COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE FINAL REPORT OF WESTERN KENTUCKY GAS ON ITS HEDGING PROGRAM FOR THE 2001-2002 HEATING SEASON AND MOTION TO CONDUCT A HEDGING PROGRAM FOR THE 2002-2003 HEATING SEASON	)	CASE NO. 2002-00093

O R D E R

On March 26, 2002, Western Kentucky Gas Company (Western) filed a report on the gas purchase hedging program it had implemented for the 2001-2002 heating season and a request for approval to implement a gas purchase hedging program for the 2002-2003 heating season. The sole intervenor in this proceeding is the Attorney General of the Commonwealth of the Commonwealth of Kentucky, through his Office of Rate Intervention (AG).

The plan filed by Western for the 2002-2003 heating season is similar to the experimental hedging plan approved by the Commission for the 2001-2002 heating season. The approved plan for the past heating season authorized Western to hedge 25 percent of its winter gas supply requirement using futures contracts. For the coming heating season Western proposes to again hedge 25 percent of its winter supply requirement, but to split the hedged volumes equally between futures contracts and costless collars.

Historically, Western has used storage as a natural hedge for approximately 50 percent of its winter supply and purchased the other 50 percent at market prices through the winter heating season. Under the plan implemented for this past heating season, Western continued its traditional use of storage but purchased 25 percent of its winter supply requirements at market prices and hedged the remaining 25 percent using futures.

From July through September of 2001, Western purchased futures contracts for the months of November 2001 through March 2002. Those contracts, for which Western incurred related transaction costs of $182,000, contained strike prices that averaged between $3.50 and $3.75 per Mcf. Due to the decline in wholesale gas prices experienced over the second half of 2001, which continued during the five-month period for which Western had entered into hedging arrangements, market prices consistently fell below Western s strike prices. Consequently, Western s gas costs, including the transaction costs of the hedging program, were approximately $5.7 million greater for the past heating season than if it had not implemented a hedging plan for a portion of its winter gas supply requirement.[1]

Western states that, although the hedges produced no direct monetary benefit in the form of lower-than-market prices due to the weakened wholesale prices, the program was a success in achieving its primary goal stabilizing gas costs for its customers. Western states that its overall gas purchasing portfolio, including its financial hedging strategy, allowed it to take advantage of the declining trend in wholesale gas prices and reduce its retail price by over 50 percent from the record highs incurred the previous (2000-2001) heating season.

[1] The commodity component in Western s Gas Cost Adjustment, which reflected a mix of gas withdrawn from storage, financial hedges and purchases at market prices, ranged from $3.00 to $3.22 per Mcf during the period November 2001 to March 2002.

PROPOSED PLAN FOR 2002-2003

Western proposes to hedge the same percentage of its winter supply requirement for the 2002-2003 heating season that it did for the 2001-2002 heating season. However, rather than relying exclusively on futures contracts for the upcoming heating season, Western proposes to split the volumes hedged equally between futures and costless collars. Collars allow a utility to establish a range, between a ceiling price and a floor price, for the price of gas, rather than a single price, as with futures. Western stated that employing collars provides additional flexibility within its plan, and that using collars could actually reduce its overall level of transaction costs.

Western provided forecast data from Salomon Smith Barney and DRI-Wefa, Inc. For the 2002-2003 winter season, these two sources forecast prices ranging from $3.50 to $5.00 per Mcf.[2] Western also indicated that it was agreeable to setting a ceiling, with no floor, on hedged volumes as a means of allowing it to reduce or cease hedging activities if price trends appear to head downward.[3]

The AG opposes Western s plan, arguing, as he did in Western s prior hedging case, that the risks and costs of the hedging program should not be borne entirely by ratepayers. The AG goes on to cite the $5.7 million in higher than market price costs that ratepayers incurred this past heating season as reason for his opposition to the plan. If the Commission approves a hedging plan for the 2002-2003 heating season,

[2] Item 3 of the Response to the First Data Request of Commission Staff, filed with the Commission April 24, 2002.

[3] Item 6 of the Response to the Supplemental Data Request of Commission Staff, filed with the Commission May 3, 2002.

the AG argues that it should reduce the volumes hedged to a level less than that proposed by Western.

DISCUSSION

For the 2001-2002 heating season Western effectively hedged 75 percent of its winter supply requirement by using its 50 percent storage hedge and its 25 percent financial hedging program. This resulted in 25 percent of its winter supply requirement being purchased at market prices. However, the decline in market prices that began in the latter part of 2001 and continued during early 2002 resulted in Western s gas cost being $5.7 million greater under the hedging program than if the program had not been implemented.

We note that a plan such as Western s 2001-2002 hedging plan, using fixed price hedging instruments, will be successful in reducing price volatility. Whether such a plan results in the lowest cost to ratepayers is entirely dependent on how market prices compare to hedged prices. In the past heating season, market prices declined, and the hedged prices resulted in higher costs to ratepayers.

