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Ralph E. Dennis
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Dear Ralph:

We are in receipt of your report entitled Natural Gas Unbundling in Kentucky: Exploring the Next Step Toward Customer Choice. We congratulate you on your efforts to obtain input from various parties and to distill them into this comprehensive report. As you so ably point out, many questions remain unanswered. Certainly there are many divergent points of view and concerns. This report is in fact a good starting point for further discussion on whether residential and small commercial customer unbundling is the next step in Kentucky.

We plan to attend the public meeting on August 22, but we decided to send you some of our thoughts as a follow-up to our earlier discussions as you consider further actions in this regard. At this time, we plan no written comments being provided by us at the August 22 meeting. We will plan to make brief comments at the meeting.

Delta, along with many other gas utilities in Kentucky, unbundled the supply and service components many years ago. Practical restrictions limited the size of customer for whom gas would be transported. Larger commercial and industrial customers have the ability to purchase their gas elsewhere and have it transported and distributed by the LDCs. Now we all must decide whether to extend this transportation to all customers, and then whether to segment the components of transmission and distribution service to all customers.

All customers have benefitted from reduced prices of natural gas at the well head over the past decade as a result of changes at the Federal level. LDCs purchase gas directly from producers and marketers and maintain pipeline and storage capacities on interstate pipelines. Additionally, companies like Delta purchase gas from Kentucky and other producers, and also maintain their own underground storage and other peak supply sources. Flowing gas is priced at market prices, with most contracts tied to market-based price indices.

Kentucky thus enjoys relatively low gas (and electric) rates and all customers (residential, commercial and industrial) benefit from this, as does the whole state through a very positive economic development climate.

Larger commercial and industrial customers seem content with their position. The questions before us, collectively, then are should (must) supply choice be provided to smaller volume customers (residential and small commercial) and, further, should other components of service of LDCs be split up so the customer (whoever that might be) may pick and choose.

The paramount question that must be always answered first is this; If we unbundle supply further, or service further, will the customer benefit from lower costs on a long-term basis?

We submit that the evidence of this result is inconclusive. The pilots we have considered thus far do not demonstrate it. We know of no overwhelming public outcry for the changes, that is, for customer choice at a more detailed level. Observing other industries in fact does not convince us that all customers have benefitted greatly from efforts there; it is questionable also whether or not the companies benefitted either.

We should not change just for the sake of change. Customers are receiving excellent service and their needs are being met at a reasonable price. Our products and services are competitive with other energy providers and customers are being added to our system at an increasing pace.

Some states, and some LDCs in those states, do not enjoy the favorable pricing and operating environment that we do in Kentucky. We can understand their concern and interest in change.

Customer choice is the new buzz-word and a national rallying cry. But, it seems to be set forth more by those who stand to benefit from it such as marketers (either independent or affiliated with LDCs or producers) or LDCs who now want to have unregulated sales or who envision a national market, and size, for their companies. Also, it is held forth by consultants, analysts, some regulators and others as a panacea that has, as yet, remained undiscovered and unproven. But, we realize at the same time that it is hard to argue against customer choice. If further unbundling comes about in response to that concern, we understand. We just hope customers benefit from that choice.

Again, we come back to the key to success with this or any change. Keep the focus on the customer. If there is long-term benefit for the customer, through lower prices or improved service, then it makes sense to consider. No one knows the complete answer to this yet. But, in looking at it we have yet to see the savings to justify the costs.

In pilots thus far, savings have been small. Gas costs are already competitive. Pipeline and storage are available to meet peak and annual needs as required.

Growth is provided for effectively by LDCs. Supply planning is in place to meet now and tomorrow's needs.

Services are already somewhat segmented. There are firm and interruptible service options, special contracts are available and standby tariffs are provided for. The small commercial and residential customers generally require firm service and peak day needs are crucial. The cold winter days must be covered reliably. The LDCs do that well. Further segmentation of detail service components do not provide avenues for real savings. The components must be provided, and they are now provided by LDCs on a cost-effective basis. LDC operations are scrutinized by Commission staffs (especially in rate cases), as well as intervenors, and all large LDCs are subject to and have had very thorough management audits in the past several years. Also, customers can choose other energy sources, such as electricity, coal, oil, propane and wood. They do not have to have us; we do have to have them to continue in business.

