COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY TO IMPLEMENT A PILOT PROGRAM TO EVALUATE THE USE OF A HEDGING PROGRAM TO MITIGATE PRICE VOLATILITY IN THE PROCUREMENT OF NATURAL GAS	)	CASE NO. 2001-128

O R D E R

On May 14, 2001, The Union Light, Heat and Power Company ("ULH&P") filed an application requesting approval of a gas procurement hedging program to be implemented on a pilot basis for the 2001-2002 and 2002-2003 heating seasons. ULH&P also requested approval of changes to the Gas Cost Adjustment ("GCA") clause contained in its tariffs to allow for recovery of the program's costs through its GCA. The proposed hedging program consists of fixed-price contracts, cost-averaging instruments based on the NYMEX strip price for a given period of time, price caps and no-cost collars. Both the Office of the Attorney General ("AG") and Commission Staff ("Staff") submitted information requests to which ULH&P responded on June 13, 2001. Portions of both ULH&P's application and its responses to information requests were filed together with a request for confidential treatment.

On June 27, 2001, the AG filed comments on ULH&P's proposed plan stating his opposition to any hedging plan that would require ratepayers to bear the financial risk of paying all of the transaction costs associated with the plan. The AG also cited the fact that ULH&P had performed no surveys to determine customer support for a hedging program.

ULH&P filed reply comments on July 2, 2001. ULH&P argued that hedging is designed to mitigate price volatility and cannot be viewed as assuring that ratepayers will pay a price that is lower than market. ULH&P also noted that the Commission recently approved a similar pilot hedging program for Western Kentucky Gas Company ("Western") in Case No. 97-513.[1]

PROPOSAL

ULH&P proposes to hedge a limited portion of its base gas supply for the months of November through March.[2] The percentage hedged will be within a minimum and maximum range identified in the application. ULH&P requested that its plan for the 2001-2002 heating season become effective immediately upon Commission approval of the application. The plan describes the volumes of gas to be hedged, the types of instruments to be acquired, the lock-in price for the gas supplies, and a price tolerance range at which the instruments will be acquired.

ULH&P proposes to file a new plan in advance of each heating season and an annual report for each year the program is in effect. ULH&P proposes to file its plan for the 2002-2003 heating season by April 1, 2002, with the plan to become effective 14 days after it is filed, absent any action by the Commission. The annual report will be filed by May 1 of the following year and will report on the plan's impact on reducing price

[1] Case No. 97-513, Modification to Western Kentucky Gas Company, A Division of Atmos Energy Corporation, Gas Cost Adjustment to Incorporate an Experimental Performance-Based Ratemaking Mechanism, Order dated June 15, 2001.

[2] Base gas is defined as the quantity of gas that is purchased each day of the month, regardless of weather or other factors. It is calculated by adding the historical minimum daily load to the maximum daily injections into interstate pipeline storage.

volatility and its impact on ULH&P's GCA customers. ULH&P stressed that the evaluation of the proposed hedging program should be based on its success in stabilizing prices in the long term rather than on realized costs or savings in a particular year.

ULH&P stated that the contracts negotiated under this hedging plan will constitute derivatives, as defined in Statement of Financial Accounting Standards 133 ("SFAS"), Accounting for Derivatives. However, the contracts are exempted from fair value accounting by the normal purchases and sales exemption contained in SFAS Statement 133. ULH&P plans to document these as normal purchases in accordance with SFAS Statement 133.

DISCUSSION

The Commission recently approved Western's program, a program similar to ULH&P's. In approving that proposal, the Commission acknowledged the tension between the objectives of obtaining the lowest gas price and reducing price volatility. ULH&P's proposed hedging program has costs associated with only one component, price caps. The potential remains for ratepayers to pay more than market if the market price falls below the hedged price. This potential, which is part and parcel of any hedging program, does not dissuade us from finding that limited hedging programs can be beneficial. The Commission notes that this potential also exists with storage withdrawals, the cost of which is passed through to ratepayers at a weighted average cost which reflects the prices of gas purchased over several months prior to the winter heating season.

