YUNKER & ASSOCIATES

Katherine K. Yunker
P.O. Box 21784
Lexington, KY 40522-1784

859-255-0629
FAX: 859-255-0746
yunker@desuetude.com

May 20, 2004
VIA HAND DELIVERY

RECEIVED
MAY 20 2004
PUBLIC SERVICE COMMISSION

Beth O'Donnell, Executive Director
Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, KY 40602-0615

Re: Case No. 2003-00266, Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator, Inc.

Dear Ms. O'Donnell:

Enclosed please find ten (10) copies of the Reply Brief to be filed in the above-referenced proceeding on behalf of an intervenor, Midwest Independent Transmission System Operator, Inc. The original of this Reply Brief was submitted to the Commission last night by leaving it in the after-hours filing box.

Thank you for your assistance in this matter.

Sincerely,

Katherine K. Yunker

Katherine K. Yunker

Enclosures

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

RECEIVED

MAY 1 0 2004

PUBLIC SERVICE COMMISSION

Reply Brief of the Midwest Independent Transmission System Operator, Inc.

Katherine K. Yunker
Benjamin D. Allen
YUNKER & ASSOCIATES
P.O. Box 21784
Lexington, KY 40522-1784
859-255-0629
fax: 859-255-0746

Stephen G. Kozey
James C. Holsclaw
MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR, INC.
701 City Center Drive
Carmel, IN 46032
317-249-5769

The Midwest Independent Transmission System Operator, Inc. ("Midwest ISO"), an intervenor, hereby presents its reply to the initial post-hearing briefs filed in the above-referenced case by Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively referred to herein as ("LGE") and by the Attorney General of the Commonwealth of Kentucky ("AG").

TABLE OF CONTENTS

DISCUSSION

I. In Their Initial Briefs, LGE and the Attorney General Either Ignore or Misconstrue the KRS 278.218 Standard for LGE's Proposed Withdrawal from the Midwest ISO.

A. KRS 278.218 applies to LGE's proposed change in operational control over its transmission assets.

The Commission has previously noted its "role as the enforcer of KRS Chapter 278" and that it "represents the public interest."[1] As such, the Commission is charged with the implementation of KRS 278.218, which applies to LGE's proposed withdrawal from the Midwest ISO: "No person shall acquire or transfer ownership of 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."[2] The Commission shall grant approval of a transfer if "the transaction is for a proper purpose and is consistent with the public interest."[3] The Commission has set forth a two-step process for determining what is in the "public interest" under this statute, explaining that a transfer or acquisition is in the public interest when the party seeking approval demonstrates that: (a) there will be no "adverse effect on service or rates;" and (b) "that the proposed transfer is likely to benefit the public," even if such benefits are not "immediate or readily quantifiable."[4] Those public benefits become relevant only after the applicant has

---

[1] 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, 10/15/96 Order at p. 2.

[2] KRS 278.218(1). For purposes of this statute, a utility is defined as a person "who owns, controls, operates, or manages any facility used or to be used for or in connection with, … [t]he generation, production, transmission, or distribution of electricity to or for the public, for compensation, for lights, heat, power, or other uses." KRS 278.010(3)(a).

[3] KRS 278.218(2).

[4] 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

satisfied "the first step by a showing of no adverse effect on service or rates."[5] The applicant for acquisition or transfer of these assets bears the burden of meeting this two-pronged standard.[6]

No party contends that KRS 278.020(4) applied to the initial change in control over LGE's transmission systems.[7] LGE specifically admits in its initial brief, however, that if KRS 278.218 had then been effective, that statute would have applied to its transfer of "limited operational control" over its transmission assets when it initially joined the Midwest ISO: "The language of [KRS 278.218] … applies to what the Companies did with respect to MISO: they transferred to MISO limited operational control of certain of their transmission assets."[8] Similar to LGE's initial decision to join the Midwest ISO, the strictures of KRS 278.218 also apply to its proposed withdrawal, in which it seeks to again acquire the "limited operational control" it previously transferred. Withdrawal from an RTO has been viewed as a change in control over facilities.[9] This view is consistent with the position taken by LGE that it transferred "the right to control" certain of

---

to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, 8/25/03 Order at pp. 4-5.

[5] *Id.* at p. 4.

[6] *Id.*

[7] Initial Post-Hearing Brief of the Midwest Independent System Operator ("Midwest ISO Brief") at 7-8; Initial Post-Hearing Brief of Louisville Gas and Electric Company and Kentucky Utilities Company ("LGE Brief") at 27-31. The Attorney General does not address this issue in his brief.

[8] LGE Brief at 28.

[9] *See* Midwest Independent Transmission Syst. Operator, Inc., Order Conditionally Authorizing Establishment of Midwest Independent Transmission System Operator, Inc. and Establishing Hearing Procedures, 84 FERC ¶ 61,231 at 62,151 (Sep. 16, 1998) ("Midwest ISO Order") (referring to the withdrawal by a transmission owner from the Midwest ISO as a transfer of control over the owner's jurisdictional facilities from the Midwest ISO back to the transmission owner); *cf. Atlantic City Electric Co. v. FERC*, 295 F.3d 1, 11-13 (D.C. Cir. 2002) (holding that joining or withdrawing from a RTO did not constitute a "disposition" of facilities within the meaning of Section 203 of the Federal Power Act, 16 U.S.C. § 824b(a), because it was a "transfer of operational control" of such facilities).

its transmission assets when it originally entered the Midwest ISO.[10] Since LGE originally transferred "the right" to operational control over its transmission facilities to the Midwest ISO, it is logical to conclude that LGE's proposed withdrawal would involve a similar transfer of that control.[11] Thus, the plain language of KRS 278.218 applies to such a transfer and imposes the burden upon LGE to prove that its withdrawal from the Midwest ISO "is for a proper purpose and is consistent with the public interest."

B. A proposed change from the status quo must be justified.

Despite the plain language of KRS 278.218, the other parties to this action have either distorted or simply evaded the burden of proof established under that statute. In his brief, the Attorney General distorts the standard set out in KRS 278.218. He states, "absent the making of a strong case for continued participation in MISO ... the Commission should authorize the Companies to seek an exit from MISO."[12] The Attorney General therefore would approve an order authorizing LGE's withdrawal from the Midwest ISO unless it was demonstrated that LGE's continued participation was cost effective, rather than requiring LGE to prove that its decision to break its commitment with the Midwest ISO and again acquire control over its transmission assets is for a proper purpose and consistent with the public interest. Based on this standard, the

[10] 2 T.E. 195:22-25 (Beer); *see also id.* 167:14-16 (Beer) ("operational control ... was transferred [to the Midwest ISO] then on February 1, 2002"); Direct Testimony of Michael S. Beer, filed 9/22/03 ("MSB Direct"), 9:21-10:2 (comparing LGE's proposed withdrawal with the exit sought by PJM in *Atlantic City Electric Co. v. FERC* and noting that such an exit involved the transfer of only operational control).

Reference herein to prefiled testimony will be by the witness's initials, an indication whether the testimony was direct or rebuttal; pinpoint cites are to page and line. Reference herein to any of the four volumes of the hearing transcript will be to the volume number followed by "T.E.," a pinpoint cite, and the witness's last name.

[11] *See* Midwest ISO Order, 84 FERC at 62,151 (withdrawal from the Midwest ISO constitutes a transfer of control over facilities).

[12] Initial Post-Hearing Brief of the Attorney General ("AG Brief") at 4.

Attorney General concludes that since, in his opinion, neither party has conclusively demonstrated the costs and benefits of Midwest ISO membership, the most appropriate resolution to this matter would be to allow LGE to withdraw from the Midwest ISO so that it may find out exactly what costs are involved, noting that "neither has been able to provide the information that will be gained only from the process of the effort to withdraw from MISO."[13] The Attorney General's argument errs in two ways: (1) it distorts the burden of proof by effectively requiring the Midwest ISO to prove that LGE's continued participation is cost-effective instead of requiring LGE to prove that its proposed withdrawal complies with KRS 278.218; and (2) it concludes that even in the absence of strong evidence from LGE that its continued participation is not cost-effective, the Commission should allow LGE to "take the plunge" and withdraw from the Midwest ISO without establishing that this change would not have any adverse effects on rates or service and is likely to benefit the public.

Although the Attorney General misconstrues the standard for this case, LGE makes every effort to evade it altogether. Rather than establishing that its proposed withdrawal from the Midwest ISO complies with KRS 278.218, LGE spends the majority of its brief attacking the Midwest ISO benefit-cost study. It states that "it is clear that the Companies' interests, not MISO's, more closely align with those of Kentucky rate-payers."[14] LGE accordingly characterizes the determinative question in these proceedings as a winner-take-all battle between its benefit-cost study and the study performed by the Midwest ISO, arguing that its analysis is "more credible" and more closely

[13] *Id.* at 3-4. For example: "Only if the Companies seek to leave MISO can the actual exit cost be determined." *Id.* at 3.
[14] *Id.* at 8.

aligned with the Commission's interests.[15] In taking this approach, however, LGE offers no support for the substance of its own benefit-cost study and, most importantly, makes no attempt to demonstrate that its proposal is "for a proper purpose" and "consistent with the public interest." The Commission did not initiate these proceedings to judge the "more credible" cost-benefit study but to determine whether LGE can meet the standard for change set out in KRS 278.218. LGE cannot simply attack the Midwest ISO's benefit-cost analysis while offering no support for its own.

LGE's evasion of the standard imposed under KRS 278.218 stems from its attempts to use these proceedings to bargain its way to an improved position that it believes is best suited for its new corporate strategy. After stating that its benefit-cost analysis is the "more credible" choice, LGE suggests that its position could change if the Midwest ISO made certain concessions. For example, LGE's benefit-cost analysis "could shift meaningfully" toward continued participation in the Midwest ISO if two things occurred: (a) the Midwest ISO dropped its Day 2 markets or permitted LGE to opt out of the market for the years 2005-2010; and (b) if FERC "restored" the original Schedule 10 compromise with the transmission owners.[16] Thus, LGE apparently extends an olive branch to the Midwest ISO and FERC that it would <u>consider</u> continued participation if it could only receive these two concessions.

Conceding that it would still need to seek FERC approval before withdrawing from the Midwest ISO,[17] LGE also pleads with the Commission that it should order it to seek permission from FERC to withdraw from the Midwest ISO because it "could help

---

[15] *Id.* at 13, 35.

[16] *Id.* at 9.

[17] *Id.* at 2; *see also* MSB Direct 9:3-5 (stating that should the Commission order LGE to withdraw from the Midwest ISO it may, "within 30 days of such action, withdraw from MISO but must obtain FERC approval to do so").

keep the exit fee well below what it otherwise would be."[18] LGE also suggests that such an order would give LG&E and KU "grounds to argue that they may exit early and cease paying Schedule charges sooner than they would if exiting under Article V."[19] Finally, LGE urges the Commission to create a regulatory asset for the potential Midwest ISO exit fee, which LGE could then amortize and recover through its base rate.[20] In this way, LGE seeks to bargain to one of several favorable outcomes while not taking a definitive stand or offering evidence regarding the costs and benefits of its proposed change in control. When viewed in light of these statements, the reasons for evasion of the standard set out in KRS 278.218 become more clear: LGE could not keep all of its options open for bargaining if it committed to a position regarding withdrawal. Rather than truly rely on its study and put forth evidence that its proposed change is for a proper purpose and in the public interest, LGE seeks to gain what is in its best interests, not the ratepayers'.