The Commission believes the following factors should be considered in reviewing Western s proposed 2002-2003 hedging plan: (1) Western s overall position relative to price volatility and (2) Western s willingness to implement a plan that only establishes a ceiling, with no floor, on hedged volumes. The Commission finds that Western s hedging proposal for the 2002-2003 heating season should be approved with one major modification. In making this finding we considered the following.

First, with 50 percent of Western s winter supply hedged through its use of storage, the Commission must consider whether it is reasonable for the remainder of

Western s winter supply requirement to be subject to market price fluctuations or for some portion thereof to be covered under a hedging program. Second, as compared to the plan implemented for the 2001-2002 heating season, if a hedging program is approved, the Commission must determine whether a fixed portion of Western s winter supply requirement should be hedged, or whether it is more appropriate to establish a range of hedged volumes.

On the first point, the Commission finds that hedging a portion of its winter supply requirement not covered by storage withdrawals is appropriate for Western. Although Western s hedging activity for the 2001-2002 heating season did not produce the absolute lowest costs for ratepayers, it did result in stable prices that were comparable to those of the Commonwealth s other major gas distribution utilities. Given that this past heating season represents only one period from which to review the results of Western s hedging activity, we are not persuaded by the AG s arguments to reduce the level of volumes that will be covered by Western s hedging plan. Therefore, as proposed, we will approve 25 percent of Western s winter supply requirement as the ceiling, or upper limit, on the volumes to be included in the hedging plan.

On the second point, we find that, instead of hedging a fixed component of its winter supply requirement, Western should establish a range of volumes for its hedging program. As previously stated, we find that 25 percent of its winter supply requirement should be the upper limit on the volumes to be hedged by Western. We further find that the range should contain no lower limit, or floor, on the volumes that may be hedged under the hedging plan. This will inject a greater degree of judgement and decision-making into the hedging plan than was included in the plan approved for the 2001-2002 heating season and provide greater flexibility to Western in the event market prices experience a decline similar to that experienced in the summer and fall of 2001.

OTHER ISSUES

Accounting and Reporting Requirements

Western did not propose any changes in the accounting and reporting requirements imposed on it by our Order approving its 2001-2002 hedging plan.[4] The Commission believes the information provided by Western in both its interim and final hedging reports was beneficial in our monitoring the activities of that plan. In order to retain those benefits, we will require that Western comply with the same accounting requirements and reporting requirements for this hedging plan. As required previously, Western is to file its interim report shortly after the November 1 start of the heating season and its final report shortly after the March 31 end of the heating season. As was done in this proceeding, Western should file its final report concurrent with any application for approval of a hedging plan for the subsequent heating season.

Administrative Case 384 Focused Management Audit

A focused management audit of the gas procurement practices of the Commonwealth s major jurisdictional gas distribution utilities, including Western, is currently being conducted for the Commission by The Liberty Consulting Group (Liberty). The fairly broad scope of the audit covers many issues, including hedging programs. The Commission expects to gain a great deal of beneficial information from the audit. However, given that Liberty s final report is not due until several weeks after

[4] Case No. 1997-00513, Modification to Western Kentucky Gas Company, a Division of Atmos Energy Corporation, Gas Cost Adjustment to Incorporate an Experimental Performance-Based Ratemaking Mechanism, Order of June 15, 2002.

the date of this Order, that information will not be available when a decision is required in this proceeding. Therefore, while the decision rendered herein does not have the benefit of Liberty s findings and recommendations on hedging, the Commission intends to take full consideration of those findings and recommendations in any future review of Western s hedging program.

FINDINGS AND ORDERS

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

1. Western s interim and final reports on its 2001-2002 hedging plan should be accepted.

2. Western s request to implement a hedging plan for 2002-2003 should be approved, subject to the modification that there be no lower limit on the volumes that may be hedged.

3. Western should file interim and final hedging reports on its 2002-2003 hedging plan in the same manner as it filed for its 2001-2002 plan.

IT IS THEREFORE ORDERED that:

1. Western s proposed hedging plan for the 2002-2003 heating season is approved as modified herein.

2. Western shall file an interim hedging report on its 2002-2003 hedging plan, containing the same type of information as its interim report on its 2001-2002 hedging plan, with the Commission no later than November 15, 2002.

3. Western shall file a final hedging report on its 2002-2003 hedging plan, containing the same type of information as its final report on its 2001-2002 hedging plan, with the Commission no later than April 15, 2003.

4. In the event Western decides to request approval of a hedging plan for the 2003-2004 heating season, its application for such approval shall be filed concurrent with its final report on its 2002-2003 hedging plan.

Done at Frankfort, Kentucky, this 24th day of May, 2002.

By the Commission

ATTEST:

Wm. H. Bowker

Deputy Executive Director