COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR RENEWAL AND PROPOSED MODIFICATION OF ITS PERFORMANCE-BASED RATEMAKING MECHANISM	))))))	**CASE NO. 2019-00437**

LOUISVILLE GAS AND ELECTRIC COMPANY'S POST-HEARING BRIEF

Louisville Gas and Electric Company ("LG&E" or the "Company") submits this post-hearing brief in support of its December 27, 2019 Application[1] in this matter. As set forth below and in the fully developed record in this case, LG&E's longstanding gas supply cost performance-based ratemaking ("PBR") mechanism has proven to be an extremely valuable tool by which significant gas cost savings have inured to the benefit of LG&E's customers. Its risk/reward feature incentivizes LG&E to purchase gas in a way that achieves those benefits. Without it, LG&E would purchase gas in a more conservative way, thereby eliminating the possibility of maximizing gas cost savings for customers. Given the demonstrated advantages of the PBR mechanism, the Commission should renew its approval of the PBR mechanism with LG&E's proposed modifications.

I. BACKGROUND

The Commission first approved LG&E's PBR mechanism over 22 years ago and renewed it most recently in Case No. 2014-00476[2] for a five-year period. That renewal is set to expire on

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[1] LG&E submitted J. Clay Murphy's Direct Testimony ("Murphy Testimony") in support of its Application. That testimony included LG&E's December 27, 2019 Report to the Public Service Commission on Gas Supply Cost Performance-Based Ratemaking Mechanism ("Report").

[2] Case No. 2014-0076, *In the Matter of: Louisville Gas and Electric Company's Proposed Renewal and Modification of its Performance-Based Ratemaking Mechanism*, Order, June 30, 2015, p. 7.

October 31, 2020; therefore, LG&E's Application has requested a renewal for another five years which would end on October 31, 2025. After LG&E filed its Application, the Attorney General of the Commonwealth of Kentucky ("AG") moved to intervene, and the Commission granted the AG's intervention on January 24, 2020. As this case progressed, LG&E responded to two sets of data requests from both the Commission Staff and the AG. The AG did not file any testimony and noted that this case could be decided based upon the existing record, but LG&E requested a hearing. The Commission granted that request, and an evidentiary hearing was held on June 22, 2020. Commission Staff then issued post-hearing data requests to which LG&E responded on July 8, 2020. The Commission provided the parties the option to file post-hearing briefs no later than July 15, 2020. Accordingly, LG&E submits this brief. As set forth below, the Commission should approve LG&E's Application in full.

II. ARGUMENT

A. LG&E's PBR mechanism is necessary to achieve the desired savings and that PBR mechanism satisfies any reasonable cost/benefit test.

Gas supply cost PBR mechanisms are primarily designed to provide local gas distribution companies ("LDCs") like LG&E with incentives to achieve performance superior to the least cost acquisition or prudence standard. They are voluntary risk/reward mechanisms that benchmark gas costs in a transparent and objective way. As the Commission has said, those benchmarks are tantamount to the least cost acquisition or prudence standard that any regulated utility must meet in its purchasing practices:

> LDCs should maintain their objective of procuring wholesale natural gas supplies at *market clearing prices*, within the context of maintaining a balanced natural gas supply portfolio that balances the objectives of obtaining low cost gas supplies, minimizing price volatility, and maintaining reliability of supply.[3]

[3] See Order in Administrative Case No. 384 dated July 17, 2001, p. 18 (emphasis added).

In other words, the benchmarks in a properly constructed PBR mechanism are the "market clearing prices" that LDCs must achieve to meet their obligation to purchase gas in a prudent or "least cost" fashion. Thus, LG&E may purchase gas at those "market clearing prices" and fulfill its obligation to purchase gas in a least cost manner. However, if LG&E is willing to take on a certain amount of risk in *how, when,* and *where* purchases are made, then a properly incentivized mechanism can encourage the Company to purchase gas supplies at less than market clearing prices. If the Company can do that successfully, gas supply costs are reduced, thereby producing savings not otherwise achievable that are shared by LG&E and its customers under the PBR mechanism.

