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

O R D E R

On December 27, 2019, Louisville Gas and Electric Company (LG&E) applied to extend and modify its existing gas cost Performance-Based Ratemaking (PBR) mechanism. On January 16, 2020, the Commission issued an Order establishing a procedural schedule for the processing of this matter. The Attorney General of the Commonwealth of Kentucky, by and through the Office of Rate Intervention (Attorney General) is the only intervenor in the case. LG&E responded to two information requests from Commission Staff and two information requests from the Attorney General. On May 29, 2020, the Attorney General filed a recommendation that the case be submitted for a ruling based on the existing evidentiary record. On that same day, LG&E requested an evidentiary hearing. A hearing was held in the Commission offices on June 22, 2020. LG&E provided responses to Commission Staff's Post-Hearing Requests for Information (PHDR) on July 8, 2020, and filed a Post-Hearing Brief (Brief) on July 15, 2020. The case now stands submitted for decision.

BACKGROUND

The Commission approved the current PBR mechanism in Case No. 2014-00476 for five years expiring October 31, 2020.[1] The currently approved program benchmarks LG&E's gas costs against three components: (1) the Gas Acquisition Index Factor (GAIF) which benchmarks actual commodity costs against prices published by *Platt's Inside FERC's Gas Market Report* for monthly purchases, *Natural Gas Week* for weekly purchases, and *Platt's Gas Daily* for daily purchases;[2] (2) the Transportation Index Factor (TIF) which benchmarks LG&E's pipeline transportation costs against the Federal Energy Regulatory Commission (FERC) approved transportation rates of Texas Gas Transmission (Texas Gas) and Tennessee Gas Pipeline Company (Tennessee Gas);[3] and (3) the Off-System Sales Index Factor (OSSIF), which benchmarks sales of gas, transportation, and storage services against LG&E's out-of-pocket costs to make such sales.[4]

Variances between LG&E's actual costs and the benchmarks are shared between shareholders and ratepayers on a sliding scale consisting of two bands. The first band covers variances from the benchmark ranging from 0 to 3.0 percent and is shared 75/25 between ratepayers and shareholders in favor of the ratepayers. The second band

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[1] Case No. 2014-00476, *Louisville Gas and Electric Company's Proposed Renewal and Modification of Its Performance-Based Ratemaking Mechanism* (Ky. PSC June 30, 2015). LG&E's PBR was first approved in Case No. 1997-00171, *Modifications to Louisville Gas and Electric Company's Gas Supply Clause to Incorporate an Experimental Performance-Based Ratemaking Mechanism* (Ky. PSC Sept. 30, 1997).

[2] Application, Testimony of J. Clay Murphy (Murphy Testimony), Report to the Kentucky Public Service Commission on Gas Supply Cost Performance-Based Ratemaking Mechanism (Report) at 8.

[3] Report at 9–10.

[4] *Id.* at 11.

covers variances greater than 3.0 percent and is shared 50/50.[5] From November 1, 2015, through October 31, 2019, LG&E achieved total savings of $20,726,465, with LG&E retaining $7,005,625 and ratepayers credited with the remaining $13,720,840.[6]

ISSUES

LG&E proposes three modifications to the current PBR mechanism. LG&E is first proposing to revise the PBR gas commodity benchmarking component by adding the New York Mercantile Exchange (NYMEX) settled closing price to the calculation of the GAIF, as well as some changes in the names of existing PBR indices.[7] LG&E proposes no modifications to the TIF or OSSIF components of the PBR mechanism.[8] Second, LG&E proposes to alter its current sharing percentages and threshold so that they are consistent with those found in the PBR mechanisms of Columbia Gas of Kentucky (Columbia Kentucky) and Atmos Energy Kentucky (Atmos).[9] Thirdly, it requests that the mechanism be renewed and approved for five years through October 31, 2025.[10]

ANALYSIS

LG&E has provided information as required by the Commission to sufficiently show that it has been successful in outperforming benchmarks to achieve lower gas cost and allowing its shareholders to benefit along with its customers through the sharing component of the PBR mechanism. In response to the incentive inherent in the PBR,

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[5] *Id.* at 14.

