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September 13, 2005

RECEIVED
SEP 13 2005
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 the original and ten (10) copies of the Post-Hearing Reply Brief to be filed in the above-referenced proceeding on behalf of an intervenor, Midwest Independent Transmission System Operator, Inc. By allowance of the Commission, a conformed copy of this brief was faxed to the Commission this afternoon — with the enclosures herein to be hand-delivered to the Commission tomorrow (9/14/05) morning.

Thank you for your assistance in this matter.

Sincerely,

Katherine K. Yunker

Enclosures

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

RECEIVED

SEP 1 3 2005

PUBLIC SERVICE COMMISSION

In the Matter of:

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

POST-HEARING REPLY BRIEF OF THE MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR, INC.

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MIDWEST INDEPENDENT TRANSMISSION SYSTEM OPERATOR, INC.

TABLE OF CONTENTS

Page

The Midwest Independent Transmission System Operator, Inc. ("Midwest ISO"), an intervenor, hereby presents its Initial Post-Hearing Reply Brief in the above-referenced proceeding in support of its position that continued membership of Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU"), (collectively, "LGE"), in the Midwest ISO provides benefits that far outweigh the cost, and as such, serves the public interest.

SUMMARY OF THE ARGUMENT

The Midwest ISO reiterates that it does not stand in an adversarial position to LGE or its business desires. It is the Midwest ISO's hope, however, that the participation of the Midwest ISO in this proceeding, and the evidentiary record compiled herein, will assist the Commission in discharging its statutory obligations to ascertain what is in the best interest of Kentucky consumers.

The Midwest ISO appreciates the Commission's decision to extend the record to receive evidence on market operations. Notwithstanding a number of skeptics, the market launched as planned, produced the results expected, and every day is vouchsafing the Midwest ISO's projections of transparency, efficiency and reliability. As set forth in the Initial Brief, and discussed briefly herein, actual cost experience to date has surpassed the benefits that the Midwest ISO projected in its models. Disputes over actual results largely reflect LGE's selective focus on a few items of expense without acknowledging the offsetting or complementing increases in revenue.

The Midwest ISO does not dispute that there may be Reliability Coordinators available to LGE that are capable of preventing blackouts. The question here is not whether blackouts can be prevented by other entities, but rather, at what cost. LGE focuses exclusively on costs incurred under Schedule 10 of the Midwest ISO's Open Access Transmission Tariff ("OATT"), but fails to account for the profound economic cost produced through an exclusive reliance on Transmission Loading Relief orders ("TLRs") to manage congestion and control loop flows as would occur with any other entity mentioned by LGE as a possible alternative.

Furthermore, the Midwest ISO asserts that the Commission continues to have full jurisdiction over retail rates. Nothing about membership in the Midwest ISO or the operation of its Day 2 market affects this relationship.[1]

Finally, LGE fails to address the "compared to what?" question. LGE advises that it will immediately file a request with Federal Energy Regulatory Commission ("FERC") for permission to withdraw from the Midwest ISO, but even at this late date offers no concrete alternative to the Midwest ISO. Choices entail costs, and until LGE advises this Commission of its choice, the Commission cannot ascertain the direct and indirect costs of such choice as would be necessary to make the informed decisions required under Kentucky statutes.

Since its inception, the Midwest ISO has worked hard to forge an organization that is responsive to the needs of its stakeholders, state commissions, and federal regulatory commissions. The Midwest ISO's processes are inclusive, its proceedings are transparent and the bases for its decisions must be justified. As in all things, seldom can an organization be all things to all members, and hence, the Midwest ISO wishes LGE well, either as a continued member or otherwise. We hope, however, that our participation in this case has served the needs of this Commission and has resulted in the development of a full and complete record upon which this Commission may act.

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1 The Midwest ISO has fully briefed the topic of the Commission's continuing jurisdiction, *see* Midwest ISO 9/05 Brief at 35–36.

ARGUMENT

I. There Is No Basis for the Order that LGE Requests.

A. The Evidence Shows That Load Benefits From the Existence of Day 2 Markets.

LGE contends on brief that there is no evidence that the existence of Day 2 markets benefits native load. The Midwest ISO respectfully submits that LGE has itself provided conclusive evidence of such a benefit.

As a predicate to their merger, LG&E and KU demonstrated that centralized dispatch of their combined resources would produce consumer benefits. The theory was that if LG&E had a resource with a running cost of $25/MWh, and KU had a resource that cost $27/MW to operate, followed by an LG&E facility with a marginal cost of $30/MW, the combined region would save if LGE's last cost facility was dispatched first, followed by KU's unit and then LG&E's resource. KU's customers would be better off having access to LG&E's $25/MW power, and LG&E's customers would benefit from the availability of KU's $27/MW generation instead of having to rely on LG&E's $30/MW facility.

Mr. Gallus' testimony demonstrates that the same phenomenon is produced by the Midwest ISO's Day 2 market, but with a significantly greater array of resources. He testified that LGE does not self-schedule because, at any given time, the LMP may be lower than the Company's cost of operation. On brief, LGE explains that "self-schedules" are not an attractive means of maintaining a virtual link between company resources and Kentucky customers because: "A possible consequence of such an offer is that the unit will run when the LMP is below the unit's production cost; for this reason the Companies have elected to avoid such offers except when operational concerns require it (*e.g.*, when a unit must run at a minimum level)."[2] In other words, the price established through the market may be $24/MWh, $26/MWh or $28/MWh, which in every case provides benefits to Kentucky consumers as opposed to relying solely on LGE resources having the hypothetical cost profile set forth above.

Actions speak louder than words. The Commission should be guided by LGE's actual performance in the market as opposed to their protestations of lack of benefits. The Commission should also be guided by its own precedent that establishes that security constrained economic dispatch provides benefit to consumers, albeit provided by a more expensive RTO.[3] And finally, the Commission should be guided by LGE's expert witness, who testified that security constrained economic dispatch is, in the long run, an optimal structure for the electric service industry.[4]

B. LGE Off-System Sales Are Consistent with the Projections of the Midwest ISO.

LGE rails, but cannot avoid the fact that the existence of Day 2 markets and LMP-driven congestion mitigation has resulted in substantial net revenues for off-system sales ("OSS"). As acknowledged in post-hearing submissions, LGE made off-system sales of 849,374/MWh, at a cost of $23.9 million.[5] Gross revenues for such transactions were $47.6 million, leaving net revenue of $23,664,000. The Midwest ISO's models predicted that the existence of a large,

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2 LGE 9/05 Brief at 29 (footnote omitted).

3 *Application of Kentucky Power d/b/a American Electric Power for Approval to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection*, Case No. 2002-00475, Order (May 19, 2004), *see also* MJM 9/29/04 Supp. Test. at 10:19-20.

4 *See* 2/26/04 T.E. 37:10-13.

