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May 19, 2004

VIA HAND DELIVERY

RECEIVED

MAY 19 2004

PUBLIC SERVICE COMMISSION

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

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

Dear Ms. O'Donnell:

Enclosed please find and accept for filing the original and ten copies of the Joint Post-Hearing Reply 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

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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PUBLIC SERVICE COMMISSION

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

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

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FILED: MAY 19, 2004

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I. Introduction

The Midwest Independent Transmission System Operator, Inc.'s ("MISO") brief[1] shows that MISO and the Companies[2] agree on two issues on which the Commission asked the parties to submit evidence in its Order initiating this investigation.[3] Specifically, the Companies and MISO agree that: (1) the Companies need not have sought Commission approval under KRS 278.020(4) to make their limited transfer of transmission system control to MISO;[4] and (2) either standalone operation or continued MISO membership would be superior to the Companies' joining a southern RTO or forming and joining a Kentucky ISO.[5]

That, however, is where the Companies' and MISO's agreement ends. First, MISO asserts that the transfer back to the Companies of its limited functional control of their transmission systems would not be in the public interest, as KRS 278.218 requires.[6] The Companies respectfully disagree with MISO because there is ample evidence in the record that such a transfer would redound to the public benefit, as the Companies discussed in their initial brief and address below.[7] Second, MISO asserts that its regional resource adequacy planning functions would not impinge on the Commission's jurisdictional authority.[8] Again, the Companies respectfully disagree. MISO, by setting and enforcing regional resource adequacy

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[1] 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"), Initial Post-Hearing Brief of the Midwest Independent Transmission System Operator, Inc., ("MISO Brief") at 3-4 (4/26/2004).
[2] Louisville Gas and Electric Company and Kentucky Utilities Company.
[3] MISO Case, Order ("Order") at 3-4 (7/17/2003).
[4] MISO Brief at 6-8; MISO Case, Joint Post-Hearing Brief of Louisville Gas and Electric Co. and Kentucky Utilities Co. ("Companies' Brief") at 27-31 (4/26/2004).
[5] MISO Brief at 33-37; Companies' Brief at 33. The Attorney General did not express an opinion on either issue in his brief. MISO Case, Post Hearing Brief of the Attorney General ("AG Brief") (4/26/2004).
[6] MISO Brief at 8-10.
[7] MISO Case, Pre-filed Rebuttal Testimony of Mathew J. Morey (2/9/2004) ("Morey Rebuttal") at 8.
[8] MISO Brief at 31-33.

requirements, would indeed be impinging on authority reserved to the states.[9] Both of these factors indicate that the Companies' continued MISO membership is not in the public interest.

But third, and perhaps most importantly, the Companies respectfully submit that MISO's cost-benefit analysis simply is not credible evidence. MISO's analysis purports to show that the Companies would enjoy more than $270 million in net benefits as MISO members over the period 2005-2010.[10] Yet again, the Companies respectfully disagree. The Companies' independent and demonstrably more credible cost-benefit analysis shows that standalone operation, as opposed to the Companies' continued MISO membership, would yield $60 million-plus (nominal dollars) in net benefits over the same period.[11] Based on this evidence, the Companies disagree with MISO's assertion that transferring transmission system operational control to the Companies would not be in the public interest.

Because the Companies' cost-benefit analysis indicates that the Companies' continued MISO membership is not in the public interest, the Companies recommend that the Commission (1) order the Companies to withdraw from MISO by seeking the requisite approval from the Federal Energy Regulatory Commission ("FERC"), in accordance with the MISO Transmission Owners Agreement ("TO Agreement"),[12] and (2) grant the Companies the authority to establish a regulatory asset in the amount of the MISO exit fee.[13]

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[9] See Section II.C. below.

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

[11] Morey Rebuttal at 8.

[12] 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.

