



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

February 21, 2005

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PUBLIC SERVICE
COMMISSION

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

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

Dear Ms. O'Donnell:

Please find enclosed an original and eight copies of the Response of Louisville Gas and Electric Company to the First Data Request of Commission Staff 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

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

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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
FIRST DATA REQUEST OF COMMISSION STAFF
DATED
FEBRUARY 9, 2005

FILED: FEBRUARY 21, 2005

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to First Data Request of Commission Staff dated February 9, 2005

Question No. 1

Responding Witness: Clay Murphy

- Q-1. Refer to pages 2 and 3 of the application. LG&E states that the Performance Based Rate-making mechanism ("PBR") has encouraged it to, among other things, increase risk-taking and maintain or improve service reliability.
- a. Provide a brief description of each of the risks listed on page 3.
 - b. Explain how the PBR mechanism can help LG&E maintain or improve service reliability.
- A-1. a. On page 3 of its Application, LG&E sets forth certain risks it has assumed in order to achieve savings under its gas supply cost Performance-Based Ratemaking ("PBR") mechanism. Those mentioned include contracting risks, storage management risks, supply management risks, transportation management risks, and credit risks.

While LG&E has assumed additional risks in order to generate savings under its PBR mechanism, LG&E has not assumed those risks without first determining that it can manage those risks. LG&E's paramount goal, irrespective of any incentive mechanism is to ensure reliable service to customers. LG&E does not take actions that would jeopardize the reliability of its system regardless of the potential savings that might be generated under the PBR mechanism. LG&E recognizes that it has an obligation to reliably serve its retail gas customers and that the cost it would incur to correct any failure to serve its customers would substantially outweigh any savings that might be produced under the PBR mechanism.

LG&E evaluates and assumes those risks for which it will be rewarded under the PBR mechanism at the time it develops and establishes its gas supply strategies, at the time it develops its gas supply portfolio, at the time it sets up its monthly gas supply activities, and each day as it manages and evaluates the gas supply activities that it must undertake to provide reliable service to its customers. LG&E's willingness to undertake these risks is derived from the rewards which it can receive. The sharing mechanism under which LG&E operates the PBR mechanism is a symmetrical sliding scale. LG&E shares in the savings (or expenses) up to 4.5% of the benchmarked gas costs on a

25%/75% company/customer basis. Beyond the 4.5% level, LG&E shares on a 50%/50% basis. Therefore, LG&E is at risk unless it performs at least as well as the benchmarks in the mechanism, and it is rewarded to the extent it can outperform those benchmarks.

LG&E has established contracting, operational, credit, or other means of managing the risks. LG&E does not take on risks that jeopardize customer service reliability, but it is willing to take on manageable risks that can yield benefits within the reasonable parameters of the PBR mechanism. Opportunities are not pursued for which the corresponding risks are not both manageable and commensurately rewarded. Because the PBR mechanism aligns the interest of LG&E and its customers, both benefit from the assumption of manageable risks.

The PBR mechanism encourages LG&E to actively respond to changing market conditions and explore more gas supply and pipeline transportation purchase and sales opportunities in an effort to encourage least cost acquisition by sharing savings or absorbing expenses under the PBR mechanism. While many of LG&E's gas supply strategies and actions to achieve savings under the PBR mechanism have proven successful, some have not. Additionally, there is the risk that strategies and activities that are currently successful may be less valuable in the future as the gas market continues to evolve. LG&E continually assesses supply and pipeline transportation purchase and sales opportunities by considering their potential to generate savings or rewards in relation to their associated risks.

By being subject to a risk/reward sharing mechanism (which was not the case before the implementation of LG&E's gas supply cost PBR mechanism) LG&E has undertaken risk to which it would not otherwise have been exposed. LG&E is exposed to risk under the PBR mechanism in two main respects. The first way in which LG&E is exposed to risk is through the overall construction of the mechanism. Unless LG&E is able to perform at least as well as the benchmarks included in the PBR mechanism, it will share in the expenses determined thereunder. The second way in which LG&E is exposed to risk is through the actions that LG&E undertakes in order to generate savings under the mechanism and share in these savings.

In order to maximize savings under its gas supply cost PBR mechanism, LG&E has implemented natural gas supply and pipeline transportation strategies which expose LG&E to contracting risks, storage management risks, transportation management risks, and credit risks. Absent the mechanism, LG&E would not have undertaken these risks and would not have been exposed to them. Each of those risks is further defined below and followed by examples of actions that LG&E has taken, or continues to take, that expose it to risk.

Contracting Risks:

Contracting risks are the risks that LG&E assumes when it enters into gas supply or pipeline transportation agreements which enable LG&E to achieve savings under the PBR mechanism. There is a risk that such agreements will not create savings and, instead, may create expenses under the PBR mechanism.

LG&E begins its determination of its gas supply strategies before a PBR Year begins. Such action is necessary in order to allow LG&E to ensure that the Winter Season gas supply resources (gas commodity, storage, and transportation) required by LG&E to provide reliable service to its retail customers are in place prior to the beginning of the Winter Season. (The Winter Season coincides with the start of the PBR Year, that is, November 1, and continues through March 31.)

At the time that LG&E enters into its gas supply agreements, it is impossible for LG&E to know if the pricing mechanisms included in those agreements will result in LG&E achieving savings or expenses under the Gas Acquisition Index Factor (“GAIF”) component of the PBR mechanism. This is the case because LG&E cannot predict whether the price it has agreed to pay under the contract will result in costs that are higher or lower than the PBR benchmark. LG&E will not know if it has achieved savings under a contract until the end of each contract month, which is when the PBR benchmark can be calculated.

When LG&E evaluates and assembles its gas commodity supply portfolio, it must determine how best to price the required gas supply agreements in relation to the benchmarks incorporated in the GAIF component of the PBR mechanism. The benchmarks incorporate both first-of-month and mid-month price indices. When LG&E determines how to price its supply agreements, it is creating contracting risk since the actual daily market prices that will occur in each month of the PBR Year cannot be known at the time the gas supply portfolio is assembled. Indeed, LG&E cannot know the actual daily prices that will determine the monthly benchmark until the last day of each month of the PBR Year.

In determining the gas supply volumes that should be priced at either a first-of-month or a mid-month price, LG&E also assumes risk with respect to the reservation fees that will be incurred. Contracts that are priced at a first-of-month index have significantly higher reservation fees than contracts priced at mid-month price indices. Importantly, gas supply reservation fees for contracts that are priced at a first-of-month index have risen significantly in recent years. When determining how many agreements to price using a first-of-month index, LG&E must weigh the risk of creating expenses under the

Historical Reservation Fee (“HRF”) component of the GAIF with the potential reward of being able to purchase gas at a first-of-month index when such purchases would create savings under the PBR mechanism. LG&E discusses the risks and results of this aspect of the PBR mechanism in its response to Commission Staff Question No. 2.

In the case of contracting for pipeline transportation services, LG&E assumes contracting risk through the negotiation of discounts with interstate pipeline transportation providers. Securing these discounts requires LG&E to evaluate the options available to it which may include seeking service from other pipelines or purchasing capacity from third-party capacity holders on the pipeline. LG&E must then take action and exploit its particular competitive situation.

Another factor that LG&E evaluates when negotiating pipeline transportation discounts is that the pipeline transporter will limit the applicability of the discount to the market receiving the discount. Therefore, as LG&E pointed out in its response to Commission Staff Question No. 3, to the extent that LG&E releases its discounted firm transportation capacity to a replacement shipper that replacement shipper must deliver gas to LG&E’s primary delivery points or LG&E will lose its discount for that portion of its capacity for the duration of the release. This delivery restriction greatly limits LG&E’s ability to release capacity at rates competitive to other releasers of capacity. However, LG&E assumes the risk that the value of these transportation discounts will outweigh the lost opportunity to release capacity and secure capacity release revenues.