[6] *Id.* at 3.

[7] *Id.* at 12–14.

[8] *Id.* at 14.

[9] *Id.* at 14–15.

[10] Murphy Testimony at 4.

LG&E has continued to develop, pursue, and manage creative supply arrangements, increased risk-taking, and has been given the incentive to negotiate intensively to improve cost performance and maintain reliability. For the GAIF and TIF PBR components, LG&E experienced net savings of $11,094,635 and $8,885,393, respectively, during the first four years of the five-year extension. For the OSSIF component, LG&E experienced net savings of $746,437.[11]

With regard to the addition of the NYMEX settled closing price to the GAIF component of the PBR mechanism, LG&E states that this additional benchmark would expand its contracting opportunities, and would be similar to Atmos's PBR mechanism which includes NYMEX as a benchmark.[12] LG&E advises that gas suppliers have proposed entering into NYMEX-based pricing arrangements, but that it would be unacceptably risky to the customers and to LG&E to enter into such arrangements without NYMEX being a component of its PBR mechanism.[13] According to LG&E, the Commission's approval of including NYMEX as a benchmark in the GAIF will allow for the opportunity to pursue additional savings.

In response to the PHDR, LG&E provided the change in the net gas cost savings and expense that would have occurred if the NYMEX had been included as part of the benchmark for each Supply Area Index (SAI) as LG&E has proposed. The results showed additional net "savings" as compared to "savings" generated using LG&E's existing

[11] Report at 9–11.

[12] Report at 12–13.

[13] Brief at 8.

benchmark for each of the four years included in the response, because while the actual cost of gas remained unchanged, the inclusion of the NYMEX increased the benchmark.[14]

LG&E pointed out problems with what it called the "back-casting" required in its response, because it could only make changes in the benchmark, and there is no way to reflect what the historical transactions and costs would have been if the benchmarks had been different. LG&E, nevertheless, claimed that the results illustrate the potential for increased gas cost savings that could be realized by adding NYMEX to the benchmarks.[15] The Commission is not convinced that LG&E's proposed modification to add NYMEX to the GAIF will result in the calculation of a more meaningful gas cost benchmark or a more reasonable gas cost or supply for its customers. While LG&E has been successful in achieving gas cost below benchmark, it is not the Commission's objective in approving PBR mechanisms to pursue increasingly greater risk in return for the possibility of incremental decreases in gas cost. Presumably any NYMEX-based contracts that LG&E would enter into would be for sources of supply that are already subject to existing benchmarks in the PBR mechanism. LG&E has not stated or shown that contracts based on NYMEX prices are necessary for reliability or would result in lower gas cost.

LG&E's proposal to modify the sharing mechanism of the PBR is the same as proposed in Case No. 2014-00476.[16] As previously discussed in this Order, LG&E's PBR currently provides that variances between LG&E's actual gas costs and the benchmarks

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[14] LG&E's response to Commission Staff's Post-Hearing Request for Information (Response to Staff's Post-Hearing Request) (filed July 8, 2020), Item 4.

[15] *Id*.

[16] Report at 14.

