COMMONWEALTH OF KENTUCKY

BEFORE THE 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. 2001-017

O R D E R

In Case No. 97-171, we approved an experimental gas procurement performance-based rate-making mechanism ("PBR") for Louisville Gas and Electric Company ("LG&E").[1] The experimental PBR, approved as a 3-year pilot, benchmarked all components of LG&E's gas cost and provided for a 50/50 sharing between ratepayers and shareholders of the amounts by which LG&E's gas costs varied from the benchmarks. The gas cost/gas procurement components contained in the PBR are: (1) Gas Acquisition Index Factor ("GAIF"); (2) Transportation Index Factor ("TIF"); and (3) Off-System Sales Index Factor ("OSSIF").

The GAIF includes LG&E's commodity costs, which are benchmarked based on the average of four indices, Gas Daily, Natural Gas Week, Inside FERC, and NYMEX closing prices. The GAIF also includes pipeline reservation fees that are benchmarked against the average of the actual reservation fees incurred by LG&E for the two most recent years.

[1] Case No. 97-171, Modification to Louisville Gas and Electric Company's Gas Supply Clause to Incorporate an Experimental Performance-Based Ratemaking Mechanism, Order dated September 25, 1997.

The TIF includes pipeline transportation costs, which are benchmarked against LG&E's pipeline suppliers' FERC-approved transportation rates. LG&E's pipeline suppliers are Texas Gas Company and Tennessee Gas Pipeline Company. The release of pipeline capacity ("capacity release"), which is a sub-part of the TIF component of the PBR, is an activity in which LG&E had engaged prior to the implementation of the PBR. Therefore, the experimental PBR contained a capacity release threshold ("CRT") that LG&E had to exceed before shareholders could participate in any savings realized through capacity release activities. During the pilot, LG&E did not exceed the CRT.

The OSSIF reflects LG&E's net revenues, or savings, from off-system sales transactions. If revenues realized exceed the costs of such transactions, there are savings to be shared between ratepayers and shareholders. If costs exceed revenues, there are increased costs to be shared.

As per the Order approving the pilot PBR, LG&E filed a report and testimony on the 3-year pilot on December 28, 2000.[2] For the pilot period, LG&E reported total savings realized under the PBR of $19.6 million. Because shareholders were not able to participate in any savings achieved as a result of capacity release activity, ratepayers retained $10.7 million of the total while shareholders received $8.9 million through LG&E's Gas Supply Clause ("GSC").

A procedural schedule was established that provided for two rounds of discovery, intervenor testimony, rebuttal testimony, and a formal hearing. The Attorney General of the Commonwealth of Kentucky ("AG") is the only intervenor in this proceeding. A formal hearing in the matter was held September 5, 2001. LG&E filed a response to a

[2] By Order dated November 5, 2000, LG&E was authorized to continue the PBR during the period the Commission was reviewing the operation of the 3-year PBR pilot.

supplemental data request from Commission Staff after the hearing. Briefs were not filed; therefore, the case stands submitted for decision.

SUMMARY OF PROPOSAL

LG&E proposes to retain the existing features of the PBR and to extend it for a period of 5 years. It also proposes to add two new features to the PBR. In the OSSIF category, LG&E presently can sell gas from storage, but cannot sell storage-related services. It proposes to add the sale of storage-related services as part of the OSSIF.[3] LG&E also proposes to add a fourth category to its PBR, a Storage Development and Cost Recovery Factor ("SDCF"), under which it would be able to recover costs and earn a return on new storage enhancement projects through its GSC on a real-time basis. Prior to beginning any such project it would be required to demonstrate that the overall costs were less expensive than the alternative, purchasing additional pipeline storage.[4]

ISSUES

Review of Pilot

LG&E contends that the PBR has functioned properly by providing incentives for it to manage its gas procurement activities in a manner that benefits both ratepayers and shareholders financially while not diminishing the reliability of its gas supply. The AG argues that the PBR should be terminated, based on his contention that LG&E has not demonstrated that ratepayers were better off under the PBR than they would have been under traditional rate-making absent the PBR. The AG contends that LG&E has

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[3] It would sell such services only if the prices were sufficient to cover its variable costs of providing the service and making a contribution to its fixed costs.