5 LGE's contention that its $23 million production cost for OSS should be netted against its $25 million gain for the Day 2 markets (which itself is a net figure) was conclusively refuted in the Midwest ISO's 9/05 Brief.

transparent market would facilitate off-system sales by LGE,[6] and such prognostications have come to pass.

LGE contends that it could have realized the same results without the Midwest ISO's markets.[7] LGE, however, overlooks the fact that the existence of the Day 2 market made over 13,000 MW of OSS possible. As Mr. Harszy testified, without LMP-driven congestion management, TLRs would be the only means of controlling loopflow and managing congestion.[8] For the comparable period in 2004, 13,239 MWh of LGE off-system sales were interdicted by TLRs, as compared to 0 MWh in the first three months of market operations.[9] And in this period, loopflows arising from the newly expanded PJM were not an issue.

While LGE complains that the Schedule 16 and 17 charges make membership in the Midwest ISO undesirable, it would bear the same Schedule 17 cost to make off-system sales through the Midwest ISO's markets.[10] Moreover, LGE would be exposed to rate pancaking for

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[6] *See* Additional Supplemental Testimony of Ronald R. McNamara, filed 2/21/05 ("RRM 2/21/05 Supp. Test.") at 3:10-12.

[7] LGE 9/05 Brief at 15. On brief, LGE states "MISO acknowledges that MISO membership is not a prerequisite to making off-system sales, i.e., the Companies could have made off-system sales even if they had not been MISO members since the start of Day 2." *Id.* LGE cites to certain testimony of Dr. McNamara, including testimony in which Dr. McNamara acknowledges LGE's ability to sell off-system were it not a member of the Midwest ISO. LGE, however, avoids Dr. McNamara's complete testimony on this point in which he explains:

[T]he benefits of being in a market as opposed to sitting on the boundary of the market is that you benefit from a least-cost dispatch, which allows you to meet your off-system sales either real-time, day-ahead, or from another generator even if it's cheaper in the time. So it should allow you to make those sales in a more efficient way.

1 T.E. 88:16-23.

[8] *See* Updated Supplemental Testimony of Roger C. Harzsy, filed 7/7/05 ("RCH 7/7/05 Supp. Test.") at 7–8, *see also* 1 T.E. at 194:15-23.

[9] Midwest ISO Redirect Exh. No. 1.

[10] 2 T.E. 10:12-20.

sales through the Midwest ISO into PJM and would lose the protections of FTRs if it was not a member of the Midwest ISO. In sum, it simply is not true that LGE would be able to enjoy all of the benefits of Midwest ISO membership if it is in fact not a participant in this organization.

On a related matter, at Subsection H of its Brief, LGE attempts to distract the Commission away from the actual data provided for the Day 2 Markets by launching into a discussion concerning the non-profit organizational structure of the Midwest ISO and various letters expressing preemptive concern with market operations. These are not matters set for hearing in this phase of the proceeding and are not matters for which LGE submitted direct evidence.[11] Hence, the Commission should strike Subsection H of LGE's Post-Hearing Brief.[12]

C. LGE requests relief that is supported by neither statute nor precedent.

In the more than 17 months since the 2004 hearings in this case, LGE has done nothing to correct the defects in the scheme it presents to the Commission. If anything, LGE's request to the Commission is now even less specific and farther beyond the bounds of Kentucky law than it was last year. At that time, LGE suggested that the "limited operational control" over its transmission assets that had been transferred to the Midwest ISO be transferred to itself for stand-alone operation. It asked for an order directing it "to apply to FERC to seek exit from

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[11] During the most recent hearing, LGE introduced a single letter from Hoosier Energy to the Indiana Utility Regulatory Commission as a cross-examination exhibit. LGE, however, failed to establish a foundation that the letter had been sent to or received by the Midwest ISO nor did it offer the author of that letter for cross-examination to be tested as to the veracity of the claims therein. All of the rest of the discussion relates to post-hearing data responses, which are not evidence in this case.

[12] The Midwest ISO recognizes that "neither the commission nor the commissioner[s] shall be bound by the technical rules of legal evidence." KRS 278.310. Should the Commission be disinclined to strike these arguments, it should nevertheless appreciate that, although available pre-hearing, LGE did not produce these documents as part of its case in chief and did not proffer the contents of those letters for examination or allow the Midwest ISO to rebut these assertions.

MISO forthwith"[13]; however, LGE conditioned its request on whether the Commission could establish a procedure through which LGE could recover the Midwest ISO exit fee from its ratepayers and whether FERC granted permission to withdraw "under conditions acceptable to the Companies."[14]

LGE now is very specific about a deadline by which the Commission should act (November 1, 2005),[15] but less definite about what it wants the Commission to do. Rather than committing to the concept of stand-alone operation, LGE now mentions "TORC operation or SPP membership, or other comparable alternatives to MISO membership…."[16] LGE wants the Commission to enter an order that:[17]

> (1) finds that the Companies' continued MISO membership is not consistent with the public interest because (1) the costs of MISO's Day 2 energy markets exceed the benefits they provide (if any) and (2) the Companies likely can obtain from other providers, such as TVA and SPP, comparable reliability coordination and other services at a lower cost and risk level;
>
> (2) requires the Companies to continue pursuing FERC authority to exit MISO, and to formulate an alternative to MISO membership that is acceptable to FERC, and ultimately to this Commission;
>
> (3) authorizes the Companies to establish a regulatory asset for the amount of the exit fee which must be paid to MISO pursuant to Section 5 of the MISO Transmission Owners Agreement; and
>
> (4) closes this investigation.

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13 LGE 4/04 Brief at 33

14 *See* Direct Testimony of Paul W. Thompson, filed 9/22/03 ("PWT 9/03 Direct") at 15:12-20.

15 LGE 9/05 Brief at 2, 33.

16 *Id.* at 32.

17 *Id.* at 2-3, 33.

Far from being able "to *continue* pursuing FERC authority," LGE states that it will initiate a FERC proceeding "as early as this month,"[18] and then strangely invites the Commission to intervene in that proceeding on their behalf "to facilitate the Companies' ultimate objective".[19]

1. LGE once again constructs its argument on the wrong standard.

The language of KRS 278.218 and subsequent decisions by the Commission make it quite clear that a change in the existing operational control of transmission facilities must be justified. The standard is that the change "is for a proper purpose and is consistent with the public interest." KRS 278.218(2). The Commission interpreted the "public interest" prong of that standard in the Kentucky Power-PJM proceeding, Case No. 2002-00475, placing the burden on the party seeking approval of the transfer:[20]

> The Commission finds that any party seeking approval of a transfer of control must show that the proposed transfer will not adversely affect the existing level of utility service or rates or that any potential adverse effects can be avoided through the Commission's imposition of reasonable conditions on the acquiring party.

