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September 6, 2005

VIA HAND DELIVERY
Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

RE: ***In the Matter of the Investigation Into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator***
Case No. 2003-00266

Dear Ms. O'Donnell:

Enclosed please find and accept for filing the original and ten copies of Louisville Gas and Electric Company's and Kentucky Utilities Company's Joint Post-Hearing Brief in the above-referenced matter. Please confirm your receipt of this filing by placing the stamp of your Office with the date received on the enclosed additional copies and return them to me in the enclosed self-addressed stamped envelope.

Should you have any questions or need any additional information, please contact me at your convenience.

Very truly yours,

Kendrick R. Riggs

KRR/ec
Enclosures
cc: Parties of Record

335544.1

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

INVESTIGATION INTO THE MEMBERSHIP OF LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY IN THE MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR, INC.	)	**CASE NO. 2003-00266**

JOINT POST-HEARING BRIEF OF LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY

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Filed: September 6, 2005

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I. INTRODUCTION

This matter is before the Kentucky Public Service Commission ("Commission") on its own motion to determine whether the Companies'[1] continued membership in the Midwest Independent Transmission System Operator, Inc. ("MISO") serves the public interest[2]. The evidence of record demonstrates that it does not, and that the Companies acted prudently when they tendered to MISO on December 28, 2004 their notice of their intent to withdraw as a member transmission owner. The Commission should, therefore, determine that the Companies' continued membership does not serve the public interest, and support the Companies' efforts to pursue such relief as may be necessary from the Federal Energy Regulatory Commission ("FERC") to permit them to terminate their membership in MISO in favor of an alternative operating structure that continues to ensure the reliable operation of their transmission system, while not resulting in costs for which there are no discernible benefits for the Companies' customers.

A. Overview

Although this proceeding presents the Commission with numerous complex issues and a vast record, KRS 278.218 requires it to answer only two questions: (1) would the Companies' exit from MISO harm the Companies' service or rates; and (2) is there a net benefit to the Companies' exit? Stated another way, the question before the Commission is whether the Companies' service or rates are put in jeopardy as a result of continued MISO membership, and whether that continued membership gives rise to a net detriment for the Companies' customers. The Commission has stated that the answers to these questions determine what is in the public interest as defined by KRS 278.218, the Kentucky statute that governs transfers of operational

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[1] Louisville Gas and Electric Company and Kentucky Utilities Company.
[2] KRS 278.218.

control of utility assets.[3] The credible evidence in the record of this proceeding shows that: (1) the Companies' exit from MISO and resulting transfer of operational control of their transmission assets to a North American Electric Reliability Council ("NERC")-certified reliability coordinator, such as the Southwest Power Pool ("SPP") or the Tennessee Valley Authority ("TVA"), will ensure the continued reliable operation of those transmission assets;[4] and (2) exiting MISO and purchasing reliability coordination and other independent transmission administration services from SPP, TVA, or a similarly qualified entity (perhaps even MISO) would result in net financial benefits to the Companies and their customers.[5] Because there exist lower-cost, viable alternatives to MISO membership that meet the KRS 278.218 public interest standard, the Companies respectfully request that the Commission enter an order by November 1, 2005 that:

(1) finds that (a) the costs of MISO's Day 2 markets exceed the benefits they provide (if any) and (b) the Companies' continued MISO membership is not in the public interest because the Companies can likely obtain comparable reliability coordination and other services from another provider or other providers at lower cost and risk levels;

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[3] In the Matter of Application of Kentucky Power Company d/b/a American Electric Power for Approval, to the Extent Necessary, to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, Order at 4 (8/25/2003). The Companies ask the Commission to note that KRS 278.218 did not exist when the Companies became founding members of MISO, and that no other then-extant Kentucky statute applied to the transfer of operational control of the Companies' transmission assets that joining MISO entailed. The Companies and MISO agree on this point (see the Companies' Joint Post-Hearing Reply Brief dated May 19, 2004, at page 1), and the Companies fully briefed this issue in its first Joint Post-Hearing Brief in this proceeding, dated April 26, 2004.

[4] All Reliability Coordinators must by certified by NERC as qualified operators according to NERC's standards.

[5] It should be noted that prior to joining MISO, American Electric Power provided the Companies with their reliability coordination. II T.E. 94 (July 21, 2005). Please also note that the Companies also expect that FERC can act on the Companies' application to exit MISO for an alternative reliability coordination arrangement within six months of the Companies' filing, as FERC did in the recent Entergy ICT proceeding. Id. at 92.

(2) requires the Companies to continue pursuing FERC authority to exit MISO, and to formulate an alternative to MISO membership that is acceptable to FERC, and ultimately to this Commission;

(3) authorizes the Companies to establish a regulatory asset for the amount of the exit fee which must be paid to MISO pursuant to Section 5 of the MISO Transmission Owners Agreement ("TO Agreement");[6] and

(4) closes this investigation.

The concurrent jurisdiction that both this Commission and the FERC have over the ultimate disposition of the question of who operates the Companies' transmission system ensures that the equally compelling interests of continued system reliability and operational efficiencies will be protected. It is vitally important, therefore, that the Commission intervene in the Companies' proceedings before FERC so that the MISO alternative that results from those proceedings will be crafted adequately to protect the national interest of independent and reliable grid operation while at the same time ensuring that Kentuckians benefit from a structure that does not require them to pay costs for which there are no discernible benefits. To ensure this outcome, it is important that the Companies complete their exit from MISO and implement their proposed alternative structure before the summer of 2006. The Commission's participation in the ensuing FERC proceedings will be essential to realizing this important goal.

The Companies expect to file with FERC as early as this month their application for the authority to exit MISO. At the same time, the Companies intend to seek approval of operating agreements for the provision of Reliability Coordination services, and for the independent operation of the Companies' transmission system, and a revised Open Access Transmission

[6] Agreement of Transmission Facilities Owners to Organize The Midwest Independent Transmission System Operator, Inc., A Delaware Non-Stock Corp., Effective Feb. 1, 2002.

Tariff ("OATT"). To facilitate the Companies' ultimate objective, it is important that this Commission enter an order granting the requested relief by November 1, 2005, and actively intervene at FERC in support of the findings requested in this proceeding.

It is important to note that the Companies are not asking this Commission to approve the transfer of the operational control of their transmission assets back to them, or to any other entity. Instead, the Companies are asking this Commission to determine that such a transfer would be in the public interest and to assist the FERC in determining an approach that would be acceptable to both commissions. As stated before, the Companies will return to this Commission for approval under KRS 278.218 for the requisite authority to implement the proposed alternative operating arrangement.

B. Background to and Review of the Commission's Investigation

On January 15, 1998, the Transmission Owners ("TOs"), including the Companies, filed their application with FERC to approve the operation of their transmission facilities by MISO. The Companies' decision to become charter members of MISO was largely due to a desire to accommodate FERC's evolving policies regarding Independent System Operators as announced in Order No. 888, as well as the desire to manage more efficiently regional transmission service under FERC Order No. 888.[7] Indeed, the Companies believe that their continued membership in MISO likely would not be open to debate at this juncture (i) had the FERC accepted the crucial Schedule 10 compromise reached at MISO's inception;[8] and (ii) had MISO agreed not to undertake its aggressive and enormously costly pursuit of the Day 2 power markets by filing its Transmission Energy Market Tariff ("TEMT"). FERC approved MISO as a Regional Transmission Organization ("RTO") on December 19, 2001. Functional control was transferred

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[7] Paul W. Thompson Direct at 2-3 (September 22, 2003); Michael S. Beer Direct Testimony at 2 (September 22, 2003).

[8] Thompson Direct at 3-5.

by the Companies to MISO on February 1, 2002. The history and details of the Companies' participation in the formation of MISO and all that changed thereafter is set forth in detail in the Companies' Direct and Rebuttal Testimonies filed earlier in this proceeding and summarized in the Companies' April 26, 2004 Post-Hearing Brief.[9]

On July 17, 2003, the Commission opened this investigation by entering an order directing the Companies to file testimony in several issues including the Companies' need to have sought Commission approval under KRS 278.020(4) to "transfer . . . control" of their transmission facilities prior to joining MISO.[10] Hearings in the investigation were held on February 25-27, 2004. After the record of evidence was closed, on March 31, 2004 MISO filed its TEMT with FERC to establish the real-time and day-ahead power markets (the so-called "Day 2 Market"). The parties submitted to the Commission simultaneous briefs on April 26, 2004, and reply briefs on May 19, 2004.

Confronted with this change in events after the record was closed and the case was submitted, on June 22, 2004, the Commission reopened its investigation by entering an order requesting the Companies to submit further testimony addressing MISO's TEMT and the cost-benefit of joining another RTO. Further hearings were held on July 20-21, 2005.

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[9] A complete copy of the Companies' April 26, 2004 Post-Hearing Brief is included in Appendix A to this September 6, 2005 Joint Post-Hearing Brief for the Commission's convenience.

[10] Order, p. 2, July 17, 2003. As discussed in detail in the Companies' April 26, 2004 Post-Hearing Brief, the plain language of the statute applies only to transfers of "utilities," which are defined as "persons" in KRS 278.010; "persons," in turn, are defined as entities: individuals, corporations, partnerships and the like. KRS 278.020(4); KRS 278.010(2), (3). Second, the statute focuses on the transfer of control of entities, including language such as "transfer of stock" and "financial, technical, and managerial abilities." KRS 278.020(4). Third, to construe KRS 278.020(4) as applicable to the Companies' limited transfer would render a more recently enacted statute, KRS 278.218, mere surplusage. Such an interpretation would violate well-established canons of statutory interpretation. Hamilton v. International Union of Operating Engineers, Ky., 262 S.W.2d 695, 699 (1953); Stevenson v. Anthem Casualty Insurance Group, Ky., 15 S.W.3d 720, 724 (1999). Finally, the direct testimony by the Companies' witness Mr. Beer in this case is that the Companies made a substantially identical transfer of operational control of their transmission system to NERC several years ago, for which the Commission did not require regulatory approval. (Beer Direct at 13; III T.E. 94.). These are critical points of statutory construction that demonstrate that KRS 278.020(4) did not and does not apply to the Companies' limited transfer to MISO.

The Day 2 energy markets have expanded MISO's functional responsibilities beyond those envisioned by its charter membership. Indeed, there is nothing in the Transmission Owners Agreement that indicates the need or authority for Day 2 power markets.[11] The Day 2 markets, with their reliance on Locational Marginal Pricing ("LMP") and Financial Transmission Rights ("FTRs"), clearly exceed the requirements of the FERC's Order No. 2000 and even requirements contemplated by the now aborted Standard Market Design Notice of Proposed Rulemaking ("SMD NOPR") and subsequent White Paper.[12] In particular, whereas the SMD NOPR made clear that market participation was to be "voluntary,"[13] MISO's Day 2 markets require that TOs offer their generation into the markets and purchase energy from the markets to supply their load, or designate certain Designated Network Resources as operating reserve or regulation capacity.[14] As a consequence, MISO's Day 2 markets exceed both MISO's charter members' initial vision and FERC's subsequent regulatory requirements and proposals.

MISO's development of the infrastructure necessary to administer the Day 2 markets has exposed the Companies to unexpectedly high Schedule 16 and 17 costs. Furthermore, the implementation and operation of the Day 2 markets has indisputably exposed the Companies to significant new financial risks with little promise of corresponding benefits.[15] For these reasons, the Companies gave MISO written notice on December 28, 2004 of their intention to withdraw

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[11] See Agreement of Transmission Facilities Owners to Organize The Midwest Independent Transmission System Operator, Inc., A Delaware Non-Stock Corp., effective Feb. 1, 2002, as accepted by FERC on June 30, 2005, ("TO Agreement"), available at:
http://www.midwestiso.org/documents/TOA%20_As%20Accepted%20as%20of%2006-30-05%20Letter%20Order_%20_ER05-1034-0.pdf.
[12] Thompson Direct at 11; I T.E. 21, 24.
[13] SMD NOPR ¶ 269.
[14] LG&E/KU / MISO Stipulation ¶¶ 9 & 18. Note that so-called "self-scheduling" does not affect this statement, as explained in greater detail infra.
[15] Morey Rebuttal at 27-35; Thompson Direct at 12.

their membership.[16] The Companies anticipate filing an application with FERC as early as this month to seek authority to withdraw from MISO and to propose an alternative method of compliance with FERC's regulation of the transmission system, including the selection of a new Reliability Coordinator.[17] The Companies' objective is to complete their regulatory and operational withdrawal from MISO before summer 2006.

II. ARGUMENT

The Companies and MISO agree that KRS 278.218 governs transfers of operational control of utility assets.[18] For a transfer of operational control of utility assets to meet the requirements of KRS 278.218(2), it must be "for a proper purpose and . . . consistent with the public interest." The Commission has explained that this statutory standard "establishes a two-step process: first, there must be a showing of no adverse effect on service or rates; and, second, there must be a determination that there will be some benefits."[19] The record before the Commission amply supports a determination that either Transmission Operator with Reliability Coordinator ("TORC") operation or SPP membership, or other comparable alternatives to MISO membership, would benefit the Companies and their customers financially while maintaining the Companies' historically excellent system reliability and compliance with NERC requirements.

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[16] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Supplemental Rebuttal Testimony of Paul W. Thompson (January 10, 2005) at 5 ll. 7-14, Exh. PWT-1.

[17] The Companies will serve a copy of their FERC application on the Commission and each party to this proceeding upon making such filing with FERC.

[18] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator, Case No. 2003-00266, Post-Hearing Brief of the Midwest Independent Transmission System Operator, Inc. ("MISO's First Brief") at 6-8 (April 26, 2004); In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator, Case No. 2003-00266, Joint Post-Hearing Brief of Louisville Gas and Electric Company and Kentucky Utilities Company ("Companies' First Brief") at 27-31 (April 26, 2004).

[19] In the Matter of Application of Kentucky Power Company d/b/a American Electric Power for Approval, to the Extent Necessary, to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, Order at 4 (8/25/2003).

A. The Companies' Actual Results in the Day 2 Markets, as well as the Results of Companies' and MISO's Cost-Benefit Analyses, Show that Withdrawal from MISO Would Produce Net Financial Benefits to the Companies and Their Customers

The point of greatest contention in this proceeding is whether continuing MISO membership produces net benefits that exceed, or net costs that are less than, those the Companies would experience if they pursued an alternative to MISO membership. This issue goes directly to the second question that KRS 278.218 requires this Commission to answer, namely whether a proposed transfer of operational control of utility assets would produce "some benefits."[20] The Companies submit that the record of the Companies' actual Day 2 results coupled with the Companies' and MISO's cost-benefit analyses show that pursuing an exit from MISO in favor of a lower-cost alternative would likely produce "some benefits," just as KRS 278.218 requires.

There are two competing cost-benefit analyses in the record of this proceeding: MISO's, which claims to show significant net benefits of continuing MISO membership as compared to TORC operation; and the Companies', which shows moderate but consistently recurring net benefits resulting from a MISO exit in favor of some alternative arrangement. Although the Commission cannot take either as being accurately predictive of what the future would hold, neither should the Commission accept MISO's discounting of the value of these analyses as general indicators of the future. MISO would have this Commission believe that these analyses are useful only for understanding which "direction" (i.e., net costs or benefits) different scenarios are likely to produce. The magnitude of predicted net costs or benefits, the assumptions used to

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[20] In the Matter of Application of Kentucky Power Company d/b/a American Electric Power for Approval, to the Extent Necessary, to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, Order at 4 (8/25/2003). The Commission stated with respect to the benefits that a proposed transfer will produce: "Such benefits, however, need not be immediate or readily quantifiable." Id.

generate those net costs or benefits, and how those results and assumptions compare to actual results are factors the Commission must take into consideration when deciding to which study it will accord the greatest credibility, and on which study it will rely as the basis for its decision. When the Commission considers all these factors, the Companies submit that the Commission will determine that the Companies' cost-benefit analysis, not MISO's, is the most credible.