[4] If the project ultimately exceeded the cost of pipeline storage, the recoverable cost would be limited to the cost of the storage alternative.

not shown that the sum of the actual costs charged to ratepayers, plus what they were charged for the savings that flowed back to shareholders, was less than what the costs charged to ratepayers would have been absent the PBR.

LG&E claims it would be virtually impossible to attempt to reconstruct the pilot period and determine what its specific purchasing strategies and decisions would have been had there been no PBR during that time. According to LG&E, absent this reconstruction, calculating what its actual gas cost would have been during that period under traditional regulation is virtually impossible. The AG argues that LG&E should have been engaged in least-cost purchasing practices regardless of whether there was a PBR and that the costs achieved during the pilot can be viewed as the level of costs that would have been incurred in the absence of the PBR.

We are not persuaded by the AG's argument that the costs incurred during the PBR pilot accurately reflect the costs that would have been incurred during that period had there been no PBR. Absent the PBR, LG&E would have had different incentives and would have engaged in different purchasing activities. The exact extent of those differences and the quantification of their impact on LG&E's gas costs is what neither LG&E nor the AG can determine. Hence, there is no definitive means by which to say whether or not ratepayers were better or worse off under the PBR compared to traditional regulation. Because of the incentives built into the PBR, it is reasonable to conclude that LG&E's actual gas costs were less than what they would have been under traditional regulation. However, under the PBR ratepayers paid actual costs, <u>plus</u> the shareholders' portion of the savings achieved, based on the difference between

actual costs and benchmarked costs. This creates uncertainty as to whether ratepayers paid more, or less, than they would have paid under traditional regulation.

Even with this uncertainty, we find that the AG has not made a strong argument for terminating the PBR. While LG&E cannot conclusively demonstrate that ratepayers are better off under the PBR, the AG cannot conclusively demonstrate that they would be better off under traditional regulation. Therefore, we find that the PBR should be continued, with modifications, on a pilot basis, to address this uncertainty. Those modifications are discussed in the following sections of this Order.

Modifications to PBR - GAIF

As an alternative to terminating the PBR, the AG makes the following recommendations: (1) that the GAIF commodity cost benchmarks be modified; (2) that the transportation cost benchmark in the TIF be modified; (3) that the proposed SDCF be denied; and (4) that the extended term of the PBR be limited to 2 years.

In the GAIF, the AG argues that the commodity benchmarks are set higher than the costs LG&E would incur under traditional regulation because they are based on contracted capacity in the four zones in which LG&E purchases gas rather than the actual volumes purchased. The AG also argues that using the mathematical average of four indices to establish the benchmark is inappropriate and that specific indices should be used to track purchases made on a monthly basis, a weekly basis, and a daily basis. The AG recommends that the benchmarks be modified to reflect actual volumes purchased and that the various indices be applied to the specific types of purchases that the given index reports (Gas Daily for daily purchases; Natural Gas Week for weekly purchases; and Inside FERC for monthly purchases). The AG would eliminate

NYMEX closing prices from the benchmark on the basis that LG&E's purchases are not structured to be comparable to what those closing prices represent.

LG&E argues that the AG's proposal to use actual volumes purchased in specific zones and to tie the price to a specific index depending upon whether the purchase is monthly, weekly, or daily, would be inappropriate, would create incentives for it to not follow market price changes throughout an entire calendar month, and would improperly insulate it from price risk. LG&E contends the AG's proposal would create inappropriate incentives which could subject it to after-the-fact disallowances because it followed the incentives rather than changes in market prices. LG&E also argues that NYMEX prices should remain in the benchmark calculation, contending that having two indices that reflect first-of-the-month prices (NYMEX and Inside FERC) along with two indices that reflect changing prices throughout the month (Gas Daily and Natural Gas Week) provides a better balance to the results.