If unbundling occurs, we believe the Commission should continue its existing transportation policies and statutory and regulatory authority. No change is needed relating to bypass, main extensions or certificate of convenience and necessity requirements.

We see no reason why LDCs should be required to exit the merchant function. We believe strongly that LDCs should be allowed to compete with marketers. That competition should be on the same basis, with the same regulatory involvement for all participants. There should be no different treatment for LDC marketing affiliates than for any other marketers. LDCs should be allowed to continue as merchants if they so elect.

The supplier of last resort issue must be addressed. If LDCs have no merchant function, they cannot be the supplier of last resort. Only pipeline capacity, storage and supply contracts allow for back-up supplies. If the gas supply does not arrive at the LDCs system, it cannot be re-delivered by the LDC and the only two solutions are the LDC as back-up or the customer is without service. If LDCs completely exit the merchant function, they will not be in a position from a supply standpoint to backstop suppliers or marketers who fail. This, we think, is a significant risk for the potential savings from the customer's standpoint.

If retail unbundling at the residential and small commercial customer level is implemented, LDCs will have stranded or transition costs that should be spread to LDC customers, either directly or through marketers who will then be supplying those customers. Under the current requirements, LDCs have maintained pipeline, storage and gas supply capabilities to meet customers' needs. If these ground rules change, LDCs need time to work through these commitments and shed them if possible. Those not shed must be recovered from LDCs' firm customers for whom they were incurred to provide firm service in the first place.

Taxes should be collected on unbundled sales on the same basis as prior to any unbundling. Now, tax revenue is reduced as it is only collected on transportation revenues that are considered to be "utility revenues". Tax changes should occur to provide the total gas bill to be taxed as it was prior to any unbundling.

Delta believes the best approach might be to wait on further unbundling while results of broad unbundling in other states are evaluated. Pilot programs have not demonstrated any conclusive results. If further unbundling is pursued, we suggest broad unbundling as opposed to pilots. We are not convinced that legislative changes are necessary. The PSC has the necessary authority and flexibility to provide for unbundling by an administrative approach under current regulations and statutes. Our only concern is that any administrative proceeding adequately consider all transition issues, including all those included herein. If there is no further unbundling, incentive ratemaking methods that share savings or price caps should be considered on a company-by-company basis.

The result of further unbundling should be a lower cost to the customer on a long-term basis. Cost savings should be worth the additional risk to the customer, particularly the risk of worse service or no gas on a cold winter day. LDCs now provide high quality service. The surety of supply for customers is good now. Growth is supported by LDCs. Customers prefer gas and have confidence in gas and the LDCs. We, collectively, in our state, need to be sure not to do anything to hurt consumer confidence in natural gas. We need to be sure not to lose any momentum if we proceed with residential and small commercial unbundling.

If unbundling occurs further than at present, we agree that there are many areas that require further analysis to ensure fairness to all. In order for there to be fair unbundling and to facilitate competition, all segments of the gas industry in our state must properly address the following:

- Customer education - This is crucial to success, as there is no outcry for residential and small commercial supply choice now.

- Consumer protection - This is necessary to protect customers from unscrupulous marketers and to insure supplier performance.

- Administrative costs - These additional costs must be accurately provided for and allocated to reflect additional costs of detailed unbundling and billing.

- LDC affiliates - There must be an opportunity for fair competition and opportunity for all; LDC affiliates and the LDC merchant function can compete with marketers.

- Tax structures - These are now are unfair for transportation; must also address revenue loss.

- Social programs and costs - These are now a part of the LDCs cost of service.

- Supplier of last resort - This includes back-up service and the obligation to serve, which the LDC has now; Key to meeting future peak day needs successfully.

- Stranded/transition costs - These must be addressed when the LDC obligations change.

- Cost allocations - These will be important to appropriately price any unbundled components.

We will cooperate with the PSC and staff in any administrative proceedings or if legislative efforts are pursued. Our intention is to be supportive of change with a goal of providing the best possible service and prices to all our customers. We would be happy to discuss any of this further at your convenience, or to provide any other input at future meetings. Thank you for the opportunity to express our opinions.

Sincerely,

Glenn

Glenn R. Jennings

/epb