[13] In the Companies' rate case, the Attorney General's witness, Mr. Robert J. Henkes, stated in his pre-filed direct testimony that he "take[s] no exception" to the Companies' plan to recover its Schedule 10 costs through base rates pending the Commission's decision in this case. LG&E Rate Case, Pre-filed Direct Testimony of Robert J. Henkes ("Henkes Direct") at 53. Furthermore, Mr. Henkes appeared to endorse the Companies' suggestion that the Commission allow the Companies the authority to establish a regulatory asset in the amount of the MISO exit fee. Id. at 53-54. Mr. Henkes, however, proposed that, rather than having a separate rate-making proceeding to include the MISO exit fee costs and terminate rate recovery of the Companies' Schedule 10 costs in base rates, the

Finally, with regard to the order the Companies recommend above, MISO makes the unfounded assertion that the order's "exact contours" are unclear.[14] Although it is true that no one can state with certainty what conditions FERC might attach to an order approving the Companies' exit from MISO, the specifics of this contingency are not the point in this case. The "contours" of the Companies' recommended order are indeed clear and are succinctly stated in the paragraph above and in the conclusion below.

II. Discussion

One point on which all parties agree is that the Companies' initial decision to help form MISO and become charter members was sound.[15] The Companies initially collaborated with other Midwest Transmission Owners ("TOs") to form MISO to comply with and help shape emerging federal regulation and institutions, and to achieve greater transmission system reliability.[16] The Companies continue to believe that these are important goals. What is now clear, however, is that both the near- and longer-term costs of MISO membership substantially

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Companies should instead continue to collect the test period Schedule 10 costs through the new base rates after exiting MISO. Id. Mr. Henkes further suggested that the Commission should order the Companies to establish a regulatory liability account for the amounts the Companies continue to recover in base rates for the Schedule 10 costs they no longer incur. Id. at 54. The balance in the regulatory liability account would be used to offset the regulatory asset the Companies establish for the amount of the MISO exit fee in the Companies' next base rate case. Id. If the regulatory liability account exceeded the amount of the regulatory asset, the excess would be returned to ratepayers in an appropriate manner. Id.

The Companies' witness, Mr. Beer, testified that the Companies endorse Mr. Henkes proposal, provided that four conditions are met: (1) FERC issues an order authorizing the Companies' exit from MISO; (2) FERC lawfully establishes the appropriate amount of the MISO exit fee; (3) MISO Schedule 10 charges concurrently cease at the time of the Companies' exit from MISO and incurrence of the exit fee; and (4) revenues associated with the MISO Schedule 10 charges be recorded in a regulatory liability account to offset the FERC-approved MISO exit fee until the Companies' next base rate proceeding. LG&E Rate Case, Pre-filed Rebuttal Testimony of Michael S. Beer at 2.

At the hearing, Mr. Henkes testified that he agreed with the Companies' position as expressed by Mr. Beer.

There is no testimony in the rate case record opposing this proposal. Indeed, the Attorney General's brief in this case supports this plan. AG Brief at 4-5.

[14] MISO Brief at 3-4.

[15] MISO Brief at 4; Companies' Brief at 2-3; AG Brief at 2.

[16] 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.

exceed what the Companies contemplated at the time they signed the TO Agreement.[17] And the Companies' cost-benefit analysis demonstrates that MISO's costs well exceed the value of the benefits MISO claims in this case.[18]

A. If the Commission Orders the Companies to Exit MISO and the Companies Obtain FERC Approval, the Transfer to the Companies of Full Operational Control of Their Transmission Assets Would Meet the KRS 278.218 Standard.

The Companies and MISO agree that the Companies' limited transfer of operational control of their transmission assets to MISO did not require Commission approval under KRS 278.020(4).[19] The Companies and MISO further agree that the Companies' limited transfer to MISO did not occur while KRS 278.218 was in effect.[20]

The Companies and MISO disagree greatly, however, with respect to MISO's contention that a transfer of operational control from MISO back to the Companies would not meet the standard set out in KRS 278.218.[21] For a transfer to meet the requirements of KRS 278.218(2), it must be "for a proper purpose and . . . consistent with the public interest." The Commission has further stated: "This standard establishes a two-step process: first, there must be a showing of no adverse effect on service or rates; and, second, there must be a determination that there will be some benefits."[22] The record before the Commission amply supports a determination that the Companies' standalone operation would benefit the ratepayers financially with no demonstrable adverse effect on service.