The only two questions that the Commission should consider to determine whether to accept MISO's cost-benefit analysis as being a reliable indicator of the net benefits of continuing MISO membership, which MISO's study claims are on the order of $46.3 million on an annually recurring basis,[21] are:

(1) Does the Commission believe that the Companies will consistently receive $22.5 million of annual FTR revenues in excess of the congestion costs they must pay, even though (a) MISO's chief witness admitted there is no evidence in the record to support such an assumption,[22] (b) other MISO market participants have a financial motive to reduce that amount to zero (or less),[23] and (c) through May 2005, the Companies paid MISO an average of $367,000 in net congestion costs?[24]

(2) Does the Commission believe that the Companies will receive net MISO transmission revenues of $25.7 million annually, notwithstanding that the

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[21] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Additional Supplemental Testimony of Dr. Ronald R. McNamara (March 3, 2005) at 4 ll. 6-8.

[22] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Additional Supplemental Testimony of Dr. Ronald R. McNamara ("McNamara Testimony") at Exh. RRM -Table 2C (March 3, 2005) ("RRM Table 2C"); I T.E. 49-50 (July 20, 2005).

[23] I T.E. 51 ln. 18 – 52 ln. 1 (July 20, 2005).

[24] Gallus Testimony (July 7, 2005) at 5, Table 2. "Net congestion costs" are those congestion costs in excess of FTR revenues.

Companies' annualized actual net MISO transmission revenues only come to $5.6 million, less than a quarter of MISO's projection?[25]

The record of this proceeding shows that the Commission must answer both of these questions in the negative as having no basis in either theory or the reality of the Companies' actual results.

1. FTR Revenues in Excess of Congestion Costs

Actual results that the Companies have reported for Day 2 operations resoundingly contradict MISO's assertion that they will receive a net $22.5 million in annual FTR revenues. Although MISO's witness questioned it,[26] the Companies' witness testified that, far from receiving FTR revenues in excess of congestion costs, the Companies paid MISO an average of $367,000 per month in net congestion costs (i.e., congestion costs in excess of FTR revenues) for the months of April and May 2005.[27] Thus, MISO's premise that the Companies would receive FTR revenues in excess of their congestion costs finds no support in the Companies' actual results as reported in this record.

MISO's flawed analysis of the Companies' reasonable expectations concerning FTR revenues and congestion costs also contradicts the theory of an efficient, transparent market that MISO claims to have established in Day 2; indeed, MISO's chief witness, Dr. McNamara, conceded that there is no evidence in the record to support MISO's assumption that the Companies will receive $22.5 million in net congestion revenues[28] year after year.[29] Moreover,

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[25] RRM Table 2C; In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Additional Supplemental Direct Testimony of Martyn Gallus ("Gallus Testimony") (July 7, 2005) at 5, Table 2.

[26] I T.E. 53-54 (July 20, 2005). It is not clear on what ground MISO's witness questioned the Companies' testimony on this point; certainly MISO has produced no evidence to contradict the Companies' assertion. Moreover, MISO's contest is somewhat puzzling because MISO's study predicted that the Companies would receive an average of $5.6 million per month in FTR revenues (not net of congestion costs) (RRM Table 2C), yet the Companies have only received $6.1 million in total FTR revenues (again, not net of congestion costs) for all of the months of April, May and June 2005 (LG&E/KU Cross Exh. No. 4).

[27] Gallus Testimony (July 7, 2005) at 5, Table 2.

[28] "Net congestion revenues" refer to FTR revenues in excess of congestion costs.

[29] I T.E. 49-50 (July 20, 2005).

Dr. McNamara testified that giving other market participants the incentive to reduce MISO's claimed $22.5 million net congestion revenue benefit to the Companies is "what the market is designed to do."[30] Dr. McNamara's testimony agreed with the pre-filed testimony of Dr. Morey, in which Dr. Morey stated that because other MISO members, not the Companies, pay the Companies net congestion revenues, these other MISO members would have a strong financial incentive to reduce sizeable and recurring net congestion revenues (i.e., FTR revenues in excess of congestion costs) paid to the Companies. To do this, these entities would either change their FTR-seeking behavior, or build new transmission or generation. MISO's premise that the Companies will receive $22.5 million annually in net congestion revenues fails, therefore, not only because it has been proven to be inaccurate in actual Day 2 operations, but also because it is theoretically untenable due to its dependence on irrational economic behavior over an extended period of time.

To further confuse the issue, MISO's chief witness testified at the hearing that some of the net congestion revenues on which MISO based its study can result from the Companies' being "on both sides" of congestion (i.e., where the Companies hold FTRs between their generation and their load).[31] The Commission should not be misled. An FTR is the right to collect (or pay) the congestion component of the difference in LMPs between a generator and a load for a given hour as determined in the Day Ahead market. When the same entity both owns the generator that is paid the generator bus LMP, and pays the LMP associated with serving its native load, as on occasion do the Companies, then it is irrelevant which "side" (load or generator) pays and which side receives the congestion component of LMP; it is simply taking money from one pocket and putting it in another. No matter how often or in what amounts the

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[30] I T.E. 51 ln. 18 – 52 ln. 1 (July 20, 2005).
[31] I T.E. 51 ll. 5-17 (July 20, 2005).

Companies perform such transactions, they still net out to zero. Only when other market participants pay congestion costs to MISO do the Companies actually benefit from the FTRs they hold through the receipt of congestion revenues. It is this benefit for the Companies, and the corresponding detriment for other market participants, that provides those market participants with the incentive to find ways to reduce those congestion costs, thereby reducing the Companies' net congestion revenues.[32] It is incontrovertible, therefore, that neither sound economic theory nor the Companies' actual Day 2 market results support MISO's assertion that the Companies will annually receive net congestion revenues of $22.5 million.

2. Transmission Revenues

MISO contends that continuing membership is beneficial to the Companies because they can expect to receive $25.7 million in annual net transmission revenue.[33] As with MISO's flawed reasoning on net congestion revenue, this contention finds no support in either the theory upon which MISO included it in its study, or in the Companies' actual Day 2 market results.

With respect to the Companies' actual Day 2 market results for the months of April and May 2005, the Companies received an average of $464,000 per month in transmission revenues from MISO.[34] MISO did not contest this amount at the hearing.[35] Had the Companies been on track to realize the annual amount of $25.7 million that MISO predicted, the Companies would have had to receive at least $2.14 million per month during this period. In fact, as MISO's witness acknowledged, if the Companies continue to earn transmission revenues at the average rate of $464,000 per month, they will receive only $5.6 million in MISO transmission revenues annually, only 22% of the amount MISO predicted.

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[32] Were the Companies actually receiving such, which the record shows they have not. I T.E. 51 ln. 18 – 52 ln. 1 (July 20, 2005); Morey Testimony (April 1, 2005) at 16 ll. 6-18.
[33] RRM Table 2C.
[34] Gallus Testimony (July 7, 2005) at 5, Table 2.
[35] I T.E. 60 ll. 8-11 (July 20, 2005).

Notwithstanding the Companies' actual transmission revenue results, MISO's original estimate was the product of fatally flawed reasoning. MISO based its $25.7 million prediction on an assumption that the Companies would receive the same transmission revenues in Day 2 as they received from MISO during the historical period from November 1, 2003 through October 31, 2004.[36] As its own witnesses acknowledged, this prediction is unsupportable because MISO neglected to net the historical transmission revenues against the transmission payments the Companies made to MISO during the same period, which came to $19.6 million.[37] Thus, MISO overstated its claimed net benefit of continued MISO membership by $19.6 million. The correct net transmission revenue figure MISO should have used is $6.1 million, an amount that approximates the annualized transmission revenue that the Companies actually received from MISO during April and May 2005.[38]

B. MISO Day 2's High Uplift Costs and Failure to Increase the Companies' Off-System Sales Margin also Support the Companies' Conclusion that MISO Membership Imposes Costs on the Companies with No Offsetting Benefits

Although the Commission need not consider any factors other than those discussed above in order to determine that continuing MISO membership will impose net costs, not net benefits, on the Companies, two other factors, high uplift costs and unimproved OSS margins, further support such a conclusion. Not only did MISO grossly overstate the net benefits that the Companies could expect from continuing membership, it also grossly understated the magnitude of the burden that such membership would place on the Companies in the form of increased

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[36] Morey Testimony (April 1, 2005) at 19-20; McNamara Testimony (November 19, 2004) spreadsheet entitled "Transmission Revenue.xls," a work paper supplied by MISO.

[37] I T.E. 59 ll. 2-12 (July 20, 2005).

[38] See Gallus Testimony (July 7, 2005) at 5, Table 2.

costs. In fact, the Companies' own predictions as to the magnitude of the costs associated with continuing MISO membership were substantially underestimated.[39]

1. Actual Uplift Costs Have Exceeded MISO's (and the Companies') Expectations

MISO's most glaring miscalculation becomes apparent when actual "uplift" charges are compared with those that MISO originally estimated. As Mr. Gallus testified, MISO originally estimated that the Company would pay $2.06 million per year in uplift costs. In fact, the Companies have, during April through June 2005, already paid amounts substantially higher than that, most notably in the form of a revenue neutrality uplift[40] and Revenue Sufficiency Guaranty ("RSG")[41] distribution payments. Information taken directly from MISO's settlement statements to the Companies show that the Companies have paid MISO $7.11 million in revenue neutrality uplift payments for the three months April - June 2005, and that the Companies have paid MISO $4.75 million in RSG distribution payments over the same period, for a three month total of $11.9 million in uplift costs.[42] These costs dwarf MISO's projected uplift costs of $2.06 million per year[43] and are costs that the Companies would not incur if they were not MISO members.[44]

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[39] Gallus Testimony (July 7, 2005) 5 ln. 2 – 6 ln. 13.

[40] Because MISO is a non-profit corporation and has no equity, it must collect from its members and other market participants an amount equivalent to its costs. Revenue neutrality uplift is the amount MISO charges its members for the difference between MISO's costs and its revenues. Thus, if MISO takes in $50 million less in a given month in revenue than its costs, it will use revenue neutrality uplift to collect the $50 million difference.

[41] RSG distributions are the amounts that MISO members pay MISO to compensate it for the RSG make whole payments. MISO pays a generator an RSG make whole payment when it runs the generator notwithstanding that the LMP at the generator is less than the generator's offer price. The RSG make whole payment is the amount of the difference between the offer price and the LMP (e.g., if MISO runs a $100/MWh offer price generator at 100 MW for one hour while the LMP is only $80/MWh, MISO will pay the generator as RSG make whole payment of $2,000). MISO collects the amount required to make all such RSG make whole payments from its members through RSG distribution uplift.

[42] Companies' Cross Exhibit No. 4.

[43] RRM Table 2C.

[44] I T.E. 243 ln. 16 – 244 ln. 7 (July 20, 2005); II T.E. 10 ln. 6 – 11 ln. 9 (July 21, 2005). Note that this result is obtained even if MISO is correct that Over-Collected Losses ("OCL") revenues the Companies have received should be offset against revenue neutrality uplift charges. As shown in LG&E/KU Cross Exh. No. 4, the Companies received only $7.2 million in OCL revenues over the same period, leaving net uplift costs of $4.7 million, still well in excess of MISO's projection of annual uplift costs of $2.06 million.

2. Increased Off-System Sales Are Not Due to Day 2

Although the Companies' actual off-system sales ("OSS") margins for the months of April - June 2005 have exceeded MISO's projections,[45] the Commission should reject MISO's contention that membership has, indeed, created net benefits for the Companies, because the Companies' recent OSS results are due entirely to factors unrelated to MISO or its markets:[46]

(1) There is no evidence in the record to suggest that the OSS margins are attributable to MISO membership. MISO acknowledges that MISO membership is not a prerequisite to making off-system sales, i.e., the Companies could have made off-system sales even if they had not been MISO members since the start of Day 2. Similarly, there is no evidence in the record to suggest that the Companies would have made fewer off-system sales, or made a comparable volume of sales, but at lower margins, had they not been MISO members;[47] and

(2) The Companies' positive OSS margin since the inception of Day 2 is largely attributable to higher energy prices and a decline in native load (due primarily to lower than normal temperatures), resulting in a greater amount of generation being available for off-system sales, and not to membership in MISO or participation in Day 2.[48]

The Companies therefore could have made roughly the same OSS margins had they not been participants in Day 2.[49] MISO's claim that increased OSS margins is a benefit is unsupportable.

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[45] Gallus Testimony (July 7, 2005) at 9, Table 3.
[46] Please note that the Companies included RSG make-whole payments in the OSS revenues reported in Post-Hearing Data Response No. 2 and in the OSS margins reported in Gallus Testimony (July 7, 2005) at 9, Table 3.
[47] I T.E. 82 ll. 16-25 (July 20, 2005); id. at 88 ll. 14-16.
[48] Gallus Testimony (July 7, 2005) at 3 ll. 2-13. As Mr. Gallus explained in that testimony, increased fuel prices (and not MISO Day 2) are largely responsible for recent high energy prices. The Companies have enjoyed a price advantage in making OSS because they have long-term, low-price fuel contracts, another factor that has nothing to do with MISO. Id.
[49] II T.E. 11 ln. 10 – 12 ln. 9 (July 21, 2005).

C. MISO's $25 Million Cash Position Statement is a Meaningless Distraction

During the latest round of hearings, MISO's witnesses attempted to argue that the net cash that the Companies have received from MISO for operations in the Day 2 markets (approximately $25 million) should be viewed as proof that the Companies' continued membership in MISO is producing net benefits.[50] As the Companies' witness, Mr. Gallus, testified, the $25 million figure does not represent a net benefit. Indeed, it is wrong to suggest that it constitutes proof that the Companies' Day 2 MISO membership has yielded any net benefits as compared to non-MISO operation.[51] For example, MISO's witness admitted that the $25 million figure did not include any of the costs of production associated with the off-system sales revenues already included in the $25 million.[52] As Mr. Gallus pointed out, the $25 million, as broken out in LG&E/KU Cross Exhibit No. 4,[53] also did not include amounts for several other significant items that contribute to the Companies' gross margin, including: (1) Schedule 10 charges the Companies paid MISO; (2) transmission revenues and costs (Schedules 1, 4 and 7); and (3) the Companies' tariff revenues for serving native load.[54] Thus, the $25 million does not comprise all of the Companies' gross margin components, nor does it represent a net benefit of the Companies' participation in MISO. This is so because it does not begin to compare the Companies' actual Day 2 energy market results with the results the Companies likely would have achieved as non-MISO members during the same period.[55] Standing alone, therefore, it does not suggest the existence of a net benefit of any kind, and provides the Commission no guidance as to whether the Companies have received net benefits from their Day 2 energy market

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[50] I T.E. 89 ll. 10-20 (July 20, 2005).
[51] I T.E. 237 ln. 12 – 238 ln. 2 (July 20, 2005).
[52] I T.E. 85 ll. 14-16 (July 20, 2005).
[53] LG&E is Louisville Gas and Electric Company, and KU is Kentucky Utilities Company.
[54] I T.E. 234 ln. 7 - 237 ln. 11 (July 20, 2005). The costs and revenues associated with MISO schedule Nos. 1, 4 7 and 10 (i.e. item numbers 1 and 2 above) are included in a separate transmission settlement statement.
[55] LG&E/KU Cross Exh. 4.

participation. As Mr. Gallus testified, it is only when the costs of producing OSS for the same period -- approximately $24 million -- are subtracted from the $25 million that any comparability to pre-Day 2 OSS is possible.[56]

D. MISO's Past Errors Call into Question the Credibility of its Latest Cost-Benefit Analysis

A final point that should inform the Commission's decision as to how much weight – if any – to afford MISO's latest cost-benefit analysis is the tortured route that MISO took to produce it. MISO's first cost-benefit analysis, filed in December 2003, included as part of its claimed net benefit of MISO membership the value of the LG&E/KU merger surcredits,[57] a contention the Companies showed to be baseless at the previous hearing,[58] and a "benefit" that MISO has not included in any of its four subsequent cost-benefit analyses. The first three cost-benefit analyses MISO filed in the latest phase of these proceedings, filed in November 2004, and January and February 2005, all contained generating units in MISO's modeling of the Companies' dispatch that the Companies neither own, nor have the right to dispatch (e.g., units owned by Big Rivers Electric Corporation and leased to Western Kentucky Energy Corporation). These errors were so significant that they compelled MISO to re-run its models and re-submit its testimony again and again.[59] Although MISO's latest study appears not to contain such obvious modeling errors, MISO's record of repeated cost-benefit errors calls into question the credibility of MISO's latest cost-benefit analysis and the weight the Commission affords it.