LGE turns this standard on its head by demanding that the Midwest ISO prove that LGE's continued membership is cost-effective instead of requiring LGE to prove that its proposed withdrawal complies with KRS 278.218. Yet, what LGE asks the Commission to find is that "continued MISO membership is not consistent with the public interest."[21]

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18 *Id.* at 4, 33.

19 *Id.* at 4.

20 *Application of Kentucky Power d/b/a American Electric Power for Approval to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection*, Case No. 2002-00475, Order granting rehearing (August 25, 2003), at 4 (emphasis in original).

21 LGE 9/05 Brief at 2, 33. The Attorney General also has inverted the burden of proof, to conclude that withdrawal was appropriate since, in his opinion, the costs and benefits of Midwest ISO membership have not been conclusively demonstrated. *See* AG 9/05 Brief at 1; AG 4/04 Brief at 4.

LGE attempts to force an inversion of the burden of proof because it is not presenting a "proposed transfer" to which the KRS 278.218 standard can be applied. In fact, LGE specifically states that "the Companies are not asking this Commission to approve the transfer of the operational control of their transmission assets back to them, or to any other entity."[22] Instead, it asks that the Commission require it "to formulate an alternative to MISO membership…."[23] Without LGE's commitment to a particular alternative, the Commission cannot address inquiries under KRS 278.218. The deficiencies in LGE's purported showing that there are more cost-effective alternatives are discussed elsewhere in this brief; however, even if LGE showed that an alternative could meet the requirements of KRS 278.218 under certain conditions, such a showing would be relevant only if that alternative was acceptable to FERC and the conditions that were in place. Thus, what LGE had to show is that every possible alternative meets the KRS 278.218 standard and that it would accept any alternative to the Midwest ISO. LGE has not only failed to meet such a strict standard, it is unwilling to commit to withdrawal under every conceivable circumstance. For example, LGE has indicated that it would reevaluate its request to withdraw from the Midwest ISO if the FERC revoked its market-based rate authority due to a violation of a merger condition.[24]

The lack of a concrete transfer proposal also means that no "acquiring party" has come forward to make certain required showings. KRS 278.218 specifies that "[n]o person shall acquire … control, or the right to control, any assets that are owned by a utility … without prior

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22 LGE 9/05 Brief at 4.

23 *Id.* at 2, 33. That, of course, is what LGE should have done in the first place.

24 *See* Additional Supplemental Rebuttal Testimony of Michael S. Beer, filed 4/1/05 ("MSB 4/1/05 Supp. Rebuttal") at 9:21–10:2.

approval of the commission." The Commission has placed specific burdens on the acquiring party for obtaining KRS 278.218 approval:[25]

> The acquiring party should also demonstrate that the proposed transfer is likely to benefit the public through improved service quality, and service reliability, the availability of additional services, lower rates, or a reduction in utility expenses to provide present services. Such benefits, however, need not be immediate or readily quantifiable.

Although LGE mentions SPP and TVA in its brief, these entities neither presented evidence nor sought Commission approval for acquisition of operational control of LGE transmission facilities. Even under the TORC option, some operational control may be transferred to a third party for reliability coordination, but no third-party transferee has come before the Commission.

At the recent hearing, Chairman Goss pointed to the chicken-and-egg practical problem created by LGE's failure to formulate a specific transfer proposal: Without knowing what LGE's intentions are, how can the Commission decide to approve a withdrawal from Midwest ISO membership?[26] LGE suggests that it may operate as a TORC, but has not provided details as to the identity of its Reliability Coordinator or its Independent Entity.[27] It has not provided detailed direct cost projections of acquiring these services from third parties. It has not identified an Independent Market Monitor (or the cost thereof) — which FERC will likely require. It has not set forth the Schedule 17 costs it will incur to make off-system sales through the Midwest ISO's

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25 *Application of Kentucky Power d/b/a American Electric Power for Approval to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection,* Case No. 2002-00475, Order granting rehearing (August 25, 2003), at 4. In addition, if reasonable conditions can avoid any potential adverse effects from the transfer, those conditions are imposed on the acquiring party. *Id.*

26 2. T.E. 88:17-24 (Chairman Goss).

27 On brief, LGE continues to refer to SPP membership as an alternative to its participation in the Midwest ISO. Since SPP is developing real-time markets, LGE's expert acknowledges that SPP will not be a cost effective alternative. Morey 9/29/04 Suppl. Test. at 21:4-7, 21-22:8

market. And it has not shown the cost impact of returning to TLRs as a means of controlling loop flow and managing congestion.[28]

There is also a legal problem raised by the lack of a proposed acquiring party and a well-formulated alternative for comparison with Midwest ISO membership. Each is a requirement built into the statute for Commission approval of a requested change in the operational control of LGE transmission facilities. The Commission's powers are purely statutory. *Boone County Water and Sewer Dist. v. Pub. Serv. Comm'n*, 949 S.W.2d 588, 591 (Ky. 1997); *South Cent. Bell Tel. Co. v. Utility Regulatory Comm'n*, 637 S.W.2d 649, 653 (Ky. 1982). "When a statute prescribes a precise procedure, an administrative agency may not add to such provision." *Id.* at 653 (citing *Union Light, Heat & Power Co. v. Pub. Serv. Comm'n*, 271 S.W.2d 361 (Ky. 1954)). KRS 278.218 does not, nor does any other statute or agency regulation, contemplate a variant in which the Commission rules that some unspecified transfer should take place, then joins the utility and a federal regulatory body to consider to whom and under what conditions the transfer should occur, and thereafter — in a separate proceeding — approves a particular proposed transfer. LGE thus requests an action by the Commission for which the Commission has no statutory authority or precedent.

2. The findings LGE requests are misdirected and irrelevant.

LGE wants the Commission to find that costs of the "Day 2 energy markets exceed the benefits they provide (if any)" and that LGE "likely can obtain from other providers … comparable reliability coordination and other services at a lower cost and risk level." These two findings do not add up to a conclusion that continued Midwest ISO membership is "not

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[28] *See* Harszy 7/7/05 Add'l Testimony 6:17-21 (discussing savings to LGE customers as a result of not using TLRs to react to congestion).

consistent with the public interest" or that withdrawal "will not adversely affect the existing level of utility service or rates or that any potential adverse effects can be avoided through the Commission's imposition of reasonable conditions on the acquiring party." The question before the Commission is not whether to approve the initiation of Day 2 operations, or the odds of achieving Day 2-level reliability at a lower cost, but whether a transfer of operational control from Midwest ISO membership will have adverse effects.

