COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

MODIFICATIONS TO LOUISVILLE GAS AND ELECTRIC COMPANY'S GAS SUPPLY CLAUSE TO INCORPORATE AN EXPERIMENTAL PERFORMANCE-BASED RATEMAKING MECHANISM	) CASE NO. 97-171

ORDER

On April 1, 1997, Louisville Gas and Electric Company ("LG&E") filed an application to modify its Gas Supply Cost ("GSC") tariff to establish an experimental performance-based ratemaking ("PBR") mechanism. The PBR would provide an incentive for LG&E in its wholesale purchases of natural gas wherein, during a three-year experimental period, LG&E will share with its customers any savings realized from its efforts to lower gas costs pursuant to this program. LG&E's actual performance would be compared to benchmarks established based on market performance. LG&E proposed to share 50 percent of any savings, as well as 50 percent of any incremental gas costs. Thus, if LG&E's realized gas cost is higher than the benchmark for that particular component of gas cost, LG&E will charge half of that higher cost to ratepayers through its GSC mechanism. The PBR mechanism had an effective date of May 1, 1997. The Commission suspended the tariff for five months and held a hearing on September 2, 1997.

LG&E's stated purpose in proposing the gas cost PBR mechanism is to achieve benefits such as improved quality of service, reduced costs, and improved returns to shareholders, while at the same time protecting the interests of its customers.

Investigation of a PBR mechanism which would accomplish these results was recommended recently by a management audit conducted for this Commission.

LG&E's proposed PBR mechanism incorporates virtually all the components of its gas cost. The four distinct pieces of the mechanism include gas commodity costs, transportation costs, storage costs associated with Texas Gas Pipeline's No-Notice Service ("NNS"),[1] and off-system sales. There is a fifth component to reconcile under- and over-recoveries of amounts billed through the gas cost incentive sharing.

After considering the evidence of record in this case and being advised, the Commission finds that LG&E's PBR Part A -- Commodity Acquisition Cost should be approved as proposed, with the exception of LG&E's stated intent to net financial transaction costs associated with risk management activities against gas cost savings. To the extent that these costs are labor-related expenses or those typically classified as O&M expenses, these costs should not be recovered through the GSC. Costs incurred by LG&E to implement this experimental program should be reported on a quarterly basis in the GSC filings with an indication of which PBR-related cost item has been charged against savings.

LG&E's PBR Part B -- Transportation Costs should be approved as proposed, with two exceptions. As previously stated, no labor-related expenses or O&M costs should be recovered through the GSC by netting them against transportation cost savings. Likewise, PBR-related costs should be reported quarterly, and any PBR-related costs charged against savings should be indicated.

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1 LG&E's own storage costs are not included.

LG&E should be required to reach a threshold level before it shares capacity release revenue. Because LG&E has already engaged in capacity release activities and arguably has attained some expertise in this area, the Commission believes that LG&E should exhibit an improvement over its past practice before it shares in these revenues. While LG&E did not actually propose that a threshold for sharing be imposed, it did suggest a methodology that might be used if the Commission decided to include one.

LG&E's suggested methodology establishes a market penetration percentage, which is a measure of LG&E's past success in releasing the capacity it had available for release, and applies that percentage to seasonal volumes releasable under design conditions to compute the applicable threshold amount. This amount would be filed within 60 days of the start of the PBR period, and would provide an objective volumetric target for capacity release. At the end of the PBR period, market prices in effect at the time of the capacity releases would be applied to the threshold volumes to determine the dollar amounts available for sharing.

The Commission finds LG&E's suggested methodology acceptable on an experimental basis. It provides an objective benchmark that will be known in advance and does not penalize LG&E for failing to release capacity when it would be in the best interest of its customers not to do so. To implement the capacity release threshold, LG&E should file a tariff that sets out the methodology described in its application and as discussed at the hearing.

LG&E's PBR Part C -- Storage Costs should be denied. Purchases made to replace gas withdrawn pursuant to NNS should be benchmarked against the prevailing cost of gas during the period when such gas must be injected, namely the summer months. LG&E proposed to compare the total withdrawal cost of storage gas at wintertime prices with the cost of storage injections during the following summer. LG&E stated that this component of the PBR mechanism would encourage it to ensure that gas purchased to replace gas withdrawn from storage will be less expensive than winter pipeline purchases, placing LG&E at risk if it was not.

Because of the terms of the NNS tariff which set out LG&E's right to inject and withdraw gas, virtually all withdrawals take place during the winter months, with injections taking place during summer months. LG&E argues that recent experience in the gas market has shown that summer prices for gas are as likely as not to be higher than winter prices, and that if it had used its proposed NNS methodology of arranging for summer injections in the winter at times when it could have known that summer price quotations were lower than prevailing winter prices, it would have achieved savings. There is no assurance, however, that this would be the case in the future. It is more reasonable, and simplifies the total proposed PBR mechanism, for the benchmark to be the cost of gas that is in effect at the time NNS injections are to be made. LG&E would still have the ability to contract for summer injections using prices available in the winter, and employ appropriate risk management practices to do so, if it believes that the experience of the recent past will continue in terms of summer prices being higher than winter prices. This is a riskier course of action than what LG&E had proposed, but the approval of 50 percent sharing for LG&E presupposes that it is willing to assume a higher degree of risk.

NNS storage injection volumes and costs should be included with those in Part A -- Commodity Acquisition Costs. Likewise, proposed Original Sheet No. 14-J and that part of proposed Original Sheet No. 14-K dealing with the No-Notice Storage Index Factor in LG&E's proposed tariff should be denied.

LG&E's PBR Part D -- Off-System Sales should be approved as proposed with the exception that no labor-related expenses or O&M costs should be recovered through the GSC by netting them against off-system sales revenues available for sharing. In addition, LG&E's PBR Part E -- Balance Adjustment should be approved as proposed. Finally, the Commission believes that to properly monitor this PBR mechanism, LG&E should file quarterly a report containing details of each transaction entered into along with spreadsheets and all supporting schedules intended to be used for tracking transactions for each part of the PBR.

IT IS THEREFORE ORDERED that:

1. LG&E's proposed Experimental Performance Based Rate Mechanism as modified herein is approved for a period of three years effective October 1, 1997.

2. Within 30 days of the date of this Order LG&E shall file its revised tariffs reflecting the Experimental Performance Based Rate Mechanism as modified herein including the capacity release threshold.

3. LG&E shall file reports as directed herein.

4. At the end of the three-year experimental period LG&E shall file with this Commission the cumulative results of the PBR program along with its assessment of its

success in realizing improved quality of service, reduced costs, and improved returns to stockholders.

Done at Frankfort, Kentucky, this 30th day of September, 1997.

PUBLIC SERVICE COMMISSION

Linda K Breathitt

Chairman

Vice Chairman

B. J. Helton

Commissioner

ATTEST:

Don Mills

Executive Director