Neither LGE's "battle of the studies" approach nor the Attorney General's recommendation to "take the plunge" satisfy the standard set out in KRS 278.218. LGE can neither evade the burden of proof set out in KRS 278.218 nor minimize the Commission's paramount authority to review the proposed transfer of control in an attempt to use these proceedings to bargain its way to a result that favors its corporate interests and not those of Kentucky ratepayers. LGE and the Attorney General cannot provide the lenses through which the Commission must examine LGE's proposed withdrawal. The Commission need look no further than KRS 278.218. It is LGE who must prove that its plan to withdraw from the Midwest ISO is for a proper purpose and in the public

---

[18] LGE Brief at 33.
[19] *Id.* at 34.
[20] *Id.*

interest, and the record in this case establishes that LGE's proposed change in control does not satisfy this standard.

II. LGE's Proposal for a Change in Control Is Not in the Public Interest.

A. Midwest ISO membership is the most cost-effective way to obtain the benefits of RTO participation and does not diminish the Commission's authority with respect to resource adequacy or DSM programs.

Membership in a "southern RTO" or a Kentucky statewide ISO offers no advantage to LGE over continued membership in the Midwest ISO.[21] There is no disagreement between the parties or evidence otherwise on this point. In fact, LGE has put everyone on notice that an unacceptable condition to withdrawal would be a requirement to join another RTO, because the Midwest ISO is the least-cost option.[22]

Furthermore, there is no contention that membership has any detrimental effect on the role of the Commission with respect to resource adequacy and demand-side management. As noted by LGE, "the Commission has clear statutory and regulatory authority to ensure that Kentucky's ratepayers are protected through state-created resource adequacy standards."[23] LGE also states a "clear, unequivocal position" that Kentucky's requirements "must be fully and fairly considered in any regional planning process."[24] The Midwest ISO agrees. In fact, "[t]he inclusion of LGE/KU in MISO wholesale energy markets does not diminish the authority of state regulators to set retail rates or to review utility resource additions, demand-side programs, or other

---

[21] *See generally* Midwest ISO Brief at 37; Direct Testimony of Mathew J. Morey, filed 9/22/03 ("MJM Direct"), Exhibit MJM-1 at pp. 17-18 (§3.1.1); *see also* MJM Direct 15:12-19:17.
[22] Direct Testimony of Paul W. Thompson, filed 9/22/03 ("PWT Direct"), 13:12-13, 16:8-14; LGE Brief at 8.
[23] LGE Brief at 32.
[24] *Id.* at 31.

utilities."[25] Further, LGE does not offer any concrete evidence that its participation in the Midwest ISO would somehow weaken the Commission's authority to safeguard Kentucky ratepayers.[26]

Far from limiting the Commission's exercise of its planning authority, LGE's inclusion in the Midwest ISO's energy wholesale energy markets actually <u>enhances</u> the scope and effectiveness of that authority by expanding the options available to the Commission in its efforts to protect Kentucky's ratepayers.[27] For example, LGE's inclusion in the Midwest ISO's wholesale energy markets would allow the Commission to (a) "[u]se location-specific prices to help identify where it may be cost-effective to build new generation or transmission capacity" and (b) "[t]ake advantage of a larger and more liquid wholesale market should it decide to shift from ratepayers to investors some or all of the capital investment risks associated with the development of new generating capacity."[28] Thus, the Midwest ISO has demonstrated that LGE's participation in the Midwest ISO wholesale market actually will benefit the Commission in the exercise of its authority regarding resource adequacy and demand-side management.

B. There will be a reliability detriment from withdrawal, because LGE cannot replicate the reliability benefits provided by the Midwest ISO.

The evidence does not support LGE's claim that there will be no measurable decline in the reliability of its systems if it withdraws from the Midwest ISO.[29] This

---

[25] Direct Testimony of Ronald R. McNamara, filed 12/29/03 ("RRM Direct"), Exhibit RRM-1 at p. 15.

[26] *See* LGE Brief at 31-32.

[27] *Id.* at p.15; *see also* Direct Testimony of Roger C. Harszy, filed 12/29/03 ("RCH Direct"), 11:13-22 (noting the improvements in the Midwest ISO planning process that can integrate LGE's planning process into a broad regional plan and that it will allow Midwest ISO to protect individual consumers and systems, such as Kentucky).

[28] Exhibit RRM-1 at p. 15.

[29] LGE Brief at 16, 19.

claim is based on a faulty assumption that, because it has not had to shed load to protect its system in the past, no such event can occur in the future.[30] LGE's own witnesses testified that today's electric service industry is far different from that which existed only a few years ago.[31] Formerly, utilities satisfied the vast majority of system demand from system resources. Transmission was an isolated phenomenon in which neighboring utilities engaged in modest economy trades. The complexion of the electric service industry has changed radically in the span of a few years, with massive amounts of power being transmitted over extensive geographic areas. Such flows are likely to increase once through and out rates are eliminated as between the Midwest ISO and PJM Interconnection, L.L.C. ("PJM"). Whereas formerly a utility could maintain reliability by monitoring its own economy trades, individual utilities are presently incapable of monitoring regional power flows and cannot by themselves undertake actions that will ensure system reliability.

LGE admitted that its previous approach to ensuring reliability is inadequate for current market conditions. Mark Johnson, Director of Transmission for LG&E Energy LLC, acknowledged that prior to Midwest ISO membership, LGE performed only post-incident analysis and did not have the capability of forecasting regional events that could affect its systems.[32] He testified that LGE is interconnected to 11 other systems, but receives information on the status of those systems only if it initiates a telephone call.[33] In addition, although LGE has a state estimator, it only solves for a limited

[30] *Id.* at 19; Rebuttal Testimony of Matthew J. Morey, filed 2/9/04 ("MJM Rebuttal"), 17:14-16.
[31] 1 T.E. 77:7-15 (Thompson); 2 T.E. 98:11-15 (Johnson).
[32] 2 T.E. 80:13-25 (Johnson).
[33] *Id.* 81:7-10; 82:16 (Johnson).

number of internal flowgates.[34] Indeed, Mr. Johnson acknowledges that in order to replicate the reliability function performed by the Midwest ISO as a stand-alone entity, it would have to spend in excess of what the Midwest ISO has invested to secure an equivalent level of reliability.[35]

Mr. Johnson agreed that an RTO enhances reliability above that achievable by a stand-alone utility.[36] He also agreed that regional control reduces congestion and loop flow.[37] He admitted that seams adversely affect reliability, and that the withdrawal of LGE from Midwest ISO would open a new seam.[38] In light of these facts, LGE's withdrawal from the Midwest ISO would be a "step backwards" in the effort to promote grid reliability through regional oversight.

The Midwest ISO provides the regional and predictive analysis that LGE is incapable of performing on its own.[39] Nevertheless, LGE avers that it can acquire reliability coordination service from a third party that will reflect the necessary regional scope. Unfortunately, apart from throwing out names, LGE has failed to identify a single entity other than the Midwest ISO that has the tools, the scope, and the capability of performing a regional reliability coordination function. LGE has not sent out any solicitations to determine the availability of reliability coordination services from a third party, whether such service could be equivalent to the service provided by the Midwest ISO, and the cost of that service.[40] LGE admits that it would cost over $1 million per

---

[34] *Id.* 84:25 (Johnson).

[35] *Id.* 86:23-87:3 (Johnson).

[36] *Id.* 96:20-21 (Johnson).

[37] *Id.* 97:20, 98:2 (Johnson).

[38] *Id.* 99:17-19 (Johnson).

[39] *See generally*, RCH Direct 2:21-3:5 (explaining Midwest ISO's obligations and reliability coordinator); 2 T.E. 244:8-16 (Harszy) (same).

[40] 2 T.E. 89:16-18 (Johnson).

year just to replace a small portion of the services provided by the Midwest ISO.[41] Even then, LGE would be required to negotiate coordination agreements with each of the interconnected utilities, an endeavor that Mr. Johnson acknowledges is not costless.[42]

The only entity to which LGE is connected that is capable of providing regional reliability coordination is the Midwest ISO. The record establishes, however, that the Midwest ISO is disinclined to provide reliability services to stand-alone entities, and particularly not in order to facilitate the withdrawal of existing members who wish to become free-riders on the regional grid.[43] Such an approach is only fair to those entities who abide by their commitments and retain their membership in the Midwest ISO. Moreover, even if the Midwest ISO provided these services, there is no evidence to support a conclusion that without LGE participation in regional real-time security constrained unit commitment and dispatch the resulting reliability would be as high as if LGE were a transmission-owner member. And even if it would be, there is no basis on which to conclude that LGE could enjoy all the reliability effects of membership without paying full dues.

LGE has acknowledged that approximately two-thirds of the functions performed by the Midwest ISO are necessary to provide the reliability coordination service to its members.[44] LGE has admitted that if it were to buy these services from the Midwest ISO, it would fairly expect to pay two-thirds of the Midwest ISO's Schedule 10 Adder.[45] LGE avers that it paid over $5 million in Schedule 10 costs in 2003.[46] Paying

[41] *Id.* 88:14-25 (Johnson).
[42] *Id.* 87:13-88:19 (Johnson).
[43] 1 T.E. 41:7-10 (Torgerson).
[44] 2 T.E. 92:1-93:1 (Johnson).
[45] *Id.* 93:6-12 (Johnson).
[46] LGE's Response to Post-Hearing Data Requests of the Commission Staff, No. 4.

the expected share for reliability coordination service from the Midwest ISO would result in charges in the range of $4 million; a far cry from the $300,000 figure upon which LGE's cost-benefits analysis is predicated.[47]

The evidence shows that LGE's customers will realize $16.2 million in expected reliability benefits between 2005-2010 from LGE's membership in the Midwest ISO.[48] This figure is derived from a probability analysis presented by Mr. Falk, which was not controverted. In its brief, LGE claims that it will realize this benefit as a free-rider.[49] However, the evidence is that LGE cannot leach reliability services from the Midwest ISO for which it does not pay.

LGE seeks to undermine the testimony of Mr. Falk by claiming that he knew nothing about its transmission system. The fact is, however, Mr. Falk did not need to know about LGE's transmission system to perform his analysis. He only needed to know the incidences of TLRs on LGE's system prior to and post-Midwest ISO membership, which allowed him to perform a statistical probability of loss of load. Assigning generally-accepted values for loss of load, Mr. Falk was able to quantify the benefit of enhanced reliability flowing from participation in the Midwest ISO. By contrast, LGE assigns no benefits to the reliability improvements acknowledged by its own witness.

LGE has not shown that there will be no adverse effect on service from changing the status quo by withdrawing from the Midwest ISO. In fact, the evidence is that there

---

[47] Exhibit MJM-1 at pp. 38-39. (indicating that such charges would exceed $1 million). 2 T.E. 88:14-89:10 (Johnson).

[48] 3 T.E. 126:3-90 (Holstein); Midwest ISO Hearing Exhibit No. 6; *cf.* Direct Testimony of Jonathan Falk, filed 12/29/03 ("JF Direct"), 1:17-19. Falk quantifies reliability benefits from Midwest ISO membership at $2.7 million per year; over six years, this totals $16.2 million.

[49] LGE Brief at 18.

will be a decrease in reliability. As LGE concedes[50], there are reliability benefits to full participation in a regional entity that cannot be completely replicated with stand-alone operation. Because LGE cannot meet the first prong of the KRS 278.218 "public interest" test, there is no need to consider whether there will be no adverse effect on rates or if the proposed transfer of operation control is likely to benefit the public.[51]

C. Even LGE does not rely on its cost-benefit study.

The only argument LGE offers for change is its contention that savings from withdrawal exceed direct costs and benefits foregone. If LGE had confidence in the conclusion of the study it sponsored, the "economically wise" decision would have been to withdraw from the Midwest ISO. Had LGE notified the Midwest ISO by December 31, 2003, of an intent to withdraw, the withdrawal could have been effective as of December 31, 2004. No such notice was given. LGE's confidence in the study's conclusion was not sufficient for LGE to take action. Neither is it sufficient to take the risk that withdrawal will actually result in net losses.

1. The study focuses on the costs of Midwest ISO membership and the effects of withdrawal on LGE rather than its ratepayers.

