1700 PNC PLAZA
500 WEST JEFFERSON STREET
LOUISVILLE, KENTUCKY 40202-2874
(502) 582-1601
FAX (502) 581-9564
www.ogdenlaw.com

KENDRICK R. RIGGS

DIRECT DIAL 502-560-4222
DIRECT FAX 502-627-8722

kriggs@ogdenlaw.com

April 26, 2004

RECEIVED
APR 2 6 2004
PUBLIC SERVICE COMMISSION

VIA HAND DELIVERY
Thomas M. Dorman
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

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

Dear Mr. Dorman:

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

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

Very truly yours,

Kendrick R. Riggs

KRR/ec
Enclosures
cc: Parties of Record
Dorothy E. O'Brien
Linda S. Portasik

302680.1

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

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

Kendrick R. Riggs
W. Duncan Crosby III
Ogden Newell & Welch PLLC
1700 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202

Dorothy E. O'Brien
Deputy General Counsel
- and -
Linda S. Portasik
Senior Corporate Counsel
LG&E Energy LLC
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40232

COUNSEL FOR LOUISVILLE GAS
AND ELECTRIC COMPANY AND
KENTUCKY UTILITIES COMPANY

FILED: APRIL 26, 2004

TABLE OF CONTENTS

I. Introduction 1

II. The Companies' Continued MISO Membership Is Not Cost-Effective, And Is Therefore Not In The Public Interest, Over The Period 2005-2010 8

A. The Companies' Initial Decision To Join MISO Was Prudent 10

B. MISO's Scope And Cost Have Expanded Well Beyond the Companies Initial Expectations 12

III. The Companies' Cost-Benefit Analysis Demonstrates That Now Is the Proper Time For The Commission To Order The Companies To Exit MISO Subject to FERC Approval 13

A. MISO Errs In Claiming Credit For The Benefits Of The LG&E/KU Merger Because Such Benefits Will Accrue Regardless Of MISO Membership 14

B. Because There Would Be No Measurable Change In The Companies' Transmission System's Reliability If The Companies Exited MISO and Operated In A Standalone Configuration, MISO Cannot Claim A Relative Reliability Benefit 16

C. MISO Errs In Claiming That The Companies Will Enjoy Significant Additional Transmission Revenue As MISO Members Because The Companies' Transmission Revenues Are Almost Completely Offset By Transmission Payments 20

D. Because MISO Membership Is Unlikely To Affect The Companies' Off-System Sales Volume, MISO Is Wrong To Claim An Increased Off-System Sales Benefit 21

E. MISO's Day 2 Markets Create Potential Risk for LG&E And Will Not Allow LG&E To Operate As It Has To Date 23

IV. KRS 278.020(4) Did Not Require The Companies To Obtain KPSC Authorization To Transfer Control Of Their Transmission System 27

V. MISO's Role In Resource Adequacy And Demand-Side Management 31

VI. Both Standalone Operation And Continued MISO Membership Are Economically Superior Alternatives To The Companies' Joining A Southern RTO Or Forming A Kentucky ISO 33

VII. The Proper Remedy In This Case Is For The Commission To Order The Companies To Pursue Exit From MISO Through FERC Forthwith, And Allow The Companies To Create A Regulatory Asset For The MISO Exit Fee........33

VIII. Conclusion 35

I. Introduction

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

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

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

---

[1] "The Commission, in its role as the enforcer of KRS Chapter 278 and all regulations promulgated pursuant to that Chapter, represents the public interest." In the Matter of: Louisville Gas and Electric Company and BellSouth Telecommunications, Inc. – Alleged Violation of Commission Regulations 807 KAR 5:041, Section 3 and 807 KAR 5:061, Section 3, Case No. 96-246, Order (October 15, 1996) (emphasis added and citation omitted).
[2] Louisville Gas and Electric Company and Kentucky Utilities Company.
[3] In the Matter of: Investigation Into The Membership of Louisville Gas and Electric Co. and Kentucky Utilities Co. In the Midwest Independent Transmission System Operator, Inc., Case No. 2003-00266 ("MISO Case"), Order at 3 (7/17/2003).
[4] MISO Case, Pre-filed Rebuttal Testimony of Mathew J. Morey (2/9/2004) ("Morey Rebuttal") at 8.
[5] MISO Case, Pre-filed Direct Testimony of Paul W. Thompson (9/22/2003) ("Thompson Direct") at 9-10, quoting MISO Proposed Revisions to Open Access Tariff, FERC Docket No. ER02-2925-000 (9/24/2002), Transmittal Letter at 2; I T.E. 23-24, 133; MISO Case, Pre-filed Direct Testimony of Michael S. Beer (9/22/2003) ("Beer Direct") at 2-4; MISO Case, Pre-filed Rebuttal Testimony of Paul W. Thompson (2/9/2004) ("Thompson Rebuttal") at 10.