Predictably, MISO's witness sought to minimize the impact of the fact that it took MISO four tries to excise the obvious errors from its cost-benefit analysis by attempting to dismiss such

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[56] See I T.E. 241-242 (July 20, 2005).
[57] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Direct Testimony of Michael P. Holstein ("Holstein Testimony") (December 29, 2003) at 2 ll. 21-24.
[58] See Companies' First Post-Hearing Brief at 14-16, summarizing the evidence, which brief is attached hereto as Appendix A.
[59] Morey Testimony (January 10, 2005) at 9-10.

analyses as mere "direction[al]" indicators, claiming that MISO's studies have consistently indicated that the Companies will obtain net benefits by remaining MISO members.[60] This assertion ignores the fact that MISO's first three cost-benefit analyses either contained implausible claims of benefits or modeling errors of such magnitude that MISO felt compelled to re-run its study, thereby disqualifying those studies from any reasonable consideration as showing even a "direction" with respect to net benefits. Moreover, MISO's fifth and final study, as demonstrated above, is based on erroneous claims of net benefits and dramatically underestimated claims of certain Day 2 costs, thus negating any "direction" that MISO might claim the fifth study provides. Thus, the only credible study that remains for the Commission's consideration is the one on which the Companies have relied throughout this entire proceeding.

E. The Companies' Study Produces Reasonable Results and Actual Results Support Companies' Study over MISO's

The Companies' cost-benefit analysis, unlike MISO's, is largely consistent with the Companies' actual Day 2 market results. For the Commission to accept the Companies' cost-benefit analysis as credibly predicting net recurring (i.e., annual) costs of continued MISO membership of $4 million to $13 million, the Commission needs only to accept two premises:

(1) Day 2 has had and will have no real impact on the Companies' off-system sales; and

(2) Day 2 has produced no reductions in the cost to serve native load.

As to the first point, the record clearly supports the Companies' contention that successful off-system sales revenues and margins are explicable as the result of non-Day 2 factors, i.e., energy

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[60] Indeed, MISO has testified with respect to each of its last four cost-benefit analyses that the Commission can have a "high degree of confidence" that continued MISO membership will yield net benefits for the Companies. I T.E. 44 ln. 7 – 45 ln. 17 (July 20, 2005). McNamara Testimony (November 19, 2004) at 54 ll. 14-16; McNamara Testimony (January 20, 2005) at 54 ll. 14-16; McNamara Testimony (February 21, 2005) at 7 ll. 4-6; McNamara Testimony (March 3, 2005) at 7 ll. 4-6.

prices were generally higher; and the Companies were able to make a greater quantity of off-system sales because their native load was lower than anticipated due to milder weather during the two-month period.[61] Moreover, the Companies have historically had great success in making off-system sales because of their low cost generation resources and the efficiency of the wholesale market that pre-dated the commencement of MISO's Day 2.[62] Thus, given that the Companies historically have fully exploited all available economic off-system sales opportunities, and that the Companies would be able to sell into MISO even as non-MISO members, there is little reason to believe that the Companies' off-system sales volumes or margins would be significantly different if the Companies were no longer MISO members.[63]

The Companies' actual Day 2 off-system sales results also confirm the reasonableness of the Companies' study's projections of the Companies' 2005 In-MISO off-system sales margins. With respect to off-system sales margins, the Companies projected in their cost-benefit analysis that the Companies would receive approximately $6.8 million per month in 2005 as MISO members.[64] This amount compares favorably with the Companies' actual average monthly OSS margin for April – May 2005, $5.1 million.[65] The Commission can therefore accept the first premise of the Companies' cost-benefit analysis knowing that it comports with actual results of the Companies' off-system sales in Day 2 markets.

The Companies' actual Day 2 energy market results have also borne out the Companies' second premise, namely that Day 2 operation will produce no reduction in the cost to serve native load. First, with respect to operations and maintenance, MISO has introduced no evidence

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[61] Gallus Testimony (July 7, 2005) at 3 ll. 2-13.
[62] Gallus Testimony (September 29, 2004) at 20 ln. 11 – 21 ln. 6.
[63] Id.; II T.E. 11 ln. 10 – 12 ln. 9 (July 21, 2005); Gallus Testimony (September 29, 2004) at 20 ll. 8-19.
[64] Morey Testimony (April 1, 2005) at Exh. MJM-1.
[65] Gallus Testimony (July 7, 2005) at 9, Table 3.

to show that the Day 2 energy markets have in any way reduced such costs.[66] Second, economic power purchase costs historically have been a nearly de minimis cost for the Companies, who have provided the vast bulk of their native load requirements with their own generation.[67] This has remained true since Day 2 energy market operations commenced; nevertheless, as Mr. Gallus noted in his pre-filed and live testimony, energy market prices have increased, not decreased, as compared to the same time one year ago.[68] Although it is true that increased energy prices are due to non-Day 2 factors, it is equally true that Day 2 has not resulted in lower costs for economic energy purchases.[69] Third and finally, MISO has not shown that the Day 2 dispatch of the Companies' generation resources has been more efficient than pre-Day 2, either with respect to the Companies or to the MISO footprint as a whole. Indeed, given MISO's increased dispatch of the Companies' combustion turbines during typically lower-demand months such as April and May, it may be reasonable to conclude that MISO's dispatch of the Companies' generation has been less efficient than the Companies' previous economic dispatch.[70] Given these three results, it is reasonable to conclude that the second premise of the Companies' cost-benefit analysis, that Day 2 operation will not reduce the Companies' costs to serve native load, is correct.

F. Continuing MISO Membership is Not in the Public Interest Because Reliability Can Be Maintained Consistent with Applicable NERC Requirements

MISO claims that it has generated reliability benefits that exceed those available from other reliability coordinators; for such a positive claim to be credible would seem to require more evidence than bare assertions that the claim is true, yet such assertions are all that MISO offers to support its position. The Companies, on the other hand, have testified that there have been no

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[66] See, e.g., II T.E. 11 ll. 16-23 (July 21, 2005).
[67] I T.E. 235 ll. 4-9 (July 20, 2005).
[68] Gallus Testimony (July 7, 2005) at 10, Table 4; II T.E. 11 ll. 16-23 (July 21, 2005).
[69] Id.
[70] Gallus Testimony at 12 ln. 10 - 14 ln. 10 (July 7, 2005).

observable reliability improvements resulting from MISO's Day 2 reliability operations.[71] Of course, this result is not surprising when viewed in light of the fact that the Companies have not had to shed load to protect their transmission system in over twenty years.[72]

Nevertheless, MISO claims that it enhances the reliability of the Companies' transmission system by: (1) operating its regional security-constrained economic dispatch, which allows it to manage congestion and loop flows region-wide while operating closer to the security limits of the system; (2) more effectively coordinating flows between utilities in the MISO footprint; and (3) monitoring the regional grid to detect and resolve local problems before they spread and become regional problems.[73] What MISO neglects to mention in its recounting of its supposed reliability benefits is that NERC standards require every NERC-certified reliability coordinator (e.g., MISO, PJM, SPP, or TVA) to: (1) have agreements in place to allow it to direct generation redispatch, transmission reconfiguration, or reduce load in order to return the transmission system to a reliable state;[74] and (2) have a "wide area view" of its own reliability coordinator area and of those areas surrounding it.[75] Therefore, any NERC-certified reliability coordinator will have the wide, regional view that MISO touts, and will have the authority generally to reconfigure the transmission and generation systems in order to preserve reliability. Moreover, even assuming that MISO Day 2 provides an incremental reliability benefit, it should be noted that MISO's chief reliability witness, Mr. Roger Harszy, testified that there is no evidence in the record of this proceeding to support the assertion that the value of the

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[71] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Additional Supplemental Direct Testimony of Mark S. Johnson ("Johnson Testimony") (July 7, 2005) at 3 ll. 8-13.
[72] See, e.g., Morey Testimony (February 9, 2004) at 17-18.
[73] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Updated Supplemental Testimony of Roger C. Harszy ("Harszy Testimony") (July 7, 2005) at 2 ln. 20 – 3 ln. 7.
[74] NERC Standard IRO-001-0.
[75] NERC Standard IRO-003-0.

incremental reliability benefit (if any) exceeds the cost MISO has charged the Companies for achieving it.[76]

One of the quantifiable, observable ways in which MISO has claimed in this proceeding that its improvement of the regional grid's reliability would be apparent was through the elimination of TLRs,[77] which TLRs one of MISO's witnesses has derided as "inadequate."[78] Yet as Mr. Harszy admitted during the latest hearings before the Commission, MISO is still calling TLRs across the MISO grid.[79] Although MISO produced an exhibit purporting to show a dramatic decrease in the Companies' total MWh volume of schedule curtailments due to TLRs during the first three months of Day 2 operation as compared to the same months one year ago,[80] the Companies' response to Post-Hearing Data Request No. 1 shows that MISO has curtailed nearly as many MWh under its new "manual redispatch" regime during the three month period May – July 2005 as it curtailed under TLRs during the three month period April -- June 2004.[81] Therefore, if reduced curtailments were to be a sign of improved reliability in MISO Day 2, such improved reliability appears not to have materialized.

Contrary to the assertion by MISO at the hearing during the cross examination of Mr. Beer, there will be no "gap" between the Companies' current membership in MISO (and the Reliability Coordination services provided thereto) and the new alternative to be proposed to FERC and this Commission.[82] The Companies will at all times have the services of a NERC-Certified Reliability Coordinator for the operation of their transmission systems. This

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[76] See, e.g., I T.E. 138 ln. 23 – 139 ln. 1 (July 20, 2005).
[77] LG&E/KU Cross Exh. No. 7, Slide 7 (MISO Annual Report page 14).
[78] CITE to RRM pre-filed testimony.
[79] I T.E. 148 ll. 19-22 (July 20, 2005).
[80] MISO Re-direct Exhibit No. 1.
[81] Companies' Response to Commission Post-Hearing Data Request No. 1 (August 5, 2005). The Companies' response shows that MISO ordered 10,505 MWh of generation reduction and 8,325 MWh of generation increase during May -- July 2005, a total curtailment of 18,830 MWh. MISO's Re-Direct Exhibit 1, introduced on July 20, 2005, shows that MISO curtailed only 15,731 MWh under TLR during April -- June 2004.
[82] II T.E. 93 (July 21, 2005).

Commission and FERC will have a full opportunity to review and evaluate the Companies' proposed reliability coordinator prior to the Companies' operational withdrawal from MISO.

Finally, the Commission can have confidence that the Companies' transmission reliability will not suffer under another reliability coordinator because it seems likely that FERC will elect to exercise its new authority under Title XII, Subtitle A of the Energy Policy Act of 2005 by establishing an Electricity Reliability Organization ("ERO"), "the purpose of which [ERO] is to establish and enforce reliability standards for the bulk-power system, subject to Commission [FERC] review."[83] The reliability standards that the ERO establishes will apply to "[a]ll users, owners and operators of the bulk-power system . . .," and the ERO will have the authority to enforce the reliability standards by levying penalties against those who violate the standards.[84] Because all reliability coordinators will have to comply with the ERO's standards, the Commission can have confidence that any entity that serves as the Companies' reliability coordinator will meet the exacting standards that the ERO establishes, and that the Companies' transmission reliability therefore will not suffer after the Companies exit MISO.

G. MISO Purported Interested in Defending "the Market" is No Longer of Any Consequence

MISO has claimed that its purpose for intervening in this proceeding was to represent the interests of "the market,"[85] a claim that seems tenuous given the testimony of MISO's chief witness in this proceeding, in which he stated that: (1) MISO has not consulted with any of its stakeholders concerning the positions MISO has taken before this Commission; (2) none of MISO's stakeholders has contacted MISO about its position in this case; (3) none of MISO's stakeholders have intervened in this proceeding; and (4) neither MISO nor any of its stakeholders

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[83] Energy Policy Act of 2005, Title XII, Subtitle A, Section 1211(a). The President signed the Act into law after July 21, 2005.
[84] Id.
[85] III T.E. 12-13 (February 27, 2004).

get to vote on the Companies' business decision to seek exit from MISO.[86] It therefore appears that "the market" has no stake in the outcome of this proceeding, yet MISO has likely expended considerable sums to participate as though "the market" did have such a stake.

That "the market" has no stake in this proceeding is supported by MISO's assertions that the Companies' exit from MISO will have almost no impact on it. Indeed, MISO's chief witness stated that he agreed that the Companies' withdrawal from MISO would have no material impact on MISO's financial position, and that he agreed with a quote from MISO's Chief Executive Officer that the Companies' withdrawal would have "a minor impact" on MISO's new Day 2 markets.[87] Moreover, MISO now testifies that there is no longer concern that other MISO members will follow the Companies if they are allowed to exit.[88] In sum, whatever MISO's initial concerns, MISO has now testified that such concerns are now satisfied, and the Commission can have confidence that eventually allowing the Companies to exit MISO will result in no "domino effect" that could harm the Day 2 markets.

H. MISO's Lack of Accountability to its Stakeholders is Inconsistent with the Public Interest of the Companies' Kentucky Customers

MISO's extensive participation in this proceeding lacks convincing justification, and is perhaps best understood in light of this fact about MISO: it has no equity against which aggrieved parties may seek recourse for imprudent spending. Indeed, its expenditures cannot be regulated after the fact by any party, including FERC, MISO's sole regulator.[89] Therefore, no matter how improper certain MISO expenditures might be, MISO has the right to collect from its members whatever revenues are required to cover these expenditures. Even if there were an

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[86] I T.E. 25 ll. 11-14 (July 20, 2005).
[87] I T.E. 19 ln. 14 – 20 ln. 7 (July 20, 2005).
[88] I T.E. 31 ll. 5-21 (July 20, 2005). Dr. McNamara testified that what Mr. Holstein previously testified was a concern, namely that other entities would "follow suit" if the Companies were to exit MISO, is no longer a concern because the Day 2 markets are now well established. Id.; III T.E. 208 ln. 24 - 209 ln. 2 (February 27, 2004).
[89] I T.E. 102 ln. 16 – 103 ln. 16 (July 20, 2005).

entity vested with jurisdiction over MISO expenditures, the corporate structure of MISO would preclude transmission owners from obtaining any relief. In fact, the lack of an equity interest would give rise to an ironic perversion of logic in the event of a disallowance. The deficiency resulting from an order requiring MISO to refund to transmission owners an imprudent expenditure would be collected from the very parties to whom the refund would be made under MISO existing tariffs.[90] And as the Commission has noted in the past, the Commission has no authority to deny the Companies recovery of FERC-approved tariff charges.[91]

MISO states that there are adequate controls on its expenditures because: (1) its budgets are reviewed by an independent board of directors; (2) FERC is its regulator; and (3) it must file reports with FERC every sixty days concerning its expenditures for certain Day 2 market implementation matters.[92] Unlike MISO, however, the Companies are accountable to this Commission and to their customers. The cornerstone of this accountability is the regulatory risk that this Commission may disallow costs that the Companies might imprudently incur. Short of asking MISO to listen to their concerns, the Companies have no meaningful control over MISO's costs. Although the absence of control by any one member is integral to MISO's elemental independence, the Companies' ability to wield meaningful influence on MISO's decision making on budgetary matters, short of exiting as a means to signal the Companies' discontent, is nonetheless inadequate and frustrates the Companies' ability to fulfill their obligation to their customers and the Commission to keep costs down.

To mitigate this concern, the MISO TOs sought to exert a meaningful degree of control over MISO by including in the original version of the TO Agreement a provision that allowed

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[90] Id.
[91] In the Matter of: Application of the Union Light, Heat and Power Company to Adjust Electric Rates, Case No. 91-370, Order, (May 26 1992) at 4.
[92] MISO's First Post-Hearing Brief at 22-24.