The Commission sees some degree of merit in the AG's proposal. Given the uncertainty expressed previously, such a modification, during the pilot, would have resulted in lower GAIF benchmarks, resulting in a reduction in the calculated savings. A reduced level of savings would, therefore, have flowed back to shareholders, resulting in a larger portion of the savings being retained by ratepayers. However, we conclude that such modification would overly limit LG&E's flexibility to acquire gas at the lowest reasonable costs, which could result in higher actual costs than are achievable under the current structure, to the detriment of both shareholders and ratepayers. Therefore, we find that the existing structure of the GAIF commodity benchmarks should be maintained.

We agree, however, with the AG on excluding NYMEX closing prices from the benchmark calculation. Given the nature of LG&E's commodity purchases, the evidence does not support their inclusion in the calculation. As to LG&E's argument concerning the appropriate balance of indices to be reflected in the benchmark, we find a more appropriate balance to be one which reflects one index for monthly purchases, Inside FERC, one index for weekly purchases, Natural Gas Week, and one index for daily purchases, Gas Daily.

Modifications to PBR – TIF

In the TIF, the AG argues that it is inappropriate to use FERC-approved pipeline transportation rates as the benchmarks against which LG&E's negotiated discounted pipeline rates should be measured. The AG claims that discounted rates are typical in the industry at present, that LG&E could have obtained discounts under traditional regulation, and that it should not be rewarded for doing something that other local distribution companies ("LDCs") have done, and are doing, without a PBR. The AG recommends that LG&E's current discounted pipeline transportation rates become the benchmarks against which its pipeline transportation rates would be measured in the future.

LG&E maintains that the AG's proposal, combined with his recommendation that the PBR be extended for only 2 years, would unfairly penalize it for its past efforts to achieve long-term cost savings and limit its ability to seek similar long-term savings in the future. LG&E claims that the AG's proposal does not recognize the linkage between obtaining pipeline discounts and the ability to release capacity. Nor does it recognize the potential impact on reliability related to federal regulatory policy that governs the

conditions under which an LDC may terminate a pipeline contract or have right of first of refusal to continue to have access to pipeline capacity on a going-forward basis.

We find that no change to the current transportation cost benchmark, i.e. – the FERC-approved pipeline rates - should be implemented. While it appears that LG&E would likely have negotiated discounts of some amount in the absence of the PBR, there is no way of knowing what the magnitude and term of those discounts would have been, compared to the discounts negotiated under the PBR. Although, during the pilot, shareholders may have benefited where they otherwise would not have under traditional regulation, we recognize that observing areas that need correction, and then making the necessary corrections, is a primary reason for initially approving programs on a pilot basis. Setting the existing discounts as the benchmark, as proposed by the AG, appears to be a less-than-objective, somewhat punitive means of addressing this issue. We find the FERC-approved transportation rates to be the most objective benchmark for this component of costs. The Commission believes adjusting the sharing mechanism is a more appropriate means of handling any inequity in the benefits and risks between shareholders and ratepayers. That issue is discussed later in this Order.

Modification to PBR - OSSIF

LG&E proposes to add the sale of off-system storage services to the OSSIF component of the PBR. Such services include, but are not limited to, balancing services, displacement services, parking and loan services, and peaking and other storage services. LG&E emphasized that it would not offer to off-system customers firm storage services that would jeopardize service to firm on-system or native load customers. LG&E also emphasized that it would not offer to provide storage services

unless the revenues from such services covered all variable costs and made some contribution to its fixed costs.

The AG made no proposals to modify the OSSIF; nor did he oppose LG&E's proposed addition of storage services. The Commission believes the addition of storage services as part of the OSSIF is reasonable, at least on a pilot basis, and will approve such addition as proposed. However, we intend to closely monitor this activity to ensure that there is no detrimental impact on LG&E's on-system customers, either from a reliability perspective or from a cost perspective.