The first requested finding does not compare the net benefits of Midwest ISO membership with the net benefits of an alternative to Midwest ISO membership. Instead, it looks at the costs and benefits specific to the Day 2 energy markets (and, possibly, to the Day 2 transmission operations). This is fine to assess the difference that Day 2 operations have made, but it says nothing about whether the benefits that membership in the Midwest ISO provides to LGE's Kentucky customers exceed associated costs. In the Midwest ISO's Initial Brief and elsewhere in this brief, it is demonstrated that Day 2 represents a net benefit to LGE[29]; however, even if it were to LGE's net detriment, that would not necessarily mean that the overall benefits of membership in Day 2 are not greater than the costs — or that membership in Day 2 was not still superior to other alternatives.

By focusing on benefits and costs of the Day 2 energy markets, LGE perhaps hoped to distract attention from this Commission's finding that the participation by a Kentucky utility in PJM would produce net benefits to Kentucky consumers.[30] LGE's witness, however, testified

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[29] *See* Initial Brief pp. 18-22, 34.

[30] *Application of Kentucky Power d/b/a American Electric Power for Approval to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection,* Case No. 2002-00475, Order (May 19, 2004).

that PJM has higher costs and so is not a preferred alternative to the Midwest ISO.[31] LGE conveniently fails to explain how the overall benefits of Midwest ISO membership can be negative when a more expensive RTO provides net benefits to Kentucky consumers that support a KRS 278.218 approval.

The second proposed finding has two main problems. One is the insufficiency under KRS 278.214 of a showing that it is "likely" that comparable coordination and other reliability services can be obtained from third parties. Probabilities and possibilities are not the standard for adverse effects.[32] A proposed transfer requires a showing that it "will not adversely affect" existing levels of service or rates or that potential adverse effects "can be avoided through the Commission's imposition of reasonable conditions on the acquiring party."[33]

The other main problem is that LGE's approach takes a much too narrow view of reliability. LGE makes much of the fact that all Reliability Coordinators must be NERC certified as capable of ensuring system reliability. It is true that TVA is a NERC-certified Reliability Coordinator and could probably ensure that thermal and loading limits on LGE's facilities are not exceeded. However, one cannot realistically compare the services available from TVA to those available from the Midwest ISO, since TVA can protect reliability only through the imprecise expedient of TLRs. The Midwest ISO will promote both reliability and efficiency through five-minute real-time security-constrained economic redispatch.

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31 MJM 9/29/04 Supp. Test. at 10:19-22.

32 LGE perhaps confused this primary step for KRS 278.218 approval with the secondary step that the acquiring party show that that the proposed transfer "is likely to benefit the public...." *See Application of Kentucky Power d/b/a American Electric Power for Approval to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection,* Case No. 2002-00475, Order granting rehearing (August 25, 2003), at 4.

33 *Id.*

LGE fixates solely on the out-of-pocket costs associated with the Schedule 10 adder. But the inefficient use of a transmission system imposes a real cost that dwarfs the Schedule 10 adder and is wholly disregarded by LGE. The record in this case demonstrates that the reliability tools available to the Midwest ISO, together with the optimization capabilities made possible by the Day 2 markets, provide superior reliability with maximum transmission utilization. The comparison between the Midwest ISO is not between whatever TVA would charge for Reliability Coordination service and Schedule 10 cost, but rather with the economic effect of managing transmission and loop flows through TLRs or a five-minute redispatch capability backed with regional protocols.

3. LGE has not provided a basis for saddling Kentucky ratepayers with the exit fee.

Without providing any rationale or support therefor, LGE summarily asks that it be authorized "to establish a regulatory asset for the amount of the exit fee upon payment of the fee."[34] It does so without establishing any bases upon which its exit fee should be converted into a regulatory asset. It also 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 LGE's corporate interest and stems from a contract into which it freely entered with other transmission owners. The ratepayers were not consulted when LGE undertook that obligation, and should not be made to bear the cost of a change in strategic direction.

[34] LGE 9/05 Brief, Argument K, at 32; *see also* 2 T.E. 98:3-5 (Michael Beer declaring "it would certainly be our intent to pursue the recovery of that amount from our ratepayers").

In 2004, 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 Kentucky ratepayers.[35] Nothing in this later phase of the proceeding suggests that LGE now contends otherwise. In the face of this position, it would be irresponsible for the Commission to create a regulatory asset to burden consumers 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 absolutely repugnant to the notions of public interest.

Perhaps because it has no intention of bearing its incidence, LGE has never provided a meaningful estimate of the exit fee. Not only has it produced inconsistent estimates and persisted in errors that lead to systematic underestimation of the amount, it has based its most recent study on an assumption that withdrawal will occur effective December 31, 2004.[36] LGE plows ahead with its analysis despite the plain fact that exit did not occur last year, and LGE itself is talking about an effective exit date in 2006.[37]

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[35] 2/25/04 T.E. 99:1-10 (Thompson).

[36] Morey 9/29/04 Supp.Test., Appx. B (Workpapers) 13/41. The assumption is that the exit fee will not be paid until 2005. *See* Morey (9/25/04) MJM-Exh2 p.59 col.2 (2005 nonrecurring expense). LGE then further stretches the counterfactual away from reality by taking a "present" value of the exit fee (and other costs) to 2003. *See* Morey 9/25/04 MJM-Exh2 (9/10/04 Suppl. Investigation p.33 ("nominal dollars"), p.59 col.1 (PV to 2003); Appx B Workpapers 39/41.

[37] LGE 9/05 Brief at 7.

It is only in the workpapers to his Supplemental Investigation that LGE witness Mathew J. Morey provides any detail about his estimated exit fee of $28.40 million for withdrawal effective as of year-end 2004. The estimate starts with unspecified July 2004 data for capital expenses for Schedules 16 and 17 and for Schedule 10, adds in assumed amounts, and sums to a $487 million total — of which LGE's "pro rata share" is $28.40.[38] Dr. Morey discounts that fee by 7% each year from a presumed payment date in 2005, to get a 2003 "present value" of $24.81.[39] The nominal amount is close to the amount presented after the 2004 hearing ($28.30 million)[40] as a corrected version of Dr. Morey's September 2003 estimate ($22.94 million).[41] Each of the three estimates ascribes a share of between 5.5% and 5.9% to LGE, but differ in the amount and makeup of the obligation to which the share is applied. For example, the March 2004 estimate sums the net obligations for Schedules 10, 16, and 17; the September 2003 estimate uses a mixture of capital and operating expenditures.

date of estimate	**estimate for 12/31/04 exit fee (in $million)**	**derivation**	
		total amount (in $million)	**LGE share**
September 2003	22.94	417.0	5.5%
March 2004	28.30	507.9	5.57%
September 2004	28.40	487.0	5.83%

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38 Morey 9/29/04 Supp.Test., Appx. B (Workpapers) 13/41.

39 *See* Morey 9/25/04 MJM-Exh2 (9/10/04 Suppl. Investigation p.33 ("nominal dollars"), p.59 col.1 (PV to 2003); Appx B Workpapers 39/41.

