COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY FOR APPROVAL OF A NATURAL GAS PURCHASE HEDGING PLAN FOR THE 2003-2004 HEATING SEASON	)))))	CASE NO. 2003-00151

O R D E R

On May 1, 2003, The Union Light, Heat and Power Company (ULH&P) filed its report on its 2002-2003 natural gas supply hedging plan and an application requesting approval to implement a permanent natural gas supply hedging plan.[1] The proposed permanent hedging plan would consist of fixed-price contracts and no-cost collars, which are the hedging instruments used by ULH&P to acquire a portion of its natural gas supply for the past two winter heating seasons. Under the plan, ULH&P would continue to file annual reports on the operation of its plan with the Commission.

ULH&P s hedging plan would follow the same general parameters that governed its hedging activities for the past two winters, but also includes a request for authority to hedge a portion of its summer natural gas purchases. ULH&P cites the increased demand for natural gas, and the resulting impact on gas prices, caused by the increase in gas-fired electric generation, as the reason for its summer season proposal. Portions of ULH&P s application were filed subject to a request for confidential treatment.

[1] ULH&P has conducted gas supply hedging plans for both the 2001-2002 and 2002-2003 winter heating seasons with Commission approval.

Both the Office of the Attorney General (AG) and Commission Staff submitted data requests to which ULH&P responded on May 21, 2003. An informal conference was held May 30, 2003, ULH&P and the AG filed written comments June 6, 2003, and the case now stands submitted for decision.

BACKGROUND

In Administrative Case No. 384, the Commission directed the Commonwealth s major gas distribution utilities to consider hedging alternatives as a means of addressing the significant price spikes and dramatic volatility in gas prices experienced during the 2000-2001 winter heating season.[2] In response to that directive, ULH&P submitted a hedging plan for the 2001-2002 heating season in May of 2001 and followed that with a similar plan for 2002-2003, which was submitted in May of 2002.[3] Subject to some modification, the Commission approved the plans submitted by ULH&P for use in its pilot gas hedging program.

In its application, ULH&P proposes a long-term gas hedging program that would not require annual filings for Commission approval and that would allow it to hedge its gas purchases for a term 18 months in the future, rather than be limited to just the next heating season, as was the case with its annual filings. ULH&P contends that annual filings, which limit when it can arrange a hedging transaction and the months the

[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, Order dated January 30, 2001.

[3] 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.

hedged purchases are delivered, unduly restrict its ability to take advantage of favorable market conditions. With the greater volatility experienced in wholesale gas markets over the past 3 years and the quickness with which prices respond to outside events, ULH&P argues that it needs greater flexibility in order to enter into hedging transactions at times other than the 6 months prior to a winter heating season and for periods other than just that specific heating season. The frequency with which ULH&P would file for approval of its hedging plan, the plan s duration, and the term of its hedged purchases were issues discussed at the informal conference and later addressed in the AG s and ULH&P s written comments.

ULH&P s proposed plan contains minimum and maximum percentages of its winter season base gas supply that will be subject to hedging. For the summer, its plan does not include a minimum percentage to be hedged. ULH&P s past winter hedging plans, as proposed, included minimums and maximums. For the 2002-2003 plan, the Commission approved a maximum, but eliminated the minimum requirement.

POSITIONS

The AG argues that ULH&P should be required to continue filing annually for Commission review and approval of any hedging plan. He cites the fact that hedging natural gas purchases is still a new endeavor for both ULH&P and the Commission as reason to continue to require annual applications. The AG contends that, even with annual filings, ULH&P can enter into transactions that cover periods beyond the upcoming heating season, or, alternatively, the upcoming summer. Concern about the volatility that ULH&P cites in support of its proposal is, according to the AG, another reason to require continued annual filings. The AG also opposes the plan having a minimum percentage, or floor, to be hedged for the winter heating season. He contends that a minimum requirement tends to produce a level of mechanistic buying without regard to what is occurring in the market.

ULH&P, in its written comments, modified its proposal to implement a permanent hedging plan that will continue until modified by a Commission Order. Therein, ULH&P asks that the plan be approved to continue until modified by a future Commission Order, but that it be required to file within 3 years (by May of 2006) for Commission review and approval of a new hedging application. It renews its proposal to prepare and file annual reports on the operation of its plan, but asks that it be permitted to enter into hedging transactions for a term as long as 24 months from the time of the transaction.

DISCUSSION AND CONCLUSION

The Commission recognizes and appreciates the concerns and arguments put forth by both ULH&P and the AG. We believe that a greater degree of flexibility, as advocated by ULH&P, is appropriate. However, we agree with the AG that a more frequent review than that proposed by ULH&P is necessary given the relative newness of gas hedging programs in Kentucky, as well as the gas supply and pricing conditions presently facing the industry. Therefore, we will approve the following:

1. ULH&P s proposed plan, subject to the following modifications, containing all the proposed components, including the proposed minimum and maximum percentages as part of the winter hedging program.

2. ULH&P must file for Commission approval of any continued hedging plan in two years (by May 15, 2005).

3. Every year, by May 15, ULH&P will file a report on its hedging activities for the 12 months ended the previous March 31, that also identifies all existing hedging arrangements for future purchases.

4. Generally, ULH&P will be permitted to enter into hedging transactions for a term up to 18 months from the time of the transaction. However, to avoid any transactions that extend beyond a reasonable period of time after the next application for approval (May of 2005), the transactions approved herein will only cover the period from the date of this Order through the traditional end of the 2005-2006 heating season, which is March 31, 2006.

Most of these items are self-explanatory; however, further discussion on allowing a minimum percentage in the winter hedging program is required. We find little cause for concern about mechanistic purchasing that does not reflect market conditions, given the documented functioning of ULH&P s management committee, which is responsible for its hedging purchases. Furthermore, in light of the current issues facing the natural gas industry, in terms of both supply and prices, and recognizing the relatively small portion of ULH&P s total winter requirements that will be subject to hedging, the Commission sees having a minimum percentage hedged, given ULH&P s relatively small percentage of gas coming from storage, as an asset to its ratepayers.

IT IS THEREFORE ORDERED that:

1. ULH&P s gas hedging plan is approved, subject to the modifications set forth above, effective with the date of this Order.

2. ULH&P shall file appropriate revisions to the hedging plan portion of its gas tariffs within 20 days from the date of the Order.

Done at Frankfort, Kentucky, this 19th day of June, 2003.

By the Commission

ATTEST:

Executive Director