Plan and the GCIM have entirely different objectives. The Hedging Plan is designed to effectuate a more balanced portfolio by fixing prices on a greater portion of Columbia's supply needs. In contrast, the GCIM compares the price Columbia negotiates for its purchase of physical gas supplies in the physical cash market with prices widely reported as commonly used indices. Even if all of Columbia's supplies were hedged pursuant to the proposed Hedging Plan, there would still be negotiations to purchase the physical gas. Customers would continue to benefit to the extent Columbia can better the market averages.

Finally, the Attorney General criticizes Columbia's proposed Hedging Plan for being too "mechanistic," and recommends the elimination of minimum hedged volume aspect of the proposal. (Attorney General Comments at 3.) While Columbia's Hedging Plan may have some "mechanistic" characteristics, the Hedging Plan was designed to avoid speculation. Columbia does not propose to gamble with customers' money, but believes that through a well reasoned, "mechanistic" approach, Columbia's gas price portfolio might be diversified, resulting in more gas price certainty and less extreme winter price spikes.

In contrast, the Attorney General would have Columbia absorb all risks (costs) when there is no potential for reward. The Attorney General would further require the removal of the minimum volume hedged component of Columbia's Hedging Plan, presumably on the assumption that there should be no restrictions on hedge volumes when gas prices are "low." The problem with the Attorney General's assumption is that it requires one to guess about gas price

trends. The Attorney General's Data Request Set 1 number 14 and Columbia's response thereto illustrate Columbia's concern about the Attorney General's approach:

> Question No. 14
>
> At page 11 of the application it states that use of the two-year window provided "a much better chance that futures prices will drop to the point of allowing prices of be set using the Plan's Trigger prices than would a Plan with a shorter window in which to price supplies."
>
> a. Does this statement reflect an expectation that gas supply prices will be trending downward over the term of the pilot program?
> b. If it does not reflect an expectation that prices will trend downward, to what is the drop in futures prices two years out attributed?
> c. If a downward trend in pricing is expected, does the "rules based" approach of the plan allow Columbia Gas to take full advantage of prices lower than triggering prices or does the fact that the plan is buying two years out prevent adaptation to a downward market trend?
> d. Does the proposal allow Columbia Gas to reduce the volumes of gas hedged at trigger prices to allow it to take advantage of downward pricing trends?
>
> Response of Columbia Gas of Kentucky:
> a. No.
> b. Columbia has not said or indicated that there will be "a drop in prices two years out". Rather, we have indicated that over a two-year time frame in a market as volatile as the natural gas futures market, there is a greater opportunity that prices will drop below Trigger Prices during a two-year period than during a shorter period. This is based on viewing the price range of NYMEX contracts over time.
> c. When futures prices are below trigger prices, hedges will be placed pursuant to the Plan up to the limits provided by the Plan.
> d. The hedging program recognizes that Columbia does not run the program based on speculative opinions about whether there is a trend and whether that trend will continue.

As stated in the data request response, Columbia believes it is inaccurate to assume, as does the Attorney General, that the best results are based on hunches and trends in the market. Columbia maintains that a stricter approach to investing in gas is appropriate. If the Commission were to require that Columbia implement a speculative hedging program, subject to continuous

guesswork by Columbia, regulators and auditors, Columbia would withdraw its hedging proposal.

Program Changes

As stated earlier herein, Columbia is proposing a change to the OSCRA as a result of discussions with marketers subsequent to the filing of the Application in this case. Those same discussions have also resulted in Columbia's decision to permit CHOICE Program marketers to make additional billing rate changes each year before Columbia will assess a fee for billing rate changes. This change will also be addressed in Columbia's Supplement to its Application.

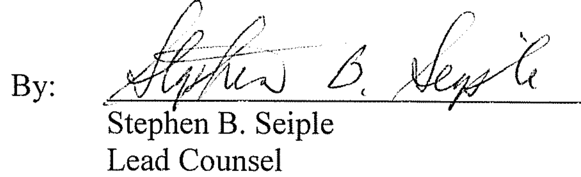
Critical Dates

Columbia appreciates the efforts of all parties to work toward a resolution of this case so that CHOICE customers may continue to receive transportation service without disruption. Columbia reiterates that April 1, 2005, is the critical proposed effective date of the proposed CHOICE program, which includes the Off System Sales and Capacity Release Sharing Mechanism. In order to provide an opportunity for benefits this summer to sales system customers, April 1, 2005 is also a critical date for implementation of Columbia's proposed Gas Cost Incentive Mechanism.

Dated this 24th day of February 2005.

Respectfully submitted,

COLUMBIA GAS OF KENTUCKY, INC.

By: 

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