On the other hand, if there is no incentive for LG&E to take on that purchasing risk, the prudent and conservative way for LG&E to purchase gas will be to simply purchase gas at market clearing prices. LG&E would cease or limit the purchasing strategies that can achieve savings such as: purchasing gas at first-of-month indices to avoid price increases occurring during the month; purchasing gas at daily indices during the month as prices fall; shifting purchases made at one supply zone to another in order to capture a lower zonal price; securing pipeline discounts; or making off-system sales.[4] For these reasons, the Commission has long supported PBR mechanisms for LDCs as a way to incentivize cost savings in a prudent manner.[5]

LG&E's PBR mechanism does not change *what* LG&E does in purchasing gas: obviously, it must purchase gas and that is *what* it will do. But the PBR mechanism changes *how*[6] it purchases gas by incentivizing LG&E to develop purchasing strategies with an acceptable degree of risk that,

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[4] See LG&E's response to PSC 1-4 for an exhaustive list of LG&E's purchasing activities that would stop or be limited absent its PBR mechanism.
[5] See LG&E's response to PSC 1-4 for a detailed description of the Commission's wise history of supporting and approving PBR mechanisms for LDCs.
[6] See LG&E's response to PSC 2-10.

hopefully, but not necessarily, will "beat" the market clearing price standards that are the "benchmarks" built into the PBR mechanism. Also, because the PBR mechanism does not change *what* LG&E must do to procure gas, the costs for LG&E's gas procurement activities are unaffected by the absence or presence of a PBR mechanism.[7] Thus, with *no* additional cost (which are embedded in base rates), the PBR mechanism creates an opportunity to achieve gas cost savings for customers.

The Commission can be sure that LG&E's PBR mechanism meets any reasonable cost/benefit test because the PBR mechanism *itself* is a continuous cost/benefit test with a proven track record of producing significant benefits for customers that outweigh any costs. Yes, it requires LG&E to take on risk in its gas procurement activities, but history has shown that the benefits outweigh those risks. LG&E explained this in its Report that was filed with Mr. Murphy's testimony which states:

> By specifying benchmarks, LG&E's gas supply cost PBR mechanism establishes the cost/benefit test to determine the effectiveness of LG&E's procurement activity. The benchmarks which are established prior to the beginning of the operation of the PBR mechanism are objective benchmarks that are intended to incent the utility to perform as desired. The benchmarks provide a meaningful framework for measuring and reviewing performance. LG&E's performance is measured by comparing actual costs to benchmark costs to determine the savings or expenses resulting under the PBR mechanism.[8]

LG&E has demonstrated that its PBR mechanism does not incentivize LG&E to take unacceptable risks that could affect reliability, service, or damage its "brand."[9] Indeed, LG&E has shown that its well-constructed PBR mechanism achieves benefits regardless of market environments, price trends, or volatility levels.

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[7] See LG&E's response to PSC's Post-Hearing Data Request No. 6.
[8] Report, p. 5.
[9] See LG&E's response to PSC 1-9.

Finally, although the amount of savings achieved over the years has varied, LG&E's share of those savings is properly sized as that share has been only approximately 3.5% of LG&E's net income on an after-tax basis for the last four years.[10]

B. The design and components of LG&E's PBR mechanism are reasonable and have consistently encouraged the desired results.

LG&E's PBR mechanism has three basic components which are the Gas Acquisition Index Factor ("GAIF"), the Transportation Index Factor ("TIF"), and the Off-System Sales Index Factor ("OSSIF").[11] The sum of the savings achieved by these three factors are then shared asymmetrically between LG&E and its customers in favor of customers.

The GAIF component benchmarks LG&E's actual gas purchase costs against a calculated benchmark of the market price of gas. To the extent LG&E can procure gas at a cost less than the benchmarked market price, savings are achieved. The GAIF benchmarks are set in a way that is consistent with the Commission's prudence threshold of "market clearing prices."[12] By using recognized sources of natural gas pricing information available in the industry[13] and that are specific to the geographic locations or "supply zones" available to LG&E, the resulting benchmarks are representative of the market price for gas.[14] The PBR mechanism incentivizes LG&E to purchase gas from a variety of geographical supply zones and to pursue a variety of flexible (and reliable) gas supply agreements in an effort to beat the market clearing prices set by the benchmarks. The result has been significant savings over the last four years of approximately $11.1 million.[15]

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[10] See LG&E's response to PSC's Post-Hearing Data Request No. 1.
[11] Report, p. 7.
[12] See Order in Administrative Case No. 384 dated July 17, 2001, p. 18.
[13] The indices used for the PBR mechanism are published by *Natural Gas Week, Platts Gas Daily, and Platts Inside FERC's Gas Market Report.*
[14] Report, p. 8.
[15] Report, p. 9.