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[17] 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.
[18] MISO Brief at 5-6.
[19] MISO Brief at 7-8; Companies' Brief at 27-31.
[20] MISO Brief at 6; Companies' Brief at 28. The Attorney General said nothing about this subject in his brief. See AG Brief.
[21] MISO Brief at 8-10.
[22] In the Matter of Application of Kentucky Power Company d/b/a American Electric Power for Approval, to the Extent Necessary, to Transfer Functional Control of Transmission Facilities Located in Kentucky to PJM Interconnection, L.L.C. Pursuant to KRS 278.218, Case No. 2002-00475, Order at 4 (8/25/2003).

MISO's contentions that the Companies' standalone operation would not meet the KRS 278.218 standard find no credible support in the record. MISO first states that MISO membership "has benefits that far outweigh the costs".[23] However, the only proper inquiry is whether MISO membership is more or less beneficial to the public interest than standalone operation.[24] The Companies' independent cost-benefit analysis clearly shows that (1) MISO's costs and the financial risks posed by its Day 1 and Day 2 markets exceed its benefits[25] and (2) standalone operation is superior to continued MISO membership.[26] Because there are demonstrable financial benefits to standalone operation, a Commission determination that the costs of MISO membership exceed the known and reasonably expected, quantifiable benefits would satisfy the KRS 278.218 standards and resulting approval of the transaction.

MISO also contends that standalone operation would harm the Companies' existing level of service reliability.[27] Reliability is, of course, of paramount concern to this Commission, the Companies and their customers. Because of its importance, MISO's allegations concerning reliability deserve close scrutiny. This Commission has regulated LG&E and KU for decades, and the respective reliability of the Companies is a matter of public record and institutional knowledge by many on the Commission staff. By contrast, MISO can demonstrate neither that membership conveys quantifiable reliability benefits, nor that standalone operation would compromise the Companies' transmission system reliability.[28] Indeed, MISO cites no authority in its brief to support its assertion that "the proposed change would adversely affect the existing

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[23] MISO Brief at 10.
[24] Morey Rebuttal at 10-11.
[25] III T.E. 32, 172; IV T.E. 28-29. See also Response of Midwest ISO to 4/8/04 Hearing Data Requests, Attachment A ("Attachment A").
[26] Morey Rebuttal at 7.
[27] MISO Brief at 10.
[28] Companies' Brief at 16-20.

level of reliability of service."[29] There simply is not sufficient credible evidence in the record to support a contention that standalone operation would compromise the Companies' transmission system reliability -- a system the Companies operated without having to shed native load for over twenty years.[30] A transfer back to the Companies of full operational control of their transmission system would indeed comport with KRS 278.218.

B. The Costs of the Companies' MISO Membership Exceed the Associated Benefits.

1. MISO has shown few quantifiable net benefits of MISO membership.

   a. MISO has not shown quantifiable reliability benefits of MISO membership, nor has it shown that the Companies' reliability would decrease in standalone operation

MISO has provided no credible, quantifiable evidence that the Companies would forego reliability benefits in standalone operation. In its brief, MISO cites the testimony of their witnesses, Messrs. Jonathan Falk and Roger Harszy, to support their claims that the Companies would enjoy net reliability benefits as MISO members over the period 2005-2010.[31] Mr. Falk erroneously assumed that, as standalone operators, the Companies would return to operating their transmission system just as they had prior to MISO's acting as the Companies' reliability coordinator.[32] The Companies stated in live and pre-filed testimony that they would engage a similarly equipped entity -- perhaps even MISO itself -- to act as the Companies' reliability coordinator.[33] MISO cannot properly count Mr. Falk's reliability benefit among the net benefits of continued MISO membership.