The Commission asked LGE to study the "costs and benefits of membership in MISO, both currently and over the next 5 to 10 years ...."[52] The study sponsored by LGE, "A Cost-Benefit Analysis of RTO Options for LGE Energy Corporation" ("the LGE study"),[53] instead focuses on costs of remaining as a member of the Midwest ISO and of operating LGE as a stand-alone system. As explained by Mathew J. Morey, LGE's

---

[50] LGE Brief at 17; *see also* 2 T.E. 87:10-12 (Johnson) (stating that LGE planned to enter into coordination agreements for reliability services).

[51] Case No. 2002-00475, 8/25/03 Order at 4-5.

[52] Case No. 2003-00266, 7/17/03 Order at 3.

[53] Exhibit MJM-1.

benefit-cost witness, due to the difficulty in quantifying the benefits of RTO membership, "comparisons were made on the basis of estimates of the costs of staying in MISO relative to estimates of the costs of pursuing any one of three alternative options."[54] Such a one-sided analysis omits consideration of the benefits from Midwest ISO membership.[55] When costs are the nearly exclusive focus, it is unsurprising that the conclusion is that the benefits of membership are not commensurate with the costs.

The LGE study concludes that withdrawal is expected to generate net savings for LG&E and KU:[56]

> By 2010, the Companies will have saved an estimated $30.23 million in net present value terms beyond payment of the exit fee. The decision to pay $23 million to withdraw from MISO to save $30.23 million more than the exit fee would appear to be an economically wise decision, in light of the difficulty in determining a correspondingly larger value that can be assigned to the benefits of continued MISO membership.

Specifically, the conclusion is that LG&E and KU would be better off by withdrawing from the Midwest ISO and operating as a stand-alone system, not that the utilities' customers would be better off.[57] Furthermore, the conclusion is that LGE would be better off regardless of whether the exit fee or other risks are shifted to LGE customers.[58]

These biases make the LGE-sponsored study an untrustworthy guide to the relative costs and benefits of continuing or withdrawing from Midwest ISO member-

---

[54] MJM Direct 4:21-23 (emphases added).

[55] "[S]ome of the factors that must be considered … can be reasonably quantified (the costs in particular), while others are subject to significant uncertainty." MJM Direct 21:12-13 (emphasis added). *See also* MJM Direct 21:20-22 (We "quantified those factors for which we could obtain reliable information and qualitatively analyzed those factors for which we could not."); *id.* at 21:16-20 (referring to difficulty in quantifying factors).

[56] MJM Direct 21:1-6; *see also id.* at 20:18-19 ("The estimated annual savings associated with a standalone option for LGE/KU is $11.13 million.").

[57] 1 T.E. 148:15-18, 149:6-150:4 (Morey). In addition, Dr. Morey testified that, even if all of the net savings were to be distributed to LGE retail consumers, "the impact on the typical residential customer is so slight that it would likely not be noticed …." MJM Direct 20:14-15.

[58] 1 T.E. 98:13-99:10 (Thompson);148:15-23 (Morey).

ship. Dr. Morey testified that his analysis was developed in two weeks;[59] however, the workpapers show that his consulting group began the project in the latter part of July 2003 — eight weeks before the testimony was filed.[60] It would appear that LGE did not know what strategy it would follow in this investigation until around September 12, 2003,[61] and only then could Dr. Morey develop a study that acknowledged benefits from membership, but left them unquantified, and resulted in net quantified savings from withdrawal.

2. Mistakes in calculating the exit fee illustrate the unreliability of LGE's cost-benefit study.

Serious problems with LGE's estimate of the exit fee estimate are indicative of just how unreliable its study is. There is no dispute that an exit fee will be due from LGE if it withdraws from the Midwest ISO,[62] or that this fee is based on the Transmission Owners Agreement provision that "[a]ll financial obligations incurred … prior to the effective date of such withdrawal shall be honored by the Midwest ISO and the withdrawing Owner."[63] The financial obligations incurred by a withdrawing Transmission Owner — its exit fee — comprise its allocated share of the total financial obligations incurred by the Midwest ISO as of the effective date of withdrawal. Despite agreement about the existence and basis for the exit fee, and the substantial effect of the

---

[59] 2 T.E. 55:20-56:3 (Morey).

[60] *See* Attachment to LGE Response to Midwest ISO Data Request No. 9, pp. 25-31(memo dated July 31, 2003 requesting specific information and indicating that the study began in late July 2003). Dr. Morey's direct testimony, to which the study was Exhibit MJM-1, was filed on September 22, 2003.

[61] On that date, LGE filed a motion to allow it to file rebuttal testimony to Amend Procedural Schedule.

[62] *See* 1 T.E. 151:11-15 (Morey); LGE Brief at 34.

[63] Agreement of Transmission Facilities Owners to Organize the Midwest Independent Transmission System Operator, Inc., A Delaware Non-Stock Corporation ("Transmission Owners Agreement"), Art. 5, § II.B, (Orig. Sheet No. 76); *see* MJM Rebuttal at 25:14-16 (quoting this provision).

exit fee on a cost-benefit analysis of withdrawal, however, there is a significant dispute about the magnitude of the fee.

For withdrawal by LGE effective December 31, 2004, the Midwest ISO estimated an exit fee of $38.1 million.[64] As explained and calculated by its Vice President and Chief Financial Officer, Michael P. Holstein, the financial obligations of the Midwest ISO are those recorded on its balance sheet and included in the footnotes to its financial statements. The total financial obligations are the sum of total liabilities as of the withdrawal date and the net present value of future costs associated with financial obligations incurred prior to the effective date of withdrawal less current assets. Examples of such future costs are (a) interest payments on senior unsecured notes, (b) interest payments on capitalized lease obligations and (c) operating lease obligations.[65] From the total, the Midwest ISO then subtracted unamortized costs relating to the ITC and GridAmerica arrangements, because these costs would be the sole responsibility of the respective entity should it elect to withdraw.[66]

To compute an exit fee applicable at a future date, the Midwest ISO calculated the future cost of the interest and lease obligations based on existing leases and senior unsecured notes over their respective terms; total liabilities and current assets were taken from projected year-end balance sheets.[67] The total financial obligations are divided among Schedules 10, 16, and 17,[68] because KU's and LG&E's allocation percen-

---

[64] Direct Testimony of Michael P. Holstein, filed 12/29/03 ("MPH Direct") 12:17-19. In the Response to LGE Data Request No. 44, this estimate was increased slightly to $38.2 million. This later estimate was used at the hearing. *See* Midwest ISO Hearing Exhibit No. 6, p. 12 of 20, lines 18-20.

[65] *See* Attachment to Midwest ISO Response to LGE Data Request No. 44, especially pp. 1-2.

[66] *See generally*, 3 T.E. 161:13-165:12 (Holstein).

[67] Attachment to Midwest ISO Response to LGE Data Request No. 44, pp. 4-5, 17.

[68] *Id.*, especially p. 3.

tages for Schedule 10 differ from those of Schedules 16 and 17.[69] The projections and other inputs into the calculation of total financial obligations and allocations to KU and LG&E for estimating the exit fee were the same data used to estimate Schedule 10, 16, and 17 costs to LGE if it does not withdraw from the Midwest ISO.[70]

In stark contrast, LGE derived estimates for the exit fee based on an allocation of Midwest ISO capital expenditures and annual operating expenses.[71] It provided estimates for two different withdrawal dates:[72]

withdrawal date	exit fee
12/31/04	$ 22.94 million
12/31/05	$ 36.14 million

Throughout the comparison with the stand-alone option, however, the LGE study uses the exit fee for a withdrawal date of December 31, 2004 ("12/31/04 exit fee"). This is crucial for the conclusion about the economic consequences of withdrawing, because the larger exit fee is that associated with the earliest date LGE could exit under the terms of the Transmission Owners Agreement.[73] Use of the larger exit fee computed by LGE in its own analysis yields results indicating that the net savings would not cover the exit fee until 2009 and the net present value (to the end of 2005) of total cumulative

[69] *See id.*, especially p. 1-2, 19, 24-27. The difference is that the ITC and GridAmerica loads are excluded from the Schedule 10 allocation to reflect the fact that unamortized ITC and GridAmerica costs are excluded from the total financial obligations to be recovered from the other members.

[70] *Id.*

[71] Exhibit MJM-1 at 51 (§3.13). LGE appears to make no use of Midwest ISO's current or projected balance sheets or its audited financial statements.

[72] *Id.*

[73] See part II.C.3 below.

savings would be reduced downward significantly, to $9.4 million from the $30.2 million calculated using the 12/31/04 exit fee.[74]

The sensitivity of the outcome to when the exit fee is to be calculated is rivaled by the dependence on how the fee is calculated. The LGE study nonetheless is founded on a deeply-flawed calculation. The exit fee is to be based on "[a]ll financial obligations incurred" before the effective date of withdrawal.[75] In the study, Dr. Morey chose to use mere proxies for the obligations of the Midwest ISO, although he admitted that "the appropriate approach to take" would have been to use the booked obligations in the calculation.[76] The estimate of $23.0 million for the 12/31/04 exit fee[77] did not include operating lease liabilities or interest expense on obligations, and explicitly excluded Schedule 10 related obligations.[78] In addition, Dr. Morey underestimated the LGE allocation percentage for Schedules 16 and 17 as 5.57% by, among other things, dividing

[74] With an end-of-2005 effective withdrawal date, the last three rows of the "Breakeven Analysis," *see* MJM Direct 14:8 (Table 1) and Exhibit MJM-1 at 54 (Table 4.1), would be as follows:

	2005	2006	2007	2008	2009	2010
net savings	-36140000	11130000	11740000	11470000	10460000	10610000
cumulative	-36140000	-25010000	-13270000	-1800000	8660000	19270000
cum. NPV	-36,140,000	-25,738,131	-15,483,960	-6,121,024	1,858,860	9,423,644

The only changes are the elimination of the "2004" column and the substitution of the estimate 12/31/05 exit fee in the "2005" column. Also, the net present value is calculated to the end of 2005 rather than 2004, but at the same discount rate (7%).

[75] Exhibit MJM-1 at p. 51 (§3.13) & n.92 (citing Transmission Owners Agreement, Art. 5, § II).

[76] 1 T.E. 157:5-13 (Morey).

[77] In his rebuttal testimony, the exit fee estimate had risen to $23.8 million, although the source of the increase is not explained and its net effect is left unmentioned. MJM Rebuttal 8:14 (Table 2), and Exhibit MJM-3.

[78] 1 T.E. 171:24-172:12 (Morey); Exhibit MJM-3.

an <u>energy</u> figure for LGE by a <u>reserved capacity</u> figure for the Midwest ISO in total.[79] Correcting for this error alone increases the LGE allocation to 7.16%.[80]

There were even more fundamental errors in the calculation. During cross-examination about his criticism of the Midwest ISO's exit fee calculation, Dr. Morey abruptly stated that he had misread the exit fee provision and now realized, "for parties that are seeking to withdraw, that there is a Schedule 10 obligation for liabilities that MISO has incurred going forward."[81] PSC Staff counsel asked Dr. Morey to re-calculate the 12/31/04 exit fee.[82] In his post-hearing response,[83] Dr. Morey used the same flawed allocation methodology as before, and then compounded the error by using the same ratio for all three schedules. However, merely by using a total-obligations figure close to the one used by the Midwest ISO,[84] Dr. Morey produces an estimate of the 12/31/04 exit fee of $28.3 million — a $4.5 million (nearly 19%) increase over his $23.8 million

---

[79] Exhibit MJM-3. In addition, Dr. Morey included 8,600 GWh of off-system sales in his computation of Schedules 10, 16, and 17 costs, but ignored them in his load ratio allocation for the exit fee estimate. The Midwest ISO does not contend that including off-system sales amounts is appropriate in either calculation, only that it is inconsistent to do so in one but not the other.