TOs to vote to remove MISO directors without having to consult other MISO members.[93] Such a provision, had it been adopted, might have provided the additional control the TOs required to protect their interests without unduly compromising MISO's independence. However, FERC subsequently eliminated that key provision from the TO Agreement,[94] leaving the TOs with no greater control over MISO than any other market participants. Therefore, although the independent board of directors may have oversight of MISO's budgets, the TOs have no effective oversight of the board.

1. The Companies are Not Alone in Their Concerns over MISO's Lack of Accountability and Governance

Concern over MISO's governance and lack of accountability is further supported by the well-documented concerns that other MISO members have lodged about MISO's spending in the creation of the Day 2 markets[95] and the results thereof, the latter being particularly well evidenced by the letter that Hoosier Energy's Chief Executive Officer lodged with the Indiana Utility Regulatory Commission.[96] In that letter, Hoosier's CEO stated:

> Hoosier Energy is very concerned about the high cost of operating the MISO energy market, high and volatile prices resulting from this market and the unconventional unit dispatch that have characterized the energy market to date. If these high costs and volatile prices continue, there is no doubt Indiana consumers will suffer."

Moreover, as demonstrated by MISO's response to the Companies' post-hearing data request seeking other complaint letters MISO has received, Hoosier is not the only MISO participant

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[93] Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER98-1438-000, Order Conditionally Authorizing Establishment of Midwest Independent Transmission System Operator and Establishing Hearing Procedures ("FERC Order Approving MISO") (9/16/1998) at 28.
[94] Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER98-1438-000, Order Conditionally Authorizing Establishment of Midwest Independent Transmission System Operator and Establishing Hearing Procedures ("FERC Order Approving MISO") (9/16/1998) at 28.
[95] III T.E. 172; IV T.E. 28-29. See also Response of Midwest ISO to 4/8/04 Hearing Data Requests, Attachment A ("Attachment A").
[96] In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc., Case No. 2003-00266, Response of the Midwest ISO to Post-Hearing Data request (August 7, 2005).

other than the Companies that has serious concerns about MISO and the Day 2 markets. For example, Ameren Energy's president wrote to MISO's CEO on April 29, 2005, stating: "The Midwest ISO market, as a whole, is operating inefficiently with limited fundamentals upon which trading decisions can be based."[97] Ameren's president and numerous other entities, including at least one state public utility commission, also have expressed concern over MISO's dispatch of combustion turbines in April while lower-cost units sat idle, and MISO's seeming failure to include the cost of dispatching those combustion turbines in LMPs.[98] The Companies therefore are not alone among MISO members in their concerns about MISO's high costs, lack of compensating benefits, and other operational problems that the Day 2 markets appear to have created.

Not only have other MISO members joined in the Companies' concerns, but non-MISO members such as East Kentucky Power Cooperative ("EKPC") have also highlighted significant difficulties that the Day 2 markets have created. EKPC's CEO recently testified before this Commission in Administrative Case 2005-00090, during the course of which he expressed serious concerns about the impacts of Day 2 operations on EKPC: "At EKPC, the MISO market and its member companies' systems are affecting daily operations today more than ever before. ... [On multiple occasions,] EKPC economic operation and transmission reliability has been compromised by MISO activities."[99] The testimony also notes that MISO redispatch directions have required EKPC to reduce the production of its lower-cost units and to curtail economy power purchases, and comments that "[t]his type of operation not only compromises the

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[97] Id.
[98] Id.
[99] In the Matter of: An Assessment of Kentucky's Electric Generation, Transmission and Distribution Needs, Case No. 2005-00090, Prepared Testimony of Roy M. Palk on Behalf of Eastern Kentucky Power Cooperative, Inc. (June 8, 2005) at 9 ll. 9-23.

reliability of transmission service to our consumers but also raises their cost of electricity."[100] These are precisely the kinds of concerns that the Companies share.

I. MISO's Day 2 Markets Erode the Commission's Authority over Retail Rates by Converting What was Formerly State-Regulated Provision of Power to Native Load Into FERC-Regulated Wholesale Transactions with MISO

MISO's witnesses have consistently and accurately testified that MISO and its TEMT cannot alter the Commission's jurisdiction over retail rates.[101] MISO's witnesses, however, have neglected to acknowledge one important fact that the Companies' witnesses have detailed: the TEMT and the Day 2 markets it creates sever the previous connection between the Companies' generation and their native load, and now require that the Companies purchase from MISO – at FERC-approved rates – the power necessary to serve native load.[102] It is this new requirement that erodes the Commission's authority in setting retail rates and oversight of the cost basis for those rates. Prior to Day 2, the Companies supplied their native load requirements almost exclusively with power from their own generation, the terms of which provision were unambiguously subject to Commission regulation, including the cost that the Companies would be allowed to pass on to native load customers through rates. But Day 2 has changed this arrangement. Now, the Companies must offer all of their available generation into the Day-Ahead and Real-Time Markets,[103] and must bid their load into the same markets.[104] As the letter from Mr. Holstein shows, all of the transactions that result from bids and offers in the MISO Day 2 markets are "federally-regulated wholesale power transaction[s]."[105] As the Commission has

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[100] Id. at 9 ll. 14-15.
[101] McNamara Testimony (November 19, 2004) at 47 ln. 10 – 48 ln. 2.
[102] Beer Testimony (January 10, 2005) at 2 ln. 14 – 4 ln. 23.
[103] LG&E/KU / MISO Stipulation ¶¶ 9 & 18.
[104] Id. at ¶13.
[105] LG&E/KU Cross Exh. 5.

noted elsewhere, it is powerless to disallow rate recovery of federally-approved charges,[106] thus the Day 2 markets have effectively eroded authority the Commission once had in setting the Companies' retail rates and the oversight of the costs upon which those rates are based.

The Commission should have a clear understanding that so-called "self-scheduling" does not impact the above analysis one iota; that is to say, "self-scheduling" does not allow the Companies or their customers to escape the impacts of the Day 2 markets, nor does a generation offer that MISO accepts cease to be a FERC-regulated wholesale transaction by virtue of being "self-scheduled." As set out in the Stipulation between MISO and the Companies in this proceeding, and as the Companies' witnesses have explained, a "self-schedule" or "must-run" is nothing more than a price-taking offer of the Companies' generation; in other words, a "self-schedule" is simply informing MISO that the Companies will run a generating unit at a certain output at a certain time, regardless of the LMP at that generator at that time.[107] A possible consequence of such an offer is that the unit will run when the LMP is below the unit's production cost;[108] for this reason the Companies have elected to avoid such offers except when operational concerns require it (e.g., when a unit must run at a minimum level).[109] But the financial consequences of such an offer aside, it is important to understand that a "self-schedule" does not serve in any way physically to link the Companies' generation to the Companies' load.[110] It is merely a way of offering the Companies' generation into the MISO markets, nothing more. And because a "self-schedule" is an offer into the MISO market, pursuant to Mr.

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[106] In the Matter of: Application of the Union Light, Heat and Power Company to Adjust Electric Rates, Case No. 91-370, Order, (May 26 1992) at 4.
[107] II T.E. 15 ln. 23 – 16 ln. 7 (July 21, 2005); LG&E/KU / MISO Stipulation ¶¶9, 12 & 18.
[108] It is important to note that the Companies would not receive RSG make-whole payments in such a scenario. The Companies can receive RSG make-whole payments only when MISO commits a unit to run when the LMP is insufficient to cover the unit's offer price. This arrangement does not apply, however, when the Companies commit their unit to run regardless of price, such as in a "self-schedule."
[109] II T.E. 15 ln. 23 – 16 ln. 7 (July 21, 2005).
[110] LG&E/KU / MISO Stipulation ¶12.

Holstein's letter, it is a wholesale transaction regulated by FERC and therefore creates additional erosion of the Commission's jurisdiction over inputs to retail rates.[111] This is another reason why the Companies' continued membership in MISO is not consistent with the public interest.

J. Recent FERC Decisions and FERC Commissioners' Comments Strongly Indicate that More Viable Alternatives to MISO Exist

Although the Companies must receive FERC approval in order to exit MISO, FERC's recent decisions concerning alternatives to RTO membership suggest that the Companies have a basis for proposing alternatives to MISO membership that will be in Kentucky's public interest and acceptable to FERC as well. One such alternative that FERC has recently approved conditionally is the Entergy Independent Coordinator of Transmission ("ICT") arrangement.[112] Under this arrangement, the SPP will act as Entergy's ICT, providing Entergy with services FERC Order No. 888 requires, but will not require Entergy to join an RTO or participate in a security-constrained economic dispatch of the type that MISO has implemented.[113] Such an arrangement or something similar to it may present the kind of alternative to MISO that will meet with FERC's approval, and demonstrates that something less than full RTO membership may be viable for the Companies.

In addition to FERC decisions, recent comments of FERC's new chairman, Joseph Kelliher, support a belief that FERC may favorably entertain alternatives to RTOs that do not embrace competitive Day 2 type markets, but which ensure that the independent operation achieves the goals and objectives that FERC set forth in its Order Nos. 888 and 2000. For example, Chairman Kelliher recently tried to dispel the notion that all RTOs must operate

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[111] LG&E/KU Cross Exh. No. 6, Slide 49.
[112] See, e.g., Entergy Services, Inc., FERC Docket No. EL05-52-000 (March 22, 2005).
[113] Id.

markets for energy, capacity and congestion like the PJM Interconnection.[114] Chairman Kelliher has also pointed out that the SPP, which FERC has approved as an RTO, does not operate markets.[115] There is good evidence, therefore, that FERC's position with respect to the necessity of RTO membership continues to evolve away from requiring membership in RTOs that administer central marketplaces.

One alternative to RTO membership might be for the Companies to exit MISO but still purchase certain independent transmission coordination and tariff administration services from MISO. Although MISO's chief executive officer stated earlier in this proceeding that MISO had no interest in selling the Companies such "a la carte" services,[116] MISO's recent decision to do just that for Duke Energy gives reason to believe that MISO would do the same for the Companies.[117] Should it persist in its refusal to engage in such an arrangement with the Companies, MISO should demonstrate that the basis for its disparate treatment of the Companies is based on something other than MISO's seemingly baseless rejection of the Companies' proposal.

Based on the foregoing, the Companies expect to file their application with FERC as early as this month for authority to withdraw from MISO and to propose an alternative method of compliance with FERC's regulation of the transmission system, including the selection of a new Reliability Coordinator and an Independent Operator. The Companies believe that the Commission's participation in these FERC proceedings will prove to be critical in enabling the Commission to influence and have confidence in the alternative that FERC ultimately approves.

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[114] Beer Testimony (April 1, 2005) at 2 ln. 21 – 3 ln. 3.
[115] Id.
[116] I T.E. 41 (February 25, 2004).
[117] Statement from Midwest ISO President and CEO James P. Torgerson RE: Duke Power Retaining Midwest ISO to Coordinate Transmission Services (July 25, 2005), attached hereto as Appendix B and available at: http://www.midwestmarket.org/publish/Document/2b8a32_103ef711180_-79da0a48324a/2005-07-25%20Statement%20from%20Jim%20Torgerson%20RE%20Duke%20Power%20anno&.pdf?action=download&_property=Attachment.

The Commission's understanding of, and support for, the FERC-approved MISO alternative will also facilitate the Companies' ability to complete their regulatory and operational exit from MISO before summer 2006.

K. Consistent with the Companies' Request for Relief to Exit MISO, the Commission Should Allow the Companies the Corresponding Accounting Treatment of the Exit Fee

If, as requested, the Commission enters an order in this investigation directing the Companies to exit MISO, the Companies would have to seek and receive a FERC order allowing their exit.[118]

In its June 30, 2004 rate case orders, the Commission determined that this issue would be addressed, if necessary, in this investigation.[119] The Companies therefore request the Commission, as part of its orders in this investigation, authorize the Companies to establish a regulatory asset for the amount of the exit fee upon payment of the fee.

III. CONCLUSION

For a transfer of control of utility assets to meet the requirements of KRS 278.218(2), it must be "for a proper purpose and . . . consistent with the public interest." The Commission has explained that this statutory standard "establishes a two-step process: first, there must be a showing of no adverse effect on service or rates; and, second, there must be a determination that there will be some benefits."[120] The record before the Commission amply supports a determination that either TORC operation or SPP membership, or other comparable alternatives to MISO membership, would benefit the Companies and their customers financially while maintaining the Companies' historically excellent system reliability.

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[118] Rebuttal Testimony of Michael S. Beer of April 26, 2004 (Case Nos. 2003-00433 and 2003-00434) ("Beer LG&E and KU Rebuttal") at 2.

[119] Case No. 2003-000433, Order p. 73; Case No. 2003-000434, Order p. 63.

[120] In the Matter of Application of Kentucky Power Company d/b/a American Electric Power for Approval, to the Extent Necessary, to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, Order at 4 (8/25/2003).

The Companies therefore respectfully request that the Commission enter an order by November 1, 2005 that:

(1) finds that the Companies' continued MISO membership is not consistent with the public interest because (1) the costs of MISO's Day 2 energy markets exceed the benefits they provide (if any) and (2) the Companies likely can obtain from other providers, such as TVA and SPP, comparable reliability coordination and other services at a lower cost and risk level;

(2) requires the Companies to continue pursuing FERC authority to exit MISO, and to formulate an alternative to MISO membership that is acceptable to FERC, and ultimately to this Commission;

(3) authorizes the Companies to establish a regulatory asset for the amount of the exit fee which must be paid to MISO pursuant to Section 5 of the MISO Transmission Owners Agreement; and

(4) closes this investigation.

The Companies further request that the Commission intervene in the FERC proceeding that the Companies will initiate to seek exit from MISO, a filing the Companies will make with FERC as early as this month. The Companies believe that the Commission's active participation in those proceedings will be necessary for the Companies to achieve their goal of attaining complete regulatory and operational exit from MISO before the summer of 2006.

Dated: September 6, 2005

Respectfully submitted,

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I hereby certify that a true copy of the foregoing Joint Post-Hearing Brief was served via U.S. mail, first-class, postage prepaid, this 6th day of September 2005, upon the following persons:

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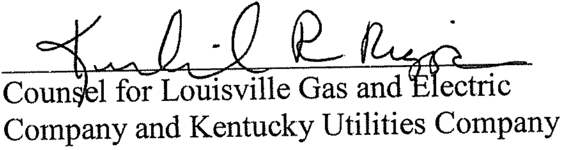

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RECEIVED
APR 2 6 2004
PUBLIC SERVICE COMMISSION

VIA HAND DELIVERY
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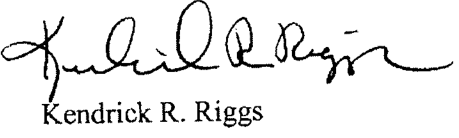
RE: ***In the Matter of the Investigation Into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator***
Case No. 2003-00266

Dear Mr. Dorman:

Enclosed please find and accept for filing the original and ten copies of the Joint Post-Hearing Brief of Louisville Gas and Electric Company and Kentucky Utilities Company in the above-referenced matter. Please confirm your receipt of this filing by placing the stamp of your Office with the date received on the enclosed additional copies and return them to me in the enclosed self-addressed stamped envelope.

Should you have any questions or need any additional information, please contact me at your convenience.

Very truly yours,



Kendrick R. Riggs

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Enclosures
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302680.1

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

INVESTIGATION INTO THE MEMBERSHIP OF LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY IN THE MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR	)	**CASE NO. 2003-00266**

JOINT POST-HEARING BRIEF OF LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY

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FILED: APRIL 26, 2004

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I. Introduction

This matter is before the Commission to determine whether the public interest[1] is served by the Companies'[2] continued membership in the Midwest Independent Transmission System Operator, Inc. ("MISO"). Kentucky ratepayers occupy the unique position of enjoying some of the lowest electric rates in the United States and whether the cost of MISO membership outweighs the benefits to Kentucky citizens is a matter appropriately within the purview of this Commission.