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

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

---

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

[7] Thompson Direct at 3-5.

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

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

[9] III T.E. 32.

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

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

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

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

---

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

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

[13] Response of MISO to the KPSC's Initial Data Requests (1/26/2004), Item No. 1.

[14] Thompson Direct at 3-5.

[15] A Locational Marginal Price is the price at which electricity supply equals electricity demand at a specified location (also referred to as a node or bus). All demand that is prepared to pay at least this price at the specified

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

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

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

---

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

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

[17] SMD NOPR ¶ 269.

[18] MISO Day 2 OATT ¶ 69.2.

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

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

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

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

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

---

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

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

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

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

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

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

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

---

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

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

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

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

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

---

[42] MISO Case Initial Order at 4.

[43] MISO Case, Pre-filed Direct Testimony of Mathew J. Morey (9/22/2003) ("Morey Direct") at 10-19, Ex. MJM-1 at 58-60; I T.E. 147-48; Pre-filed Direct Testimony of Robert R. McNamara (12/29/2003) ("McNamara Direct") at 4.

[44] III T.E. 13-15.

[45] III T.E. 141-43.

[46] III T.E. 208-09.

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

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

---

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

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

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

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

---

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

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

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

[52] Id.

[53] Id.

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

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

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

[54] Id.

[55] Thompson Direct at 3-5.

[56] Id.; Response of LG&E and KU to the Initial Data Request of MISO (10/6/2003), Item No. 18.

[57] Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER98-1438-000, Order Conditionally Authorizing Establishment of Midwest Independent Transmission System Operator and Establishing Hearing Procedures ("FERC Order Approving MISO") (9/16/1998) at 28.

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

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

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

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

---

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

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

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

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

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

---

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

---

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

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

---

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

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

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

---

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

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

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

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

---

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

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

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

---

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

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

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

---

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

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

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

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

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

---

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

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

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

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

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

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

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

---

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

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

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

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

---

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

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

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

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

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

---

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

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

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

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

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

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

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

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

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

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

---

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

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

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

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

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

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

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

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

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

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

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

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

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

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

---

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

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

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

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

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

---

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

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

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

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

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

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

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

---

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

VIII. Conclusion

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

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

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

---

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

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

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

---

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

Dated: April 26, 2004

Respectfully submitted,

Kendrick R. Riggs

W. Duncan Crosby III
Ogden Newell & Welch PLLC
1700 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202
Telephone: (502) 582-1601

Dorothy E. O'Brien
Deputy General Counsel
- and -
Linda S. Portasik
Senior Corporate Counsel
LG&E Energy LLC
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40232
Telephone: (502) 627-2561

COUNSEL FOR LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY

CERTIFICATE OF SERVICE

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

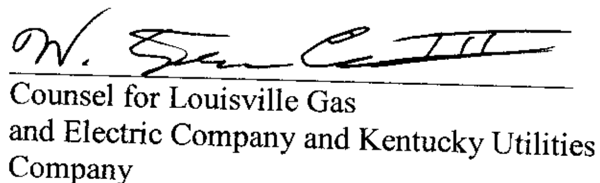
Katherine K. Yunker
Benjamin D. Allen
Yunker & Associates
Post Office Box 21784
Lexington, Kentucky 40522-1784

James C. Holsclaw
Stephen G. Kozey
Midwest ISO
701 City Center Drive
Carmel, Indiana 46032

Elizabeth E. Blackford
Assistant Attorney General
Office of the Attorney General
Utility & Rate Intervention Office
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601-8204

David F. Boehm
Boehm, Kurtz & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, Ohio 45202

Stephen L. Teichler
1667 K Street, N.W., Suite 700
Washington, DC 20006-1608



Counsel for Louisville Gas
and Electric Company and Kentucky Utilities
Company