The TIF component benchmarks LG&E's actual pipeline transportation costs against the transportation rates approved by the Federal Energy Regulatory Commission ("FERC"). LG&E has firm pipeline transportation capacity entitlements on the interstate pipeline systems of Texas Gas Transmission, LLC ("Texas Gas") and Tennessee Gas Pipeline Company, LLC ("Tennessee Gas").[16] FERC is the regulatory body having jurisdiction over, and establishing the rates charged by, Texas Gas and Tennessee Gas. Thus, the FERC-approved tariff rates for those two entities are used to set the TIF transportation benchmarks. Importantly, FERC has very recently reviewed interstate pipeline transportation rates in connection with the tax changes in the Tax Cuts and Jobs Act of 2017. As a result of FERC's review, Texas Gas' rates remained the same and Tennessee Gas' rates will have phased-in reductions through 2022.[17]

In some circumstances, a pipeline customer may be able to negotiate a discount from the FERC-approved rate. For LG&E, it has been able to negotiate a discount with Tennessee Gas, but it has been unable to do so with Texas Gas. The difference between the FERC-approved rate and the discounted rate creates the savings shared by LG&E and its customers. The ability to obtain such a discount depends on a number of factors, including: market conditions, capacity availability, type of service, or a unique competitive situation. But regardless of the circumstances, an interstate pipeline entity is <u>not</u> required to offer any discount at all.[18]

Since the FERC-approved rates for Tennessee Gas are undergoing phased-in reductions, the difference between LG&E's discounted rate and the FERC-approved rate – which difference adds to savings achieved for LG&E and its customers – will decrease in the future, all else being equal.

[16] Report, p. 8.
[17] Report, p. 10, fn. 4.
[18] Report, p. 10.

The fact that LG&E has negotiated a discount with Tennessee Gas has raised the question of whether the benchmark for Tennessee Gas purchases under the TIF component should be that discounted rate. Setting the benchmark at the discounted rate creates a flawed benchmark. Discounts are voluntary on the part of the pipeline, and pipelines may withhold discounts even if they have unsold capacity available which remains unsold at the FERC approved rate.[19] Moreover, the existence and level of any discounts can and do evolve over time due to marketplace changes driven by increased electric generation gas loads, demand for liquefied natural gas, and exports to Mexico.[20] Finally, discontinuing the use of FERC-approved rates to benchmark PBR activities could have unintended negative impacts on reliability by encouraging cheaper, less reliable alternatives to firm proprietary pipeline capacity. Certainly, the PBR mechanism should not be altered in ways that sacrifice reliability.

As a result of the TIF component, LG&E has been able to achieve significant savings for it and its customers over the years. Over the last four years, savings of approximately $8.9 million[21] were achieved.

The OSSIF component of the PBR mechanism is simple. To the extent LG&E can sell gas to off-system purchasers for more than LG&E's out-of-pocket costs incurred to make such sales, any difference is shared between LG&E and its retail customers. An "off-system" sale is the resale of natural gas to parties other than LG&E's retail customers. While the savings achieved under the OSSIF component are not as significant as under the other two components, LG&E has been able to achieve such savings of approximately $0.7 million over the last four years.[22]

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[19] Report, p. 10
[20] LG&E's response to PSC 1-1, p. 2 of 9, shows the increasing demand for natural gas for electric generation, liquefied natural gas, and exports to Mexico.
[21] Report, p. 11.
[22] Report, p. 11.

C. LG&E's proposed modifications to the PBR mechanism, including the "sharing" percentages, are reasonable and should be approved.

LG&E has requested three main changes[23] to the PBR mechanism. First, of course, LG&E has requested that it be renewed and approved for another five years.[24] As discussed above, the PBR mechanism has proven to be a very valuable tool for LG&E that has encouraged behavior resulting in significant gas cost savings for customers. Without it, those savings would not have been achieved. On that basis alone, the mechanism should be renewed.

Second, LG&E has requested an addition to the gas commodity benchmarking component by adding the New York Mercantile Exchange ("NYMEX") settled closing price to be used under the GAIF component of the PBR mechanism.[25] This additional benchmark would expand LG&E's gas supply contracting opportunities similar to those provided for in Atmos Energy Corporation's PBR mechanism which includes NYMEX as a benchmark.[26] Gas suppliers have proposed pricing arrangements to LG&E using the widely-followed and industry-respected natural gas NYMEX price, but because NYMEX is not a component of the current PBR mechanism, LG&E has declined to enter into NYMEX-based transactions because doing so brings with it an unacceptable level of risk for both the Company and customers.[27] Approval of NYMEX will allow for that opportunity.