are shared between shareholders and ratepayers on a sliding scale consisting of two bands. The first band covers variances from the benchmark ranging from 0 to 3.0 percent and is shared 75/25 between ratepayers and shareholders in favor of the ratepayers. The second band covers variances greater than 3.0 percent and is shared 50/50. LG&E again proposes in this case to change to a sharing more favorable to shareholders, with 70/30 sharing of gas cost savings for amounts up to 2.0 percent and a 50/50 sharing for amounts above 2.0 percent. LG&E describes the proposed change as being more equitable, because LG&E's shared portion would be closer to the ratepayer portion, although it contends that ideally sharing should perfectly align the utility's and ratepayers' interests through a symmetrical 50/50 sharing.[17] LG&E also points out that the proposal is consistent with Atmos's and Columbia Kentucky's PBR sharing percentages. In case the Commission does not find the proposed sharing percentages reasonable, LG&E offered an alternative proposal at the June 22, 2020 hearing, in its PHDR responses, and in its Brief, to implement a 70/30 sharing between ratepayers and the utility and for amounts up to 2.0 percent of benchmarked gas costs, but to lower the utility's sharing by changing to a 60/40 sharing in favor of ratepayers for amounts over 2.0 percent.[18]

With regard to LG&E's proposal to increase its initial sharing portion over a narrower range, the Commission likewise is not convinced that such a change is necessary or beneficial to its customers. Over the four years in LG&E's Report, LG&E's total calculated gas cost savings achieved through the PBR mechanism was $20,726,465, which was 4.6 percent of total gas cost of $447,680,992 for PBR years

[17] Brief at 10.

[18] Response to Staff's Post-Hearing Request, Item 1 and Brief at 10.

19 through 22.[19] In recognition of the need to provide a meaningful incentive to LG&E that still provides the greatest possible gas cost savings to customers, the Commission finds there is good cause to change the sharing allocation to 70/30 as proposed by LG&E, but to increase the range for initial sharing so that the upper end of the band reflects historical achieved savings, resulting in a band of 0 to 4.6 percent. The Commission also finds that the current 50/50 sharing of variances greater than 4.6 percent should continue going forward.

During the course of this proceeding, an additional issue which has been raised through discovery is the Delivery Area Index (DAI). LG&E's PBR tariff benchmarks purchases that are in excess of its firm daily contract entitlements with interstate pipelines using the DAI. Pursuant to LG&E's tariff, it calculates the DAI benchmark based on the price postings from the Texas Gas Transmission (TGT) Zone 1 and TGT Zone 4 and then uses the higher of the two to determine the "savings" or "expense" generated by a given purchase made in excess of firm daily contract entitlements. LG&E identified the savings realized under the DAI as $22,622 over the past four years, with LG&E only making purchases in excess of its firm daily contract entitlements on four days during that period. LG&E indicated that if it had entered into firm contracts to meet peak demand, it would have cost $382,777 in the winter of 2017/2018 and $558,412 in the winter of 2018/2019.[20]

At the June 22, 2020 hearing, LG&E was asked how the DAI calculation could result in anything but savings, based on the assumption that the benchmark would either

[19] Report, Appendix A.

[20] Response to Staff's Post-Hearing Request, Item 2.

be met if gas was purchased from the higher priced zone or would be beaten if gas was purchased from the lower cost zone.[21] LG&E responded by claiming that the DAI benchmark accounts for a very small portion of the savings realized under the PBR tariff.[22] LG&E further argued that the purpose of the DAI benchmark is to provide an incentive for daily purchases to meet certain extraordinary situations in which demand exceeds firm supply, and claimed that without the incentive LG&E would enter into firm capacity contracts to supply that demand, which would result in higher gas cost.[23]

LG&E was also asked at the hearing why it only included in the DAI benchmark two of the five zones from which it can obtain gas. LG&E indicated that the benchmark is set up this way because the DAI it is such a relatively small component of the PBR, and for simplicity's sake.[24] Based on questions from the hearing LG&E provided two alternative DAI benchmark calculations that it characterized as "problematic" that would use the lowest gas price indices from either (1) the two existing TGT zones currently contained in the DAI benchmark calculation or (2) all TGT and Tennessee Gas Pipeline zones from which it can obtain gas.[25] LG&E stated that both alternatives resulted in lower savings achieved for its customers and shareholders, and that the second alternative was unduly complicated.[26] The Commission reasons that LG&E's arguments do not support retaining the DAI in its current form.