Another factor that LG&E considers when pursuing transportation discounts is the ability and likelihood that the pipeline from whom the discounts are being sought may seek to recapture some of those discounts by bypassing LG&E and serving LG&E’s customers directly. LG&E must consider the risk of a “retribution” bypass when leveraging its competitive position to pursue transportation discounts.

While LG&E has always participated in federal energy regulatory proceedings affecting its pipeline transporters and the services they provide, LG&E has a heightened sense of interest since regulatory changes can affect its performance (and the costs of gas supply to customers) under the PBR mechanism. On a going-forward basis, LG&E assumes certain transportation contracting and management risks arising out of potential changes in regulation by the Federal Energy Regulatory Commission (“FERC”). For example, a risk to which LG&E may be exposed is the potential change in regulation associated with pipeline discounting practices. On November 22, 2004, FERC issued a Notice of Inquiry (“NOI”) addressing the issue of pipeline ratemaking policy as related to transportation discounts offered by interstate pipelines to shippers due to gas-on-gas competition from other

interstate pipelines. The NOI was precipitated by a court order on judicial review on behalf of local distribution companies (“LDCs”) which are captive to a single pipeline. They object to allocating to other customers the revenues lost by pipelines as a result of gas-on-gas competition.

In the NOI, FERC is focused on how the revenue shortfall from discounts will be handled, not whether discounts are allowable. However, if pipelines cannot recover the costs of discounts from other ratepayers through the rate making process, pipelines will be less likely to offer discounts in response to gas-on-gas competition. Because LG&E is served by two interstate pipelines, it has been able to negotiate discounted rates with both pipelines. If FERC changes its discounting policy, the savings which LG&E has been able to achieve under the TIF component of the PBR mechanism could be eliminated, thereby increasing LG&E’s risk under the PBR mechanism.

Storage Management Risks:

Storage management risk is the risk that LG&E assumes in managing its storage withdrawal and injection patterns and schedules in such a way as to ensure that reliability is not jeopardized but also that (to the extent possible) savings can be achieved under the PBR mechanism.

Prior to the PBR mechanism, LG&E did not assume risks associated with its management of storage injection and withdrawal schedules. Currently, under the PBR mechanism, LG&E assumes the risk of managing its storage, not only because it must adhere to contractual requirements and/or good operating practices, but also because it may be required to make purchases when the cost of those purchases exceed the PBR benchmarks. For example, in response to the loads on its system and storage withdrawal and/or injection parameters, LG&E may be required to forego purchases during the month when prices are low, and therefore, forego an opportunity to generate savings under the PBR mechanism relative to the benchmarks. Conversely, for example, in responding to the loads on its system and storage withdrawal and/or injection parameters, LG&E may need to make purchases during the month when prices are high (and may therefore generate expenses under the PBR mechanism relative to the benchmarks). In other words, a certain element of risk is imposed upon LG&E because it is required to serve its system gas loads in a reliable fashion in the context of storage operating parameters, both system loads and operating parameters being variables over which LG&E has no control and yet assumes risk in managing. In addition, LG&E’s Gas Supply and Gas Control departments have carefully coordinated their efforts to accelerate or defer injections to take advantage of lower prices occurring in the market.

LG&E has used storage injection flexibility to take advantage of creative summer supply options of which LG&E has become aware since the

inception of its PBR mechanism. For example, LG&E purchases some Summer Season supplies that allow the supplier to recall (interrupt) the gas. LG&E is exposed to storage management risk associated with such recallable supplies. Although this recallable gas can be purchased at less than market prices, the supplier may interrupt the gas supply being sold to LG&E.

Supply Management Risks:

Supply management risk is the risk that LG&E assumes in aggressively managing its supplies to prevent expenses from being generated under the PBR mechanism. Supply management risk also reflects the exposure that LG&E assumes when it enters into supply agreements that offer the potential to generate savings under the PBR mechanism but may challenge its ability to manage its supplies.

LG&E generates savings under the GAIF by successfully managing supply options available to it in such a way that it can successfully out-perform the benchmarks incorporated in the GAIF. LG&E aggressively manages its gas supplies in order to take advantage of price movements and to ensure that purchases will be made at less than applicable PBR mechanism supply indices. LG&E monitors the daily price of gas to determine if there is an upward or downward price trend. To determine price trends, LG&E monitors *NYMEX* transactions, prices posted in *Gas Daily*, and prices quoted by suppliers. Depending on price movement, LG&E reviews its gas requirements, current purchase agreements, pipeline constraints, and storage capabilities to determine if actions can be taken to reduce gas supply costs by responding to the incentives incorporated in the gas supply cost PBR mechanism.

LG&E must manage its gas supplies in the context of its obligation to serve its customers and the market prices reflected in the benchmarks of the GAIF. Consequently, LG&E is exposed to the risk inherent in the mechanism that, in responding to these load conditions, the purchases it must make may occur when prices are high (and may therefore generate expenses under the PBR mechanism relative to the benchmarks). Conversely, LG&E may be required to forego purchases during the month when prices are low (and may therefore generate savings under the PBR mechanism relative to the benchmarks). In other words, a certain element of risk is imposed on LG&E by being required to serve its system gas loads in a reliable fashion in the context of storage operating parameters, both system loads and operating parameters being variables over which LG&E has no control and yet assumes risk in managing.

LG&E increases its supply management risks by entering into supply arrangements that offer the potential to generate savings under the PBR mechanism but may challenge its ability to manage its supplies. For

example, LG&E purchases most of its Summer Season gas on a shorter-term basis allowing it to incorporate a variety of supply arrangements intended to provide supply at less than market prices. Under some of these arrangements, LG&E purchases a portion of its Summer Season supplies under agreements that provide the supplier with the limited right to “recall” gas for its own use. LG&E also purchases a portion of its Summer Season supplies under agreements that provide the supplier with the limited right to “put” or sell additional volumes of gas to LG&E. Supply agreements with “recall” and “put” rights allow LG&E to purchase gas below an index price but can make it more difficult for LG&E to manage its supply portfolio. Absent the incentive to undertake these kinds of activities, LG&E would not have undertaken the associated risks assumed to generate savings.

LG&E increases its supply management risks by minimizing the amount of supply flexibility that it has under contracts that are priced at a first-of-month index in an effort to reduce the reservation fees associated with such contracts. LG&E must carefully manage the limited flexibility it has under these contracts to respond to price movements in an effort to create savings under the GAIF, and yet at the same time ensure that it has adequate contract flexibility to meet its obligation to serve reliably its retail gas loads.

LG&E increases its supply management risks by purchasing fixed quantities of gas at constrained receipt points. By purchasing a portion of its gas supply at these constrained points, LG&E can avoid the payment of reservation fees and is able to purchase the natural gas at a significant amount below an index price. However, LG&E does assume some risk in doing so. One risk is that LG&E will be able to manage its system in such a way that it can accept the fixed quantities it purchases. Even though the gas is purchased at less than index, LG&E still must ensure that it can physically take the gas. LG&E also gives up the ability to purchase other quantities of gas should the price fall below the price for such gas. Even if gas prices fall to a level below the contract price, LG&E still must take the gas. On a going-forward basis, LG&E is also assuming some risk under the PBR mechanism because potential pipeline expansion projects currently being proposed by Texas Gas Transmission LLC (“Texas Gas”) could ease current restrictions on that portion of its system. If that is the case, LG&E would not be able to secure that gas at a discount.

LG&E increases its supply management risk by selling gas off-system. LG&E must evaluate credit risks as discussed below. In addition to monitoring the loads on its gas system, LG&E must also monitor the activity of the counter-party to whom it has sold gas in order to ensure compliance with the terms of the sale.