Pursuant to the Commission's instruction upon initiating this investigation, the Companies commissioned an independent cost-benefit study of their membership in MISO.[3] That study shows that the costs of the Companies' MISO membership will exceed its benefits by more than $60 million (nominal dollars) over the period 2005-2010.[4] MISO's expanded scope and the costs attendant thereto far exceed what any party – including MISO – anticipated when the Companies became charter members.[5]

It is with some reluctance that the Companies report these results. The Companies became charter members of MISO because they believed MISO, as operator of a regional, seamless transmission grid, could cost-effectively deliver improved regional transmission system

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[1] "The Commission, in its role as the enforcer of KRS Chapter 278 and all regulations promulgated pursuant to that Chapter, represents the public interest." In the Matter of: Louisville Gas and Electric Company and BellSouth Telecommunications, Inc. – Alleged Violation of Commission Regulations 807 KAR 5:041, Section 3 and 807 KAR 5:061, Section 3, Case No. 96-246, Order (October 15, 1996) (emphasis added and citation omitted).

[2] Louisville Gas and Electric Company and Kentucky Utilities Company.

[3] In the Matter of: Investigation Into The Membership of Louisville Gas and Electric Co. and Kentucky Utilities Co. In the Midwest Independent Transmission System Operator, Inc., Case No. 2003-00266 ("MISO Case"), Order at 3 (7/17/2003).

[4] MISO Case, Pre-filed Rebuttal Testimony of Mathew J. Morey (2/9/2004) ("Morey Rebuttal") at 8.

[5] MISO Case, Pre-filed Direct Testimony of Paul W. Thompson (9/22/2003) ("Thompson Direct") at 9-10, quoting MISO Proposed Revisions to Open Access Tariff, FERC Docket No. ER02-2925-000 (9/24/2002), Transmittal Letter at 2; I T.E. 23-24, 133; MISO Case, Pre-filed Direct Testimony of Michael S. Beer (9/22/2003) ("Beer Direct") at 2-4; MISO Case, Pre-filed Rebuttal Testimony of Paul W. Thompson (2/9/2004) ("Thompson Rebuttal") at 10.

reliability as well as enhanced off-system sales potential.[6] Indeed, the Companies believe that their continued membership in MISO would likely not be open to debate at this juncture (i) had the Federal Energy Regulatory Commission ("FERC") accepted the crucial Schedule 10 compromise reached at MISO's inception;[7] and (ii) had MISO agreed not to undertake its aggressive and enormously costly pursuit of the so-called Day 2 markets, which efforts are expected to cost more than $190 million[8] and pose multi-million dollar financial risks to the Companies.[9] However, the Companies stand behind their experts' cost-benefit analysis, and if the Commission finds that the Companies' continued MISO membership is not in the public interest, the Companies respectfully submit that the Commission (1) order the Companies to pursue an exit from MISO by seeking the requisite approval from FERC, in accordance with the MISO Transmission Owners Agreement ("TO Agreement"),[10] and (2) allow the Companies to create a regulatory asset to cover the MISO exit fee.

The Companies initially collaborated with other Midwest Transmission Owners ("TOs") to form MISO for three reasons: (1) to comply with and help shape emerging federal regulation and institutions, such as MISO; (2) to achieve greater transmission system reliability; and (3) to

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[6] Beer Direct at 3; Thompson Direct at 2-3; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.

[7] Thompson Direct at 3-5.

[8] III T.E. 172; IV T.E. 28-29. See also Response of Midwest ISO to 4/8/04 Hearing Data Requests, Attachment A ("Attachment A"). Attachment A provides the following cost breakdown of the roughly $190 million Day 2 markets costs:

> The projected $192 million total start-up costs for all activities associated with efforts to develop and implement the day-ahead, real-time, and FTR market systems consists of $103 million in capital costs, $72 million in deferred start-up costs and $17 million for reimbursement of market participant costs associated with costs to exchange data with the Midwest ISO. Of the $192 million projected total, approximately 25% is for FTR-related costs (Schedule 16) and 75% is for day-ahead and real-time systems costs (Schedule 17).

[9] III T.E. 32.

[10] Agreement of Transmission Facilities Owners to Organize The Midwest Independent Transmission System Operator, Inc., A Delaware Non-Stock Corp., Effective Feb. 1, 2002, ("TO Agreement"), Art. V, Sec. I; Art. VII, Sec. D.

create an expanded wholesale sales market through the elimination of "pancaked rates" across the MISO footprint.[11] The Companies continue to believe that these are important goals, some of which have been partly achieved through MISO membership. What is now clear, however, is that both the near- and longer-term costs now substantially exceed what the Companies contemplated at the time they signed the TO Agreement.[12] To be specific, there has been an 1100% increase in operating expenditures and a 311% increase in capital expenditures since 2000.[13]

The costs of MISO development for which the Companies are being asked to bear responsibility have exceeded the Companies' initial expectations for two reasons. First, they are higher because FERC rejected the TOs crucial Schedule 10 compromise, which would have allowed the Companies to defer for five years (until the end of the transition period around 2008) certain implementation and administration costs (i.e., Schedule 10 costs), with the attendant expectation that a national, de-regulated market would result in little or no cost borne by native load customers not causing the costs.[14] Second, the Companies have been unsuccessful in their attempts to dissuade MISO from going forward with its plan to implement its proposed Day 2 markets.

Through its proposed Day 2 energy market initiative, MISO has expanded its functional responsibilities beyond those envisioned by its charter membership. The proposed Day 2 markets, with their reliance on Locational Marginal Pricing ("LMP")[15] and Financial

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[11] Beer Direct at 3; Thompson Direct at 2-3; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.
[12] Thompson Direct at 9-10, quoting MISO Proposed Revisions to Open Access Tariff, FERC Docket No. ER02-2925-000 (9/24/2002), Transmittal Letter at 2; I T.E. 23-24, 133; Beer Direct at 2-4; Thompson Rebuttal at 10.
[13] Response of MISO to the KPSC's Initial Data Requests (1/26/2004), Item No. 1.
[14] Thompson Direct at 3-5.
[15] A Locational Marginal Price is the price at which electricity supply equals electricity demand at a specified location (also referred to as a node or bus). All demand that is prepared to pay at least this price at the specified

Transmission Rights ("FTRs"), clearly exceed the requirements of the FERC's Order No. 2000 and even requirements contemplated by the now aborted Standard Market Design Notice of Proposed Rulemaking ("SMD NOPR") and subsequent White Paper.[16] In particular, whereas the SMD NOPR made clear that market participation was to be "voluntary,"[17] MISO's Day 2 markets require that TOs either self-schedule their own generation, i.e., sell their generation into the market and buy it back from MISO, or offer into the market for third-party purchase all Designated Network Resources.[18] As a consequence, MISO's Day 2 markets exceed both what MISO's charter members initially envisioned and FERC's subsequent regulatory requirements and proposals.

MISO's development of the infrastructure necessary to administer the Day 2 markets has exposed the Companies to unexpectedly high Schedule costs. Furthermore, the eventual implementation of the proposed Day 2 markets will indisputably expose the Companies to significant new financial risks with little promise of corresponding benefits.[19] Because the Companies' MISO membership is not cost-effective and is likely to become less so, the time is now right for the Commission to order the Companies to pursue an exit from MISO by seeking the requisite approval from FERC, and to approve the Companies' creation of a regulatory asset to cover the MISO exit fee.

Conversely, MISO states that the Companies would enjoy $270 million (nominal dollars) in net benefits if they remained MISO members during the period 2005-2010.[20] To support its claim that the benefits of MISO membership outweigh the significant costs, MISO asserts that it

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location has been satisfied. All supply that is prepared to operate (i.e., generate power) at or below this price in the specified location has been purchased.

[16] Thompson Direct at 11; I T.E. 21, 24.

[17] SMD NOPR ¶ 269.

[18] MISO Day 2 OATT ¶ 69.2.

[19] Morey Rebuttal at 27-35; Thompson Direct at 12.

[20] Morey Rebuttal at 7; MISO Case, Pre-filed Direct Testimony of Michael P. Holstein (12/29/2003) ("Holstein Direct") at 14.

is responsible for all of the benefits flowing from LG&E and KU's merger.[21] Of course, MISO did not engage in the planning and execution of any of the cost-saving initiatives the Companies implemented.[22] MISO's attempt to claim credit for the LGE/KU merger benefits exemplifies the challenge it faces in identifying demonstrable and meaningful benefits of the Companies' MISO membership.

MISO further claims that the Companies' transmission system's reliability has improved as a result of MISO membership.[23] MISO's claimed benefit is erroneous, however, because MISO failed to measure its assertion of increased reliability relative to the Companies' operating in a standalone configuration or in terms of a forward-looking perspective.[24] MISO's key witnesses admitted that they did not have knowledge of the Companies' system, either with respect to the characteristics of the generation fleet or its transmission system.[25] In particular, MISO's witness, Mr. Jonathan Falk, admitted that he had no knowledge of the capabilities or limitations of the Companies transmission system, nor was he aware of how the Companies historically have operated their transmission system.[26] These deficiencies notwithstanding, Mr. Falk felt comfortable offering an opinion on the reliability of the Companies' system and its operation.

Further, MISO failed to analyze whether these same alleged increases in reliability could be accrued in other, less costly ways. The Companies' witnesses testified that any alleged increase in reliability can be captured through reliability coordination arrangements that will

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[21] MISO Case, Pre-filed Direct Testimony of James P. Torgerson (12/29/2003) ("Torgerson Direct") at 9-11; Morey Rebuttal at 9, 12-13.
[22] III T.E. 144-52.
[23] MISO Case, Pre-filed Direct Testimony of Jonathan Falk (12/29/2003) ("Falk Direct"); Morey Rebuttal at 9-10, 13-20.
[24] Morey Rebuttal at 11-12.
[25] II T.E. 224.
[26] Id.

comply with national, regional and statewide reliability standards.[27] Indeed, it is telling that, other than stating that it has no intention of selling its reliability services to non-members, MISO did not offer any explanation as to why the Companies could not obtain equal levels of reliability by contracting with other vendors.[28] Thus, there is little evidence in the record to suggest that the Companies could not obtain these same alleged increases in reliability absent their full membership in MISO.

Finally, MISO asserts that the Companies will enjoy increased off-system sales as MISO members.[29] MISO's witness on this issue, Dr. Robert R. McNamara, admitted that his projection of the Companies' MISO-member off-system sales was based on "merciless[] . . . optimization," and offered no explanation for why the Companies have never actually produced that many off-system sales.[30] Dr. McNamara further admitted that he did not run or directly supervise the running of the computer model (ProMod IV),[31] nor did he run sensitivity analyses of,[32] or even review,[33] all of the various data and other inputs the model used to generate MISO's projections of the benefits to the Companies of MISO membership. At best, MISO's off-system sales benefit claims are speculative.

In addition to an analysis of costs and benefits, the Commission asked the parties to address the Companies' need to have sought Commission approval under KRS 278.020(4) to "transfer . . . control" of their transmission facilities to MISO.[34] There are several reasons that

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[27] MISO Case, Pre-filed Rebuttal Testimony of Mark S. Johnson (2/9/2004) ("Johnson Rebuttal") at 4-6; Morey Rebuttal at 8.
[28] IV T.E. 90-91.
[29] Morey Rebuttal at 7-8, 23-25.
[30] III T.E. 98.
[31] III T.E. 24, 117-19.
[32] Id.
[33] Id.
[34] MISO Case Initial Order at 3-4.

Commission approval was not required.[35] First, the plain language of the statute applies only to transfers of "utilities," which are defined as "persons" in KRS 278.010; "persons," in turn, are defined as entities: individuals, corporations, partnerships and the like.[36] Second, the statute focuses on the transfer of control of entities, including language such as "transfer of stock" and "financial, technical, and managerial abilities."[37] Third, as is discussed in more detail later in this brief, to construe KRS 278.020(4) as applicable to the Companies' limited transfer would render a more recently enacted statute, KRS 278.218, mere surplusage. Such an interpretation would violate well-established canons of statutory interpretation.[38] Accordingly, the Commission should avoid such an interpretation of KRS 278.020(4). Finally, the testimony in this case is that the Companies made a substantially identical transfer of operational control of their transmission system to NERC several years ago,[39] for which the Commission did not require regulatory approval. These are critical points of statutory construction that demonstrate that KRS 278.020(4) did not and does not apply to the Companies' limited transfer to MISO.

The Commission also asked the parties to address "the appropriateness of, and jurisdictional basis for, MISO to provide services traditionally within the supervision and control of the Commission, including, but not limited to, resource adequacy and DSM."[40] As discussed in greater detail below, the Companies' believe that the interests of Kentucky ratepayers are best served by a Commission with the authority to set its own requirements.[41]

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[35] Beer Direct at 11-14. See also III T.E. 94.
[36] KRS 278.020(4); KRS 278.010(2), (3).
[37] KRS 278.020(4).
[38] Hamilton v. International Union of Operating Engineers, Ky., 262 S.W.2d 695, 699 (1953); Stevenson v. Anthem Casualty Insurance Group, Ky., 15 S.W.3d 720, 724 (1999).
[39] Beer Direct at 13; III T.E. 94.
[40] MISO Case Initial Order at 4.
[41] Beer Direct at 17-18.

Finally, the Commission asked the parties to investigate the feasibility of the Companies' joining a southern RTO.[42] The uncontroverted evidence in this case shows that joining a southern RTO (i.e., the now-defunct SeTrans RTO) or attempting to create a Kentucky ISO would be more costly than either continued MISO membership or standalone operation.[43]

Ultimately, in seeking the most credible answers to its questions in this investigation, the Commission must determine which parties' motives more closely align with its own; namely, to further what is in the public interest. The Companies represent their customers and their shareholders. As responsible, low-cost utilities, the Companies have a demonstrated record of striving to hold down costs and to keep rates for their customers as low as possible without sacrificing service quality or system reliability. By contrast, MISO represents not solely the interests of the Companies' or their ratepayers, but also the interests of (1) "the market,"[44] (2) MISO's other TOs, who would necessarily shoulder more cost responsibility should the Companies exit MISO,[45] and (3) MISO itself, which is concerned that the Companies' exit could precipitate other TOs' departures.[46] Although it is only natural for the Companies and MISO to advocate for their respective constituencies and interests, it is clear that the Companies' interests, not MISO's, more closely align with those of Kentucky ratepayers.

II. The Companies' Continued MISO Membership Is Not Cost-Effective, And Is Therefore Not In The Public Interest, Over The Period 2005-2010

The Companies' independent, impartial cost-benefit analysis shows that, over the years 2005-2010, standalone operation of their transmission system is economically superior to continued MISO membership, joining a southern RTO, or creating and joining a Kentucky

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[42] MISO Case Initial Order at 4.
[43] MISO Case, Pre-filed Direct Testimony of Mathew J. Morey (9/22/2003) ("Morey Direct") at 10-19, Ex. MJM-1 at 58-60; I T.E. 147-48; Pre-filed Direct Testimony of Robert R. McNamara (12/29/2003) ("McNamara Direct") at 4.
[44] III T.E. 13-15.
[45] III T.E. 141-43.
[46] III T.E. 208-09.

ISO.[47] Although the Companies have obtained benefits from MISO membership, MISO overstates the value of its benefits and understates the risks of its so-called Day 2 markets, which are proposed to commence in December of this year. Indeed, MISO's Day 2 markets are a major source of the Companies' concern because the potential risks are so difficult to quantify.

As the Companies' cost-benefit analysis stands, continued MISO membership is, although inferior to standalone operation, superior to the other two alternatives the Companies' expert evaluated. Indeed, were MISO to drop its Day 2 markets or, at the very least, permit the Companies to opt out of the Day 2 markets for the period 2005-2010, and if FERC restored the original Schedule 10 compromise, it is possible that continued MISO membership would become the Companies' best option over the period 2005-2010. Were such a scenario to play out, the Companies would still have concerns about MISO's governance structure, but the cost-benefit analysis could shift meaningfully, at least for that period. However, given that MISO has filed its Day 2 tariff and that MISO's Chief Executive Officer ("CEO") stated in his live testimony that MISO was not disposed to allow the Companies to abstain from Day 2 participation,[48] it seems unlikely that the Companies could participate only in the reliability coordination and open-access functions of MISO. Because MISO is a unitary package that has evolved substantially from its inception into something well beyond what the Companies ever contemplated, on the basis of their independent cost-benefit analysis the Companies believe the Commission should order the Companies to seek exit from MISO through the FERC and allow the Companies to create a regulatory asset for the prudently incurred MISO exit fee.[49]

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[47] Morey Direct at 10-19, Ex. MJM-1 at 58-60.
[48] I T.E. 47.
[49] Thompson Direct at 15-16; II T.E. 158-65.