Third, LG&E has proposed a modification to the sharing mechanism percentage as between LG&E and its customers.[28] As an initial matter, LG&E emphasizes that, with or without any

[23] In addition to the three main changes, LG&E has also requested minor name conforming changes to match the names of the gas price indices used as benchmarks in the GAIF component. Murphy Testimony, p. 4; Report, p. 13.
[24] Murphy Testimony, p. 4.
[25] Murphy Testimony, p. 4; Report, pp. 12-13.
[26] Report, p. 13.
[27] See LG&E's response to PSC's Post-Hearing Data Request No. 5.
[28] Murphy Testimony, p. 4; Report p. 14.

modifications made to the sharing percentages, the portion of the savings retained by LG&E has been and will continue to be properly sized. On that point, LG&E has demonstrated that:

- As a percentage of LG&E's net income for its gas business, LG&E's share of the savings on an after-tax basis has averaged only approximately 3.5% over the last four PBR years;
- As a percentage of actual gas supply costs, LG&E's share of the savings has averaged only approximately 1.6% over the last four PBR years; and
- As a percentage of the total Gas Supply Cost Component determined pursuant to LG&E's Gas Supply Clause under the PBR mechanism, the PBR Recovery Component that recovers LG&E's share of savings has averaged only approximately 1% over the last four PBR years.[29]

These reasonable percentages demonstrate that the PBR mechanism has done *exactly* what it should do, which is, of course, to incentivize LG&E to achieve savings by rewarding LG&E with a meaningful but *reasonable* amount of savings dollars – all while delivering a significant amount of savings to customers.

Sharing percentages between LG&E and its customers were an issue in LG&E's last PBR mechanism case.[30] In that case, LG&E proposed a 30/70 Company/Customer sharing for all amounts up to 2% of the benchmarked gas cost and any amounts above 2% to be shared 50/50. The Commission determined that proposal to be "too abrupt" of a departure from the then-existing 25/75 Company/Customer sharing of amounts up to 4.5% of the benchmarked gas cost and a 50/50 sharing for amounts above 4.5%. The Commission then applied a 25/75 Company/Customer sharing for amounts up to 3% and a 50/50 sharing for amounts exceeding 3%.[31] In this case, LG&E has proposed the next logical step towards what it perceives to be the Commission's transition (based on the words "too abrupt") to a more equitable sharing of savings between LG&E

[29] See LG&E's response to PSC's Post-Hearing Data Request No. 1.
[30] Case No. 2014-00476, Order, June 30, 2016, p. 4.
[31] Case No. 2014-00476, Order, June 30, 2016, p. 6.

and its customers. The proposal is the same as proposed in the 2014 case which is a 30/70 Company/Customer sharing for amounts up to 2% and a 50/50 sharing for amounts above 2%.[32]

The proposed sharing arrangement would be more equitable as it would move LG&E's shared portion to be slightly closer to the Customer portion. It would provide a further incentive for LG&E to surpass the least cost acquisition standard. And it would fairly compensate LG&E for taking on the risk of absorbing losses suffered for a failure to meet that least cost acquisition standard. Ideally, sharing should be symmetrical (50/50) as that would create a perfect alignment between Company and Customer interests. The proposal would get closer to such symmetry. Finally, the proposal is consistent with other gas LDCs subject to Commission jurisdiction.[33]

To the extent the Commission still believes it is not the right time to move to the proposed sharing percentages, LG&E offered an alternative proposal at the June 22, 2020 hearing and in its post-hearing discovery responses: a 30/70 Company/Customer sharing for amounts up to 2% of benchmarked gas costs and a 40/60 Company/Customer sharing for amounts over 2%.[34] Additionally, any sort of "cap", threshold, or limit to the savings that LG&E should be allowed to retain would be counterproductive. As stated above, the PBR mechanism has done an excellent job of incentivizing LG&E's gas purchasing activities to maximize benefits for LG&E and its customers. If a "cap" is imposed, the incentive will be less (and perhaps negated), and thus LG&E's gas purchasing activities could be affected in a way that would not produce maximum savings.

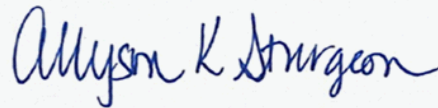
[32] Report, pp. 14-15.
[33] See LG&E's response to PSC 2-3.
[34] See LG&E's response to PSC's Post-Hearing Data Request No. 1.

III. CONCLUSION

LG&E's PBR mechanism has been a very effective tool by which LG&E has been able to achieve significant gas cost savings since its inception in 1997. Most of those savings have been provided directly to LG&E's customers. With respect, the Commission should renew the PBR mechanism for another five years with the requested modifications so that LG&E and its customers can continue to reap all possible benefits.

Dated: July 15, 2020

Respectfully submitted,



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CERTIFICATE OF COMPLIANCE

In accordance with 807 KAR 5:001 Section 8, I certify that the electronic filing of this document is a true and accurate copy of the same document to be filed in paper medium; that the electronic filing has been transmitted to the Commission on July 15, 2020; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and that within 30 days following the end of the state of emergency announced in Case No. 2020-00085, a paper copy of this filing will be delivered to the Commission.

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