Transportation Management Risks:

Transportation management risk is the risk that LG&E assumes in managing its transportation agreements in a low cost manner that generates savings under the Transportation Index Factor (“TIF”) component of the PBR mechanism. LG&E assumes transportation management risk through the release of pipeline capacity not needed for system loads, the negotiation of discounts with interstate pipeline transportation providers, and, in the dispatching and management of pipeline services.

LG&E assumes transportation management risk through the release of pipeline capacity not needed for system loads. In LG&E’s response to Commission Staff Question No. 3, some of the credit risks associated with the release of pipeline capacity are discussed. In addition to the credit risks, LG&E must also ensure that adequate capacity is retained to ensure that reliable service can be maintained for retail customers. LG&E has increased the array of potential replacement shippers, actively searched for replacement shippers, and negotiated the highest possible price for released capacity. LG&E expended more effort to create capacity release revenues in recent years even as changes to the pipelines’ tariffs (as a result of FERC Order 637) have made the market for such capacity more competitive.

Therefore, reliability related risk tolerances are an important factor in determining whether or not an LDC is willing to exploit its particular competitive situation. The LDC must identify potential risks and determine if it is willing to manage such risks prior to seeking discounts. If the LDC chooses to pursue discounts, then it will be required to approach the pipeline and leverage its particular situation in order to begin the discount negotiation process.

LG&E assumes transportation management risk in choosing which pipeline service to dispatch. As with gas commodity supply dispatching, LG&E must respond to system loads and utilize the gas transportation that is required in order to ensure that savings are generated for both the company and its customers under the PBR mechanism. LG&E must ensure that it first dispatches the least cost transportation arrangements in order to ensure that savings are generated under the PBR mechanism.

Credit Risks:

LG&E assumes credit risk that the counter-party will not pay LG&E when it makes an off-system sale. LG&E also assumes credit risk when it releases (sells) pipeline capacity in that the buyer may not pay Texas Gas for the capacity, and as a result LG&E will not receive a credit on its Texas Gas invoice.

There are credit risks in the operation of LG&E's PBR mechanism. For example, in making off-system sales of natural gas, LG&E is essentially extending credit to a counter-party assuming that it will pay LG&E for the gas sold to it by LG&E. During the review period, LG&E generated about \$4,700,606 in net revenue savings under the Off-System Sales Index Factor ("OSSIF") component of the gas supply cost PBR mechanism. In order to achieve that level of savings, LG&E had to sell and extend credit to counter-parties in an amount equal to the amount of the sales. LG&E made off-system natural gas sales in 14 of the 36 months included in the period covered in the review of this PBR mechanism. The average amount of credit extended was about \$2.8 million per month for each of these 14 months. By contrast, net revenues (or savings under the OSSIF) averaged about \$336,000 per month for each of those same months.

Similarly, credit risks can arise in the release of pipeline transportation capacity as discussed in LG&E's response to Commission Staff Question No. 3.

LG&E takes several actions to reduce credit risk. LG&E has credit procedures in place to ensure that when it makes an off-system sale that it is transacting with a creditworthy counter-party. LG&E reviews on an ongoing basis the credit ratings of potential counterparties as determined by credit rating agencies in order to establish credit limits for each counter-party based on its credit ratings and other factors that indicate its creditworthiness. LG&E does not make an off-system sale to a counter-party when that transaction would extend credit to the counter-party in excess of the credit limit determined by LG&E's credit procedures.

- b. LG&E's paramount goal, irrespective of any incentive mechanism which may or may not be in place, is to ensure reliable service to customers. LG&E's current PBR mechanism approved in Case No. 2001-00017 has not resulted in any service reliability problems. The benefits under the gas supply cost PBR mechanism can never outweigh the costs associated with a loss of gas supply reliability

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 yet flexible supply management. LG&E's PBR mechanism does not provide incentives that could encourage it to take actions that sacrifice reliability in order to achieve lower costs. Instead its benchmarks incorporate reasonable benchmarks that encourage actions to maintain reliability at its current level. For example, the gas supply cost PBR mechanism does not encourage LG&E to seek lower cost interruptible or recallable transportation options in lieu of firm pipeline capacities. As such,

the PBR mechanism appropriately benchmarks firm pipeline transportation capacity against its equivalent. The sharing mechanism is also balanced. For example, even though the sharing mechanism incorporates a sliding scale, that sliding scale is symmetrical. Similarly, the sharing mechanism does not incorporate dead-bands, sliding scales, or other mechanisms that penalize (or fail to reward) LG&E for assuming risks. The presence of thresholds, dead-bands, or caps in one or more components of the mechanism could also cause the LDC to pursue gas supply strategies which may endanger reliability in an attempt to outperform a threshold. Other changes to the benchmarking mechanisms can also encourage gas supply contracting which might reduce reliability by encouraging behavior designed to out-perform benchmarks without giving consideration to reliability.

In addition, LG&E has enhanced gas supply reliability. For example, in the process of negotiating a new transportation agreement with Tennessee Gas Pipeline Company ("Tennessee"), LG&E secured a defined minimum delivery pressure guarantee that was greater than that required by Tennessee under its tariff. LG&E determined that such a guarantee was necessary in order to maintain system delivery pressures and operating requirements. If Tennessee had failed to provide such a guarantee, LG&E would have terminated further negotiation with that pipeline irrespective of other factors.

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to First Data Request of Commission Staff dated February 9, 2005

Question No. 2

Responding Witness: Clay Murphy

Q-2. Refer to page 8 of the application. Explain why the savings under the Gas Acquisition Index Factor were substantially higher for the 12 months ended October 31, 2003, than for the corresponding period ended either October 31, 2002, or October 31, 2004.

A-2. The factors that influence the level of savings achieved under the GAIF are reflected in the ability of LG&E's gas supply strategies to respond effectively to a variety of exogenous factors including system loads, price behavior, and supply reservation fees. When comparing the results under the GAIF from one PBR Year to another, it is important to recognize that the factors influencing performance under the GAIF are not constant from one PBR Year to another PBR Year. Consequently, such comparisons are not meaningful except insofar as they demonstrate the risks inherent in the PBR mechanism itself.

The savings or expenses achieved by LG&E under the GAIF component of the PBR mechanism are calculated by comparing the total annual Benchmark Gas Costs ("BGC") for the PBR Year to the total annual Actual Gas Costs ("AGC") for the same period. The BGC is made up of two gas commodity cost components. The first component is Total Annual Benchmarked Gas Commodity Costs ("TABMGCC") and the second component is Historical Reservation Fees ("HRF"). The TABMGCC applies the applicable price indices to all gas commodity purchases on either Texas Gas or Tennessee and the HRF is the average of the reservation fees for the prior two years.

In order to explain why the savings achieved by LG&E under the GAIF of the PBR mechanism were substantially higher for the 12 months ended October 31, 2003, than for the corresponding period ended October 31, 2002, or October 31, 2004, it is important to analyze the savings achieved by LG&E under both the TABMGCC and the HRF components of the BGC. The savings achieved under each of these components is set forth below:

<u>PBR Year Ended</u>	Gas Commodity (TABMGCC) Savings/ (Expenses)	Reservation Fees (HRF) Savings/ (Expenses)	Total GAIF Savings/ (Expenses)
October 31, 2002	\$1,539,237	(\$1,289,242)	\$ 249,995
October 31, 2003	\$7,467,273	\$ 43,552	\$7,510,825
October 31, 2004	\$5,474,359	(\$2,737,394)	\$2,736,965

During the three years referenced, the commodity cost savings for the PBR Year ended October 31, 2003, were approximately \$6,000,000 higher than the commodity cost savings for the PBR Year ended October 31, 2002, and approximately \$2,000,000 higher than the commodity cost savings for PBR Year ended October 31, 2004. The higher commodity cost savings achieved by LG&E for the PBR Year ended October 31, 2003, can be attributed to the ability of LG&E's gas supply strategies to respond to external factors (such as system loads and price behavior), particularly during the months of December 2002, January 2003, and February 2003.