[80] The 2004 combined reserved capacity figure for KU and LG&E is 50.1 GWh. Attachment to Midwest ISO Response to LGE Data Request No. 44, pp. 1-2. Dividing those 50.1 GWh by the total Midwest ISO reserved capacity figure used by Dr. Morey (700 GWh) equals 7.16%. Note, however, that the 700 GWh figure for the Midwest ISO is overstated because it includes ITC (84.4 GWh) and GridAm (124.1 GWh) load — even though those entities and associated obligations are excluded from the allocation. *See id.* pp. 24-25.

[81] 1 T.E. 159:2-24 (Morey); *see also id.* 160:16-21 (Morey) ("upon reading the tariff, I recognize that … there should be a portion within the exit fee that accounts for that [Schedule 10-related obligation]"). In Exhibit MJM-3, Dr. Morey subtracted $7.8 million from a "Total Exit Fee" estimate of $31.59 million to derive an "Exit w/o Sch. 10" of $23.79 million.

[82] 2 T.E. 54:3-23 (Morey).

[83] LGE Response to Midwest Post-Hearing Data Request No. 6 (attaching Exhibit MJM-6, a revised version of Exhibit MJM-3).

[84] *Compare* Exhibit MJM-6 ($507.9 million) *with* Attachment to Midwest ISO Response to LGE Data Request No. 44, pp. 1-2 ($508.9 million combined total obligation for KU and LG&E for Schedules 10, 16, and 17).

estimate.[85] He makes no effort to communicate the effect that this increase has on the study's results — whether this narrows or reverses the purported net savings from withdrawing and operating a standalone system. Like all the other risks in LGE's proposal, any uncertainty is left for others to bear.

3. LGE's actions belie the claimed credibility of its study.

Although LGE refers to Dr. Morey's study as the "more credible cost-benefit analysis,"[86] it does not claim that the study is well-founded or reliable. Perhaps due to the admission of errors in the calculation of the exit fee, LGE never mentions a dollar figure for the fee and refers only to "nominal savings," without trying to present an amount net of the exit fee.[87] More telling than that omission, however, is that LGE did not trust the study results enough to take action on them.

Article Five of the Transmission Owners Agreement provides for voluntary withdrawal:[88]

> A Member who is also an 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, nor shall any such notice of withdrawal become effective any earlier than five (5) years following the date that the Owner signed this Agreement except as provided for in Article Five, Section IV and Article Seven of this Agreement.

---

[85] In LGE Response to Post-Hearing Data Request No. 6, Dr. Morey mistakenly refers to the $23.8 million as LGE's "original estimate." The estimate initially presented in his direct pre-filed testimony was $23.0 million. MJM Direct 14:5-7 (Table 1); Exhibit MJM-1 at p. 51 (§ 3.13). The post-hearing estimate represents a more than 23% increase over the initial 12/31/04 exit fee estimate.

[86] LGE Brief at 35.

[87] *See, e.g.*, LGE Brief at 1, 36. The reference to "a $60.8 million net benefit," *id.* at 14, apparently is to LGE's claim that in future years there will be savings net of losses due to withdrawal.

[88] Transmission Owners Agreement, Midwest ISO FERC Electric Electric Tariff, First Revised Rate Schedule No. 1, Art. 5, § I (Orig. Sheet No. 75).

An order requiring the member to withdraw is not necessary. Furthermore, the specific "help" LGE asks from the Commission is not necessary: the claimed conclusion that it would be better off does not depend upon shifting the exit fee or other risks to LGE customers.[89]

As LGE understands,[90] withdrawal under Article 5 cannot be effective until December 31st of the year following the year effective notice is given.[91] LGE had the study results in September 2003, but did not give notice of withdrawal at that time. Nor did it give notice on or before December 31, 2003 (or to this day).[92] Under Article Five, the earliest that LGE now can withdraw from the Midwest ISO is December 31, 2005.

Although acknowledging that Article Five grants it the option of seeking withdrawal on its own initiative,[93] LGE refuses to proceed without a Commission order. According to LGE, an order that it should seek exit with FERC will allow it to invoke the withdrawal provisions of Article Seven, providing "a right to nearly immediate exit ...."[94] LG&E and KU want "grounds to argue that they may exit early and cease paying Schedule charges sooner than they would if exiting under Article V" and "could help keep the exit fee well below what it otherwise would be."[95]

This "earlier exit" idea is built on a foundation of shifting sands. Article Seven withdrawal is not available to LGE now, years after FERC granted approval of the

---

[89] 1 T.E. 98:13-99 (Thompson); 1 T.E. 148:19-23 (Morey).

[90] Attachment to LGE Response to Midwest ISO Supp. Data Request No. 4, p.26 & n.2.

[91] MPH Direct 12:8-17.

[92] Indeed, it appears that LGE decided by October 2003 that no withdrawal notice pursuant to Article Five would be given in 2003. LGE Response to Commission Staff Initial Data Request No. 11, p.2 (effective date of "voluntary withdrawal" would be 12/31/05).

[93] LGE Brief at 33 & n.177.

[94] *Id.* at 33.

[95] *Id.* at 33-34.

Transmission Owners Agreement.[96] The text of the Agreement and the context of its withdrawal provisions establish that any window for invoking Article Seven withdrawal has long since closed.[97]

The provision cited by LGE is part of a section that addresses "rights and obligations in the event required regulatory and other approvals or acceptances are not obtained."[98] The particular provision about state regulatory approval reads, in full:[99]

> <u>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</u> in the sole judgement of that signatory, <u>such signatory</u> or any other signatory that is, in its sole judgement, adversely affected by such regulatory action (whether or not the signatory is subject to that regulatory authority's jurisdiction) <u>may</u>, no later than thirty (30) days after the date of such action, or after any such signatory concludes reasonably that the state regulatory authority has refused to act, and upon notice to all signatories, <u>withdraw from this Agreement</u>. In such event, the signatories shall, negotiate in good faith to determine whether changes should be made to this Agreement or the Transmission Tariff to address the reasons for such signatory's withdrawal.

Thus, the section in general and the cited provision in particular look to the initial approvals or acceptances. They are phrased in terms of what happens if approval is not obtained or permission to participate is refused, rather than on <u>revocation</u> of approval or refusal to <u>continue</u> to permit participation.

---

[96] *See* Midwest ISO Order, 84 FERC ¶ 61,231.

[97] *See* MPH Direct 12:23-13:29.

[98] Transmission Owners Agreement, Art. 7, §A (Orig. Sheet No. 79). The Agreement notes that it "is subject to acceptance or approval by the FERC and <u>may be</u> subject to actions of respective state regulatory authorities ...." *Id.* (emphasis added). No party to this proceeding argues that Commission approval under KRS 278.020 was needed for LGE to transfer function control of transmission facilities to the Midwest ISO. However, if deemed to have been necessary, Commission "acceptance" can be found in the requirement of a commitment to Midwest ISO membership as an express condition to the E.ON and Powergen acquisitions. *See* Midwest ISO Brief at 7-8 & n.18 (explaining that to the extent KRS 278.020 (4) approval was required, "[i]t appears that such approval was actually granted by the Commission").

[99] Transmission Owners Agreement, Art. 7, §A.3 (Orig. Sheet No. 80) (emphases added).

It is significant as well that notice of withdrawal under Article Seven is to be given to all signatories, while similar notice under Article Five is to be given to the president of the Midwest ISO.[100] Article Seven notice is given by and to Agreement signatories because that article is applicable to the events prior to the formation and operation of the Midwest ISO, before it was an entity with members or to which notice could be given.[101] In addition, withdrawal under Article Seven is from the Agreement; under Article Five, withdrawal is from membership or is of the member's facilities from the Transmission System.[102] The only provision for withdrawal of facilities from the Transmission System is in Article Five, Section I. This difference also reflects that Article Seven applies to the period before the Midwest ISO existed, or at the latest, had operational control over transmission owner's facilities, while Article Five applies past the start-up of operations.[103]

It was the intent of the signatories to the Transmission Owners Agreement (including LG&E and KU) that Article Seven operated only in the preoperational state of the Midwest ISO.[104] The potential for unlimited availability of withdrawal on 30 days' notice, as well as the absence of a requirement to obtain FERC approval, was challenged by certain intervenors in the FERC docket seeking acceptance of the Transmission

---

[100] *Compare id.*, Art. 7, §A (Orig. Sheets No. 79-80) *with id.*, Art. 5, §I (Orig. Sheet No. 75).

[101] *Cf. id.*, Art. 5, §I (Orig. Sheet No. 75) (providing that no notice of withdrawal would become effective less than five years from the date the transmission owner signed the Agreement "except as provided for in Article Five, Section IV and Article Seven of this Agreement"); *id.* §IV (providing for a signatory's right to withdraw "from the Agreement" because of an unacceptable configuration of the Midwest ISO, with the right expiring on December 31, 1998).

[102] Article Five is designated "Withdrawal of Members"; in contrast, Article Seven discusses withdrawal only incidentally to the actions of "Regulatory, Tax, and Other Authorities" that are its subject.

[103] *See also id.*, Appendix F ("Bylaws of the Midwest ISO"), Article III, §3.1(d) ("Withdrawal of Members"), (Orig. Sheets No. 172-173) (repeating the provisions of Art. 5, §I).

[104] MPH Direct 13:8-29.

Owners' Agreement. The response by the founding applicants (including LGE) was summarized by FERC as follows: "Applicants state that only two types of withdrawals are allowed without [FERC] approval: regulatory out withdrawals and withdrawals by December 31, 1998, each of which, according to Applicants, should be exercised well before Midwest ISO operations begin."[105]

Even if Article Seven withdrawal were available at this late juncture, it could not be triggered by the order LGE is requesting from the Commission. An order "to apply to FERC to seek exit from MISO forthwith" [106] does not constitute a refusal to permit participation in the Midwest ISO. Nor can an order giving LGE "full support" to withdraw from membership be construed to impose conditions on participation that adversely affect LGE. Rather than being "imposed," the order would be as requested by LGE — and the conditions requested (shifting the exit fee to ratepayers, FERC permission to withdraw "under conditions acceptable to the Companies")[107] would all be to benefit LGE.

Furthermore, if LGE were truly interested in expediting withdrawal, it could have proceeded "forthwith" on its own initiative and pursued its request for a Commission order. Notice in the fourth quarter of 2003 under Article Five, followed by an application to FERC for approval could have advanced the date of an eventual FERC decision.[108] All the participants in this proceeding might now know whether the FERC would allow withdrawal and, if so, whether the conditions placed on withdrawal were

[105] Midwest ISO Order, 84 FERC at 62,150-151.
[106] LGE Brief at 33.
[107] PWT Direct 15:12-20.
[108] LGE concedes that a transmission owner's withdrawal under either Article Five or Article Seven requires FERC approval. LGE Brief at 34 & n.178.

acceptable to LGE and what effect those conditions might have on LGE ratepayers and the relative benefits of Midwest ISO membership.[109]

Finally, if credence is placed in the conclusions of the LGE-sponsored cost-benefit study, it was imprudent not to give notice of withdrawal by December 31, 2003. Without such notice, the effective date of withdrawal will be postponed until no earlier than December 31, 2005. According to the study, postponement will have at least two deleterious effects. First, realization of the purported savings from stand-alone operation will be similarly postponed. Second, the LGE study projects that the exit fee will be 35% greater at the end of 2005 than at the end of 2004.[110] The combined effect of the larger, later exit fee on the results of Dr. Morey's break-even analysis is that the net savings would not cover the exit fee until 2009 and the net present value (to the end of 2005) of total cumulative savings would be reduced to $9.4 million from the $30.2 million calculated for the 12/31/04 exit fee.[111] According to the LGE study, not giving notice by the end of last year is the equivalent of throwing away tens of millions of dollars.