The Commission appreciates the AG's concern regarding public support for hedged gas prices. After all, it is the ratepayer who will ultimately pay for the program's costs regardless of the benefit received. Although ULH&P has not conducted any surveys, it did state in its response to the AG's information request that ULH&P had received thousands of calls this past winter from customers complaining about high bills. ULH&P felt that customers were concerned and negatively impacted by the high prices, leading it to believe that the proposed hedging program would minimize significant future price increases. Information obtained during the Commission's administrative case on increases in natural gas prices also indicated public support for reducing volatility in gas costs.[3]

The Commission does not desire to limit ULH&P's flexibility unduly in implementing its 2001-2002 plan. However, we are aware of the potential level of costs that could be incurred under the plan. Therefore, we will approve the 2001-2002 plan as proposed with modifications. In response to the Staff's information request, ULH&P provided a backcast of the costs and savings that would have occurred if the proposed 2001-2002 plan had been in effect during the 2000-2001 heating season. The response indicated ULH&P could have saved millions of dollars on its gas purchases with price caps accounting for a certain percentage of the total volumes hedged. The calculated savings resulting from the use of price caps, when netted against their costs, accounted for only a small portion of the total calculated savings. In order to guard against excessive costs due to over-reliance on price caps, the Commission will approve the

[3] Administrative Case No. 384, An Investigation of Increasing Wholesale Natural Gas Prices and the Impact of Such Increases on the Retail Customers Served by Kentucky Jurisdictional Natural Gas Distribution Companies.

use of price caps for a portion of the volumes reflected in the 2001-2002 hedging plan. That portion may not exceed the percentage used in the backcast.

The Commission will also impose a modification in the plan for the 2002-2003 winter heating season. ULH&P proposed that its plan for the 2002-2003 winter season become effective 14 days after it is filed. Based on the experience of this proceeding, the Commission finds that a 14-day review period is not sufficient for either the Commission Staff or intervenors to adequately review such a filing. The Commission, therefore, will approve the modified program, and ULH&P's proposed tariff, with the review period for the 2002-2003 plan extended to 45 days.

The Commission stresses that although it encourages ULH&P to explore different purchasing practices, ULH&P is still responsible for making prudent decisions in its gas procurement. ULH&P should pursue an objective of procuring wholesale natural gas supplies at the lowest reasonable costs, within a gas supply portfolio that balances the objectives of obtaining low cost gas supplies, minimizing price volatility and maintaining reliability of supply.

This is the second pilot hedging program approved by the Commission that was submitted in response to the price volatility experienced during the 2000-2001 heating season. As with the previously approved hedging program, we find that certain information, in addition to that proposed by ULH&P, will be necessary in order for the Commission to review the program and evaluate its effectiveness. Such review will be critical in considering whether additional hedging programs by ULH&P, or other companies, might be appropriate in the future.

In order to initiate this review, ULH&P shall file with the Commission, by no later than November 30, 2001, an interim report on the hedging activity in which it engages between now and the November 1, 2001 beginning of the upcoming heating season. This report should identify each contract, the date and cost of each transaction, the price reflected in the contract, and the accounting entries made by ULH&P to record each hedging transaction. The report should also include a brief narrative discussion of the factors that influenced ULH&P's purchasing decisions, including, but not limited to: (1) futures prices or price caps and floors at the time of purchasing decisions; (2) market price trends at the time of purchasing decisions; (3) market price forecasts at the time of purchasing decisions; and (4) nationwide storage levels, and (5) ULH&P's own pipeline storage levels at the time of purchasing decisions.

FINDINGS AND ORDERS

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. ULH&P's proposed hedging plan for the 2001-2002 heating season should be approved on a pilot basis subject to the percentage limitation on the volumes hedged through price caps as described herein.

2. ULH&P's overall pilot hedging program and its proposed changes to its GCA clause should be approved with a 45-day period specified for the review of its 2002-2003 hedging plan.

3. ULH&P should file an interim hedging report, as described herein, no later than November 30, 2001, and a final report on its 2001-2002 hedging plan, as described herein, no later than May 1, 2002.

4. Absent any future change ordered by the Commission, ULH&P should file its 2002-2003 hedging plan by April 1, 2002, the interim report on its 2002-2003 plan by November 30, 2002, and the final report on its 2002-2003 plan by May 1, 2003.

IT IS THEREFORE ORDERED that:

1. ULH&P's pilot hedging program, its hedging plan for the 2001-2002 heating season, and its revised GCA tariff are approved subject to the modifications prescribed herein, effective on and after the date of this Order.

2. ULH&P shall file its revised GCA tariffs within 20 days from the date of this Order.

3. ULH&P shall file an interim hedging report on its 2001-2002 hedging plan as described herein no later than November 30, 2001.

4. ULH&P shall file a final hedging report on its 2001-2002 hedging plan as described herein no later than May 1, 2002.

5. Unless otherwise ordered by the Commission, ULH&P shall file its 2002-2003 hedging plan by April 1, 2002, the interim report on its 2002-2003 plan by November 30, 2002, and the final report on its 2002-2003 plan by May 1, 2003.

Done at Frankfort, Kentucky, this 16th day of July, 2001.

By the Commission

ATTEST:

Wm H Bowker

Deputy Executive Director