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November 22, 2005

Dennis G. Howard, II
Acting Director
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Suite 200
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PUBLIC SERVICE
COMMISSION

RE: LG&E Gas Cost Adjustment
Case No. 2005-00454

Dear Mr. Howard:

Enclosed please find LG&E's responses to your questions referenced in your November 15, 2005 letter regarding the above-referenced matter.

If you have any questions or concerns, please do not hesitate to contact me.

Sincerely,

Elizabeth L. Cocanougher
Senior Corporate Attorney

ELC/kmw
Enclosure

cc: Beth O'Donnell, Executive Director
Public Service Commission

Question No. 1

With reference to gas used by LG&E for consumption in its gas-fired electrical generators, and gas used to supply its end-use retail customers:

- a. Is there any difference in price? If so, what? If pricing can be compared only on a periodic basis (i.e., January compares to January), please indicate the period compared.**
 - b. Are there different suppliers? If so, why?**
 - c. Is or are any of LG&E's suppliers affiliated in any way with E.ON or any of its subsidiaries?**
 - d. Are there different terms of supply? If so, what?**
 - e. Is any of the gas supply for use in generation of electricity stored, and if so, where?**
- a. The gas costs charged to the electric generation units served by LG&E's gas distribution system and the gas costs recovered from retail gas customers through the Gas Supply Clause ("GSC") are the same. Natural gas used in electric generation is charged at the weighted average cost of purchased gas ("WACOG"),¹ with one exception as explained below.

LG&E provides natural gas supplies to five different generating stations located behind its natural gas distribution system. Specifically, these stations are Cane Run, Mill Creek, Paddy's Run, Zorn, and Waterside.

For all units at these stations except Paddy's Run 13 ("PR13"), gas is transferred from the Gas Business to the Electric Business at the monthly WACOG, which is the same cost level that is recovered from customers through the GSC. Except for PR13, these units generally use volumes of gas which can typically be supplied through LG&E's contractual pipeline entitlements. However, the volume of gas used at PR13 can be both very large and very erratic because it is used to generate electricity. Consequently, LG&E's pipeline capacity is inadequate to supply these volumes and LG&E's Gas Business must purchase gas to meet PR13's forecasted needs.. These gas purchases are charged directly to the Electric Business.

None of the amounts charged to the Electric Business for gas used at these stations are recovered from gas customers through the Gas Supply Clause.

This aspect of LG&E's gas procurement was described in the Commission's "Final Report: Audit of Five Major Kentucky Gas Local Distribution Companies" ("Audit Report"). In Conclusion No. 3 of Section 7 of the audit report dealing with LG&E, the auditors stated:

¹ The WACOG does not reflect the cost of gas from storage, only the cost of the gas that is purchased during that month.

LG&E is a combination gas and electric utility, and Gas Supply provides gas for five (5) electric plants behind the LG&E distribution system. The methods used to charge the plants for gas are appropriate.

Gas Supply procures gas for start-up and stabilization at four (4) of the electric plants, and the electric side of the company pays the average purchased gas cost. The remaining plant (Paddy's Run Unit #13) requests gas as needed, and Gas Supply makes a discrete purchase to meet that requirement, charging the actual cost of the discrete purchase. Further, to insure that no cross-subsidization between the gas and electric sides takes place, Gas Supply charges one (1) hour of time per day for services related to pricing, purchasing, and accounting for that supply.²

In Conclusion No. 6 of Section 7 of the audit report dealing with LG&E, the auditors stated:

The procurement function appears to be in compliance with KRS 278.

Transactions with Servco (the shared services affiliate), which are detailed in the C[ost] A[llocation] M[annual], are based upon Service Agreements that have been filed with the SEC as required by PUHCA, and therefore meet the pricing requirements of KRS 278.2207. Gas procurement services provided to five electric plants behind the LG&E gas distribution lines (see Conclusion #3) are appropriately charged to the electric side of the utility.³

- b. The suppliers from which LG&E purchases gas supplies to serve the gas needs of its Electric Business are among some of the same suppliers that supply gas to LG&E for its retail gas customers.
- c. None of LG&E's suppliers are affiliated in any way with E.ON or any of its subsidiaries.
- d. The term of the supply matches the need for those supplies. Therefore, purchases to serve shorter-term (e.g., daily) needs have different terms than purchases to serve longer-term (e.g., weekly, monthly, seasonal) needs.
- e. Because the natural gas supplied by LG&E to the electric generation facilities described is priced at the weighted average cost of purchased gas as described above,

² Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.3

³ Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.4

LG&E's electric generation stations do not benefit from any gas stored by LG&E in its storage facilities.