III. The benefits from LGE membership in the Midwest ISO exceed the associated costs.

This is a case about commitment and its consequences. LG&E and KU committed to form the Midwest ISO, a commitment that its 10 other founding members relied upon. LG&E committed to remain in the Midwest ISO to effectuate its merger with

[109] This is the sort of "information that will be gained only from the process of the effort to exit MISO." AG Brief at 3.

[110] Exhibit MJM-1 at p. 51 (§3.13). In contrast, the Midwest ISO estimates that the 12/31/06 exit fee will be $28.9, almost $10 million lower than the 12/31/04 exit fee. Attachment to Midwest ISO Response to LGE Request No. 44, pp. 1-2.

[111] *See* footnote 74 above, and accompanying text.

Kentucky Utilities.[112] LGE also committed to support the Midwest ISO as a compliant organization under Order No. 2000 of the Federal Energy Regulatory Commission ("FERC").[113] And LGE committed to the development of competitive markets throughout the Midwest.[114] These commitments have benefited LGE and continue to do so.

While LGE asserts that multiple changes of circumstances now warrant its bid to withdraw from the Midwest ISO, the only thing that really has changed is the business strategy of LGE. When LGE made its commitment, the corporate strategy was to be an active player in competitive markets, securing corporate profits through off-system sales ("OSS") of low-cost power.[115] This strategy did not require the permission or validation of the Commission. Two corporate acquisitions later, LGE has revised that corporate strategy[116] and now wishes to be free from those commitments. But rather than invoke the contractual rights open to it, LGE seeks to make the Commission complicit in its actions and to assure that ratepayers instead of shareholders will bear the cost of its corporate change of heart. It would have the Commission trigger a federal reevaluation of the terms and conditions of its merger.[117] And it would risk a net loss of benefits from membership and saddle consumers in Kentucky with over $38 million in withdrawal costs incurred in pursuit of a corporate strategy now changed.

---

[112] 2 T.E. 154:21-23 (Beer).

[113] Midwest Independent Transmission System Operator, Inc., Order Granting RTO Status and Accepting Supplemental Filings, 97 FERC ¶ 61,326 (December 20, 2001) ("Midwest ISO RTO Order").

[114] *See* Midwest ISO Hearing Exhibit No. 4.

[115] *See* 1 T.E. 81:7-12, 84:15-20 (Thompson).

[116] 1 T.E. 86:2-4 (Thompson).

[117] MSB Direct, 4:7-32; 7:1-9; 7:12-22.

A. Changes in circumstance do not warrant LGE's withdrawal.

LGE avers that its initial efforts to create the Midwest ISO and to participate in that organization were prudent for a number of reasons, none of which have changed. However, it now contends that three unanticipated events have occurred that fundamentally change the value of its participation and warrant its withdrawal.[118] First, LGE claims that the Midwest ISO unexpectedly has begun developing markets that will impose higher cost on participants. Second, it argues that FERC undermined an essential compromise leading to the formation of the Midwest ISO by requiring all load to pay the administrative cost of the Midwest ISO under Schedule 10 ("the Schedule 10 Adder") of the Midwest ISO Open Access Transmission Tariff ("OATT"). Third, it claims that it lost control over the Midwest ISO, and the costs thereof, when FERC refused to sanction the right of transmission owners to unseat the Midwest ISO Board of Directors. None of these events either were unexpected or prejudicial to Kentucky ratepayers.

1. The mission of the Midwest ISO has not changed.

LGE asserts that it is entitled to back away from its commitments because the mission of the Midwest ISO has changed. Specifically, LGE claims that the Midwest ISO's pursuit of Day 2 markets is an unprecedented aberration from the intent of the original members of the Midwest ISO.[119] The record, however, does not bear the weight of LGE's charges.

The Midwest ISO was created to achieve three broad objectives: (1) nondiscriminatory transmission access; (2) competitive markets for wholesale sales of

[118] LGE Brief at 11-12.
[119] LGE Brief at 4.

electric energy; and (3) reliable operation of the transmission grid.[120] In their application to FERC for approval to establish the Midwest ISO, LG&E, KU, and the other Transmission Owners (collectively, "TOs") averred that:[121]

> [T]he Midwest ISO will provide substantial benefits to market participants in the Midwest .... [T]he elimination of transmission rate pancaking on a regional scale should produce an overall reduction in the cost of transmitting energy within the region. In addition, market participants will benefit from (1) one stop shopping for transmission service, (2) the establishment of uniform and clear rules by the ISO, (3) the separation of control over the transmission facilities from marketing functions, (4) large scale regional coordination and planning of transmission and (5) enhanced reliability.

Nothing in the record indicates that these benefits have not been attained or do not benefit consumers in Kentucky in like manner and to the same extent as consumers throughout the region. Nevertheless, LGE does not accord any value to these accomplishments or try to quantify their value in any manner.[122]

The further evolution of the Midwest ISO was not unanticipated. In considering the application of LGE and the other TOs, FERC noted that the sponsors had[123]

> characterize[d] what has been filed with us as 'the initial implementation of the ISO.' We concur with this assessment and view their proposal as an ISO which will undoubtedly continue to evolve both with respect to its geographic configuration and how it will perform certain activities and functions.

Initially, the contemplation was that the Midwest ISO would monitor critical flowgates, administer an open-access transmission tariff and assist in the resolution of transmission constraints. It would rely on existing institutions and existing tools — control area operators and Transmission Loading Relief ("TLR") orders — to effectuate operations.

---

[120] *See, e.g.*, Transmission Owners Agreement, Art. 2, § I.D (Orig. Sheet No. 19).

[121] Midwest ISO Order, 84 FERC at 62,140.

[122] LGE's expert witness testified that he did not consider consumer benefit in performing his analysis. 1 T.E. 149:6-16 (Morey). A benefit-cost analysis that ignores the benefits that underlie the prudence of the initial effort is suspect on its face.

[123] Midwest ISO Order, 84 FERC at 62,142.

In the parlance of the founding members, this mode of operation represented "Day 1." The founding members, however, appreciated that a regional organization could achieve efficiencies and levels of operational sophistication beyond the reach of individual utilities. Hence, they contemplated an evolution of the Midwest ISO into an organization that would be capable of managing transmission congestion through market-based mechanisms, that would provide regional planning and outage coordination and that would be capable of providing real-time imbalance services.

Among the cornerstones to the Midwest ISO's Day 2 market is the use of Locational Marginal Pricing ("LMP") to value and resolve transmission system congestion. LMP quantifies the cost of redispatch undertaken to resolve transmission congestion. Those costs are generally borne by consumers on the side of a congested interface where generation costs are higher. In the absence of transmission congestion, the market will clear at a single price and thus the LMP will be zero.

The redispatch of generation to relieve constraints, however, is not a new phenomenon, nor is it a product of Standard Market Design or any other FERC initiative. Instead, it is an economically efficient means to address transmission congestion and is a profoundly more precise tool than the current practice of invoking TLRs. Actual operating experience shows that the inherent imprecision of current congestion management practices both leaves substantial amounts of transmission capacity unused during periods of congestion and curtails transactions with little regard for their economic value.[124] Indeed, in their original application to establish the Midwest ISO, LGE and the other TOs stated that their approach to the transmission constraints was "'market-based' and ... provides for more effective and efficient

[124] RRM Direct 11:22-24, 14:11-15.

congestion relief than the status quo because of greater regional coordination and use of redispatch rather than curtailment."[125]

In Order No. 2000, FERC required all public utilities to join an RTO or to demonstrate that the organization of which they were a member was compliant. LGE (as did other TOs) advised FERC that the Midwest ISO is a compliant RTO.[126] It did so knowing that an RTO must provide real-time balancing services, which requires the establishment of real-time markets. It did so knowing that the Midwest ISO would be required to implement an LMP-type mechanism to manage congestion within one year of RTO approval. LGE and the other also embraced the Midwest ISO compliance filing, which stated that:[127]

> [I]ts [current] congestion management provisions are in technical compliance with the requirements of Order No. 2000 for Day One operations. However, it concedes that, while market-based, its Day One approach is not sufficiently dynamic to achieve the optimal long-term efficiencies envisioned under Order No. 2000. Accordingly, the Midwest ISO <u>and its stakeholder committees</u> [including LGE] have studied and evaluated potential long-term, or Day-Two, congestion management solutions for the Midwest ISO, and have arrived at the conclusion that such a solution should be based on a hybrid approach that incorporates the most desirable elements of both locational marginal pricing (LMP) and physical flowgate methodologies ....

With respect to real-time balancing services, the Midwest ISO indicated a Day 1 intention to keep shippers "in balance" through the use of bilateral schedules arranged with third-party providers. However, for Day 2, the Midwest ISO proposed to link real-time balancing with the real-time locational markets needed to effectuate LMP for congestion

[125] Midwest ISO Order, 84 FERC at 62,162. Under the original plan, however, the costs of redispatch would be shared among all load, including bundled native load, on a *pro rata* basis rather than directly assigned to specific transmission customers, which is the effect of LMP pricing. *See* Midwest ISO OATT, Attachment K.

[126] *See* Midwest ISO Exhibit No. 1 (January 16, 2001 Order No. 2000 Compliance Filing of Specified Transmission Owners (including LGE), filed at the FERC, in Docket No. RT01-96-000) at pp. 3-4.

[127] Midwest ISO RTO Order, 97 FERC at 62,512 (emphasis added).

management.[128] FERC approved the Midwest ISO's approach "conditional on its commitment to file a Day Two proposal for congestion management that will improve the efficiency of the markets in the Midwest region, including the real-time imbalance energy market."[129] Again, LGE filed in support of the Midwest ISO's proposal and adopted it as its own compliance with Order No. 2000.[130]

The only aspect of the markets currently being designed by the Midwest ISO that was not mandated by Order No. 2000 is a security constrained, centralized economic dispatch protocol, which is a bid-based dispatch queue utilizing the lowest cost resources regionally available to satisfy load.[131] However, this too cannot be considered a surprise, given the FERC finding in that Order that "markets that are based on locational marginal pricing and financial rights for firm transmission service appear to provide a sound framework for efficient congestion management."[132] Indeed, LMP markets are the means by which RTOs have implemented security-constrained economic dispatch — the very approach that has made possible the merger savings claimed by LGE.[133] The Midwest ISO is proposing to do precisely the same thing, but on a regional basis.

Three years after the fact, it is too late for LGE to profess shock and surprise that the Midwest ISO is developing markets to support an LMP-based congestion management regime and a real-time balancing market. It has known about those activities for

---

[128] *Id.* at 62,522.

[129] *Id.*

[130] *See generally* Midwest ISO Exhibit No. 1 (Specified TOs' Order No. 2000 Compliance Filing).

[131] *See generally* Regional Transmission Organizations, 65 Fed. Reg. 809 ("Order 2000") (codified at 18 C.F.R. Part 35).

[132] Order 2000, 65 Fed. Reg. at 887.

[133] Midwest ISO RTO Order, 97 FERC at 62,508.

years, and positively embraced them when it was in its self-interest to do so. It thus is simply incorrect for LGE to allege that the Midwest ISO has expanded its functional responsibilities beyond those envisioned by its charter membership. At every step, the charter members knew and intended that the Midwest ISO would use a market-based scheme of redispatch to relieve congestion.[134] Similarly, it is not true to say that the functions being developed by the Midwest ISO "exceed the requirements of the FERC's Order No. 2000 ...." The functions being developed by the Midwest ISO are those mandated by the FERC in finding the Midwest ISO to be a compliant RTO, which application was supported by LGE as a member of the Midwest ISO TOs.[135]

LGE also contends that "implementation of the proposed Day 2 markets will indisputably expose the Companies to significant new financial risks with little promise of corresponding benefits."[136] The evidence shows the opposite. LGE is not required to sell into or purchase from markets sponsored by the Midwest ISO.[137] It may schedule their resources and remain "in balance" through their own control area operations. If it does not import power (which it should not if it is a truly low-cost producer), LMP charges are not an issue. Indeed, LGE's own witness conceded that the markets being developed by the Midwest ISO represent the epitome of efficiency and will result in long-term benefits for all consumers in the Midwest.[138] Furthermore, LGE freely admits that it intends to use the Midwest ISO's markets to make OSS for corporate profit. It just does not want to have to pay for what it plans to use.