40 LGE Response to PSC Hearing Data Request No. 6.

41 9/22/03 MJM Test., Exh. MJM-1, § 3.13, p. 51. In Dr. Morey's 2004 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 2/9/04 Rebuttal at 8 (Table 2), and Exhibit MJM-3; *see also* Morey 2/04 Testimony, Exhibit MJM-3 (subtracting $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).

Although the Midwest ISO has twice provided all the information needed to accurately calculate both the total obligation and LGE's share thereof, and in its May 2004 reply brief explained a number of the flaws with LGE's calculations,[42] LGE has never mended its estimation method. For example, LGE continues to use the same share percentage for Schedule 10 as that for Schedules 16 and 17, even though the former should be higher,[43] and erroneously calculates the share as a ratio between an LGE energy figure and a Midwest ISO reserved capacity figure.[44]

In response to an October 2004 Commission Staff data request, the Midwest ISO provided the underlying data and details of an estimation of the exit fee for a withdrawal effective at year-end 2005 — $40.24 million.[45] LGE's only revealed attempt at projecting a year-end 2005 exit fee yielded a flawed estimate of $36.14 million.[46] These estimates are of a fee substantially larger than that used by LGE in its benefit-cost comparisons. If LGE was proposing to bear the cost of the exit fee, its use of biased estimates for a patently unrealistic withdrawal date might be described as foolishly optimistic. It is less forgivable that it uses deceptively small figures when it is asking that someone else be made to pay.

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[42] Midwest ISO 5/19/04 Reply Brief at 16-20.

[43] There are exclusions from the Midwest ISO load total for the Schedule 10 ratio but not for the Schedule 16 and 17 ratio. *See* Midwest ISO 5/19/05 Reply Brief at 16-17. The LGE share for Schedule 10 thus should be higher than that for Schedules 16 and 17. *See* 10/29/04 MISO Rspns to PSC Staff 10/13/04 Request No. 11 (9.1% for Schedule 10; 6.4% for Schedules 16 and 17).

[44] Midwest ISO 5/19/04 Reply Brief at 18-19. No derivation is given for the share percentage in the September 2004 estimate.

[45] 10/29/04 MISO Rspns to PSC Staff 10/13/04 Request No. 11. The Midwest ISO also provided exit fee estimates for year-end 2007 ($27.16 million) and 2009 ($14.53), to illustrate the decline in the exit fee with later effective withdrawal dates.

[46] Morey 9/03 Testimony, Report §3.13, p.51.

4. LGE's requested "closing" reaches no conclusion.

The "closing" that LGE requests is only temporary. LGE anticipates a later proceeding at which it will actually put the KRS 278.218 question to the Commission:[47]

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

As pointed out in MISO's 5/19/04 Brief, if LGE were truly interested in expediting withdrawal, it could have proceeded "forthwith" on its own initiative with an application to FERC and so advanced the date of an eventual FERC decision.[48] Had LGE sought FERC approval earlier, 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 acceptable to LGE and what effect those conditions might have on LGE ratepayers and the relative benefits of Midwest ISO membership.[49]

More than two years after LGE's claimed discovery that it was in its self-interest to withdraw, LGE has made no concrete proposal of an alternative to Midwest ISO membership. No Commission order was needed for LGE to formulate that alternative, or to apply to FERC, or to file for Commission approval of a proposed transfer. After all the testimony, studies, data

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[47] LGE 9/05 Brief at 4.

[48] LGE concedes that withdrawal requires FERC approval. LGE 9/05 Brief at 32 (citing Rebuttal Testimony of Michael S. Beer of April 26, 2004 (Case Nos. 2003-00433 and 2003-00434) at 2); *see also* LGE 4/04 Brief at 34 & n.178.

[49] In the way that LGE has set things up, this is the sort of "information that will be gained only from the process of the effort to exit MISO." AG 4/04 Brief at 3.

responses, conferences, and hearings in this proceeding, it is troubling that LGE's only plan is to get the Commission to order it to have one.

II. LGE's Assessment of the Benefit–Cost Studies is Without Merit.

A. LGE Focuses on a Narrow Set of Issues while Failing to Present a Plausible Case that the Benefits of Withdrawal Outweigh the Costs.

LGE invites the Commission to make its decision based on a narrow subset of near-term benefits and costs.[50] This part of the reply brief will address those issues individually. However, it is important to first place that discussion in the context of the substantial benefits of regional transmission operations that LGE overlooks or assumes away.

As described in the Midwest ISO's Brief, the transparent price signals in the Day 2 energy markets will create incentives for LGE to improve its operating efficiency, potentially avoiding the need for more than 170 MW of new generating capacity based on reductions in forced outage rates alone. Such price signals also could facilitate the development of commercial and industrial demand response programs that could achieve "an additional 100 MW or more of peak demand reduction."[51] And, LGE concedes that such price signals will reveal where it may be cost-effective to invest in new generating or transmission capacity and provide a "strong financial incentive" for such investment.[52] In the absence of such price signals, LGE

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50 LGE 9/05 Brief at 8-20.

51 RRM 12/29/03 Direct Test. at Exhibit RRM-1, p. 16.

52 LGE 9/05 Brief at 11. LGE would have the Commission take into consideration the impact of such incentives, such as the effect on investment in new generation or transmission facilities, only to the extent it might lower LGE FTR revenues — without recognizing that such investments also would lower LGE's congestion and operating costs. 1 T.E. 51:18–52:16; RRM 3/3/05 Supp. Test. at 10:16–19.

remains at risk for making costly errors in the location of new capacity.[53] Transparent prices also will help the Commission do its job, providing a benchmark for fuel and operating costs.

Aside from suggesting that the future is uncertain, LGE has never offered a serious critique of the conclusion that the cost of Midwest ISO membership is a modest investment in comparison to such intermediate and longer-term efficiency gains.[54]

There is no other alternative that can provide equivalent state of the art systems to ensure the reliable and efficient operation of the LGE transmission system. LGE has not identified a preferred reliability coordinator or presented evidence on the capabilities of any alternative reliability coordinator. It just asserts, without any supporting evidence, that all reliability coordinators are equal. LGE's Brief claims that it has maintained "historically excellent system reliability and compliance with NERC requirements."[55] However, the only systematic analysis of LGE's historical performance found that:[56]

- Prior to joining the Midwest ISO, LGE had not even been monitoring contingencies that could have led to system failure;
- LGE customers "have reaped substantial reliability benefits" as a result of LGE's membership in the Midwest ISO; and
- The fact that LGE had experienced no major outages "was a matter of luck."

The Midwest ISO provides a regional view of power flows, continuous analysis of potential contingencies, and real-time dispatch that improves utilization of LGE transmission assets while proactively avoiding potential reliability issues. If LGE withdraws from the Midwest ISO, it will be stepping back to an imprecise and inefficient TLR-based system for managing reliability and

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53 RRM 3/3/05 Supp. Test. at 10:16 -19.

