COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY TO IMPLEMENT A NATURAL GAS SUPPLY HEDGE PLAN	)))	CASE NO. 2003-00149

O R D E R

On April 30, 2003, Louisville Gas and Electric Company (LG&E) filed an application proposing two alternative natural gas hedge plans for the winter of 2003-2004. LG&E s proposed alternatives are: (1) a hedge plan for 2003-2004 using storage only, and (2) a hedge plan for 2003-2004 featuring storage and call options.

Alternative 1 would continue LG&E s current natural gas procurement strategies that rely on stored gas to help mitigate price volatility. LG&E s tariff contains additional aids to customers for reducing fluctuations in gas bills, such as its Budget Payment Plan and its quarterly Gas Supply Clause mechanism (GSC). Alternative 1 is essentially what the Commission approved in LG&E s last hedging case.[1]

Alternative 2 would use storage, as in Alternative 1, plus call options to set a ceiling for the price paid for a percentage of LG&E s winter natural gas purchases. The use of call options protects against price fly-ups while also allowing LG&E to participate in price decreases. LG&E s proposal defines several aspects of its plan:

[1] Case No. 2002-00136, The Application of Louisville Gas and Electric Company to Implement a Natural Gas Supply Hedge Plan, Order dated August 20, 2002.

- A Target Strike Price (TSP), which is the lowest strike price for a call that LG&E would purchase. The TSP was determined by using two standard deviations above the average price of the New York Mercantile Exchange over the previous two years.

- A winter maximum financial hedge volume, which is the maximum amount of the winter load that LG&E would cover with calls.

- A Price Stabilization Fund (PSF), which is the maximum amount in total that LG&E would spend purchasing call options. LG&E would not necessarily use the entire PSF to purchase call options; both the actual amount spent and the actual volume hedged would depend on the price of call options at the time of purchase.

LG&E proposed recovery of Alternative 2 s expenses through its GSC. The call options would cover a specified period during the winter heating season, although they would be purchased during a previous time period. Under Alternative 2, LG&E would file two reports with the Commission, the first within 60 days following the first month of the financial hedging plan and the second within 60 days of the final month of the hedging period.

On May 14, 2003, the Attorney General, through his Office for Rate Intervention (AG), was granted intervention in this case. The AG did not issue any interrogatories during the proceedings.

On May 28, 2003, representatives of LG&E, the AG and Commission Staff met at the Commission s offices. On June 2, 2003, LG&E and the AG filed a joint motion to suspend the procedural schedule in order to conduct settlement discussions. On June

20, 2003, the parties filed separate comments, which recommended Alternative 1, and LG&E requested that the case be submitted to the Commission without a hearing.

DISCUSSION

LG&E and the AG both support Alternative 1, although for different reasons. LG&E stated that utilizing the storage only alternative would provide the most cost-effective hedge against gas price volatility. LG&E s analysis showed that its proposed financial hedging strategies do not reduce volatility below that achieved through Alternative 1. The AG also supports Alternative 1, but cites the conflict between LG&E having a Performance Based Ratemaking mechanism in place while operating a financial hedging program as his reason. The AG concurred with LG&E regarding the limited benefit that hedging can provide. The Commission acknowledges that, at the level of financial hedging proposed under Alternative 2, LG&E s customers would experience little additional price mitigation. The Commission is also aware that LG&E already has some of the lowest gas costs in Kentucky. LG&E s and the AG s unanimous support leads the Commission to find in favor of and approve Alternative 1.

FINDINGS AND ORDERS

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that Alternative 1 in LG&E s proposed hedging plan should be approved.

IT IS THEREFORE ORDERED that LG&E shall implement Alternative 1 of its natural gas supply hedging plan.

Done at Frankfort, Kentucky, this July 22, 2003.

By the Commission

ATTEST:

Executive Director