---

[134] The Midwest ISO has adopted protections that might not have been envisioned by the charter, for example, that Kentucky native load benefits from redispatch pursuant to LMP, and is protected from any net adverse impact by Financial Transmission Rights ("FTRs").

[135] *See generally* Specified TOs' Order No. 2000 Compliance Filing.

[136] LGE Brief at 4.

[137] 3 T.E. 29:8-10; 43:2-14; 43:20-23; 79:4-19; 86:8-10; 88:7-14 (McNamara).

[138] 2 T.E. 37:10-13 (Morey).

Although LGE here claims that its participation in the Midwest ISO might be advantageous if it was permitted to opt out of the Day 2 markets for the period 2005-2010,[139] it has been an ardent opponent of permitting any utility to opt out of the Day 2 market. The evidence at trial showed that when a Wisconsin utility sought to be excluded from the Day 2 market, LGE was a signatory to a letter to Mr. Torgerson stating that no utility should be allowed to opt out of the Midwest ISO's Day 2 market.[140] LGE fails to explain how the Midwest ISO is somehow derelict in not allowing it to opt out of the market, but is irresponsible to even consider permitting a delayed entry of another utility. Moreover, LGE does not actually want to opt out of the Day 2 market, as it fully intends to take advantage of that market by making off-system sales at the border.[141] What LGE really wants is not to have to pay for the market advantages it expects to reap.

The Commission should not be misled into thinking that LGE will be able to enjoy the most important benefits of Day 2 market participation without being a Midwest ISO member. For example, participation in the market from within the Midwest ISO will assure a load-serving entity (or supplier) that it can consistently purchase (or sell) real-time or day-ahead energy at the best competitive price bid (or offered) with respect to the location of its load (or generation). However, if LGE is outside the Midwest ISO and elects to sell into that market at the border, it will not know the settlement price at the time of its bid, will have no assurance that its price bids will be accepted,

---

[139] LGE Brief at 9.

[140] *See* Midwest ISO Hearing Exhibit No. 4 (letter, dated Feb. 11, 2004); 2 T.E. 109:15-22 (Johnson).

[141] 2 T.E. 140:13-25, 141:8-12 (Gallus).

and will not know at the time of its bid whether some alternative bilateral transaction might have proven to be more profitable.[142]

2. Decisions related to the Schedule 10 Adder benefit Kentucky ratepayers.

LGE alleges that the Midwest ISO has become cost-ineffective because FERC has required all load, including bundled retail, to pay the Midwest ISO's Schedule 10 Adder.[143] The Midwest ISO notes, however, that the deferral of costs that had been proposed by LGE would have merely moved recovery of such cost beyond the rate freeze that LGE agreed to as part of the LG&E-KU merger. By eliminating the need for deferrals, FERC actually benefited Kentucky ratepayers, albeit possibly to the corporate detriment of LGE.

Schedule 10 of the Midwest ISO OATT is the means by which the Midwest ISO recovers its administrative costs. Schedule 10 represents a formula rate in which the monthly cost of operations[144] forms the numerator, and MWhs of transmission service under the Midwest ISO Tariff forms the denominator. The ISO costs to be recovered under Schedule 10 include the ISO's deferred pre-operating costs, the costs associated with building and operating the Security Center, including capital costs and operating expenses, and costs associated with administering the tariff. During a six-year transition period, the ISO cost recovery adder is capped at $0.15/MWh.[145] The sum total of any capital and operating costs in excess of the $0.15/MWh cap as of the end of the six-

---

[142] *See generally* RRM Direct 19:19-25.

[143] LGE Brief at 2-3, 11; PWT Direct 3:21-5:3.

[144] Exclusive of Scheduling Service (Schedule 1), FTR Service (Schedule 16) and Energy Market Service (Schedule 17).

[145] *See* MPH Direct 7:10-19 (explaining that the ISO Cost Recover Adder is capped at a maximum rate of $0.15 per MWh through January 31, 2008).

year transition period are amortized monthly over the succeeding five years and recovered under Schedule 10.[146]

In its initial order approving the Midwest ISO's formation, FERC determined that the proposed Schedule 10 Adder had not been shown to be just and reasonable and set that schedule for hearing.[147] Among the objections to the proposal was the assertion that all load, not just Transmission Customers, should contribute to the administrative cost of creating and operating the Midwest ISO. In November 1999, a FERC Administrative Law Judge recommended that the MWhs of all load form the denominator of the Schedule 10 formula.[148] That recommendation was accepted by FERC in an October 11, 2001 order,[149] and thereafter reaffirmed.[150]

The net effect of the original transmission owners' plan was merely to shift costs from current customers to customers on the system after the expiration of the transition period.[151] The deferral of the collection of Schedule 10 costs would not save consumers money. Instead, deferrals would have caused higher costs because the Midwest ISO would have to borrow money to fund current operations, the interest on which would have been added to the amounts required to be collected in the five-year period following the transition period. Thus, after the six-year transition period, Kentucky bundled

---

[146] *See* Midwest ISO ("OATT"), Schedule 10, Part II.

[147] Midwest ISO Order, 84 FERC at 62,167.

[148] Midwest Independent Transmission System Operator, Inc., *et al.*, 89 FERC ¶ 63,008 at 65,045 (Nov. 26, 1999) (initial decision).

[149] Midwest Independent Transmission System Operator, Inc., *et al.*, 97 FERC ¶ 61,033 (Oct. 11, 2001).

[150] Midwest Independent Transmission System Operator, Inc., 102 FERC ¶ 61,192 (Feb. 24, 2003). That decision is currently before the U.S. Court of Appeals for the District of Columbia Circuit. *See Midwest ISO Transmission Owners, et al. v. FERC*, Case Nos. 02-1121, etc.

[151] Under that plan, only about 30% of the load would pay the Schedule 10 Adder in the transition period, which would have meant that the Midwest ISO would have had to defer approximately 70% of its current cost.

load would have to pay not only current cost, but deferred costs as well.[152] With the expiration of the cap, the TOs' plan could have resulted in severe rate shock for future customers.

Timing, however, was important to LGE's corporate interest. Having agreed to a rate freeze to recognize substantial merger benefits,[153] LGE was precluded from passing through its then-current Schedule 10 charges to the ratepayers of Kentucky. But allowing the Midwest ISO to recover its cost from all load permits the Midwest ISO to remain below the cap and not to incur deferrals, which means that Kentucky ratepayers will not face a rate shock when the transition period expires.

3. Elimination of preferential rights occurred in 1998.

In its brief, LGE alleges for the first time that the FERC unexpectedly divested TOs of a preferential right to unseat the Midwest ISO Board of Directors, altering the balance of burdens and benefits expected from Midwest ISO membership.[154] However, LGE could not reasonably have expected to maintain a preferential right to influence board decisions, since "independence" is the bedrock principle of ISO formation. Indeed, LGE's own witness testified that a right of unilateral action in any one customer class would compromise the independence of the Midwest ISO.[155]

Moreover, FERC refused the TOs the right to privileged control of the Midwest ISO in its initial order approving the creation of the organization <u>in 1998</u>.[156] Like other

---

[152] *See generally* Transmission Owners Agreement, Appendix C.

[153] *See* Louisville Gas and Electric Company, et al., 82 FERC ¶61,308 at 62,223 (1998) ("LGE Merger Order") (stating that LGE agreed to cap base rates for a five year period as part of FERC's order approving merger).

[154] LGE Brief at 12.

[155] 2 T.E. 110:1-4 (Johnson).

[156] FERC found that: "While Transmission Owners initiate action to unseat the ISO Board for unauthorized acts, final action should be subject to the vote of all the Members. We direct

signatories, LGE had reserved the right to withdraw if it objected to any condition the FERC placed on ISO creation.[157] LGE did not elect to withdraw from the Midwest ISO within 30 days of the FERC order that rejected the proposed right of the owners to unseat the Board of Directors. Accordingly, it must be assumed that LGE did not consider such right to be material to its participation at the time. It is too late now to assert, six years after the fact, that the elimination of a preferential right to unseat the board is a current change of circumstance warranting action by this Commission.

B. The existence of the Midwest ISO made the LG&E-KU merger possible.

LGE is the dominant supplier of electric service in the Commonwealth of Kentucky. The merger between LG&E and KU not only diminished competition in the state but also sharply increased market concentration in generation. In its federal merger proceeding, it was a foregone conclusion that the FERC would have to adopt some form of market power mitigation or be required to deny the application as inconsistent with its merger guidelines.[158]

LGE took the offensive in these proceedings and asserted that the merger could occur and market power need not be mitigated because it was, and would remain, a member of the Midwest ISO both under Order No. 888 and Order No. 2000. Indeed, LGE repeatedly committed to remain a member of an organization that would provide open access transmission. There were repeated instances in which regulatory authorities approved the merger on specific reliance on LGE's commitment to remain in the

---

Applicants to modify the ISO Agreement to place any action to unseat the ISO Board before the ISO Membership." *Midwest Independent System Operator, Inc.*, 84 FERC at 62,151.

[157] *See* Transmission Owners Agreement, Art. 7, § A.2 (Orig. Sheets Nos. 79-80).

[158] *See generally* LGE Merger Order.

Midwest ISO.[159] Thus, the existence of and membership in the Midwest ISO was the *sine qua non* of approval of the merger in its present form.

LGE states that "MISO's own witnesses ... acknowledge that these merger benefits will flow to the Companies and their ratepayers regardless of whether the Companies are MISO members."[160] No such acknowledgement was made. The Midwest ISO witnesses sensibly disclaimed that they could predict the counterfactual, *i.e.*, what federal authorities would have done if LGE had not obligated itself to participate in the Midwest ISO. On the other hand, LGE acknowledged that federal authorities could unwind the merger if LGE reneged on a commitment upon which such authorities relied in granting its approval:[161]

> <u>FERC relied heavily on the Companies' "continued participation" in MISO.</u> The FERC stated:
>
> > In this case, LG&E and KU have ... filed for approval to transfer operational control over their transmission facilities to the Midwest ISO. We find that the proposed mitigation measures and ratepayer protection mechanisms, in conjunction with LG&E's and KU's participation in the Midwest ISO, will ensure that the merger will not adversely affect competition, rates or regulation....
>
> 82 FERC ¶ 61,308 (1998), Docket No. EC98-2-000, Order issued March 27, 1998, slip op. at 1-2. That same order, although acknowledging the Companies' right to seek an exit from MISO, made clear the FERC's authority to revisit the competitive ramifications of that decision:
>
> > We regard LG&E and KU's participation as parties in the Midwest ISO filings as evidence of their commitment to membership in the Midwest ISO. <u>Our approval of the merger is based on LG&E and KU's continued participation in the Midwest ISO.</u> If LG&E and KU seek permission to withdraw from the Midwest ISO proceeding or the ISO once it is operating, we will evaluate that request in light of its impact on competition in the KU destination markets ....

---

[159] MSB Direct 4:7-32.

[160] LGE Brief at 14 (citing 3 T.E. 145-49 (Holstein); JPT Direct at 10-11).

[161] MSB Direct 4:7-32 (ellipses and emphases added).