54 RRM 12/29/03 Direct, Exh. RRM-1, p. 16.

55 LGE 9/05 Brief at 7.

56 *See* Direct Testimony of Jonathan Falk, Filed December 29, 2003, at 2:20-21.

doing so in an environment in which the Midwest ISO and PJM energy markets have significantly increased power flows and reliability challenges across the LGE transmission system.

LGE suggests that concerns related to merger benefits were shown to be baseless.[57] Nothing could be further from the truth.[58] At a minimum, the Commission should expect if LGE withdraws that FERC will rescind LGE's authority to sell power at market-based rates. The impact would be to impair the higher sales margins that LGE now enjoys. Furthermore, LGE's Brief does not even mention the $40.2 million exit fee for which LGE will be liable if it has approval to leave the Midwest ISO by December 31, 2005.[59]

LGE has focused exclusively on short-term benefits and costs. Their case depends entirely on showing both that there are net short-term benefits for some – still undefined – alternative to the Midwest ISO and that those short-term benefits outweigh the sum of the efficiency, transparency, reliability, transmission asset utilization, market-based pricing and potentially other merger benefits, plus the cost of LGE's exit fee obligation. Even if for the sake of argument one were to accept LGE's arguments regarding short-term benefits, LGE would not have proven that withdrawing from the Midwest ISO is in the public interest.

When one examines its underlying premises, LGE's case on short-term benefits and costs lacks fundamental plausibility. Having dismissed the financial results of Day 2 operations as providing "the Commission no guidance as to whether the Companies have received net benefits,"[60] LGE relies on its earlier benefit-cost studies. Yet those studies are fundamentally

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[57] LGE 9/05 Brief at 17.

[58] Midwest ISO 9/05 Brief at 31–36; *see also* Midwest ISO Reply Brief 5/04 at 38-39.

[59] 10/29/04 Midwest ISO Response to Commission Staff 10/13/04 Request No. 11.

[60] LGE 9/05 Brief at 16.

flawed. LGE purports to compare regional transmission operations based on security-constrained dispatch of generation to local transmission operations and dispatch using models that include no representation of the transmission system in LGEE or within any other control area. It has constructed the studies so as to avoid any possibility of identifying benefits associated with regional transmission operations. For this reason, LGE's studies are of no help to the Commission and should be disregarded.

LGE's Brief argues that "to accept the Companies' cost-benefit analysis as credible," the Commission "needs" to accept that Midwest ISO regional economic dispatch and regional energy markets integrated with operation of the transmission system have no real impact on off-system sales and produce no reductions in the cost to serve native load.[61] However, these premises — that LGE maintains this Commission must accept to find its studies credible — are on their face totally implausible.

B. Midwest ISO Regional Security-Constrained Economic Dispatch is Reducing the Cost to Serve LGE Native Load Customers.

LGE's own decision not to self-schedule its generation to meet to serve its native load is an on-going admission that LGE believes that regional security-constrained economic dispatch saves money for consumers. Indeed, it would be surprising if LGE attempted to self-schedule the operation of their own generation without regard for regional transmission operations.

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[61] LGE 9/05 Brief at 18. It is correct to say that the Commission must accept these assertions to accept the results of LGE's studies. Its underlying models use the same hurdle rates and represent off-system sales in the same way whether or not LGE is within the Midwest ISO regional market. *See* RRM Rebuttal Testimony 11/19/04 at 82. In LGE's models, the hurdle rate or cost of moving power between areas is the factor that distinguishes local from regional dispatch of generation. *See id.*

LGE's own expert, Dr. Morey, concedes the efficiency benefits of regional unit commitment and dispatch:[62]

> In principle, it will usually be impossible for a region with many system operators to achieve the same low-cost commitment and dispatch that can be achieved by a single regional system operator. A single regional system operator should ordinarily have the information, software, and communications systems needed to determine the lowest achievable cost of regional commitment and dispatch.

This Commission is well aware of the significant economic benefits of centralized dispatch. Such benefits were the basis for the LG&E–KU merger.

The Midwest ISO's studies demonstrated that regional unit commitment and dispatch would reduce the generation cost to serve native load customers by at least $11.3 million per year.[63] And, review of actual results known at the time of the hearing show that LGE is benefiting from Day 2 operations, confirming the studies' indication that it such operation would provide a positive benefit in LGE's favor.[64] In contrast, the only affirmative support offered for LGE's position is Mr. Gallus' view that, "we felt our dispatch was pretty efficient already."[65] A feeling that LGE was already "pretty efficient" is hardly an adequate basis on which to assume away the benefits from centralized dispatch.

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62 MJM 9/22/05 Direct, Exh. MJM-1 at p. 17.

63 RRM 3/3/05 Supp. Test., Table 2C.

64 1 T.E. 89:10-17, 121:12–122:10. In reviewing the net $25 million market settlement in LGE's favor, Dr. McNamara also took into consideration production costs, Schedule 10 charges, transmission tariff revenues and costs, LG&E and KU tariff revenues for serving native load, additional off-system sales revenues from financial schedules for which energy is not settled in the Midwest ISO market, and the unavailability of more than 500 MW of high-margin Brown generation that would have increased off-system sales margins and lowered congestion costs.

65 2 T.E. 12:1-2.

C. Midwest ISO Regional Energy Markets are Improving LGE Off-System Sales Margins.

LGE would have the Commission believe that there is "no real impact on LGE's off-system sales" from its participation in regional energy markets that both extend within the Midwest ISO from Kentucky, Ohio, and Michigan to Missouri and Manitoba and are coordinated with PJM markets that tie the Midwest to Mid-Atlantic states from Virginia to New Jersey and Pennsylvania.[66] This claim is not based on analysis or evidence. It is based entirely on "an assumption" by Mr. Gallus that the revenues LGE would receive from off-system sales outside of the Midwest ISO would be the same that it would earn in the Midwest ISO.[67] Mr. Gallus' assumption is that LGE has "fully exploited all available economic off-system sales opportunities."[68] Even LGE witness Dr. Morey would find such an assumption difficult to accept:[69]

> Because of time and information constraints, it will usually be difficult, if not impossible, for market participants to find all [cost-reducing trades with participants in other areas].

Mr. Gallus' assumption of optimized off-system sales, first, is a physical impossibility because while Midwest ISO is optimizing regional economic dispatch and related transactions every five minutes, LGE is able to adjust its trades outside the Midwest ISO market only on an hour-by-hour basis. In addition to this obvious constraint, Dr. McNamara explained in detail why it is not possible outside of the Midwest ISO to optimize bilateral transactions without direct reference

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66 LGE 9/05 Brief at 18.