Modification to PBR - SDRF

LG&E states that, from a cost recovery standpoint, the SDRF will level the playing field between developing on-system storage and purchasing pipeline storage. Under traditional cost recovery treatment, on-system storage facilities are considered part of an LDC's investment in plant on which it is permitted to earn a return through base rates, while pipeline storage costs are recovered through the gas cost adjustment ("GCA"), or GSC, in the case of LG&E. LG&E cites as precedent for its proposal the Commission's treatment of the costs incurred by Delta Natural Gas Company, Inc. ("Delta") for the development of its Canada Mountain storage field.

The AG opposes the SDRF on the basis that such costs are not gas procurement costs, and should not be eligible for recovery in the absence of a general rate application. The AG argues that to permit what LG&E has proposed would constitute single-issue rate-making and allow LG&E to recognize increases in one component of cost without recognizing changes in revenues and other costs.

LG&E points to the fact that a similar mechanism was previously approved for Delta; however, significant differences in circumstances distinguish LG&E's proposal from the Delta situation.[5] Delta had no on-system storage and was totally reliant on expensive purchased storage whereas LG&E already possesses a significant amount of on-system storage capacity. Delta had identified a specific storage development project, the Canada Mountain storage field, as a means of reducing its reliance on expensive pipeline storage; LG&E has no specific projects even in the planning stage at this time. Delta had developed a specific cost estimate for the project; LG&E, having no specific projects planned, has developed no such estimates.

In addition to these distinctions, the AG makes a valid argument against recovering such costs through LG&E's GSC. Absent extraordinary circumstances, such as those Delta faced, we find that the costs of storage development projects should continue to be recovered through base rates. However, having reached this conclusion, we believe that LG&E should have some incentive to pursue such projects. Therefore, although the proposed SDCF is denied, we find that LG&E should be able to submit storage development projects for Commission review, as proposed in the SDCF, to determine if a given project is a cost-effective alternative to purchasing pipeline storage. Projects that pass this review could then be treated as regulatory assets, with LG&E allowed to accrue AFUDC during construction to cover the carrying costs on its investment until such time as it can seek recovery through base rates. In this manner, LG&E would not receive current cost recovery, but it would not forego cost recovery due

[5] Case No. 95-098, The Application of Delta Natural Gas Company, Inc., for an Order Authorizing the Purchase and Financing of the Canada Mountain Storage Field, Order dated September 7, 1995.

to the passage of time between beginning a project and recovering the costs through base rates.[6]

Sharing Ratio

LG&E proposed no change in the existing sharing ratio, under which variances between actual costs and benchmarked costs are shared 50/50 between ratepayers and shareholders. The issue of modifying the ratio was raised through data requests and cross-examination. Generally, both LG&E and the AG indicated that a change in the 50/50 ratio could be appropriate in conjunction with changes in other aspects of the PBR mechanism, and that such a change should reflect changes in the levels of risk to which LG&E is exposed.[7]

The two aspects of the PBR under which LG&E has had the greatest exposure to risk are capacity release and supply reservation fees. LG&E did not better the CRT at any time during the pilot due largely to changes within the industry, which reduced the value of pipeline capacity. In addition, there has been an upward trend in supply reservation fees during the pilot period. The Commission believes that the sharing ratio and the components of the PBR should be, and in fact are, interrelated in such a way that the potential risks and rewards to both ratepayers and shareholders inherent in the various components of the PBR should be reflected in the sharing ratio.

Having considered these risk factors, we find that the CRT should be removed from the PBR given the changes in the industry since the approval of the PBR pilot.

[6] This, of course, depends upon whether LG&E files for base rate recovery in a timely manner.

[7] Such changes should also reflect the potential risks to which ratepayers are exposed.

However, we conclude that supply reservation fees should remain a component of the GAIF rather than being removed from the PBR. Contrary to its experience of consistent inability to exceed the CRT, LG&E achieved savings of $1,304,000 in one year of the pilot and incurred costs of $1,219,000 and $126,000, respectively, in the other years, for a 3-year net cost of $41,000 associated with supply reservation fees. In addition, we agree with LG&E that one of the strengths of its PBR is that it benchmarks every component, every dollar, of gas costs. For these reasons, we find that supply reservation fees should remain a component of the PBR.