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[21] Hearing Video Transcript of the June 22, 2020 Hearing, 9:29:18- 9:35:58.

[22] *Id.*

[23] *Id.*

[24] Response to Staff's Post-Hearing Request, Item 2.

[25] *Id.*

[26] *Id.*

The goal of the PBR is to incentivize utilities to achieve lower gas costs for customers. Given the very limited use of daily purchases in excess of firm supply, it does not appear that the incentive provided by the DAI resulted in LG&E foregoing significant amounts of firm capacity to meet instances where demand is abnormally high. Rather, given the size of the DAI "savings" as compared to the actual amount of daily purchases in excess of firm commitments, it appears that the current structure of the DAI incentive overly compensates LG&E on the rare instances in which its demand exceeds its firm contract commitments. Thus, although the DAI has not generated a significant amount of savings to be shared amongst LG&E and its customers over the last four years, the Commission finds it reasonable to adjust the DAI benchmark to include all zones in which LG&E has firm capacity contracts at the time it makes the daily purchases, and to require it to use the lowest DAI from those zones based on the second alternative provided in response to Item 2 of the PHDR.

LG&E requested that its PBR mechanism be approved for five years effective November 1, 2020, through October 31, 2025. The Commission finds that the PBR mechanism should be approved as modified herein only through March 31, 2021. The Commission ordered the same PBR expiration date for Columbia Kentucky in its most recent PBR proceeding, with a goal of taking consistent action with regard to gas cost PBR mechanisms for the three local distribution companies (LDCs) that have such mechanisms in their tariffs.[27] Atmos filed for continuation of its PBR mechanism on

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[27] *See* Case No. 2017-00435, *Electronic Application of Columbia Gas of Kentucky, Inc. to Extend Its Gas Cost Adjustment Performance Based Rate Mechanism* (Ky. PSC July 24, 2020).

August 31, 2021, to be effective for five years beginning June 1, 2021.[28] The Commission will consider during the pendency of the three proceedings the larger issue of PBR as it applies to gas cost, the appropriateness of all gas purchasing activities included in incentive mechanisms, the construction and consistency of all approved benchmarks, and best practices of sharing mechanisms between LDCs and their customers.

IT IS THEREFORE ORDERED that:

1. LG&E's proposal to modify the GAIF component of the PBR mechanism by adding NYMEX as a benchmark is denied.

2. LG&E's proposed modification to the gas cost sharing calculation is denied.

3. The current gas cost sharing calculation shall be modified as required herein, so that LG&E receives 30.0 percent of variances from 0 to 4.6 percent, with sharing thereafter allocated 50/50 between LG&E and its customers.

4. The DAI benchmark calculation shall be modified as required herein.

5. The PBR tariff text changes proposed by LG&E that are not related to the addition of the NYMEX or changes to the sharing mechanism are approved.

6. LG&E's current PBR mechanism, with the modifications approved herein, is extended beginning November 1, 2020, through March 31, 2021.

7. No later than January 31, 2021, LG&E shall file an evaluation report on the most current results of the PBR available at the time of filing. This report shall be considered in a proceeding which will be established to continue, modify or terminate the PBR mechanism. LG&E shall also file with that report any testimony and supporting

[28] *See* Case No. 2020-00289, *Electronic Request of Atmos Energy Corporation for Modification and Extension of Its Gas Cost Adjustment Performance Based Ratemaking Mechanism* (filed Aug. 31, 2020).

documentation that it would propose to be considered, in addition to the record of this case, to assist the Commission in determining whether gas cost PBR should be continued for Kentucky LDCs, or whether it should be modified or terminated.

8. Within 20 days of the date of this Order, LG&E shall file with this Commission, using the Commission's electronic Tariff Filing System, revised tariff sheets setting out the PBR tariff revisions approved herein, and reflecting that they were approved pursuant to this Order.

9. This case is closed and removed from the Commission's docket.

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By the Commission

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