A. The Companies' Initial Decision To Join MISO Was Prudent

Although it is now prudent for the Commission to order the Companies to exit MISO, that would not always have been the case. Indeed, the Companies' decision to become charter members of MISO and the Companies' membership to this point certainly has been prudent. The Companies had three primary goals in helping to form and initially joining MISO as it was originally conceived: (1) to comport with emerging federal regulations, such as Order No. 888 (and subsequently Order No. 2000); (2) to achieve greater transmission system reliability; and (3) to increase opportunities for the Companies' to take full advantage of their generation fleet through off-system sales.[50] All of these goals were in the best interests of the Companies' native load customers. However, the Companies never anticipated that MISO would expand so significantly beyond its original charter and become as costly as it has.[51]

Native load customers stood to gain from the Companies' involvement in the development of MISO from the outset. The Companies hoped to help to influence the direction of future federal regulation, because the Companies' failure to do so could well have resulted in even less favorable – and perhaps mandatory – ISO/RTO structures.[52] Although the Companies began discussions with other TOs about the possibility of forming MISO earlier, it became clear after FERC issued Order No. 888 in April of 1996 that regional transmission coordination, then in the form of ISOs, was the wave of the federal regulatory future.[53] The Companies then faced a choice: they could either stay out of the fray and watch as others developed the regulations and entities that likely would substantially impact them and their customers, or they could remain

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[50] Beer Direct at 3; Thompson Direct at 2-3; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.

[51] Thompson Direct at 9-10, quoting MISO Proposed Revisions to Open Access Tariff, FERC Docket No. ER02-2925-000 (9/24/2002), Transmittal Letter at 2; I T.E. 23-24, 133; Beer Direct at 2-4; Thompson Rebuttal at 10.

[51] Thompson Direct at 2-3; Beer Direct at 2-3; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.

[52] Id.

[53] Id.

involved and help shape the regulatory landscape and entities within and with which they would work in the future.[54] The Companies wisely chose the latter course.

In taking the path of remaining actively engaged in molding MISO, the Companies and the other TOs were able to secure important provisions in the TO Agreement originally submitted to FERC that made MISO cost-effective and reasonably controllable in the short- and long-terms. The first, and arguably most important, of these provisions was the Schedule 10 compromise, which allowed the Companies to defer significant portions of the Schedule 10 costs they might otherwise pay by not applying Schedule 10 charges to bundled native load during the transition period (which was to end around 2008).[55] Because at the time of MISO's formation the Companies reasonably expected that the amount of bundled native load within the MISO footprint would diminish substantially over the course of the transition period with the advent of state or federally mandated retail choice, the Schedule 10 compromise meant that the Companies' deferral of Schedule 10 costs might ultimately result in complete avoidance of the deferred costs.[56]

The other important provision of the original TO agreement -- which provision has become even more significant in the wake of MISO's increasingly broad functional role -- was that TOs could vote to remove MISO directors without having to consult other MISO members.[57] Although the Companies understood and appreciated that Order No. 888 required that ISOs had to be independent, they and the other TOs also understood that the TOs had the greatest stake in the system; they therefore desired to exert some degree of control greater than

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[54] Id.
[55] Thompson Direct at 3-5.
[56] Id.; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.
[57] Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER98-1438-000, Order Conditionally Authorizing Establishment of Midwest Independent Transmission System Operator and Establishing Hearing Procedures ("FERC Order Approving MISO") (9/16/1998) at 28.

those whose stake was not so great. The TOs' power to remove directors without having to consult other members provided the additional control the TOs required to protect their interests without unduly compromising MISO's independence.

FERC significantly reduced the economic viability of the Companies' continued membership in MISO when it set for hearing – and ultimately rejected – both the Schedule 10 compromise and the TOs' power to remove directors as part of its conditionally approving MISO's application to become an ISO in January 1998.[58] FERC's decision effectively made the Companies' MISO membership more expensive and weakened the Companies' ability to influence MISO's direction. The loss of these two key provisions has contributed to burgeoning MISO cost and scope and has required the Companies to pay more in MISO costs than the Companies initially anticipated. Although the Companies have consistently fought to restore the Schedule 10 compromise before FERC and in the courts,[59] and to exert greater influence over decision making at MISO,[60] their efforts have thus far yielded little.

B. MISO's Scope And Cost Have Expanded Well Beyond the Companies Initial Expectations

It is difficult to overstate the degree to which MISO has exceeded the Companies' initial expectations both in scope and in cost. For example, in 2004 MISO's operating budget mushroomed to $190.8 million and its capital budget swelled to $80.6 million.[61] The Companies' expectations aside, these figures represent an 1100% increase in operating expenditures and a 311% increase in capital expenditures from 2000.[62] At least some of this

[58] Id. at 28, 62.
[59] Thompson Direct at 6-9.
[60] See, e.g., Thompson Direct at 9-11.
[61] Response of MISO to the KPSC's Initial Data Requests (1/26/2004), Item No. 1.
[62] Id.

substantial increase in spending is attributable to a 231% increase in MISO personnel, from 201 employees in 2001 to 465 budgeted employees in 2004.[63]

MISO's witnesses tried to justify these large increases as the result of the natural transition from MISO's start-up phase to its implementation phase,[64] but a significant part of the Companies' concern lies with just what MISO has implemented and will implement in the future, particularly the Day 2 markets. MISO's witnesses stated that MISO estimates it will spend a total of $190 million to create the Day 2 markets.[65] These markets are structures that, MISO admits, federal regulations, i.e., Orders No. 888 and No. 2000, do not require.[66] There simply is no explicit mandate for MISO to provide real-time and day-ahead, LMP-based markets with FTRs as a means to manage congestion and allocate transmission capacity. Accordingly, there is no mandate for MISO to spend money on them. Moreover, the proposed markets' reliance on a system of FTRs allocated to transmission users as a means to hedge congestion costs exposes the Companies to new, substantially greater financial risk -- a level of risk that the Companies do not incur with their current use of physical transmission rights.[67] In summary, MISO's Day 2 markets are risky, expensive and not required by federal regulation.

III. The Companies' Cost-Benefit Analysis Demonstrates That Now Is the Proper Time For The Commission To Order The Companies To Exit MISO Subject to FERC Approval

There are two cost-benefit analyses before the Commission in this case: the Companies' and MISO's. To determine which is more credible, the Commission need only consider the following:

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[63] Id.
[64] See, e.g., I T.E. 29-31.
[65] III T.E. 172; IV T.E. 28-29.
[66] Thompson Direct at 9-10, quoting MISO Proposed Revisions to Open Access Tariff; I T.E. 23-24.
[67] Morey Rebuttal at 28-32.

(1) The Companies' study demonstrates a $60.8 million net benefit associated with standalone operation, while MISO's claims over $270 million in net benefits attributable to the MISO membership option.[68]

(2) The Companies represent their interests and those of their ratepayers; MISO admits that it represents the interests of its other TOs and the undifferentiated "market."[69]

(3) The Companies' methodological approach was to compare the relative costs and benefits of the Companies' remaining in MISO versus operating in a standalone configuration for the period 2005-2010.[70] In contrast, two of the four main benefits MISO claims in its study - the benefits of the LG&E/KU merger[71] and MISO's claimed reliability benefits - would still be obtained if the Companies were in a standalone configuration.[72]

(4) The two principal benefits MISO claims the Companies could enjoy only as MISO members are increased transmission revenues and an increased net margin on off-system sales, both of which are based on highly dubious assumptions about transaction costs for and the manner in which the Companies conduct their off-system sales.[73]

A. MISO Errs In Claiming Credit For The Benefits Of The LG&E/KU Merger Because Such Benefits Will Accrue Regardless Of MISO Membership

The most dubious claim MISO makes in its cost-benefit analysis is that it can include as a benefit of MISO membership the projected cost savings flowing from the LG&E/KU merger, which savings make up over half of MISO's claimed net benefits ($143.8 million in merger benefits out of $270.3 million net benefits of MISO membership).[74] However, MISO's own witnesses undermined this position at hearing by acknowledging that these merger benefits will flow to the Companies and their ratepayers regardless of whether the Companies are MISO members.[75] Indeed, MISO's CEO stated in his pre-filed testimony that "it is impossible to know" whether FERC would have approved the LG&E/KU merger had the Companies not been

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[68] Id. at 7-8.
[69] III T.E. 13-17, 141-43.
[70] Morey Rebuttal at 10-11.
[71] Id. at 12-13.
[72] Id. at 16-20.
[73] II T.E. 74-75.
[74] Morey Rebuttal at 7-9.
[75] III. T.E. 145-49; Torgerson Direct at 10-11.

MISO members.[76] The only justification MISO musters for its claim that the Commission should count the LG&E/KU merger benefits as benefits of MISO membership is that FERC conditioned its approval of the merger on the Companies' participation in MISO, a point that is (1) irrelevant to a study of relative costs and benefits of the Companies' ongoing MISO membership and (2) speculative.[77] FERC stated the following in its orders approving the LG&E/KU merger and the LG&E/KU/Powergen/E.ON merger, respectively:

> Our approval of the merger is based on LG&E and KU's continued participation in the Midwest ISO. If LG&E and KU seek permission to withdraw from the Midwest ISO . . . once it is operating, we will evaluate that request in light of its impact on competition in the KU destination markets, use our authority under section 203(b) of the FPA to address any concerns, and order further proceedings as appropriate.[78]
>
> Applicants have shown that the combination of their [E.ON Powergen's, LG&E's and KU's] generation and transmission facilities will not harm competition. As Applicants note, LG&E and KU have committed to transfer operational control of their transmission systems to the MISO and will remain members of the Midwest ISO at least until the end of 2002. Furthermore, they have committed to be members of a Commission-approved RTO thereafter.[79]

What the above passages from FERC's merger orders show is that FERC views ISO or RTO membership as one way to combat market power concerns. What they do not show, however, is that such membership is the only way the Companies can allay whatever market power concerns FERC might have in reviewing any petition the Companies might submit to exit MISO.[80] And

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[76] Torgerson Direct at 10-11.
[77] Id.
[78] Louisville Gas and Electric Company, LG&E Energy Marketing, Inc., and Kentucky Utilities Co., FERC Docket Nos. EC98-2-000 & EC98-111-000, Order Approving Merger, Accepting Proposed Agreements for Filing, Accepting and Suspending Open Access Transmission Tariff, and Establishing Hearing Procedures ("FERC Order Approving LG&E/KU Merger") (3/27/1998) at 20.
[79] E.ON AG and Powergen plc, LG&E Energy Corp., Louisville Gas and Electric Co., and Kentucky Utilities Co., FERC Docket No. EC01-115-000, Order Authorizing Merger and Granting Waiver ("FERC Order Approving E.On Merger") (10/15/2001) at 6.
[80] Indeed, the Companies were working on alternative market power solutions, and FERC implied in its LG&E/KU merger order that other solutions might have sufficed.

what they certainly do not show is that FERC would unwind the LG&E/KU merger if the Commission ordered the Companies to seek exit from MISO, which must occur in order for MISO to claim plausibly that the merger benefits are exclusive benefits of MISO membership. Because LG&E and KU's merger benefits are not, in fact, benefits of MISO membership, it was an error for MISO to count them as such. Subtracting the erroneous benefit from MISO's total brings MISO's claimed net benefits to $126.5 million.

B. Because There Would Be No Measurable Change In The Companies' Transmission System's Reliability If The Companies Exited MISO and Operated In A Standalone Configuration, MISO Cannot Claim A Relative Reliability Benefit

MISO claims that over the period 2005-2010, the Companies will enjoy $16.2 million in expected reliability benefits as MISO members that they would not enjoy in a standalone configuration, erroneously assuming that the Companies, operating in a standalone configuration, would return to operating their transmission system exactly as they had before MISO began acting as the Companies' reliability coordinator.[81] MISO's assumption is erroneous because the Companies have stated that they will secure reliability coordination services from a properly equipped entity. Whether it is MISO, TVA, or another reliability coordinator, there is no basis for believing that the Companies' transmission system's reliability will degrade if the Companies exit MISO.[82]

Moreover, MISO's witness, Mr. Roger Harszy, indicated that MISO will conduct its reliability coordination surveillance function in a manner that encompasses all utilities bordering the MISO footprint (i.e., the first-tier utilities).[83] This naturally encompasses the Companies' service territory, regardless of the Companies' membership status. Without any quantification of

[81] Falk Direct at 1; Morey Rebuttal at 7-8.
[82] Johnson Rebuttal at 4-5.
[83] II T.E. 257.

a relative decline in the Companies' transmission system reliability should the Companies exit, MISO cannot claim a relative reliability benefit of $16.2 million; it should be subtracted from what is left of MISO's net benefits, $126.5 million, for a new MISO net benefit of $110.3 million.

Further, it is worthy of note that MISO did not ask its expert to determine if MISO provides its alleged reliability benefits cost-effectively.[84] The Companies have real reason to be concerned about the fact that the Companies have paid over $12 million in Schedule 10 charges in 2002 and 2003[85] but have not been able to realize workforce reductions or any appreciable cost savings.[86] Accepting MISO's claimed reliability benefit figure for the sake of argument, the Companies have paid MISO over $12 million to obtain $5.4 million in expected reliability benefits for the years 2002 and 2003.[87] Although MISO speaks of the value of the services it provides other than reliability coordination, the Companies' witnesses testified that the Companies can perform the same services for about $1 million per year, plus the cost of purchasing outside reliability coordination services.[88] Therefore, even if the Commission accepts MISO's reliability benefit figure, there is no basis in the record for concluding that MISO is providing the benefit cost-effectively.

For the Companies to enjoy the same level of reliability outside MISO as they now enjoy inside it, they will have to obtain reliability coordination services from another entity. Even though there are others that could provide adequate reliability coordination services, MISO is the logical entity to provide such services.[89] Interestingly, MISO has stated that it would not provide

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[84] II T.E. 210.
[85] Response of LG&E and KU to the KPSC's Post-Hearing Data Requests (2/25/2004), Item No. 4.
[86] II T.E. 184.
[87] Id.; Falk Direct at 1; Morey Rebuttal at 7-8.
[88] Johnson Rebuttal at 5-6; Morey Rebuttal at 8.
[89] Johnson Rebuttal at 4-5.

the Companies such services should the Companies operate in a standalone configuration.[90] This is troubling for several reasons. First, MISO has to this point acted as the Companies' reliability coordinator and has, presumably, installed most, if not all, of the systems required for MISO to act as the Companies' reliability coordinator in the near future. Second, MISO's witnesses have stated that having a single transmission operator with a broad view of the transmission system is better for overall system reliability.[91] Thus, it would seem that MISO could best protect its remaining members by acting as reliability coordinator to the Companies as standalone entities.[92] Third, MISO has a stated policy of monitoring the transmission systems of utilities bordering the MISO footprint to provide better reliability for the entities inside MISO.[93] Since MISO would continue to monitor the Companies' system should the Companies operate as standalone entities, it would seem to be beneficial for MISO to provide the Companies full-fledged reliability coordination services for compensation. Fourth, MISO has stated that it is a non-profit entity. Providing these services at cost to non-members harms no one and, by MISO's own admission, increases system reliability.[94] Indeed, MISO has stated that one effect of the Companies' exit would be to drive up costs for the remaining TOs.[95] Any such increased costs could be easily mitigated by MISO spreading its fixed costs by charging the Companies a fair rate to provide reliability coordination services. Regrettably, the Commission and the Companies have been left to wonder why MISO declines to provide these services. The only answer offered by MISO regarding its prospective refusal to provide such services to the Companies as standalone entities

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[90] IV T.E. 90-91.
[91] See, e.g., IV T.E. 90-91.
[92] Id.
[93] II T.E. 257.
[94] IV T.E. 89-91.
[95] III T.E. 141-43.

is that MISO simply does not desire to provide such services,[96] notwithstanding that MISO does indeed provide such services to merely prospective MISO members in the MAPP region.[97]

Finally, MISO's refusal to act as the standalone Companies' reliability coordinator aside, there is ample reason to doubt the value MISO assigns to its claimed reliability benefit. MISO's witness responsible for generating its reliability benefit figure, Mr. Jonathan Falk, testified that: (1) he knew nothing at all of the Companies' transmission system and did not, therefore, tune his reliability benefit figure to it;[98] (2) he based his expected per-outage lost kilowatt-hours figure on NERC Disturbance Analysis Working Group data, thus his estimate is a national, not Kentucky-based, figure;[99] (3) he based his "value of lost load" figures on his "reading of the literature," which he admits have no particular connection to the value of lost load in Kentucky;[100] and (4) he chose an average value of "p," which is the average probability of an outage under undeclared TLR Level 4 conditions.[101] Mr. Falk used an average value of p that is significantly higher than the historical data would suggest, purposefully ignoring the fact that the Companies have not had to shed load to protect their grid in over twenty years.[102] All of these factors – the ignorance of the Companies' system, the failure to use Kentucky-specific data, and the refusal to take the historical performance of the Companies into account – render MISO's claimed reliability benefit figure suspect.