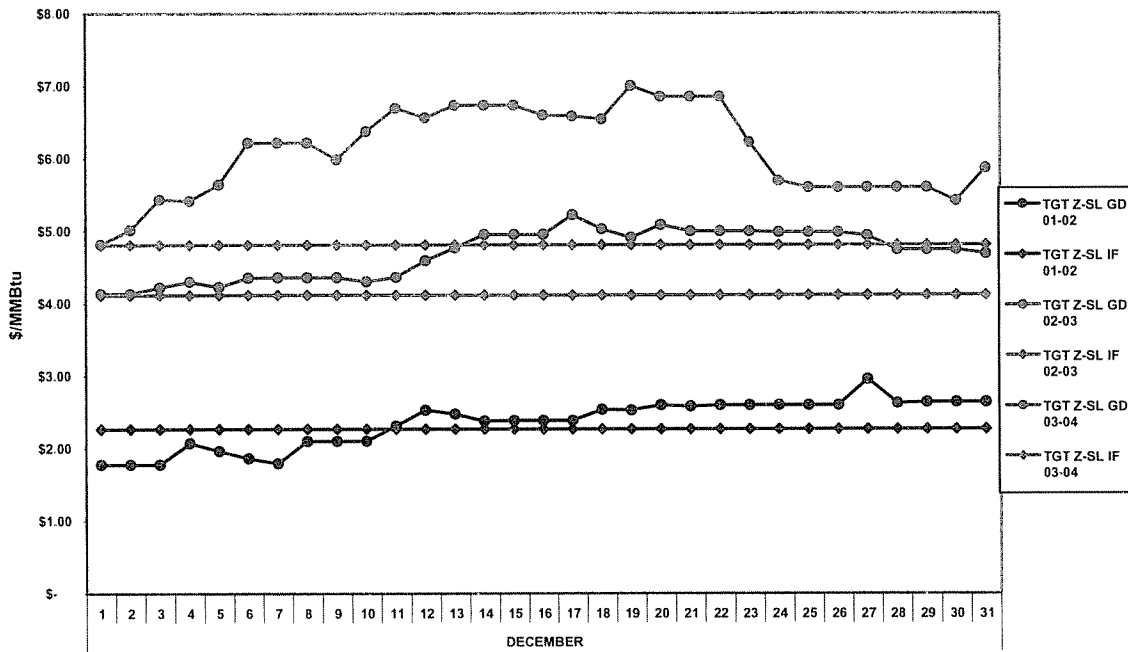
For example, LG&E purchased about 6,600,000 MMBtu more natural gas in the PBR Year ended October 31, 2003, than in the PBR Year ended October 31, 2002, and it purchased about 5,300,000 MMBtu more natural gas in the PBR Year ended October 31, 2003, than in the PBR Year ended October 31, 2004. This factor contributed to the higher level of savings achieved by LG&E for the PBR Year ended October 31, 2003, because the more gas that LG&E is required to purchase during a PBR Year, the more opportunity it has to generate savings or expenses under the PBR mechanism. In the case of the PBR Year ended October 31, 2003, LG&E was able to generate additional savings.

Additionally, gas prices during the months of December 2002, January 2003, and February 2003 generally trended upward as reflected in the indices used to calculate the TABMGCC. The movement of gas prices in these three months during the other two PBR Years did not exhibit the same behavior. Instead the gas prices either exhibited little change from the beginning to the end of the month, or declined during the month.

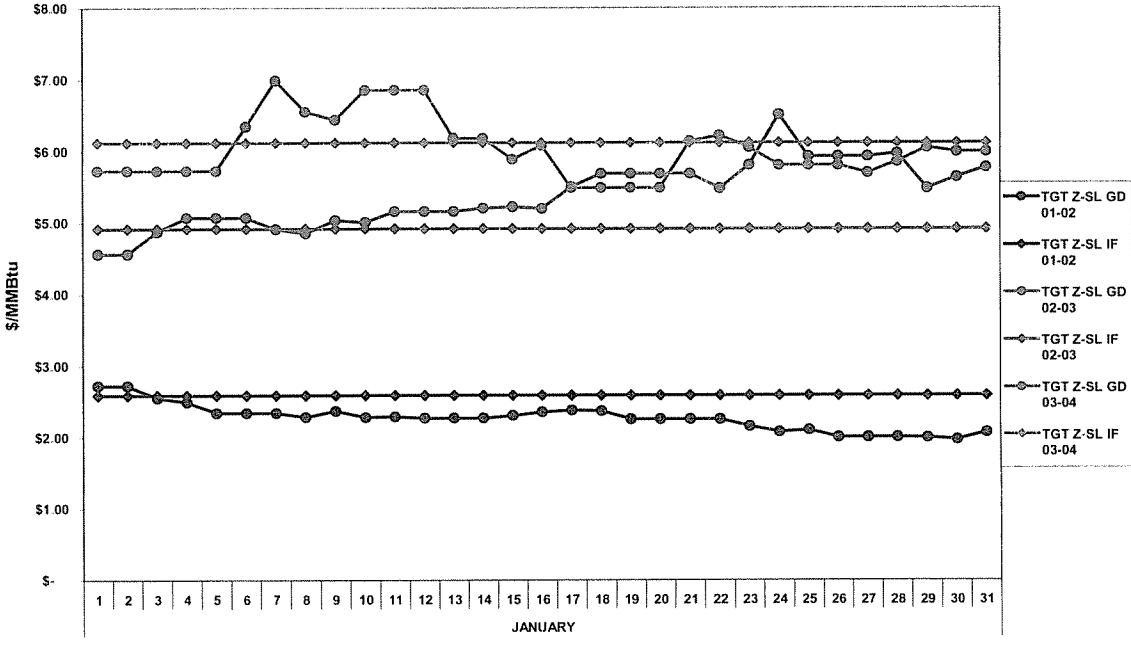
The three graphs included below illustrate the differences in gas price movement that can occur from month to month and year to year. Each graph shows the behavior of prices for gas purchased in Texas Gas's Zone SL ("Texas Gas Zone SL") for the months of December, January and February of the three PBR Years discussed herein. The graphs show the behavior of prices for gas purchased in Texas Gas Zone SL as reflected in both a first-of-month price posting (*Inside F.E.R.C. – Gas Market Report*) and a mid-month price posting (*Gas Daily*). The

blue lines on each chart show the price data for the applicable month for the PBR Year ended October 31, 2002. The red lines on each chart show the price data for the applicable month for the PBR Year ended October 31, 2003, and the green lines show the price data for the applicable month for the PBR Year ended 12 months October 31, 2004. While these charts focus on the movement of gas prices in Texas Gas Zone SL, similar price behavior was seen in gas price postings for Texas Gas Zone 1, Tennessee Zone 0, and Tennessee Zone 1 during December, January, and February of the three PBR Years discussed herein.