67 2 T.E. 11:10-14.

68 LGE 9/05 Brief at 19.

69 MJM 9/22/05 Direct, Exh. MJM-1 at p. 17.

transmission operations, under continuously changing grid conditions, and where market participants have an incentive not to disclose the true economic cost or value or power.[70]

The reality is that within the Midwest ISO energy markets, LGE has been earning unprecedented margins on off-system sales — net $23.7 million in the first three months. LGE does not present any counterfactual analysis attempting to establish a basis for the assumption that it could have earned as much outside of the Midwest ISO. Instead, it attempt to explain away the increased sales volumes to the good fortune of milder than normal weather.[71] However, while mild weather could leave LGE more energy to sell, it also implies that LGE's neighbors had less need to purchase, which would cause prices to fall. This did not occur. LGE further suggests that its higher margins are attributable to higher fuel prices pushing up the market price of power. However, it offered no analysis to support this position, and fuel price updates to levels comparable to actual levels during this period were included in the Midwest ISO's analysis.[72] By the standards set forth in LGE's Brief, one must conclude that LGE's benefit–cost study is not credible.

The Midwest ISO's study provides the only counterfactual analysis of what occurs with and without LGE participation in Midwest ISO energy markets. It projects that LGE off-system sales will increase with unfettered access to large regional markets, Due to that increased demand for LGE's relatively low cost power, the study then anticipates LGE off-system sales prices and revenues will be higher in the Midwest ISO than the prices and revenues both in Day 1 and if LGE were to operate outside the Midwest ISO and PJM markets.[73]

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70 RRM 11/19/04 Rebuttal Test. at 83-84; *see also id.* 74 – 75.

71 LGE 9/05 Brief at 19.

72 RRM 1/20/05 Test., Appx. C at 7–8

73 RRM 3/3/05 Supp. Test., Table 4C.

D. Uplift Charges are Reasonable and Reflect Costs that would be Incurred by LGE Outside of the Midwest ISO.

LGE complains about charges associated with Midwest ISO accounting categories for "Revenue Neutrality Uplift" and "Revenue Sufficiency Guarantee." These somewhat obscure accounting categories reflect two very different sets of underlying costs. Those underlying costs do not fundamentally change whether LGE is in or out of the Midwest ISO.

As previously explained by Dr. McNamara and note by LGE, the Revenue Neutrality Uplift primarily reflects a correction to a FERC-required refund calculation. This calculation results in the Midwest ISO refunding more than the appropriate amount of Over Collected Loss Revenues, and the Revenue Neutrality Uplift corrects that calculation so that the total refunds of Over Collected Losses equals the correct amount. While this accounting may be an indirect way of getting to the right figure, LGE has not offered any evidence that the resulting net revenues returned to LGE are inappropriate. The sum of relevant accounting calculations are designed to ensure that LGE incurs the same average cost of transmission losses that it would outside of the Midwest ISO.

The Revenue Sufficiency Guarantee (RSG) payments cited by LGE are related to a different set of underlying costs. The LGE Brief inappropriately lumps together these two cost categories, mislabeling RSG as "uplift." As explained in the Midwest ISO's Initial Brief, the Day-Ahead market settles based on the demand that is bid into the Day-Ahead market. Next day forecasted and actual loads can be different from those bid into the Day-Ahead market. As a result, additional units may be committed to ensure that adequate capacity will be on line to meet forecasted and real time loads. The incremental cost (in excess of what would be recovered at LMP) of committing this additional capacity needed to maintain system reliability is recovered through the RSG. Whenever possible, these incremental costs are directly assigned to the utility for which the additional capacity must be committed.[74]

The RSG charges that are the basis of LGE's complaint represent the direct assignment to LGE for the cost of committing additional generation needed to reliably serve LGE load. In the absence of LGE participation in the Midwest ISO, LGE would have had to commit the same or higher cost units to maintain reliable system operations. Thus, while the accounting categories in which such costs fall would change, there is no evidence that LGE could avoid the underlying costs that gave rise to these charges by being outside of the Midwest ISO.

E. The Midwest ISO has Provided a Credible and Reliable Analysis of the Benefits and Costs of LGE Participation.

LGE's position is that there are only two issues that the Commission should consider to determine whether the Midwest ISO's benefit – cost analysis is reliable:

- Will LGE consistently receive $22.5 million of annual FTR revenues in excess of congestion costs?
- Will LGE receive "net" transmission revenues[75] in the Midwest ISO of $25.7 million annually?

Asking whether these numbers turn out to be precisely as forecast is to ask the wrong question. The issue in this case is whether LGE can establish that it is in the public interest to transfer the operation of its transmission system from the Midwest ISO to an unspecified third party. Analysis of benefits and costs is an <u>integrated</u> analysis; if one changes an assumption such that a

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74 1 T.E. 66:5-11, 201:20–204:11.

75 The Midwest ISO has never argued that net LGE transmission revenues would equal $25.7 million. As will be addressed below, it would not have been appropriate given the structure of the Midwest ISO benefit-cost calculation to substitute a "net" transmission revenue figure for the figure utilized.

particular benefit may be lower, the same change may imply that another benefit has increased. LGE's analysis of only select parts of the effect of changing assumptions can be misleading.

For every case the Midwest ISO analyzed, it presented alternative figures for each of these two parameters on which LGE asks the Commission to focus. Each of Dr. McNamara's exhibit tables comparing alternate scenarios presents results based on our best estimates for these variables and alternative benefit calculations under the very conservative assumptions of lower FTR revenues and that LGE transmission revenue would be the same within the Midwest ISO and under the TORC option.[76] In the latest analysis, when FTR revenues were discounted to 90% of an already conservative projection and LGE was assumed to receive no transmission revenue benefit, the net recurring annual cost to LGE from leaving the Midwest ISO was nonetheless $20.3 million per year.

LGE's Brief reiterates an allegation of error in the Midwest ISO's initial inclusion of LGE affiliate-owned generators in its analysis. Any "error" was that of LGE. The Midwest ISO openly disclosed its assumptions. LGE knew beforehand that any Midwest ISO modeling would be on the assumption that LGE would coordinate its dispatch with that of its affiliate-owned generation and, as other Midwest ISO members do, dynamically schedule such units that are physically outside its control area. LGE vetted our assumptions and for more than a year after reviewing both our assumptions and the results of our initial study did not object to these affiliate owned units being treated as LGEE control area generation. When LGE later came back to say that that was not how it would operate its generating units, the Midwest ISO redid the analysis to match LGE's stated intentions — and found that the decision to include or not include those units did not have a major impact on the results.

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[76] RRM 3/3/05 Supp. Test., Tables 3C, 13C and 14C.

F. Actual Results are Consistent with LGE's Achieving Significant Net Benefits from FTR Revenues in Excess of Congestion Costs.