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[96] IV T.E. 90-91.
[97] IV T.E. 11.
[98] II T.E. 224.
[99] Id.
[100] Id. at 226.
[101] Falk Direct at 10-12.
[102] See, e.g., Morey Rebuttal at 17-18.

C. MISO Errs In Claiming That The Companies Will Enjoy Significant Additional Transmission Revenue As MISO Members Because The Companies' Transmission Revenues Are Almost Completely Offset By Transmission Payments

MISO posits that the Companies will enjoy $12.7 million per year, for a total of $76.1 million from 2005-2010, in additional transmission revenues as MISO members that the Companies would not enjoy in a standalone configuration.[103] This is an erroneous figure because historically the Companies' transmission revenues have equaled their transmission payments, and the Companies do not expect this relationship to change in the foreseeable future, regardless of the Companies' RTO status.[104]

Assuming that the magnitude of MISO's transmission revenue figure is correct for the sake of argument, it is irrelevant because MISO wrongly assumed that the Companies deliver their energy at the generator bus and then charge more to transmit the energy to the customer.[105] First, the Companies often do not sell energy that way; the Companies' energy price includes the cost of transmission to the customer's bus.[106] Second, if the Companies did sell power at the generator bus within the standalone configuration, transmission revenues would be received from the third party to whom the power was sold, and there would be no offsetting payments by the Companies' trading arm. Thus, in that case, the transmission revenues would be higher under the standalone option than under the MISO membership option because customers do not pay point-to-point transmission charges in MISO. Because MISO was wrong to include additional transmission revenue in its remaining net benefits figure, $110.3 million, the Commission should reduce it by the erroneously added $76.1 million, for a remaining MISO net benefits figure of $34.2 million.

[103] Morey Rebuttal at 7-8.
[104] Morey Rebuttal at 21-23.
[105] II T.E. 74-75.
[106] Id.

D. Because MISO Membership Is Unlikely To Affect The Companies' Off-System Sales Volume, MISO Is Wrong To Claim An Increased Off-System Sales Benefit

MISO relies upon numerous faulty or dubious assumptions concerning the Companies' ability to generate and sell power outside its control area to claim that the Companies would make an additional $8.35 million per year, for a total of $50.1 million from 2005-2010, should they remain in MISO instead of pursuing a standalone configuration.[107] MISO based its off-system sales ("OSS") margins claim on the Companies' making 8.6 million MWh of OSS as MISO members, but only 5.7 million MWh of OSS as standalone entities.[108] To obtain such a low number for the Companies' standalone OSS relative to MISO membership, MISO's witness, Dr. McNamara, had first to assume, on the basis of his "professional judgment," that the Companies would incur a $3 per MWh transaction cost for standalone OSS[109] and would face certain transmission constraints.[110] Other than Dr. McNamara's "professional judgment," there is no evidence in the record to support such a high transaction cost;[111] even accounting for it and Dr. McNamara's posited transmission constraints,[112] though, MISO's model calculated that the Companies would enjoy 8 million MWh of standalone OSS, for a margin of $19 million per year (as compared to MISO's claimed $21.8 million per year for continued MISO membership).[113] Therefore, even if the Commission accepted Dr. McNamara's professional judgment as to the $3/MWh transaction cost and transmission constraints, MISO's OSS benefit would come only to $13.6 million, <u>not</u> $50.1 million.

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107 Morey Rebuttal at 7-8.
108 Morey Rebuttal at 23-25.
109 <u>Id.</u>; III T.E. 22-23.
110 McNamara Direct at 15-17, Ex. RRM-1 at 7-8.
111 III T.E. 22-23.
112 McNamara Direct at 15-17, Ex. RRM-1 at 7-8.
113 Morey Rebuttal 23-25.

As much as the unlikely $3/MWh transaction cost and transmission constraints reduced MISO's projection of the Companies' standalone OSS, it was not until Dr. McNamara again exercised his professional judgment to scale back his own projections of the Companies' standalone OSS by over 30% that he produced the standalone OSS figure MISO claimed the Companies would achieve, 5.7 million MWh.[114] Dr. McNamara justified this radical reduction of the standalone OSS number – but not the MISO membership OSS number – by noting that the Companies had only 5.7 million MWh of OSS in 2002. He offers this opinion despite his admission that he does not know anything about the Companies' system or generation fleet.[115] He also justified the reduction on the premise that ProMod IV could not be set up to account fully for all of the real-world restrictions and limitations on the Companies' ability to make OSS, yet he provided no explanation why the same was not true of the ProMod IV runs of the continued MISO membership scenario.[116] That is to say, Dr. McNamara gave <u>no account</u> of why the Commission should lend any credence to the ProMod IV model given that Dr. McNamara felt the need to correct the model's output by <u>thirty percent</u>.

Indeed, much about MISO's use of ProMod IV in its cost-benefit analysis is concerning. In his live testimony, Dr. McNamara told the Commission that nobody at MISO either ran or directly supervised the running of the ProMod IV model.[117] In addition, Dr. McNamara did not review all the inputs that were used in the model runs, but only those he thought "critical."[118] Just how Dr. McNamara determined which inputs were "critical" is unknown, because no one performed sensitivity analyses of the various model inputs; if indeed someone performed such analyses of certain inputs, Dr. McNamara testified he did not know which inputs were analyzed

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[114] <u>Id.</u>
[115] III T.E. 42.
[116] McNamara Direct Ex. RRM-1 at 8-9.
[117] III T.E. 24, 117-19.
[118] <u>Id.</u>

nor what the results of such analyses might have been.[119] Such sensitivity analyses might have been useful in determining what the model's margin of error was, which Dr. McNamara admitted existed but the value of which he did not know.[120] All of these facts, as well as Dr. McNamara's thirty percent scaling back of the ProMod IV projection of the Companies' standalone OSS, give ample reason to doubt the significance of other of MISO's claimed benefits, such as MISO's claim that the Companies will avoid $2.7 million per year in operations costs, an amount that is only 0.4% of the Companies' total cost to serve their control area load.[121]

Unlike MISO, the Companies have reasonably assumed that they would make approximately the same amount of OSS either in or out of MISO.[122] The Companies' witness testified that the Companies expect to be able to sell their power into MISO because there will be a Locational Marginal Pricing node[123] at the Companies' MISO interface, allowing the Companies to sell into MISO at that point.[124] There is no evidence in the record that disputes or contradicts this assumption.[125] Because MISO premised its claim of a MISO membership OSS benefit on an implausibly high transaction charge and a suspect 30% scaling back of MISO's calculation of standalone OSS, the Commission should subtract MISO's claimed OSS benefit, $50.1 million, from MISO's remaining net benefit figure, $35.2 million, for a new MISO net benefit amount of negative $15.9 million.

E. MISO's Day 2 Markets Create Potential Risk for LG&E And Will Not Allow LG&E To Operate As It Has To Date

Whatever may be the flaws of the current MISO structure and services, they are small compared to the risks and costs of MISO's proposed Day 2 markets. Most troubling about the

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[119] Id.
[120] III T.E. 48-50.
[121] McNamara Direct Ex. RRM 1-4.
[122] Morey Rebuttal at 25.
[123] See n.15.
[124] II T.E. 140.
[125] II T.E. 141.

Day 2 markets is that there appear to be no obvious net benefits that would accrue to the Companies from Day 2 market participation. If the Day 2 markets "go live" in December 2004 as MISO currently plans, MISO will have spent approximately $190 million to implement them, including the costs of delaying market implementation at the TOs' behest.[126] Over the course of 2005-2010, MISO estimates the Companies will pay $36.2 million in Schedules 16 and 17 costs[127] – the Companies estimate approximately $51 million[128] – yet, as shown above, the Companies will receive no additional net transmission revenue benefit, nor will they be able to make appreciably more OSS, if any.

One reason why the Companies' costs for the Day 2 markets are high is that Schedule 17 charges are allocated to TOs based on the total of all service the TOs schedule with MISO, including both OSS and what TOs self-schedule to serve native load.[129] This method of computing Schedule 17 charges is at odds with the methods other RTOs such as PJM use.[130] It is also inconsistent with the way MISO itself computes Schedule 16 charges, which are based only on sales TOs make into the markets, not what TOs use to serve their native load.[131] Were MISO to compute Schedule 17 charges as it computes Schedule 16 charges, the Companies' Day 2 markets costs might decrease significantly.

There are also potential material risks associated with the use of FTRs in the Day 2 markets in place of physical transmission rights. These are risks the Companies do not face today, including the risks of under- and over-hedging with FTRs, and the risk of "cram-down."[132] Cram-down occurs when FTR payouts are less than their face value due to the RTO's

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[126] III T.E. 172; IV T.E. 28-29.
[127] Holstein Direct at 14; Morey Rebuttal at 27-28.
[128] Morey Rebuttal Ex. MJM-4.
[129] IV T.E. 30-33.
[130] Id.
[131] Id.
[132] Morey Rebuttal at 29.

receiving insufficient congestion revenues to finance fully the FTRs used.[133] Although MISO downplays these risks in its pre-filed testimony as nearly non-existent by estimating the Companies' total FTR-related risk at $70 per year,[134] one of MISO's witnesses acknowledged during live testimony that such risks have materialized in the form of real losses for at least some TOs in PJM, which uses a similar system of financial transmission rights.[135] One way TOs have incurred losses in PJM is through cram-down. In PJM, cram-down has resulted in FTR payouts of 90% of the FTRs' nominal value in 1990 and 95% in 2002.[136] MISO did not address this financial risk issue in its cost-benefit study and has provided no evidence that cram-down will be absent in their proposed Day 2 markets. Cram-down is a real risk arising in the Day 2 markets that must be accounted for in any cost-benefit analysis of MISO membership, particularly when that membership mandates participation in the short-term energy market and requires physical transmission rights be converted to financial transmission rights.

Besides cram-down, FTRs in the Day 2 markets present hedging risks that could cost the Companies millions of dollars. There is some risk of under-hedging, which occurs when the LMP at the sink is greater than at the source due to congestion and the FTR holder has inadequate FTRs to cover the entire scheduled transaction.[137] With an adequate amount of FTRs, however, the under-hedging risk is fairly small. This, in effect, is what MISO witness Dr. McNamara demonstrated in MISO's cost-benefit analysis by allocating FTRs to the Companies sufficient to cover scheduled load under expected congestion in all but a very small number of hours. But this kind of allocation creates an even greater risk, that of being over-hedged -- a risk

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[133] Id.
[134] McNamara Direct Ex. RRM 1-6; Morey Rebuttal at 28-30.
[135] III T.E. 99-100.
[136] Id.
[137] Id. at 28-29.

MISO does not address.[138] Over-hedging risk is possible because MISO plans to use obligation-type, directional FTRs.[139] A directional FTR entitles the FTR holder to a payment whenever the LMP at the sink is greater than the LMP at the source (i.e., the congestion "runs in the same direction" as the FTR). In MISO's proposed Day 2 markets, if the scheduled MW in the day-ahead market equal the MW transmitted in the real-time market and equal the MW FTR coverage, then, when congestion occurs, the FTR holder receives payment from MISO equal to what it pays for congestion; the FTR holder is completely hedged. If, on the other hand, the MW FTR held exceeds the MW actually scheduled in the day-ahead market and the MW transmitted in the real-time market, then when congestion "runs in the opposite direction," i.e., the LMP at the source is greater than the LMP at the sink, the directional FTR in the proposed MISO Day 2 markets obliges the FTR holder to pay more than the holder receives in congestion cost revenue.[140]

The Companies' witness, Dr. Mathew Morey, estimated that the Companies faced over-hedging exposure of $3.2 million per year.[141] Although MISO's CEO expressed willingness to indemnify the Companies against any FTR losses the Companies incur to serve their native load,[142] there is no concrete proposal to that effect in the record. Moreover, the Companies question what is the resource behind the indemnification given that MISO is a non-profit, limited equity entity. There remains, therefore, a multi-million dollar financial risk for the Companies in the Day 2 markets due to over- and under-hedging FTRs.

The Companies are not alone in their concerns about the Day 2 markets. The Wisconsin TOs sent MISO a Memorandum of Understanding to express their desire to remain out of the

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[138] Id. at 30-32.
[139] Id. at 30.
[140] Id.
[141] Id. at 32.
[142] IV T.E. 38-39.

Day 2 markets for five years.[143] MISO also noted that other TOs, including those in Michigan and the MAPP region, have at various times expressed the desire to avoid Day 2 participation.[144] Indeed, the MISO TOs expressed such grave concern prior to and immediately after MISO originally filed its Day 2 tariff on July 25, 2003 (already delayed from MISO's original plan to file on June 30, 2003) [145] that MISO moved to withdraw the tariff on October 17, 2003.[146]

Despite the protest of its TOs, MISO is continuing with Day 2 implementation across its footprint and will allow no exceptions. MISO recently re-filed its Day 2 tariff on March 31, 2004,[147] and its witnesses stated in live testimony that MISO intends to implement the Day 2 markets in December of this year.[148] And MISO's CEO and other witnesses made it abundantly clear that they have no intention of allowing the Companies, the Wisconsin utilities, or any other TOs to avoid Day 2 start-up. The time for the Commission to order the Companies to exit MISO, therefore, is now, before this new set of costs and risks accrues.

IV. KRS 278.020(4) Did Not Require The Companies To Obtain KPSC Authorization To Transfer Control Of Their Transmission System

The Companies did not seek Commission approval under KRS 278.020(4) to transfer limited operational control of its transmission facilities to MISO because the statute simply does not apply to situations such as this one. There is no testimony in the record suggesting that such approval was required. [149] The General Assembly provided the clearest evidence that KRS

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[143] LG&E Hearing Ex. 3, Letter of February 16, 2004, from the Wisconsin and Upper Peninsula of Michigan System (WUMS) to James Torgerson, CEO of MISO, re: WUMS Utilities' Desire to Defer Day 2 Start-up in Wisconsin.
[144] IV T.E. 35-36.
[145] Thompson Direct at 9-11.
[146] Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER03-1118-000, Motion of the Midwest Independent Transmission System Operator, Inc., to Withdraw Without Prejudice the July 25. 2003, Energy Markets Tariff Filing (10/17/2003).
[147] I T.E. 42-43.
[148] Id.
[149] Beer Direct at 11-14. See also III T.E. 94.