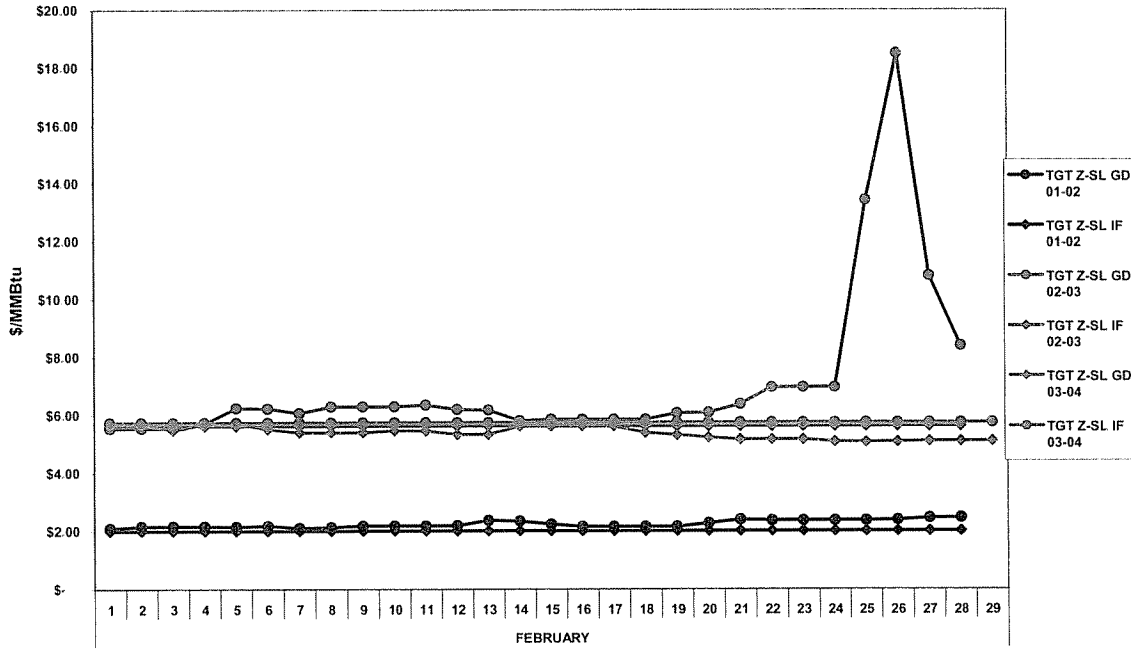
Comparison of Natural Gas Prices
 for PBR Years Ended October 31, 2001, 2002, and 2003
 Month of December



Comparison of Natural Gas Prices
 for PBR Years Ended October 31, 2001, 2002, and 2003
 Month of January



Comparison Natural Gas Prices
 for PBR Years Ended October 31, 2001, 2002, and 2003
 Month of February



As these graphs illustrate, prices in December, January, and February of the PBR Years ended October 31, 2002 and 2004 had different pricing patterns (combined with other load and market characteristics) than the pricing patterns that occurred

in December, January, and February of the PBR Year ended October 31, 2003. This afforded LG&E less opportunity to generate savings under the GAIF component of the PBR mechanism in the PBR Years October 31, 2002 and October, 31, 2004, than during the PBR Year ended October 31, 2003. Conversely, pricing patterns (combined with other load and market characteristics) in the PBR Year ended October 31, 2003, afforded LG&E greater opportunity to generate savings under the GAIF than in the other two PBR Years.

When comparing the savings achieved by LG&E in the PBR Year ended October 31, 2003 versus the PBR Year ended October 31, 2002, it is also important to take into consideration that LG&E's ability to achieve savings under the GAIF for the PBR Year ended October 31, 2002, was reduced by the fact that LG&E did not receive a Commission Order in Case No. 2001-00017 to renew the PBR mechanism until October 26, 2001. In order to ensure reliable supply for its customers, LG&E had already entered into supply contracts by that date that would be in effect during the PBR Year beginning November 1, 2001, and ended October 31, 2002. The provisions of those supply contracts reflected the incentives provided by the GAIF component of the PBR mechanism approved by the Commission in Case No. 97-171. Pursuant to the Commission Order dated October 26, 2001, the Commission modified the incentives provided by the GAIF component of the PBR mechanism effective November 1, 2001. By October 26, 2001, LG&E was unable to adjust its supply portfolio to respond to the new incentives for the PBR Year beginning on November 1, 2001.

Specifically, the PBR mechanism approved in Case No. 97-171 included two first-of-month price indices (*Inside F.E.R.C.--Gas Market Report* and *NYMEX*) and two mid-month price indices (*Gas Daily* and *Natural Gas Week*). Therefore, the original mechanism provided an incentive to purchase 50% of supplies below a first-of-month price and 50% of supplies below a mid-month price. The Commission Order dated October 26, 2001, removed *NYMEX* from the indices used to calculate the GAIF benchmark. As a result, the current PBR mechanism approved in Case No. 2001-00017 includes one first-of-month price index (*Inside F.E.R.C.-Gas Market Report*) and two mid-month price indices (*Gas Daily* and *Natural Gas Week*). Therefore, the current mechanism approved in Case No. 2001-00017 provides an incentive to purchase 33% of supplies below a first-of-month price and 67% of supplies below a mid-month price. The Order dated October 26, 2001, substantially changed the incentives provided to LG&E under the GAIF, but LG&E could not incorporate those incentives into its gas supply strategies until the PBR Year ended October 31, 2003. This contributed to LG&E achieving lower savings under the commodity costs component of the GAIF and higher expenses under the HRF component of the GAIF for the PBR Year ended October 31, 2002.

When comparing the savings achieved by LG&E in the PBR Year ended October 31, 2003, versus the PBR Year ended in either October 31, 2004, or October 31, 2002, in addition to load characteristics and pricing behavior (both variables

outside of LG&E's control), it is important to consider that LG&E's ability to achieve savings under the GAIF was reduced by rising reservation fees. For example, LG&E achieved substantial commodity cost savings under the GAIF for the PBR Year ended October 31, 2004 of about \$5,500,000, but its overall savings under the GAIF were cut in half as a result of about \$2,700,000 in expenses calculated under the HRF component of the GAIF.

The HRF component benchmarks LG&E's annual supply reservation fees for the PBR Year against the average of its annual supply reservation fees for the previous two PBR Years. When negotiating supply agreements in mid-2003 for the PBR Year ended October 31, 2004, LG&E determined that reservation fees had increased significantly for certain types of supply arrangements.

The risk that LG&E has taken under this component to date is evidenced by the fact that LG&E has achieved expenses, not savings, under the HRF component of the GAIF in 5 of the 7 years that it has operated under a PBR mechanism.

LG&E has taken several actions over the years to mitigate the impact of increasing gas supply reservation fees such as reducing the volume of gas supply arrangements priced at first-of-month indices (which pricing arrangements commands higher supply reservation fees), minimizing the monthly volume change flexibility required under its supply agreements (which flexibility command higher supply reservation fees), eliminating shoulder months included in its supply contracts incorporating first-of-month pricing, and relying more on the use of pricing provisions that are tied to daily price indices (which also command lower supply reservation fees). Taking any of these actions to their extreme could result in savings under the HRF, but may reduce supply reliability or result in overall expenses occurring under the GAIF. In developing its annual gas supply strategies, LG&E must balance the extent to which it will take these or other actions to reduce supply reservation fees against its desire to provide reliable, low cost supply to its customers.

Another action which LG&E could take to prevent expenses from occurring under the HRF, but which it has not taken, is to remove longer-term, flexible contracts and their associated reservation fees from its gas supply contract portfolio (that is, "de-contract") and share in the benefits of term supply "de-contracting" through the HRF component of the PBR mechanism. This strategy would require LG&E to purchase all of its gas on a short-term, daily basis subject to the availability of gas supply in the marketplace at the prevailing daily price. LG&E has continued to include longer-term, flexible contracts in its supply portfolio despite the fact that they increase LG&E's exposure to expenses under the HRF component of the GAIF because of the reliability they provide. These contracts are also beneficial because they provide the flexibility to respond to changes in load and in the market price of gas. One way to ensure that the LDC is not encouraged to de-contract is to benchmark reservation fees on a contemporaneous basis, not on an historical basis. Another alternative the Commission may want to consider is

discontinuing the use of the HRF to benchmark LG&E's supply reservation fees, and benchmark those costs outside of the PBR mechanism.