Mr. Beer testified that, because FERC relied on LGE's continued participation in the Midwest ISO in finding no material competitive effect from the LG&E-KU merger, "LG&E's and KU's withdrawal from MISO could prompt the FERC to revisit its orders approving LG&E's and KU's merger, as well as the Companies' merger with E.ON AG."[162] Although noting that LGE could not be sure what conditions FERC might impose if it revisited the merger or acquisitions, he pointed out that the conditions could be quite costly:[163]

> [The FERC has] clarified that "if LG&E and KU seek permission to withdraw" from MISO, the FERC would re-evaluate such [competitive] impact and use its ongoing authority under FPA Section 203 (under which FERC examines and conditions mergers) "to address any concerns, and order further procedures as appropriate." Similarly, in its order approving LG&E's and KU's merger with E.ON AG, the FERC relied at least in part on the Companies' commitment to remain members of a FERC-approved RTO after 2002. Thus, any attempt to exit MISO at this juncture could trigger a reassessment of competitive impact in that context as well. Although unlikely, the FERC could also attempt to impose harsher sanctions, including the divesture of certain generation or transmission assets, as market power mitigation measures.

Indeed, given the current circumstances in which the integrity of energy companies generally is in doubt, a feckless "bait and switch" move by LGE may provoke the ire of federal authorities and encourage reevaluation of the merger *de novo*, with no credit accorded the "commitments" to take voluntary steps to mitigate market power.

Wholly apart from the merger condition/commitment, some form of market power mitigation might be imposed on a utility's taking back control of its transmission facilities. The FERC has held generically that when a seller possesses market power, it

---

[162] *Id.* 8:3-4.

[163] MSB Direct 8:7-20 (emphasis added).

will not be entitled to sell power at market-based rates.[164] Mr. Beer acknowledged this possibility and its detrimental effects:[165]

> FERC has suggested that a jurisdictional entity's failure to join an RTO could lead to certain indirect sanctions such as <u>revocation of market-based rate authority</u> and, in the Companies' case specifically, increased and/or renewed scrutiny of corporate restructuring transactions. .... Revocation of the Companies' market-based rate authority could hamper the Companies' ability to make off-system sales, from which customers currently derive a substantial benefit through base rate credits. The annual credit associated with off-system sales currently embedded in LG&E's and KU's base rates totals approximately $43 million. Although revocation of LG&E's and KU's market-based rate authority would not affect the Companies' ability to sell power into the wholesale market at cost-based rates, it is possible that, in this circumstance, base rates would need to be adjusted to remove at least some portion of this base rate credit. Similarly, the current level of off-system sales margins used in the calculation of the Earnings Sharing Mechanism could decline commensurate with any decline in bulk power sales due to the loss of market-based rate authority.

Thus, if the market-based rate authority of LGE is revoked, over $43 million per year in profits credited to base rates from OSS will be lost.

C. LGE benefits from the distribution of point-to-point transmission revenue within the Midwest ISO.

By remaining in the Midwest ISO, LGE will continue to receive an allocation of the transmission revenue that Midwest ISO collects throughout its footprint for service provided under Schedules 1, 7, 8 and 14 of the Midwest ISO OATT. The revenue distributed to LGE from this Midwest ISO-wide pool is expected to be approximately $21.8 million per year.[166] As a stand-alone entity, LGE would not participate in the pooling and distribution of Midwest ISO transmission revenues. Given that it would be surrounded by larger interconnected markets, external parties would have no reason to

---

[164] *See generally,* Termoelectrica U.S., LLC, Order Conditionally Accepting Market-Based Rate Schedule and Code of Conduct, Denying Waiver Order Nos. 888 and 889 and Denying Request to Make Affiliate Sales, 102 FERC ¶61,024 at 61,046 (Jan. 10, 2003).

[165] MSB Direct 7:1-4, 12-22 (emphasis added).

[166] RRM Direct 5:1.

include a stand-alone LGE transmission system in their contract paths when scheduling transmission service. The transmission revenue received would reflect the volume of power exports from its service territory, equaling an expected $9.1 million annually.[167] As a result, LGE stand-alone transmission revenues would be approximately $12.7 million dollars per year less than the transmission revenues projected for LGE if it remains in the Midwest ISO.[168]

This benefit is important to an overall determination of whether LGE would be financially better off by continuing its membership because (a) it was not taken into account in LGE's own analysis and (b) the total benefit of $76.1 million for the period 2005–2010 exceeds what LGE asserts to be the net cost of Midwest ISO membership for the same period.[169] Additionally, the calculation of this benefit is based on actual historical revenue distributions to LGE as a member compared to stand-alone revenues calculated from actual LGE OSS and transmission rate determinates. Thus, the Commission could decide that continued Midwest ISO membership is in the interest of LGE consumers based on transmission revenue benefit alone, without having to reach any questions related to production cost modeling.

In its post-hearing brief, LGE first claims that Midwest ISO's calculation of this benefit "is an erroneous figure because historically the Companies' transmission revenues have equaled their transmission payments ...."[170] However, Dr. Morey's

---

[167] *Id.* 5:4-5.

[168] *See* Exhibit RRM-1, pp. 13-14 (comparing LGE's transmission revenues in and out of the Midwest ISO); 3 T.E. 137:2-9 (Holstein) (same). The transmission revenue benefit is based on a comparison of point-to-point transmission service revenues that are paid by third parties either directly or indirectly through purchased power prices that permit LGE Energy Trading to recover its delivery costs.

[169] *Compare* 3 T.E. 137:2-9 (Holstein) ($76.1 million) *with* MJM Rebuttal 7:1 ($65.3 million).

[170] LGE Brief at 20 (citing MJM Rebuttal 21:8-23:8).

testimony contains no historical data on LGE's transmission payments and no comparisons of actual transmission payments to revenues. Nor did LGE present such historical data at any other point in this proceeding. Instead, there is merely an assertion that, in the future, "nearly 100% of the transmission service revenues are expected to be accounted for in terms of transmission payments by Energy Trading."[171]

In calculating LGE revenues from OSS, Dr. McNamara used "export revenues at LGE/KU generator bus Locational Marginal Prices."[172] Contrary to LGE's assertion, he has not "assumed the Companies deliver their energy at the generator bus."[173] Nowhere in his report does Dr. McNamara make (or need to make) an assumption regarding the delivery point for LGE OSS. He calculated OSS revenue using generator bus prices because this represents the net revenue LGE receives after subtracting an amount at least equal to any transmission charges paid by LGE Energy Trading. If LGE makes a profitable off-system sale and delivers that power at a point outside its own system, the price at that external delivery point has to cover both the cost of the power (*i.e.*, the generator bus price) and the cost of shipping it to the delivery point (*i.e.*, the transmission charges paid by LGE). If the transaction is economic, the price at an external delivery point will always exceed the generator bus price by at least the amount of any transmission charges paid by LGE. Dr. Morey conceded this point on cross-examination.[174]

---

[171] MJM Rebuttal 22:11-12.

[172] Exhibit RRM-1 at p. 10.

[173] LGE Brief at 20.

[174] 2 T.E. 29:15-30: 4 (Morey). It is a self-evident point to anyone who has bought a product through a catalog or internet site. To sell its product, an internet book seller's price for a given title has to be less than the price of that book at a neighborhood store by at least the amount of the shipping charges.

By using the generator bus price to calculate revenues on OSS, Dr. McNamara used a revenue number from which he had in effect already deducted any transmission payments made by LGE Energy Trading.[175] In suggesting that the Transmission Revenue Benefit be offset by again deducting transmission charges paid by LGE Energy Trading,[176] LGE is proposing to double count the transmission charges it paid when making OSS. Given that any transmission charges paid by LGE for OSS will depend on the volume of OSS, the appropriate place in the analysis to address those charges is in the comparison of LGE's net margin on OSS within the Midwest ISO and on a stand-alone basis, as Dr. McNamara has done.

LGE's claim that transmission payments by its Energy Trading unit should nearly offset transmission revenues rests entirely on a false assumption that the transmission revenues it receives as a member are based on the volume of point-to-point transactions over LGE transmission facilities associated with LGE Energy Trading OSS.[177] As a stand-alone entity, LGE would collect transmission revenues based on whether its transmission facilities were on the "contract path" used to schedule a given transaction.[178] However, what would be true for a stand-alone (or pre-Midwest ISO) LGE is not accurate with respect to LGE as a Midwest ISO member. As a member, LGE benefits from the distribution according to specific allocation formulas of revenues under Schedule 1 (Scheduling, System Control, and Dispatch), Schedule 7 (Firm Point-to-Point Service), Schedule 8 (Non-firm Point-to-Point Service) and Schedule 14 (Through and

---

[175] Dr. McNamara's OSS revenues are net of both transmission payments made to LGE and transmission payments made to other transmission providers. *See generally* Exhibit RRM-1 at p.10 (§2.11).

[176] MJM Rebuttal 21:22-22:6.

[177] MJM Rebuttal 22:7-12.

[178] Regional Transmission Organizations, FERC Notice of Proposed Rulemaking, 64 FR 31,190 at 31,400 (June 10, 1999).

Out Rate).[179] If, for example, a point-to-point transaction sourcing in Cinergy and delivered to Big Rivers were to displace a sale from an adjacent LGE generator, this would not change the Schedule 1, 7, 8, or 14 transmission revenues received by LGE as a Midwest ISO member. Nor would the identity of the party selling that power affect the transmission revenues.

Furthermore, LGE's assertion that "customers do not pay point-to-point transmission charges in MISO,"[180] is not supported by the record. In fact, a variety of types of transmission service customers, including load serving entities that are Midwest ISO members, today reserve and pay for substantial volumes of point-to-point transmission service. The $21.8 million per year of Schedule 1, 7, 8, and 14 transmission revenue that LGE can expect to receive as a member equals the Midwest ISO's actual distribution of such revenue to LGE over 12-month period from December 2002 through November 2003.[181] As Dr. McNamara testified, the Midwest ISO expects to continue to distribute to LGE comparable amounts of point-to-point transmission service revenue.[182] And, LGE witness Dr. Morey conceded that Dr. McNamara's "transmission revenue estimate presented under the MISO option has empirical support."[183]

D. LGE fails to rebut evidence showing significant OSS revenue flowing from participation in the Midwest ISO.

It only makes sense that OSS will be higher if LGE is part of the Midwest ISO market given that LGE will incur lower transmission charges to make sales and have access to a large, integrated regional market. The implementation of centralized

---

[179] Exhibit RRM-1 at p. 13; *see also* Transmission Owners Agreement, Appendix C.
[180] LGE Brief at 20.
[181] Exhibit RRM-1 at pp. 13-14 (§4) and Table RRM_1-7.
[182] *Id.* at p. 13 (§4).
[183] MJM Rebuttal 21:21-22.

dispatch across the Midwest ISO footprint will increase the ability for participants to sell off-system for several reasons.[184] First, improvements in the efficient use of generation and transmission assets will increase the opportunity for participants to engage in profitable transactions beyond the Midwest ISO border. Second, since one outcome of implementing centralized dispatch will be the creation of a willing and able buyer (*i.e.*, the market) at every node, the costs of transacting at the border will be significantly reduced. Third, transparent five-minute pricing will further reduce existing barriers to transacting outside of the Midwest ISO footprint. Lastly, use of LMP will facilitate the creation and increased use of financial rather than physical contracting methods; such methods will further serve to reduce transaction costs, especially for off-system transactions, with a commensurate potential for increase in sales beyond the Midwest ISO footprint.