Having found that the CRT should be removed from the PBR, and that the AG raises legitimate concerns as to whether ratepayers benefited from the results achieved during the pilot under the PBR versus what results could have been achieved under traditional regulation, we find that the 50/50 sharing does not accurately reflect the relative risks to ratepayers and shareholders. A properly structured PBR, with an appropriate sharing ratio, will better ensure that ratepayers benefit under the PBR compared to traditional regulation. During the pilot, LG&E consistently bettered the benchmarks each and every year by 4 to 6 percent, with an average savings as a percentage of total gas costs equal to 4.7 percent. Given LG&E's inability to demonstrate that ratepayers were better off under the PBR than they would have been under traditional regulation, a 50/50 sharing, after the elimination of the CRT, is unacceptable.

In evaluating possible modifications to the sharing ratio, we have taken into account the concerns expressed by LG&E about various asymmetrical types of sharing methods. Having considered those concerns, the Commission finds that a sliding scale

sharing mechanism should be established. The sliding scale, consisting of two bands, will provide for a larger percentage of savings, or costs, to be shared by ratepayers when the variance from the benchmarked costs is relatively small, but will provide for a 50/50 sharing ratio as the variance becomes larger. Given that LG&E's savings exceeded its actual gas costs by at least 4 percent in each year of the 3-year pilot, and averaged approximately 4.7 percent during that period, we find that the first band should cover variances from the benchmark ranging from 0 percent up to 4.5 percent. For savings or costs within this band the sharing ratio shall be 75/25 in favor of ratepayers. The second band will cover variances of 4.5 percent and greater and will include a sharing ratio of 50/50 between ratepayers and shareholders.

Extended PBR Term

LG&E proposed to extend the term of the PBR for an additional 5 years. The AG's proposal to extend the PBR for only 2 years is based on his argument that ratepayers did not benefit under the PBR, and that, at most, LG&E should have 2 additional years to demonstrate that its PBR does benefit ratepayers. LG&E argued that a 2-year extension was inadequate and would hamper its ability to successfully pursue a least-cost gas procurement strategy.

We find that a 2-year extension would not adequately enable LG&E to operate under the modified PBR approved herein. However, we find no reason to extend the PBR for a full 5 years, as requested by LG&E. The original pilot was approved for 3 years and was extended for an additional year pending completion of this review. Therefore, we find that a second pilot for 4 years, beginning on and after the effective date of this Order, is a reasonable and appropriate extension of the PBR. This 4-year

extension will function in the same way as the cumulative 4-year pilot that was ultimately approved in Case No. 97-171. Within 60 days of the end of the third year, which will be October 31, 2004, LG&E should file a report on the 3-year period ended on that date to initiate a review proceeding of the same type as this proceeding. Throughout the 4-year period, LG&E will continue to file the quarterly reports with the Commission as it has during the initial pilot approved in Case No. 97-171.

The Commission, having considered the evidence of record and being otherwise sufficiently advised, HEREBY ORDERS that:

1. LG&E's pilot gas cost PBR, as modified herein, is extended for 4 years from the date of this Order.

2. LG&E's proposed storage development cost recovery factor is denied.

3. Within 60 days of the end of the third year of the 4-year extension, LG&E shall file an evaluation report on the results of the PBR for the first 3 years of the extension period, and the Commission shall review same for purposes of determining whether the PBR should be continued, modified, or terminated.

4. LG&E shall file quarterly reports of its activity under the extended PBR in the same manner as it has done during the initial PBR pilot period.

5. LG&E shall file its revised tariff sheets setting out the revisions to its PBR tariff, approved herein, within 20 days from the date of this Order.

Done at Frankfort, Kentucky, this 26th day of October, 2001.

By the Commission

ATTEST:

Executive Director