When comparing the total savings achieved under the GAIF during one PBR Year to the total savings achieved during another PBR Year it is important to take into account that the factors that influence performance under the GAIF are not constant from year to year. LG&E had a greater opportunity to create savings under the GAIF component for the PBR Year ended October 31, 2003, as compared to the PBR Years ended October 31, 2002, and October 31, 2004. This is the case because the PBR Year ended October 31, 2003, was characterized by different price behavior and load characteristics, as well as other factors, such as those related to supply reservation fees, than the PBR Years ended either October 31, 2002, or October 31, 2004.

When comparing the total savings achieved by LG&E under the TIF and OSSIF components of the PBR mechanism during one PBR Year to the total savings achieved during another PBR Year, it is also important to take into account that the factors that influence performance are not constant from year to year. For example, savings under the TIF component of the PBR mechanism were greater for the PBR Years ended October 31, 2003 and October 31, 2004 than the PBR Year ended October 31, 2002. This can be attributed to pipeline contracting changes made by LG&E. One contracting change made by LG&E beginning in the PBR Year ended October 31, 2003, was to terminate and renegotiate a transportation agreement with Tennessee under which LG&E was able to decrease its pipeline transportation costs by securing larger pipeline transportation discounts than for the PBR Year ended October 31, 2002.

Additionally, savings under the OSSIF component of the PBR mechanism decreased in the PBR Years ended October 31, 2003, and October 31, 2004, compared to PBR Year ended October 31, 2002. This reduction was, in part, caused by LG&E's reduced reliance on contracts incorporating first-of-month pricing which in turn reduced LG&E's opportunities to make off-system sales. As discussed in this response, LG&E made this change in its gas supply strategies in response to new incentives provided by the Commission in Case No. 2001-00017 and to reduce expenses caused by rising reservation fees under the HRF. LG&E determined that the risk of incurring known higher reservation fees outweighed the potential for exploiting unknown but potential off-system sales opportunities.

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to First Data Request of Commission Staff dated February 9, 2005

Question No. 3

Responding Witness: Clay Murphy

Q-3. Refer to page 11 of the application. LG&E states that one of the ways it ensures savings under the Transportation Index Factor is to release pipeline capacity not required by LG&E to service its customers. Provide a description of when LG&E does not require pipeline capacity and the amount of savings it can generate.

A-3. LG&E's pipeline capacity transportation costs may be offset by credits from the release by LG&E of certain volumes of pipeline capacity. The level of capacity release credits depends on the price negotiated between LG&E and the capacity buyer (subject to FERC regulatory requirements and market conditions) and the volume of capacity released. Like all releasors of capacity, LG&E remains at risk for these capacity release revenues. The replacement shipper (the purchaser of the released capacity) does not pay LG&E (as the releasing shipper) but must pay the pipeline who in turn credits the releasing shipper's (LG&E's) invoice for the amount of the capacity release transaction. If the replacement shipper does not pay the pipeline, the credit on the releasing shipper's (LG&E's) invoice is reversed. It is incumbent on LG&E to monitor the creditworthiness of potential replacement shippers to ensure that it is making releases of capacity to creditworthy entities.

During extreme winter weather conditions, LG&E generally does not have any capacity to release because all of its capacity is needed to meet its retail gas load requirements. During more moderate winter weather conditions, LG&E may have capacity available for release but there may not be a market for the releasable capacity, since many other potential capacity releasors will also have capacity available for release under the same conditions. In other cases, LG&E may choose not to release some of its available pipeline capacity in order to retain the ability to meet unexpected load changes on its system and/or to make full use of the flexibility available to it under its No-Notice Service ("NNS") on Texas Gas's system, thereby maintaining supply reliability.

LG&E's capacity release activity and rights can also be infringed upon by the discount agreements which LG&E is able to negotiate with Texas Gas and Tennessee. Under the terms of those discount agreements, to the extent that LG&E releases its discounted firm transportation capacity to a replacement shipper who delivers gas to points other than LG&E's primary delivery points,

LG&E will lose the discount for that portion of its capacity for the duration of the release. This provision requires LG&E to release capacity with the restriction that such capacity can only be used to deliver gas to LG&E's primary delivery points, which means the gas has to be delivered to LG&E's system. Releasing capacity with this restriction greatly limits LG&E's ability to both release the capacity and to achieve potentially higher rates for the capacity. However, LG&E assumes the risk under the PBR mechanism that the value of the transportation discounts that it has negotiated will outweigh the lost opportunity to release capacity and secure capacity release revenues.

The rates that replacement shippers are willing to pay for released pipeline transportation capacity are a fraction of the pipeline's tariff rates. Many occasions occur when the capacity has no market value whatsoever. In other words, LG&E may be unable to find a buyer for all of the capacity it may have available from time to time. This may be the case because there is no market for the capacity or because of the terms under which LG&E is willing to make the release. For example, LG&E typically releases its capacity for shorter periods and on a recallable basis (that is, LG&E can interrupt the release with adequate notice in order to use the capacity itself to meet its system loads). LG&E may also restrict the use of the capacity being released to deliveries to its system. During the three-year review period, LG&E released 11,608,500 MMBtu at an average rate of \$0.0714/MMBtu to generate total capacity release revenues of \$828,892.50.

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to First Data Request of Commission Staff dated February 9, 2005

Question No. 4

Responding Witness: Clay Murphy

Q-4. Refer to page 12 of the application. LG&E states that it has sought savings under the Off System Sales Index Factor by participating in various sales of natural gas, transportation and storage services in the off system market.

- a. Describe the source of the gas, transportation and storage services sold off-system and include in the response whether these resources were originally purchased to serve LG&E customers.
- b. If yes, is the sale only made if it recoups the amount originally paid for the resource? Explain the response.

A-4.

- a. The savings achieved under the OSSIF have been achieved solely through the sales of gas supplies in the off-system market. All of the gas sold was sourced from gas supply agreements which LG&E had in place to serve LG&E's retail customers in the event of extreme winter weather conditions. Like the release of pipeline capacity discussed in response to Commission Staff Question No. 3, LG&E was able to sell this gas in the off-system market to third parties because the gas was not required to serve retail customer gas loads.

No sales of transportation (other than released pipeline transportation capacity discussed in Commission Staff Question No. 3) or storage services have been made during the review period. Specifically, LG&E did not enter into any storage service transactions because the market for such products would yield little apparent margin, and the PBR sharing mechanism offers little incentive to pursue marginal transactions.

- b. It is LG&E's intention to make an off-system sale of natural gas only if the price the buyer is willing to pay for the gas is greater than the expense LG&E incurs in order to make the sale.

In the case of off-system sales of natural gas, the expenses associated with the gas commodity sale would not have been incurred by LG&E except

for the fact that the sale was made. LG&E notes that on at least one occasion, due to unforeseen market conditions, a sale of natural gas was made in the month of April 2002 which resulted in a net loss.

LG&E also notes that selling gas off-system is not without risk. As discussed in LG&E's response to Commission Staff Question No. 1, credit risk can be associated with making off-system sales of gas.

LOUISVILLE GAS AND ELECTRIC COMPANY

CASE NO. 2005-00031

Response to First Data Request of Commission Staff dated February 9, 2005

Question No. 5

Responding Witness: Clay Murphy

Q-5. Refer to page 13 of the application.

- a. LG&E states that a longer experimental period may enable it to achieve greater savings. Has LG&E considered requesting permanent status for the PBR mechanism?
- b. LG&E proposes new sharing ratios for the PBR mechanisms. Explain the basis for the new sharing ratios. Provide any workpapers or other documentation that support that response.