Question No. 2

Did LG&E fill to capacity all of its gas storage facilities during the non-heating season? If not, why not, and when did storage begin occurring?

Yes. LG&E's storage injection season commences on or about June 1 and concludes on or about October 31. LG&E reached its targeted working gas inventory level in its on-system storage of about 14,200,000 Mcf on October 31. Because of the injection limitations of on-system storage fields and limited amounts of pipeline capacity to transport gas to LG&E (to serve both retail gas loads and inject gas into storage), LG&E must make its gas purchases throughout the summer months. LG&E must reach targeted inventory levels within these operational constraints and therefore has only a very limited ability to time purchases to coincide with favorable market prices. Without storage volumes at targeted inventory levels, retail gas customers cannot be reliably served.

Question No. 3

Why did LG&E purchase gas when the wholesale price thereof was at its peak?

LG&E assumes that this question is referring to the level of the expected gas costs for November, December, and January that were included in the Gas Supply Clause (“GSC”) filing in Case No. 2005-00401 that was made on September 29, 2005. In that filing, LG&E requested that the Commission approve its Gas Supply Cost Component (“GSCC”) of \$15.4139 effective November 1, 2005. At the time that LG&E made this filing, the actual cost of a portion of its supply costs for November, December, and January were fixed because LG&E had purchased gas in the summer and injected it into storage.¹ The actual cost of the remaining non-storage gas had not been established at the time of the filing since these volumes are purchased at market-clearing prices during November, December, and January. As provided for in LG&E’s GSC, and as set forth in the filing, the cost of this gas was based on the expected cost of gas as reflected by a published index. As of September 29, 2005 the expected cost of gas on the New York Mercantile Exchange (“NYMEX”) for November, December, and January was about \$15/MMBtu.

On November 9, 2005, LG&E filed to reduce its gas supply costs on an interim basis. This opportunity arose because (1) the expected gas price (as reflected on the NYMEX) for December and January had fallen to about \$12/MMBtu, and (2) LG&E had not locked in the purchase of any gas at the \$15/MMBtu level for these months.² Because LG&E had not locked in the \$15/MMBtu price for the non-storage portion of its supply LG&E is able to propose a reduction in its GSCC to reflect the decrease in expected natural gas prices.

LG&E requested the Commission to reduce its rates to reflect the significantly lower expected cost of gas at the first available opportunity. This gas cost reduction to customers could not have been realized if the company had been locked into higher prices for the supply it must purchase this winter. LG&E requested this reduction to reflect lower price expectation in order to allow customers to experience immediate benefits of lower expected gas costs rather than refund potentially over-collected amounts at a later date.

¹ This storage price remains unchanged in filing in Case No. 2005-00454, which LG&E requested to become effective December 1, 2005.

² The decrease in expected prices reflected in the November 8, 2005, filing was due in large measure to increased supply availability as hurricane-damaged facilities are restored to service and decreased demand as a result of milder temperatures. For example, at the time LG&E had proposed rates to become effective November 1, 2005, 80 percent of the natural gas production in the Gulf area was shut-in due to damage caused by Hurricanes Katrina and Rita. As of November 8, 2005, about 45 percent of production was shut-in. Recovery efforts, combined with warmer-than-normal weather have caused expected natural gas prices to decrease.

Question No. 4

Why was the gas price LG&E was prepared to charge its customers approximately 20% greater than the price charged by Delta Natural Gas, a company with 1/10th the customer base of LG&E? Should LG&E consider looking for a new gas supplier, or other means to secure cheaper gas?

LG&E disagrees with the suggestion in the first question that the number of customers somehow has an influence on the price paid for natural gas.

While LG&E is unfamiliar with the particular purchasing strategies and attributes of Delta Natural Gas, there are a number of factors that make the purchasing strategies of each local distribution company (“LDC”) different. These differences can impact both the price paid for natural gas and, consequently, the price charged therefor.

Gas supply strategies among LDCs differ and produce different results depending upon actual events. Over time, LG&E’s strategies have produced gas rates for its residential customers that are below the state and national averages.