LGE alleges that the Midwest ISO model is unreliable because LGE assertedly paid $367,000 per month in the first two months in net congestion cost as opposed to receiving $22.5 million per year in net FTR revenues. Where Mr. Gallus came up with this figure is unknown. The only documentary evidence in the record[77] shows that during the relevant period, LGE received $10,729,000, net of congestion in the real-ahead market, paid $1,409,000 in the day-ahead market, and collected $6 million under its FTRs. The net of these categories is a positive $15,431,000, which is wholly consistent with the Midwest ISO's model.

Even if the Commission had been given some basis for and reason to believe Mr. Gallus' figure, it would have to take into consideration the outage of more than 500 MW of capacity at the Brown generating station during the period covered by Mr. Gallus' figure. LGE congestion costs are low because west-to-east transmission constraints depress prices at LGE's Louisville load center relative to (and in many hours below) the prices at Brown, which is located to the east of the constraints.[78] In all the hours when the LMP (without losses) is higher at Brown than at LGE's load hub, each additional MWh of generation at Brown reduces LGE congestion costs. Additionally, the comparatively high value of generation at the Brown station reflects the fact that when it is available, Brown provides counter flows across constrained facilities in the LGE system that further reduce overall congestion costs. If one selects a brief period, as Mr. Gallus did, when the major Brown generators are temporarily out of the equation, the results will be unrepresentative.

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[77] LG&E/KU Cross Examination Exh. 4.

[78] RRM 3/3/05 Add. Supp. Test. at 9–10; RRM 7/7/05 Supp. Test. at 6:18–8:5.

LGE benefits from low congestion costs relative to FTR revenues because generating stations like Brown are able to create counter flows — power flows moving in the opposite direction of and off-setting the primary direction of flow across constrained transmission facilities. As a result, regional markets reward LGE with relatively high prices for generation from such power plants and correspondingly low and often negative congestion costs.

As a fall-back, LGE alleges that it will not be able to perpetually collect $22.5 million in annual FTR revenues in excess of its congestion costs because other market participants have an incentive to take other actions to eliminate the congestion that LGE generation helps offset or capture some of LGE's FTR revenue. The incentive to reduce such congestion exists only to the extent other parties can reduce it at a cost that is lower than paying LGE to operate those generating stations that provide counter flow across constrained elements of the grid. As a practical matter, the options available to third parties would be to:

- Site and build new generation that provides counter flow across the same constraints: This will not be realized in the next few years and would involve significant investments.
- Site and build new transmission facilities to relieve the relevant constraints: The Midwest ISO's analysis identified the primary constraints as being located on the LGE transmission system. Even if a third party was willing and able to site and build parallel transmission lines, it is far from clear whether such an investment could relieve the constraint without additional action by LGE.

While in theory LGE is correct, the available options would take more than five years and considerable investment to realize.[79] It is also difficult to see how third parties could capture LGE FTR revenues. FTRs are allocated based on historical transmission investment and existing

[79] 1 T.E. 50:19–51:17.

transmission rights. LGE FTRs are on paths from its own generation to its native load representing LGE investments and transmission rights.

Finally, if LGE is right and third parties do invest to reduce the congestion that LGE's generators are currently being paid to offset, the elimination of congestion will lower total production costs and improve market efficiency. This would also provide a specific benefit to LGE because even though its counter-flow payments or FTR revenues might decline, its congestion costs could decline by an equal or greater amount.

G. The Midwest ISO presented Reasonable Estimates of Overall Benefits associated with Transmission Charges and Revenues.

LGE states that the Midwest ISO's estimates are unreliable because it only earned $464,000 per month in transmission revenue during the first three months of market operations,[80] while the high end of the Midwest ISO's estimate of transmission revenues based on actual historical data was $25.7 million per year or $2.1 million per month. As indicated above, the Midwest ISO presented a range of results based on at the high end on actual historical revenues and at the low end on there being zero transmission revenue benefit from remaining in the Midwest ISO.

The lower than the high estimate of revenue being distributed to LGE is largely due to the elimination of through and out rates for transactions within the PJM/Midwest ISO super region.[81] At the time Dr. McNamara filed the analysis including the $25.7 million figure, it was not clear what would be the net effect of elimination of PJM/Midwest ISO through-and-out rates or

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[80] It is not clear from LGE's testimony whether the $464,000 per month figure is intended, consistent with the remainder of LGE's position, to be net of transmission charges paid by LGE. Comparing such a net figure to the figure used in the Midwest ISO's analysis would be an inappropriate apples-to-oranges comparison.

[81] *Midwest Independent Transmission System Operator, Inc.*, 100 FERC ¶ 61,137 (2002), *order reversing initial decision and directing elimination,* 104 FERC ¶ 61,105 (2003).

whether the Midwest ISO would reduce its current discounting of other point-to-point transmission charges. While the elimination of PJM/Midwest ISO through-and-out rates has reduced transmission revenue, it has been an additional factor in increasing margins on off-system sales since pancaked transmission rates are not charged for such transactions. Thus, LGE is making less in transmission revenue, but its off-system sales revenue is significantly higher than was estimated in the Midwest ISO's analysis due in part to the elimination of through and out rates.

LGE further argues that the Midwest ISO's projection based on the actual distribution of $25.7 million in pooled transmission revenues to LGE should have been reduced by the $19.6 million in transmission charges LGE paid during the same period. This assertion is simply wrong and based on a complete misrepresentation of Dr. McNamara's testimony. Contrary to LGE's Brief, Dr. McNamara did not agree that the $25.7 million estimate should be reduced by transmission charges paid by LGE. To do so would be to double count such charges. The transmission charges that LGE pays associated with its off-system sales have already been deducted from the off-system sales revenue in the Midwest ISO's benefit-cost study.[82] Dr. McNamara explained:[83]

> When we did this study, we assumed that the sales were taking place *as if* they were being taken at the generator bus so that we didn't have to make any assumption as to who would actually be paying for transmission service. It could be LG&E and KU paying for transmission service or it could be somebody else paying for it. .... So our numbers are net of that calculation [net of transmission payments]. To put them in would be to essentially double count.

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[82] RRM 11/1/9/04 Rebuttal Test. at 86.

[83] 1 T.E. 123:2–124:5.

LGE is clutching at the straws of an argument shown to be baseless in an earlier point in this proceeding.[84]

CONCLUSION

WHEREFORE, the Midwest ISO respectfully requests that the Commission close this investigation without ordering any change in the continued membership of LGE in the Midwest ISO.

[84] Midwest ISO Reply Brief 5/19/04 at 43-44. In addition, Mr. Beer testified that virtually all LGE's off-system sales occur at the generator bus. 2 T.E. 75:10-11.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this the 13th day of September, 2005, a true and correct copy of this Post-Hearing Reply was sent by first-class U.S. Mail to:

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