A-5.

- a. LG&E has considered requesting permanent status of its gas supply cost PBR mechanism but has been dissuaded from doing so for a number of reasons. Chiefly, those reasons relate to the potential evolution of the gas markets and the limited level of rewards received by LG&E under the current sharing mechanism for assuming the potential risks associated with a permanent mechanism.

For example, certain changes in the natural gas markets cannot be anticipated. These changes may be driven by fundamental changes in national energy policies or by federal energy regulatory initiatives, to name just two examples. Such changes could render the mechanism irrelevant, or create risk levels which LG&E would be unwilling to undertake given the reward levels embedded in the mechanism at the time. LG&E, therefore, supports a longer-term 5-year mechanism, which is nonetheless open to periodic review as proposed by LG&E in order to keep the mechanism reflective of changes in market fundamentals and other marketplace realities.

See also LG&E's response to Attorney General Question No. 7.

- b. As the Commission pointed out in its Order dated October 26, 2001, in Case No. 2001-00017, “[b]ecause of the incentives built into the PBR mechanism, it is reasonable to conclude that LG&E’s actual gas costs were less than what they would have been under traditional regulation.” (at p. 4)

The current PBR sharing mechanism is a symmetrical sliding scale. LG&E shares in the savings (or expenses) up to 4.5% of the benchmarked gas costs on a 25%/75% company/customer basis. Beyond the 4.5% level, LG&E shares on a 50%/50% basis.

In order to further increase the incentives provided to LG&E under the PBR mechanism, LG&E proposes that for savings (and expenses) up to 2% of benchmarked gas costs, sharing will be 30%/70% in favor of customers; for savings (and expenses) greater than 2% and up to 3% of benchmarked gas costs, sharing will be 40%/60% in favor of customers; for savings (and expenses) greater than 3% and up to 4% of benchmarked gas costs, sharing will be 50%/50%; and for savings (and expenses) greater than 4% of benchmarked gas costs, sharing will be 60%/40% in favor of LG&E.

The design of LG&E’s proposed sharing mechanism is based on several factors. Those factors include the Commission’s preference for a sliding scale sharing mechanism, the need for the sharing mechanism to be symmetrical, the ability of the mechanism to encourage the desired behavior (savings, not expenses), and the ability of the mechanism to encourage LG&E to take on risks.

LG&E’s requested modification is based upon the recognized preference of the Commission for a sliding scale sharing mechanism in its Order in Case No. 2001-00017. LG&E is proposing to modify the current sliding scale in order to better encourage, incent, and reward effective and efficient gas supply cost management.

The proposed mechanism is based on LG&E’s conclusion that the proposed mechanism should be symmetrical, similar to the current sharing mechanism. Both the current sharing mechanism and the proposed sharing mechanism are symmetrical. Symmetrical sharing mechanisms ensure that both shareholders and customers participate equally in the risks and rewards associated with the gas supply cost PBR mechanism. Sharing mechanisms that are not balanced, or that include thresholds or deadbands, are potentially punitive and create disincentives which could encourage perverse or inappropriate behavior in the context of a gas supply cost PBR mechanism.

Because it is symmetrical, the proposed sharing mechanism will more strongly encourage LG&E, not only to generate savings under the PBR mechanism, but also to prevent expenses under the PBR mechanism. The proposed sharing mechanism is based on the assumption that requiring LG&E's shareholders to assume a greater amount of any expenses under the mechanism will further encourage LG&E to prevent expenses from occurring under the mechanism. Under the current sharing mechanism, LG&E shares 25% of the expenses created under the PBR mechanism to the extent that those expenses are not greater than 4.5% of benchmarked gas costs. Under the proposed sharing mechanism, LG&E would share between 30% and 50% of any expenses generated under the PBR mechanism unless such expenses are greater than 4% of benchmarked gas costs. Under the current sharing mechanism, LG&E would share 50% of any expenses that are greater than 4.5% of benchmarked gas supply costs. Under the proposed sharing mechanism, LG&E would share 60% of any expenses above 4% of benchmarked gas costs. (See Examples A through D in the attached workpapers which compare the expenses that LG&E could be exposed to under both the current and proposed sharing mechanisms.)

The proposed sharing mechanism is also based on the assumption that increasing the opportunity for LG&E's shareholders to share savings under the PBR mechanism will further encourage LG&E to take actions that support efficient gas supply cost management and produce savings under the PBR mechanism. As discussed in LG&E's response to Commission Staff Question No. 1, LG&E assumes a variety of risks operating under the PBR mechanism. The risks which have been (or could be) assumed by LG&E should be rewarded in a manner that encourages LG&E to assume those risks and maximize performance and potential savings for customers. See Examples E through H in the attached workpapers which compare the opportunity for savings that LG&E has under both the current and proposed sharing mechanisms.

Examples of actions that LG&E may take if the current sharing mechanism is modified as proposed by LG&E are set forth in LG&E's response to Attorney General Question No. 11. Also, see Examples I and J in the attached workpapers which illustrate two potential scenarios that require LG&E to balance the risks it may assume under the PBR mechanism, with the potential for reward. Examples of actions that LG&E took to modify its gas supply portfolio and gas supply strategies as a result of the Commission reducing the sharing percentage applicable to LG&E in Case No. 2001-00017 are set forth in Attorney General Question No. 13.

Proposed Sharing Mechanism Workpapers

LG&E's proposed sharing mechanism is based upon the assumption that increasing the exposure of LG&E's shareholders to savings and expenses under the PBR mechanism will further encourage LG&E to take actions that support efficient gas supply cost management. The examples below support LG&E's conclusion that the design of the proposed sharing mechanism produces a better incentive than the design of the current sharing mechanism to encourage LG&E to prevent expenses or achieve savings under the PBR mechanism.

Encouraging Reductions in Expenses: Examples A through D illustrate how the proposed sharing mechanism would be superior to the current mechanism in encouraging lower expenses under the PBR mechanism.

Example A

Assume:

- (i) LG&E generates PBR expenses of \$1,000,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The expenses of \$1,000,000 are 2% of LG&E's benchmarked gas costs ($\$1,000,000 / \$50,000,000 = 2\%$).

Under the current sharing mechanism, LG&E would be exposed to \$250,000 ($\$1,000,000 \times 25\%$), or 25% of the expenses generated. Under the proposed mechanism, LG&E would be exposed to \$300,000 ($\$1,000,000 \times 30\%$) in expenses, or \$50,000 ($\$300,000 - \$250,000$) more in expenses than it would be exposed to under the current sharing mechanism. LG&E is thus encouraged to reduce expenses.

Example B

Assume:

- (i) LG&E generates PBR expenses of \$1,500,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The expenses of \$1,500,000 are 3% of LG&E's benchmarked gas costs ($\$1,500,000 / \$50,000,000 = 3\%$).

Under the current sharing mechanism, LG&E would be exposed to \$375,000 ($\$1,500,000 \times 25\%$), or 25% of the expenses generated. Under the proposed mechanism, LG&E would be exposed to \$500,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%)$] in expenses, or \$125,000 ($\$500,000 - \$375,000$) more in expenses than it would be exposed to under the current sharing mechanism. LG&E is thus encouraged to reduce expenses.

Example C

Assume:

- (i) LG&E generates PBR expenses of \$2,000,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The expenses of \$2,000,000 are 4% of LG&E's benchmarked gas costs ($\$2,000,000 / \$50,000,000 = 4\%$).

Under the current sharing mechanism, LG&E would be exposed to \$500,000 ($\$2,000,000 \times 25\%$), or 25% of the expenses generated. Under the proposed mechanism, LG&E would be exposed to \$750,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%) + (\$500,000 \times 50\%)$] in expenses, or \$250,000 ($\$750,000 - \$500,000$) more in expenses than it would be exposed to under the current sharing mechanism. LG&E is thus encouraged to reduce expenses.