A variety of factors can lead to different purchasing strategies for each LDC. The overall strategy for each LDC, though different, can comport with the guidance of the Commission that “[t]he LDCs should maintain their objective of procuring wholesale natural gas supplies at market clearing prices, within the context of maintaining a balanced natural gas supply portfolio that balances the objectives of obtaining low cost gas supplies, minimizing price volatility and maintaining supply reliability.”¹

Factors that can cause price differences among LDCs include, but are not limited to, the following:

- The source of the gas supply accessible to each LDC is limited by the interstate pipelines that transport natural gas to the LDC. For example, the supply that can be accessed on the interstate pipelines that transport natural gas to LG&E comes primarily from the Gulf Coast. Hurricanes Katrina and Rita significantly and adversely impacted Gulf Coast production, reducing supply availability and resulting in higher prices. Other production areas were not similarly affected by hurricane activity.
- The interstate pipeline services required by each LDC can be different. The interstate pipeline transportation service costs of each LDC vary depending on the pipelines that transport natural gas to the LDC and the types of contractual arrangements that each LDC has with its interstate pipeline transporters, and demand and demand characteristics placed on the LDC by its customers.
- The amount of storage accessed by each LDC is different as are the operational constraints associated with that storage. Some LDCs have more storage capacity and some have less. As explained, in LG&E’s response to Question No. 2, LG&E

¹ See Commission Order in Administrative Case No. 384, dated July 17, 2001, at p. 18.

has about 14,000,000 Mcf of storage working gas. The operational constraints associated with storage can also limit the volume of gas that can be injected into or withdrawn from storage each day. As explained in response to Question No. 2, LG&E must purchase gas throughout the summer in order to complete its targeted storage injections. Other LDCs, because of the physical characteristics of their storage, may be able to complete storage injections in a lesser timeframe or during different months. In LG&E's case, it would be impossible for LG&E to purchase all of the gas it requires for storage during one or two months. However, other LDCs may have this option.

Additionally, LDCs use different strategies to mitigate price volatility. A key component of LG&E's strategy is its reliance upon its significant quantities of gas storage to provide gas at a price fixed before the start of the winter.² These volumes are supplemented by gas purchased at market-clearing prices over the course of the winter. Therefore, LG&E's strategy allows it to achieve a balanced portfolio of each type of gas supply (fixed price from storage and market-priced gas) in order to achieve the best price mix for customers.³ Other LDCs may utilize fixed-price contracts for gas purchases because they do not have access to the significant gas storage volumes as does LG&E. Reliance on fixed-price gas supplies can produce different results in different circumstances. The Commission has recognized that fixed price contracts are not a least cost procurement tool and that the use of non-market priced supplies can produce prices that are above market prices.⁴

LG&E has demonstrated and the Commission has accepted⁵ that in LG&E's case, purchasing gas supplies at non-market prices will not further the Commission's direction to mitigate the price volatility to which customers are otherwise exposed,⁶ also recognizing that "the A[ttorney] G[eneral] expressed his preference for no financial hedging activity in order to keep the long-term costs to consumers as low as possible."⁷

The second question presumes that LG&E purchases gas supplies from a single supplier. In fact, LG&E purchases natural gas supplies from many different suppliers through a

² See Commission Order in Administrative Case No. 384, dated July 17, 2001, at p. 5, viz., [t]he Commission recognizes the importance of storage from an operational standpoint and as a means of mitigating the impact of winter price increases on consumers."

³ See Commission Order in Administrative Case No. 384, dated July 17, 2001, at p. 10, viz., "[t]he Commission encourages the LDCs to pursue a balanced portfolio of gas supply contracts...."

⁴ See Commission Order in Administrative Case No. 384, dated July 17, 2001, at pp. 9-10, viz., "[t]he Commission recognizes that obtaining gas supplies at market clearing prices produces lower overall long-run costs and does not suggest that the LDCs turn away from their historic, and current, procurement strategies."

⁵ See Commission Order in Case No. 2004-00198 dated August 6, 2004.

⁶ See Commission Order in Administrative Case No. 384, dated July 17, 2001, at p. 8., viz., "the Commission encourages the LDCs to consider limited hedging strategies as a means of mitigating some portion of the price risks to which consumers are subjected."

⁷ See Commission Order in Case No. 2004-00198 dated August 6, 2004 at pp. 2-3.

competitive bidding process. The purchase of natural gas supplies from many suppliers helps lower costs and enhances supply reliability.

Question No. 5

In the PSC case in which E.ON obtained PSC approval for the acquisition of PowerGen which owned LG&E and Kentucky Utilities (2001-00104), experts for the joint applicants testified that the acquisition would produce additional synergies and cost efficiencies which would be passed on to rate payers.¹ Have any such efficiencies/synergies been produced, and if so, how are they being passed on to LG&E customers? If not, why not?

In terms of gas procurement, synergies are difficult to achieve in a highly commoditized marketplace like that for natural gas. E.ON owns neither other gas distribution companies nor any natural gas production assets in the U.S. Any gas procurement efficiencies are passed on to LG&E's customers through the Gas Supply Clause.

¹ See, e.g. Hearing Transcript, pp. 24, 27; Direct testimony of Dr. Gaul, p. 12; Application, generally.