278.020(4) did not and does not apply to transfers of the sort the Companies made to MISO when it enacted KRS 278.218, which expressly addresses such transfers:

> No person shall acquire or transfer ownership or control, or the right to control, any assets, that are owned by a utility as defined under KRS 278.010(3)(a) without prior approval of the commission . . ..[150]

The language of this statute (that, importantly, was not in effect when the Companies made their transfer to MISO[151]) applies to what the Companies did with respect to MISO: they transferred to MISO limited operational control of certain of their transmission assets. The statute goes on to require the Commission to grant its approval when a transfer is for a proper purpose and in the public interest,[152] neither of which is a particularly specific criterion, and the statute certainly does not imply that it applies to transfers of entities. This statutory language stands in stark contrast to KRS 278.020(4):

> No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the commission by sale of assets, transfer of stock, or otherwise, or abandon the same, without prior approval of the commission. The commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.[153]

The plain language of this statute, coupled with the statutory definition of "utility" as a "person," meaning a natural person, partnership, corporation, or two or more persons sharing a joint or common interest, [154] clearly indicates that this statute is aimed at the transfer of control of an entity, not the assets such an entity controls. All the terms of KRS 278.020(4) point toward regulating transfer of control of an entity: "utility," "sale of assets," "transfer of stock," and "financial, technical, and managerial abilities," are terms usually applied to entities, not to

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[150] KRS 278.218(1).
[151] The Companies made their transfer on February 1, 2002; the statute became effective on April 24, 2002.
[152] KRS 278.218(2).
[153] KRS 278.020(4) (emphasis added).
[154] KRS 278.010(2), (3).

entities' assets. KRS 278.020(4) simply did not and does not apply to transfers like the Companies' to MISO, which was a limited transfer of control over certain assets, not a utility.

Beyond the plain language of the two statutes, there are two canons of statutory interpretation that militate for the Commission's finding that KRS 278.020(4) did not and does not apply to transfers like the one at issue here. Those canons are: (1) "it will not be presumed that the legislature intended a useless or futile thing";[155] and (2) courts "should construe a statute, if possible, so that no part of it is meaningless or ineffectual."[156] Were the Commission to adopt a reading of KRS 278.020(4) that encompassed transfers such as the Companies' to MISO, it would effectively render the later statute, KRS 278.218, redundant and mere surplusage. To do so would attribute to the General Assembly the intent to do a "useless or futile thing" and would render KRS 278.218 effectively meaningless, both in clear contravention of the canons cited above.

In addition to reasons of formal statutory interpretation, KRS 278.020(4) does not apply to the Companies' transfer to MISO because this case is distinguishable from the Big Rivers case that Commission staff suggested supplies the precedent necessary to show that KRS 278.020(4) did indeed require the Companies to seek Commission approval of their transfer to MISO.[157] The Commission should distinguish this case from Big Rivers because the Big Rivers case concerned a type of transfer – Big Rivers' granting a twenty-five year lease of all its generation assets – that was entirely unlike the transfer the Companies made to MISO.[158] Indeed, in the Big Rivers case the Commission called Big Rivers Electric Corp.'s lease all of its generation assets to WKEC for twenty-five years a means for Big Rivers to "divest itself of its generating

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[155] Hamilton v. International Union of Operating Engineers, Ky., 262 S.W.2d 695, 699 (1953).
[156] Stevenson v. Anthem Casualty Insurance Group, Ky., 15 S.W.3d 720, 724 (1999).
[157] II T.E. 195-96 (citing KPSC Order of April 30, 1998, In the Matter of: Big Rivers Electric Corp., Case No. 97-204 ("Big Rivers"), Order (4/30/1998) ("Big Rivers Order")).
[158] Id.

capacity,"[159] and noted that during the lease period WKEC – not Big Rivers – was to perform "all necessary operations and maintenance services."[160] In other words, Big Rivers essentially sold WKEC its generation assets for twenty-five years, a transaction that neatly fits KRS 278.020(4). But the transaction in the Big Rivers case is nothing at all like the limited control the Companies transferred to MISO because the Companies continue to own, staff, maintain and operate all of their transmission assets; MISO merely coordinates and evaluates transmission capacity and reliability functions.[161] The MISO TO Agreement also explicitly states that the Companies retain legal and equitable title to their transmission assets:

> Legal and equitable title to the respective properties comprising the Transmission System . . . shall remain with each respective Owner (unless the Owner transfers title to another entity), and is not charged by this Agreement. The respective Owners shall retain all rights incident to such legal and equitable title, including, but not limited to, the right, subject to applicable federal or state regulatory approvals, to build, acquire, sell, dispose of, use as security, convey any part of their property, or use such property for purposes other than providing transmission services . . ..[162]

Given the manifest material factual dissimilarities between the cases, it is appropriate to distinguish the Big Rivers case and not apply KRS 278.020(4) to the Companies' limited transfer of control to MISO.

Finally, the Companies had ample good faith reasons to believe that they need not acquire the Commission's permission to make their transfer to MISO. First, as the Companies' and MISO's witnesses have noted, the Companies transferred a comparable level of control of the Companies' transmission system to NERC some time before the MISO transfer,[163] to which the Commission did not object and for which the Commission did not require the Companies to

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[159] Big Rivers Order at 13.
[160] Id. at 1 (emphasis added).
[161] Beer Direct at 13.
[162] Id.
[163] Id.; III T.E. 94.

seek approval.[164] Second, the Companies had regular communications with the Commission concerning MISO. The Companies believe that the Commission was aware of MISO's start-up date, and therefore the Companies' transfer plans, well in advance because Kentucky was on the MISO Advisory Committee before 2002 and led the Committee in 2002. [165] The Commission had full and fair information regarding all MISO issues as they related to the Companies yet did not indicate that Commission approval would be required in order to affect the transfer on February 1, 2002. Finally, the Companies had and continue to have a good faith belief that KRS 278.020(4) did not and does not require the Companies to seek such approval.

V. MISO's Role In Resource Adequacy And Demand-Side Management

The Companies' have stated a clear, unequivocal position with respect to resource adequacy and demand-side management: Kentucky's requirements must be fully and fairly considered in any regional planning process – through MISO or otherwise – and should any such process fail to protect Kentucky's interests, the Commission and the Companies must move to protect the ratepayers' interests.[166] The Commission would be on solid legal footing should it elect to challenge any regional resource adequacy regime that did not adequately protect Kentucky's ratepayers. Federal Power Act Section 201(b)(1) enumerates subject matter as to which no federal jurisdiction lies, which includes "facilities used of the generation of electric energy . . .[and] facilities used in local distribution or only for the transmission of electric energy in intrastate commerce . . .."[167] In addition to FERC's and the states' traditionally reading FPA § 201 to reserve resource adequacy and demand-side management to the states, in its April 28,

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[164] Beer Direct at 13.
[165] KPSC Final Order in Admin. Case 387 (3/29/2004).
[166] Beer Direct at 17-18.
[167] Id. at 15.

2003 SMD White Paper the FERC stated that resource adequacy remains the bailiwick of states that choose to act on the matter:

> The Commission clarifies that nothing in the Final Rule will change state authority over these matters. We will not include a minimum level of resource adequacy. The RTO or ISO may implement a resource adequacy program only where a state (or states) asks it to do so, or where a state does not act.[168]

These excerpts show that the Commission has clear statutory and regulatory authority to ensure that Kentucky's ratepayers are protected through state-created resource adequacy standards. Any challenge to that authority would be legally assailable.

The Companies have also expressed concern in this case that Kentucky's current participation in MISO's regional resource adequacy planning -- through Kentucky's membership in the Organization of MISO States ("OMS") – may prove inadequate to the task of securing Kentucky's interests.[169] Although it has input into MISO's resource adequacy planning, the OMS is merely an advisory body, and a body in which Kentucky has only one vote and no veto power.[170] The Companies have stated that Kentucky's interests being drowned out in such an organization is unacceptable.[171] Indeed, existing state processes are the only safeguards assuring Kentucky's ratepayers that resource adequacy policies are created in their interests.[172] It is wholly appropriate, then, for the Commission to remain wary of any regional resource adequacy planning process, through MISO or otherwise.

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[168] FERC White Paper (FERC Docket No. RM01-12-000), "Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design," (4/28/2003) at 5.
[169] Id.
[170] Id.
[171] Id. at 18.
[172] Id. at 17.

VI. Both Standalone Operation And Continued MISO Membership Are Economically Superior Alternatives To The Companies' Joining A Southern RTO Or Forming A Kentucky ISO

The uncontroverted evidence in this case is that either continued MISO membership or operating in a standalone configuration would be economically superior to the Companies' joining a southern RTO, such as the now-defunct SeTrans, or forming a Kentucky ISO.[173] When it existed, SeTrans planned on creating an LMP-based market with FTRs, as well as implementing other undesirable attributes of MISO.[174] The SeTrans option was even less attractive than continued MISO membership, however, largely due to the Companies' poor interconnection with SeTrans.[175] And the Companies ruled out the Kentucky ISO alternative early on as too costly due to the significant set-up and start-up costs of such an operation.[176]

VII. The Proper Remedy In This Case Is For The Commission To Order The Companies To Pursue Exit From MISO Through FERC Forthwith, And Allow The Companies To Create A Regulatory Asset For The MISO Exit Fee

The Companies' impartial and independent cost-benefit analysis shows unambiguously that the Companies' continued MISO membership is economically inferior to standalone operation. If the Commission finds the Companies' cost-benefit analysis more credible or persuasive than MISO's, the Commission should order the Companies to apply to FERC to seek exit from MISO forthwith. Although the Companies could seek exit from MISO without a Commission order,[177] such an order could help keep the exit fee well below what it otherwise would be. Article VII.A.3 of the TO Agreement provides the Companies a right to nearly immediate exit in the event of adverse state regulatory action:

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[173] Morey Direct at 10-19, Ex. MJM-1 at 58-60; I T.E. 147-48.
[174] Id. at 5.
[175] Id.
[176] Morey Direct at 10-19, Ex. MJM-1 at 58-60; I T.E. 147-48.
[177] TO Agreement, Art. V, Sec. I.

> In the event any state regulatory authority refuses to permit participation by a signatory or imposes conditions on such participation which adversely affect a signatory in the sole judgment of that signatory, such signatory . . . may, no later than thirty (30) days after the date of such action, . . . withdraw from this Agreement. . . .

The above provision stands in marked contrast to the ordinary withdrawal provision, Article V, Section I, which does not allow a TO to exit until the end of the calendar year following the year in which the TO applies to MISO's President for exit:

> [A]n Owner may, upon submission of a written notice of withdrawal to the President, commence a process of withdrawal of its facilities from the Transmission System. Such withdrawal shall not be effective until December 31 of the calendar year following the calendar year in which notice is given.

Both exit provisions require FERC approval for a TO to exit, however.[178] Therefore, it is in the Companies' and, ultimately, the customers' best interests for the Commission to order the Companies to seek exit with FERC so that the Companies have grounds to argue that they may exit early and cease paying Schedule charges sooner than they would if exiting under Article V.

The Commission should also authorize the Companies to establish a regulatory asset to cover the exit fee the Companies will incur on exiting MISO because exit at this time is prudent. Once the Companies acquire all the necessary approvals for exit, they will take the requisite ratemaking steps to remove MISO-related expenses from base rates and begin amortization and base rate recovery of the regulatory asset over a specific (e.g., five-year) term.[179]

Finally, if the Commission does not find the Companies' cost-benefit analysis to be the most credible and persuasive, it should order the Companies to remain in MISO. Such an order would, of course, render moot any question of authorizing the Companies to create a regulatory asset for the MISO exit fee.

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[178] See TO Agreement, Art. V, Sec I; Art. VII.D.
[179] Beer Direct at 11.

VIII. Conclusion

The Companies have sought unbiased, honest answers to the questions the Commission posed in opening this investigation, the most significant of which -- whether the Companies' MISO membership is cost-effective -- aligned the Companies' interests with the Commission's: the Companies' desire for financial strength and integrity and their equally strong desire to protect their ratepayers mirror the Commission's interest in having strong, economically vibrant Kentucky utilities that are capable of keeping costs down for ratepayers. The Companies submit, therefore, that theirs is the more credible cost-benefit analysis, having been wholly performed by an independent party and motivated by a genuine and self-interested desire to know the most cost-effective course for the Companies to take.

Unlike the Companies, MISO, by design and its witnesses' admissions, does not share the Commission's motives and interests. When asked, "Why are you here?" MISO's witnesses responded that they were before the Commission to represent the interests of the "market;"[180] MISO itself, which has some concern that the Companies' departure could instigate a broader exodus of TOs from MISO;[181] and the other MISO TOs, which MISO claims will have higher costs if the Companies leave.[182] MISO's stated motives, the Companies submit, may have impacted its analysis.

MISO produced a cost-benefit analysis that claims the Companies would enjoy over $270 million in net benefits by remaining in MISO.[183] Were its analysis plausible, the Companies would be the first to advocate for their continued MISO membership. Unfortunately, of MISO's

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[180] III T.E. 13-15.
[181] III T.E. 208-09.
[182] III T.E. 141-43.
[183] Morey Rebuttal at 7; Holstein Direct at 14.

claimed benefits, the majority are not relative benefits,[184] and the bulk of the remainder are based on faulty assumptions about how the Companies do business[185] or are the result of "professional judgments" [186] made by experts. The Companies submit that MISO's cost-benefit analysis is not credible and should be rejected in its entirety.

In contrast to MISO's study, the Companies' independent cost-benefit analysis shows that the Companies' best course of action is to pursue exit from MISO, which should achieve a savings of over $60 million (nominal dollars) over the period 2005-2010.[187] To aid the Companies in exiting as quickly and cost-effectively as possible by minimizing the MISO exit fee, the Companies request that the Commission order the Companies to pursue exit from MISO through the FERC forthwith and allow the Companies to create a regulatory asset to cover the exit fee the Companies will have to pay.

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[184] Morey Rebuttal at 11-12.
[185] II T.E. 74-75.
[186] Morey Rebuttal at 23-25; III T.E. 22-23, 42.
[187] Morey Rebuttal at 8.

Dated: April 26, 2004

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was served upon the following parties by regular mail, postage prepaid, on this 26th day of April 2004.

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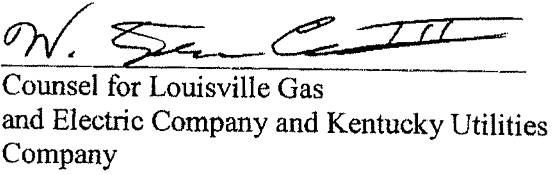

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300077.10

Statement from Midwest ISO President and CEO James P. Torgerson
RE: Duke Power Retaining Midwest ISO to Coordinate Transmission Services

July 25, 2005

"After a rigorous selection process, Duke Power has chosen the Midwest ISO as its transmission coordinator. We are very pleased to have the opportunity to provide independent tariff administration and planning services for Duke Energy.

We believe our expertise in operating the transmission grid in the Midwest demonstrates we are well-suited to perform the functions that Duke has requested.

While Duke is not formally joining the Midwest ISO, the company is retaining our services to carry out certain transmission functions. Specifically, as Independent Entity, the Midwest ISO will assume responsibility for a number of core transmission functions, including:

- Evaluation and approval of all transmission service requests;
- Calculation of Total Transfer Capability ("TTC") and Available Transfer Capability ("ATC");
- Operation and administration of the Duke Open-Access Same Time Information System ("OASIS");
- Evaluation, processing, and approval of all generation interconnection requests, and performance of related interconnection studies; and
- Coordination of transmission planning."

About the Midwest ISO

The Midwest ISO manages one of the world's largest energy markets using security constrained economic dispatch of electricity. In addition, the organization administers Day-Ahead, Real-Time and Financial Transmission Rights markets as well as Locational Marginal Pricing at over 1,400 nodal locations. Consistent with FERC Order No. 2000 and its Midwest Markets Tariff, the Midwest ISO utilizes a market-based platform for grid congestion management. The Midwest ISO was approved as the nation's first RTO in 2001. Membership in the organization is voluntary. The Midwest ISO acts in close cooperation with the 15 states and the province of Manitoba, where it operates 97,000 miles of transmission lines. The organization is responsible for ensuring fair access and reliable operation of a system with a peak load of 119,000 MW and 131,000 MW of generation. The non-profit organization was founded in 1998, is governed by an independent Board of Directors, and is headquartered in Carmel, Indiana with an operations center in St. Paul, Minnesota. For more information on the Midwest ISO, visit www.midwestiso.org or www.midwestmarket.org.