COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY FOR A DEVIATION TO ALLOW THE UNION LIGHT, HEAT AND POWER COMPANY TO PURCHASE NATURAL GAS FROM CINERGY MARKETING & TRADING	)))))	CASE NO. 2002-00375

O R D E R

On October 11, 2002, The Union Light, Heat and Power Company (ULH&P) filed an application seeking a deviation from the requirements of KRS 278.2207(1)(b) to permit ULH&P to purchase natural gas from an affiliated company, Cinergy Marketing & Trading (CM&T). ULH&P desires to purchase natural gas from CM&T for resale to ULH&P s native load customers. CM&T is engaged in the business of marketing natural gas and electricity. Because of the relationship between ULH&P and CM&T, the pricing for the proposed transaction must comply with KRS 278.2207(1)(b), unless a deviation is granted.

In order to secure its gas supply requirements for the 2002-2003 winter season, ULH&P, along with The Cincinnati Gas & Electric Company and Lawrenceburg Gas Company,[1] issued a request for proposal (RFP) seeking bids on gas supply. ULH&P sent the RFP to 13 producers and marketers and received 10 responses. The responses were evaluated using the following factors: price, supply constraints, diversity of suppliers, suppliers past performance history, suppliers credit ratings, and

[1] ULH&P, The Cincinnati Gas & Electric Company, and Lawrenceburg Gas Company are all regulated affiliate utilities of Cinergy Corp.

suppliers physical constraints. At the end of the review process, 5 suppliers were selected for ULH&P, including CM&T. Pursuant to ULH&P s pilot hedging program[2] procedures and based on the NYMEX (Henry Hub) forward price at that time, ULH&P s Natural Gas Hedging Committee decided to hedge the price of natural gas supply for ULH&P. Based on this decision and the terms of the proposed gas supply agreement, ULH&P negotiated a fixed price for natural gas with CM&T.

The proposed transaction between ULH&P and its affiliate CM&T is governed by KRS 278.2207. The applicable sections provide:

> (1) The terms for transactions between a utility and its affiliates shall be in accordance with the following:
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> (b) Services and products provided to the utility by an affiliate shall be priced at the affiliate s fully distributed cost but in no event greater than market or in compliance with the utility s existing USDA, SEC, or FERC approved cost allocation methodology.
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> (2) A utility may file an application with the commission requesting a deviation from the requirements of this section for a particular transaction or class of transactions. The utility shall have the burden of demonstrating that the requested pricing is reasonable. The commission may grant the deviation if it determines the deviation is in the public interest.

ULH&P states that the proposed transaction with CM&T is not priced in compliance with its existing Securities and Exchange Commission and Federal Energy Regulatory Commission approved cost allocation methodologies because those cost allocation methodologies do no apply to commodity transactions. ULH&P further notes that the

[2] See Case No. 2001-00128, 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 June 7, 2002.

proposed transaction is not priced at CM&T s fully distributed cost because natural gas is a commodity, and as a marketer, CM&T sells natural gas at the market price.[3]

ULH&P contends that a deviation from KRS 278.2207(1)(b) is in the public interest and should be granted for several reasons. First, the use of a competitive bidding process resulted in the transaction with CM&T being initially priced at the market price. Consequently, ULH&P s customers would not pay above-market prices as a result of the transaction. Second, the reservation fee bid by CM&T is lower than the reservation fee bid by other competing suppliers who were not awarded contracts. Thus, ULH&P customers would experience savings if the Commission approves the proposed transaction. Finally, the Agreement ULH&P proposes to enter into with CM&T provides that ULH&P may lock in a fixed price with CM&T and ULH&P states that it has successfully negotiated a fixed price with CM&T for a portion of its gas supply that is below the forward market price. ULH&P contends this could result in additional cost savings for ULH&P s customers. As of October 7, 2002, the closing NYMEX (Henry Hub) price for delivery during November 2002 through January 2003 appears to be substantially above the fixed price ULH&P has negotiated with CM&T.[4]

The Commission finds that ULH&P s proposed transaction with its affiliate CM&T results from a competitive bidding process that was open to numerous gas suppliers and finds that the factors ULH&P used to evaluate the responses appear reasonable. We note that ULH&P s contract with CM&T includes provisions that should minimize the

[3] Application at 2-3.

[4] Application at 8.

possibility that the gas price will exceed the comparable market price. We also note that there is no provision for a change in the reservation fee bid by CM&T. It appears that, as of October 7, 2002, the closing NYMEX (Henry Hub) price for delivery during November 2002 through January 2003 is substantially above the fixed price ULH&P has negotiated to locked in with CM&T.[5] From the information supplied, we find that ULH&P s decision to include CM&T as a gas supplier and its decision to lock in a fixed price with CM&T for a portion of its gas supply is reasonable and further find that the transaction should be beneficial to ULH&P and its customers.

Therefore, the Commission finds that ULH&P s request to deviate from the provisions of KRS 278.2207(1)(b) is reasonable and should be granted. The Commission recognizes that the proposed Agreement with CM&T is for an initial term of 5 months, November 1, 2002 through March 31, 2003, and that it contains an option to extend for additional periods. The Commission finds that the approval to deviate should apply only to the proposed transaction with CM&T to supply gas for the initial 5-month term. ULH&P must seek prior Commission approval for any and all transactions with CM&T not specifically approved herein.

IT IS THEREFORE ORDERED that:

1. ULH&P s request to deviate from the provisions of KRS 278.2207(1)(b), as provided by KRS 278.2207(2), is granted.

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[5] Application at 8.

2. This deviation applies only to the proposed transaction between ULH&P and CM&T for the supply of natural gas for November 1, 2002 through March 31, 2003.

3. ULH&P shall file, within 10 days of their execution, all documents associated with this transaction.

Done at Frankfort, Kentucky, this 1st day of November, 2002.

By the Commission

ATTEST:

Wm H Bowker

Deputy Executive Director