Example D

Assume:

- (i) LG&E generates PBR expenses of \$2,500,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000;
- (iii) The expenses of \$2,500,000 are 5% of LG&E's benchmarked gas costs ($\$2,500,000 / \$50,000,000 = 5\%$), and
- (iv) 4.5% of LG&E's benchmarked costs is equal to \$2,250,000 ($4.5\% \times \$50,000,000 = \$2,250,000$).

Under the current sharing mechanism, LG&E would be exposed to \$687,500 [$(\$2,250,000 \times 25\%) + (\$250,000 \times 50\%)$], or slightly more than 25% of the expenses generated. Under the proposed mechanism, LG&E would be exposed to \$1,050,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%) + (\$500,000 \times 50\%) + (\$500,000 \times 60\%)$] in expenses, or \$362,500 ($\$1,050,000 - \$687,500$) more in expenses than it would be exposed to under the current sharing mechanism. LG&E is thus encouraged to reduce expenses.

Encouraging Savings: Examples E through H illustrate how the proposed sharing mechanism would be superior to the current mechanism in encouraging savings under the PBR mechanism.

Example E

Assume:

- (i) LG&E generates PBR savings of \$1,000,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The savings of \$1,000,000 are 2% of LG&E's benchmarked gas costs ($\$1,000,000 / \$50,000,000 = 2\%$).

Under the current sharing mechanism, LG&E would share in \$250,000 ($\$1,000,000 \times 25\%$), or 25% of the savings generated. Under the proposed mechanism, LG&E would share \$300,000 ($\$1,000,000 \times 30\%$) in savings, or \$50,000 ($\$300,000 - \$250,000$) more in savings than it would share in under the current sharing mechanism. LG&E is thus encouraged to increase savings.

Example F

Assume:

- (i) LG&E generates PBR savings of \$1,500,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The savings of \$1,500,000 are 3% of LG&E's benchmarked gas costs ($\$1,500,000 / \$50,000,000 = 3\%$).

Under the current sharing mechanism, LG&E would share in \$375,000 ($\$1,500,000 \times 25\%$), or 25% of the savings generated. Under the proposed mechanism, LG&E would share in \$500,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%)$] in savings, or \$125,000 ($\$500,000 - \$375,000$) more in savings than it would share in under the current sharing mechanism. LG&E is thus encouraged to increase savings.

Example G

Assume:

- (i) LG&E generates PBR savings of \$2,000,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000, and
- (iii) The savings of \$2,000,000 are 4% of LG&E's benchmarked gas costs ($\$2,000,000 / \$50,000,000 = 4\%$).

Under the current sharing mechanism, LG&E would share in \$500,000 ($\$2,000,000 \times 25\%$), or 25% of the savings generated. Under the proposed mechanism, LG&E would share in \$750,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%) + (\$500,000 \times 50\%)$] in savings, or \$250,000 ($\$750,000 - \$500,000$) more in savings than it would share in under the current sharing mechanism. LG&E is thus encouraged to increase savings.

Example H

Assume:

- (i) LG&E generates PBR savings of \$2,500,000 under the PBR mechanism;
- (ii) Assume LG&E's benchmarked gas costs are \$50,000,000;
- (iii) The savings of \$2,500,000 are 5% of LG&E's benchmarked gas costs ($\$2,500,000 / \$50,000,000 = 5\%$), and
- (iv) 4.5% of LG&E's benchmarked costs is equal to \$2,250,000 ($4.5\% \times \$50,000,000 = \$2,250,000$).

Under the current sharing mechanism, LG&E would share in \$687,500 [$(\$2,250,000 \times 25\%) + (\$250,000 \times 50\%)$], or slightly more than 25% of the savings generated. Under the proposed mechanism, LG&E would share in \$1,050,000 [$(\$1,000,000 \times 30\%) + (\$500,000 \times 40\%) + (\$500,000 \times 50\%) + (\$500,000 \times 60\%)$] in savings, or \$362,500 ($\$1,050,000 - \$687,500$) more in savings than it would share in under the current sharing mechanism. LG&E is thus encouraged to increase savings.

Rewarding Manageable Risk: LG&E's proposed sharing mechanism is based on the assumption that increasing the opportunities for LG&E's shareholders to share savings under the PBR mechanism will further encourage LG&E to take actions that support efficient gas supply cost management but which actions may increase LG&E's exposure to risk. The examples below support LG&E's conclusion that the design of the proposed sharing mechanism produces a better incentive than the design of the current sharing mechanism to encourage LG&E to assume risks associated with certain transactions, and thereby produce greater savings under the PBR mechanism.

Rewarding Risk: Examples I and J illustrate how the proposed sharing mechanism would be superior to the current mechanism in rewarding risks taken under the PBR mechanism. These examples illustrate two of the purchasing decisions that require LG&E to weigh the risk and reward associated with the decision in the context of the incentives provided by the PBR mechanism.

Example I

Assume:

- (i) LG&E has the opportunity to sell 10,000 MMBtu of gas off system for 5 days;
- (ii) The counter-party will pay \$6.25 per MMBtu for the natural gas;
- (iii) It will cost LG&E \$6.15 per MMBtu to purchase the natural gas;
- (iv) The sale will generate \$5,000 [$(10,000 \times 5 \times (\$6.25 - \$6.15))$] in savings under the OSSIF component of the PBR mechanism, and
- (v) LG&E and its customers would assume credit exposure of \$312,500 ($10,000 \times 5 \times \6.25) if LG&E makes the off-system sale.

This scenario would require LG&E to weigh the credit risks of making this transaction against the potential reward it may receive under the PBR mechanism. Under the current sharing mechanism, assuming LG&E produces overall savings under the PBR mechanism that are less than 4.5%, LG&E will share in \$1,250 or 25% of the net revenues (savings) that result from this sale. This amount of money would not be enough for LG&E to assume the credit risk and supply management risk that are inherent in making the sale, and neither LG&E nor its customers would realize any potential benefits. Under the proposed mechanism, depending on the percent of LG&E's savings as compared to its benchmarked gas costs, LG&E will share in \$1,500 to \$3,000 (or 30% to 60%, depending on where the savings fall in the sliding scale) of the savings generated by this off-system sale. Under the proposed mechanism, LG&E is more likely to accept the credit and supply management risks that are inherent in making this off-system sale.

Example J

Assume:

- (i) LG&E has 20,000 MMBtu per day of pipeline capacity to release;
- (ii) A current forecast of LG&E's load requirements indicates that LG&E could release the capacity for 5 days (subject to changes in weather and other factors);
- (iii) LG&E can release 20,000 MMBtu per day of pipeline capacity for 5 days on a non-recallable (firm) basis to Buyer A for \$0.15 per MMBtu per day, or \$15,000, or
- (iv) LG&E can release 20,000 MMBtu per day of pipeline capacity for 5 days on a recallable (interruptible) basis to Buyer B for \$0.05 per MMBtu per day, or \$5,000.

In determining whether to release the capacity to Buyer A or Buyer B, LG&E must weigh the potential savings that each capacity release transaction may produce under the PBR mechanism against the potential credit and supply management risks associated with each potential capacity release. While Buyer A's offer results in \$10,000 (\$15,000 - \$5,000) more in capacity release revenue than Buyer B's offer, Buyer A's offer requires LG&E to assume more credit and transportation management risk than Buyer B's offer. Under the current sharing mechanism, LG&E is less encouraged to accept the additional risks of releasing the capacity to Buyer A for \$15,000 and may choose to release the capacity to Buyer B for \$5,000 to mitigate its credit risk and transportation management risk.