LGE critiques Dr. McNamara's testimony on conflicting grounds, that, on the one hand, his $3 per Mwh transaction cost is too high and at the same time that he lacked a basis for scaling of OSS back to the volumes of recent historical levels of OSS actually experienced by LGE.[185] Both critiques cannot be accurate. If the transaction cost estimate was in fact too high, the barriers to trade in the model represented by the hurdle rate would be reflected in modeled stand-alone OSS being lower than historical OSS. In fact the reverse occurred, and Dr. McNamara scaled back stand-alone OSS to historical levels to reflect an overly conservative hurdle rate. However, even if Dr. McNamara had not scaled OSS to historical levels, he testified on cross-examination that the net

---

[184] RRM Direct 5:11017, 20:6-12; Exhibit RRM-1 at p. 16.
[185] LGE Brief at 21-22

present value benefit of LGE remaining in MISO would still be in excess of $81 million.[186]

The Midwest ISO is mildly amused that LGE criticizes Dr. McNamara because he did not personally run the ProMod IV model.[187] This criticism runs counter to LGE's contention that its cost-benefit study is inherently more trustworthy because no one at LGE had anything to do with it.[188] More telling, however, is the fact that LGE did not even bother to run a ProMod IV analysis.[189] Dr. Morey testified that the entirety of his analysis was developed in two weeks, which was an insufficient timeframe to engage in the work necessary to run the ProMod IV models.[190] Midwest ISO's analysis was supervised by Dr. McNamara, an expert in the field of electric restructuring, and trumps the unsupported and unquantified assumption by LGE that it would make approximately the same amount of OSS either in or out of the Midwest ISO.[191]

Moreover, LGE's assumption that it will make approximately the same amount of OSS whether in or out of the Midwest ISO is flawed. The Midwest ISO has no intention of operating its market at no charge to non-members. Rather, it is considering an access charge for non-members selling into the Midwest ISO/PJM market that will approximate roughly the cost that would be incurred by a member who supports such markets. As such, net revenue from OSS will be lower if LGE is outside of the Midwest ISO than it would be if it remains in the organization. Furthermore, LGE OSS would be lower outside the market not just because of a possible Midwest ISO access charge, but

---

[186] 3 T.E. 40:16-17 (McNamara).
[187] LGE Brief at 22.
[188] *Id.* at 8.
[189] 2 T.E. 50:15-20 (Morey).
[190] *Id.* 55:20-56:3 (Morey).
[191] LGE Brief at 23.

due to: (1) LGE point-to-point transmission charges; (2) the inefficiencies of having to rely on bilateral transactions; and, (3) Midwest ISO real-time security-constrained economic dispatch is more precise than stand-alone congestion management and will be able to stretch the capabilities of the transmission system.[192]

E. Midwest ISO markets create opportunities for LGE and present minimal risk.

LGE claims that there are "no obvious net benefits that would accrue to the Companies from Day 2 market participation."[193] If LGE eschewed any ambition to participate in such market, this claim could have some superficial credibility. Of course, however, LGE plans to take advantage of the Day 2 market; it simply wants to avoid its allocated cost of market creation.[194]

1. There are benefits to the proposed markets regardless of LGE's actual participation in them.

The existence of Day 2 markets will present LGE a number of opportunities not heretofore available and will generate transparent prices against which activities within LGE may be measured.[195] LGE is not required to sell power into, or acquire power from, the day-ahead and real-time markets being established by the Midwest ISO.[196] LGE may self-schedule its resources and operate in the same manner as it does today. The only difference will be in efficiencies. If load is greater than scheduled resources, power will be supplied at competitive prices without transaction costs. If the output of resources exceed load, power is automatically purchased at transparent competitive

---

[192] RRM-1 at pp. 8-9.
[193] LGE Brief at 24.
[194] 2 T.E. 141:8-12 (Gallus).
[195] RRM Direct 6:13-8::4, 17:17-21:9.
[196] *Id.* 8:5-9; 3 T.E. 79:4-9, 80:1-15, 86:8-10, 88:7-14 (McNamara).

prices. If congestion arises, the Midwest ISO markets will quantify the cost of congestion relief and allow for a comparison of the inefficiency of TLR actions.[197]

Even if LGE chooses not to participate in Midwest ISO markets, the existence of those markets will reveal the price of non-participation. There may be times when power is cheaper in the Midwest ISO market than LGE's marginal source of generation, or the market may reveal opportunities for LGE to sell power in excess of its incremental cost of production. Information concerning the cost of self-supply and the value of opportunities foregone may be a useful benchmark to regulatory authorities. And, the information will be available without LGE having to bear the expense of finding, negotiating, and settling its own set of what are frequently less than optimal bilateral transactions. Finally, LMP will reveal the true cost of congestion relief and allow regulatory authorities to compare that cost with the far higher price of invoking TLRs.[198] These are all near-term benefits from centralized, security-constrained economic dispatch and participation in a large, integrated regional LMP market.

The bigger picture also should take into consideration that participation in transparent markets will change incentives and provide the Commission with greater information to drive efficiency improvements. Comparable incentives, for example, have resulted in actual improvements in forced outage rates at PJM utilities, such that if LGE steam and turbine forced outage rates were reduced to even the average rates achieved in PJM, this would represent the equivalent of 170 MW of additional capacity.[199] The cost of Midwest ISO membership is a modest investment when compared to the potential for longer-term efficiency gains.

---

[197] Exhibit RRM-1 at p. 10 (§2.10); *see also id.* Table RRM_1-4.
[198] *Id.* at p. 15.
[199] *Id.* at p. 16-17.

2. The availability of FTRs adds a tool for managing congestion costs.

LGE claims that FTRs represent a material risk.[200] FTRs allow entities at risk of incurring LMP charges a means to avoid the price risk of congestion,[201] providing an additional protection beyond what would be available to LGE outside the Midwest ISO. Participation in an LMP market does not create, and in fact reduces, congestion costs.[202] Outside of the market, LGE would have only physical transmission rights. When a physical right is curtailed outside of an LMP market, the utility receives no compensation for the resulting congestion costs.[203]

Those most at risk of bearing congestion costs are those who are under-hedged and located in regions that are highly congested where the price of power in load centers is significantly higher than prices at their sources of generation.[204] Dr. McNamara's testimony demonstrates that for LGE the financial consequences of being under-hedged for nearly 7% of peak load are de minimis.[205] LGE appears to concede that, apart from risks associated with "cram-down," Dr. McNamara has demonstrated the risk of under-hedging to be small.[206]

In its rebuttal testimony, to which Midwest ISO did not have the opportunity to respond, LGE raised for the first time the issue that the PJM pool has experienced

---

[200] LGE Brief at 4, 13, 24-26.

[201] RRM-1 pp. 11-13.

[202] *See generally id.* at pp. 14-15.

[203] *Id.* at p. 11.

[204] Although there may be exceptions, typically one should expect load center prices to be higher generator bus prices. If congestion is limited, the price differences also will be limited.

[205] Exhibit RRM-1 at p. 11-13 and Table RRM 1-6.

[206] LGE Brief at 25.

"cram-down" — paying less than the nominal value of FTRs.[207] However, LGE provided no details regarding the circumstances which led to such under payments in PJM, provide indications that such circumstances would be present in the Midwest ISO market, explain the trend toward declining underpayments in PJM from 1990 to 2002, or indicate that such underpayments remain an issue in PJM. Even if the Commission were to assume a small "pro rata" underpayment, the fact that in peak load periods there is a near total lack of financial consequences from under-hedging indicates that any "cram-down" related costs also would be minimal. LGE has not made any demonstration that under-hedged congestion costs associated with "cram-down" could be of a material amount. If LGE does not need to acquire FTRs or the financial value of any FTRs is low because it is, in fact, a low-cost producer, then the discussion of the "cram-down" experience in PJM is merely an academic exercise.

LGE hypothesizes that there is a risk of over-hedging when the LMP at its generators (or source) is greater than the LMP at its load centers (or the sink).[208] However, LGE also claims that it is a low-cost producer seeking to retain the advantage of that status for its customers. To the extent that LGE nominates for its native load FTRs from its generators to its load centers, the risk that generator prices will substantially exceed load center prices will be slight. By LGE's own claim, there is no reason to believe its customers face a significant risk from over-hedging. Moreover, LGE's only attempt to quantify this risk was in the rebuttal testimony of Dr. Morey.[209] His supposed quantification of such a risk is flawed in that, as he concedes on cross-examination, his analysis is based on a summer peak FTR nomination that he has applied to LMP values

---

[207] MJM Rebuttal 29:3-4, 15-19.
[208] *Id.* 31:11-32:2.
[209] *Id.* 30-32 and Exhibit MJM-5.

covering off-peak and fall, spring and winter seasons. He conceded that LGE's ability to nominate fewer FTRs in off-peak periods and the fall, spring, and winter seasons would reduce any over-hedging risks.[210]

F. LGE acted prudently in joining the Midwest ISO, and acts prudently in continuing its membership.

LGE asserts that it acted prudently in joining the Midwest ISO. The Midwest ISO agrees. Such participation satisfied federal requirements, improved regional reliability and promoted competition. LGE's continued participation in the Midwest ISO is also prudent. The evidence is uncontradicted that the reliability provided by the Midwest ISO far surpasses that available to LGE as a stand-alone entity. The security constrained, economic dispatch model being implemented by the Midwest ISO is beneficial to maintaining a low-cost, efficient electric service industry. And, the merger savings currently enjoyed by LGE's customers will continue unabated.

LGE has shown no basis upon which its exit fee should be converted into a regulatory asset. It does not show that the incurrence of such a fee is unavoidable or is the product of a federal regulatory fiat. To the contrary, the incurrence of the exit fee will be pursuant to a determination of the corporate interest of LGE and will be pursuant to a contract into which LGE freely entered. The ratepayers were not consulted when LGE made its obligation, and should not be made to bear the cost of a change in strategic direction. LGE's own witness testified that withdrawal from the Midwest ISO would be in the corporate interest of LGE even without recovery of the exit fee from the ratepayers of the Commonwealth of Kentucky.[211] In the face of this testimony, it would be irresponsible for the Commission to create a regulatory asset to burden consumers

---

[210] 2 T.E. 21:22-22:2 (Morey).
[211] 1 T.E. 99:1-10 (Thompson).

with a cost freely incurred by LGE for which there is no necessity that it receive reimbursement. The Commission should take LGE at its word and allow it to internalize both the costs and benefits associated with any withdrawal from the Midwest ISO. Otherwise, the Commission should direct LGE to pay to its ratepayers the net benefit that it testifies would accrue from withdrawal from the Midwest ISO. The asymmetrical nature of the relief sought — ratepayers bear costs while the utilities' corporate parents reap benefits — is generally repugnant to the notions of public interest.

CONCLUSION

WHEREFORE, for the reasons stated in its initial brief and this reply brief, and on the evidence of record, the Midwest ISO respectfully suggests that the Commission close this investigation without ordering any change in the continued membership and participation of LG&E and KU in the Midwest ISO.

Respectfully submitted,

Katherine K. Yunker
Benjamin D. Allen
YUNKER & ASSOCIATES
P.O. Box 21784
Lexington, KY 40522-1784
859-255-0629
fax: 859-255-0746

Stephen G. Kozey
James C. Holsclaw
MIDWEST INDEPENDENT TRANSMISSION
SYSTEM OPERATOR, INC.
701 City Center Drive
Carmel, IN 46032
317-249-5769

BY: Katherine K. Yunker

ATTORNEYS FOR MIDWEST INDEPENDENT
TRANSMISSION SYSTEM OPERATOR, INC.

CERTIFICATE OF FILING AND SERVICE

I hereby certify that on the 19th day of May, 2004, the original and ten (10) copies of this Reply Brief were sent for hand-delivery to the Commission for filing, and a copy was sent by first-class U.S. mail to:

Michael S. Beer
Linda S. Portasik
LG&E Energy Corp.
220 West Main St.
P.O. Box 32030
Louisville, KY 40232-2030

Elizabeth E. Blackford
Assistant Attorney General
Utility & Rate Intervention Division
1024 Capital Center Drive; Suite 200
Frankfort, KY 40601-8204

Kendrick R. Riggs
Allyson K. Sturgeon
OGDEN NEWELL & WELCH PLLC
1700 PNC Plaza
500 West Jefferson Street
Louisville, KY 40202

David C. Boehm
Boehm, Kurtz & Lowry
Suite 2110 CBLD Building
36 East Seventh Street
Cincinnati, OH 45202

Ben Allen

Attorney for Midwest Independent Transmission System Operator, Inc.