COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY TO IMPLEMENT AN EXPERIMENTAL LIMITED NATURAL GAS SUPPLY HEDGING PLAN	))))	CASE NO. 2001-253

<u>O R D E R</u>

On August 13, 2001, Louisville Gas and Electric Company ("LG&E") filed a request for approval of a limited natural gas supply hedging program to be implemented as a pilot for the 2001-2002 heating season. LG&E's filing included a motion for confidentiality on all details of the program.

LG&E proposes to limit its hedging instruments to call options, with the costs and benefits passed on to customers through its Gas Supply Clause ("GSC"). LG&E proposes to establish a Price Stabilization Fund ("PSF"), set at a maximum amount, in order to cap the expense that could be passed on to customers and to permit the costs and benefits of the plan to be tracked, measured and verified separately from its Performance-Based Ratemaking ("PBR") mechanism. LG&E states that it prefers the use of call options over futures contracts in order to allow customers to participate in downward price movements while protecting them against price "fly-ups." Commission Staff and the Attorney General ("AG") submitted data requests to which LG&E responded on September 10, 2001. The AG filed comments on September 14, 2001 and LG&E filed reply comments on September 20, 2001.

DISCUSSION

LG&E would hedge a portion of its base gas requirements for three months of the upcoming heating season. The volume hedged would depend on the price of the options at the time of purchase. The average call option prices cited in LG&E's application ranged from $.0508 per mmBtu for a $7.00 strike price to $.9100 per mmBtu for a $3.00 strike price.

LG&E would document the call options used in its plan in accordance with Financial Accounting Standard 133. The hedging plan will be separate from its PBR so that the plan's costs and benefits will flow through the GSC to its customers. Recognizing that the objectives of a PBR and a hedging plan are at odds, LG&E requests discretion to manage the plan and retain the ability to maximize performance and pursue a least cost purchasing strategy under its PBR.

LG&E proposes to file a report, subject to confidential treatment, immediately after the beginning of the first month of the hedge period. LG&E would describe any transactions entered into, NYMEX prices at the time of transactions, market price trends at the time of transactions, nationwide storage levels at the time of transactions, and its own storage levels at the time of transactions. After the 2001-2002 heating season, LG&E proposes to file a second report that would evaluate the results of the plan in terms of mitigating price volatility. LG&E would make a decision on whether to file a hedging plan for the 2002-2003 heating season at that time or some later date.

The AG's comments include many of the same objections he voiced on other hedging proposals reviewed in recent cases.[1] The AG objects to LG&E's plan on four grounds:

1. The proposal is inherently risky and the benefits are speculative.

2. The plan assigns all costs to customers while creating the opportunity for shareholders to profit under LG&E's PBR.

3. The plan lacks specific definition concerning the volume of gas that will be hedged and the cost of the call options.

4. The plan is limited in nature.

The AG requests that the Commission deny the plan. In the alternative, the AG requests that LG&E be required to share the costs in an amount equivalent to its opportunity to benefit under its PBR, and that the Commission define and limit the hedging devices approved.

In its reply comments, LG&E reiterates that its plan will not provide any benefit to shareholders through its PBR and that the Commission has previously acknowledged that hedging plans may cause customers to pay higher costs over time. LG&E states that it believes that the AG's objections are based, in part, on a misunderstanding of the plan.

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[1] Case No. 1997-513, 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; and Case No. 2001-128, The 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, Order dated July 16, 2001.

LG&E's plan is designed to protect customers against natural gas price spikes similar to those experienced during the 2000-2001 heating season. However, current market prices are much more favorable than they were in the summer and fall of 2000 when increases in the price of natural gas were already being experienced. Nationally, storage volumes are substantially higher than they were last year at this time. It therefore appears that the price of natural gas this coming heating season should experience less upward pressure than last heating season. Although the Commission has approved two hedging plans in recognition of the volatility of natural gas prices, those plans were approved and implemented at a time when market prices for the upcoming heating season were much less favorable than they currently are. For these reasons, and because of the short implementation time prior to the beginning of the 2001-2002 heating season, the Commission concludes that LG&E's proposal is untimely and should be denied. Nevertheless, in keeping with the directives provided in Administrative Case No. 384,[2] the Commission encourages LG&E to file a hedging plan for the 2002-2003 heating season, if it desires, in the spring of 2002, when there will be ample time to implement any approved program.

IT IS THEREFORE ORDERED that LG&E's proposed hedging plan is denied.

[2] Administrative Case No. 384, An Investigation of Increasing Wholesale Natural Gas Prices and The Impacts of Such Increases on the Retail Customers Served by Kentucky's Jurisdictional Natural Gas Distribution Companies, Orders dated January 30, 2001 and July 16, 2001.

Done at Frankfort, Kentucky, this 5th day of October, 2001.

By the Commission

ATTEST:

Executive Director