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[29] MISO Brief at 10.
[30] See, e.g., Morey Rebuttal at 17-18.
[31] MISO Brief at 11-16.
[32] MISO Case, Pre-filed Direct Testimony of Jonathan Falk (12/29/2003) ("Falk Direct") at 1; Morey Rebuttal at 7-8.
[33] See, e.g., MISO Case, Pre-filed Rebuttal Testimony of Mark S. Johnson (2/9/2004) ("Johnson Rebuttal") at 4-6; Morey Rebuttal at 8.

The Companies also showed in their brief that the way Mr. Falk calculated this supposed benefit is debatable at best.[34] Mr. 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;[35] (2) he based his expected per-outage lost kilowatt-hours figure on NERC Disturbance Analysis Working Group data, making his estimate a national, not a Kentucky-based, figure;[36] (3) he based his "value of lost load" figures on his "reading of the literature," which figures he admits have no particular connection to the value of lost load in Kentucky;[37] and (4) he chose an average value of "p," which is the average probability of an outage under undeclared TLR Level 4 conditions,[38] that is significantly higher than the historical data would suggest. In choosing an average value of "p," Mr. Falk purposefully ignored the fact that the Companies have not had to shed load to protect their grid in over twenty years.[39] 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' stewardship of their transmission system into account – diminish the persuasiveness of MISO's claimed reliability benefit figure.

The Companies further note that Mr. Falk testified that he was not hired to determine whether MISO provided its claimed reliability benefit cost-effectively.[40] He did, however, testify that the Companies should pay no more than $2.7 million per year to obtain the expected reliability benefit he calculated.[41] Yet the Companies paid over $12 million in Schedule 10 charges in 2002 and 2003[42] and were unable to realize appreciable cost savings as a result of

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[34] Companies' Brief at 19.
[35] II T.E. 224.
[36] II T.E. 224.
[37] II T.E. 226.
[38] Falk Direct at 10-12.
[39] See, e.g., Morey Rebuttal at 17-18.
[40] II T.E. 210.
[41] II T.E. 227-28.
[42] Response of LG&E and KU to the KPSC's Post-Hearing Data Requests (2/25/2004), Item No. 4.

their MISO membership.[43] On Mr. Falk's account, then, it appears that the Companies' continued MISO membership is not cost-effective or in the public interest.

Also unpersuasive is Mr. Harszy's testimony in support of MISO's contention that the Companies' reliability would be diminished in standalone operation.[44] First, MISO cites Mr. Harszy as stating that MISO employs communications systems, a State Estimator, and other tools to perform its reliability coordination function,[45] but provides no evidence that other entities the Companies might engage -- such as TVA -- do not utilize comparable tools to perform the same function. Second, MISO cites Mr. Harszy as stating that the Companies' reliability would suffer -- even if MISO acted as the Companies' reliability coordinator -- if the Companies did not also purchase a suite of other services from MISO, including tariff administration.[46] The Companies respectfully observe that there is no link established in the record between tariff administration and transmission system reliability. Further, Mr. Harszy stated there is only a "potential of more risk" to the Companies' reliability if the Companies do not purchase a host of ancillary services from MISO.[47] MISO can cite to no substantive, quantitative evidence to support Mr. Harszy's assertion.

MISO also cites several quotes from the Companies' witness, Mr. Mark Johnson, as supporting their contention that the Companies' transmission system reliability could suffer if the Companies exit MISO.[48] The bulk of these quotes amount to the following: (1) the Companies do not currently possess sufficient capabilities to act as their own reliability coordinator; (2) having real-time information on the states of neighboring control areas can lead to increased

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[43] II T.E. 184.
[44] MISO Brief at 11-12.
[45] MISO Brief at 11.
[46] MISO Brief at 12.
[47] II T.E. 252.
[48] MISO Brief at 14-16.

reliability; and (3) the Companies do not have price quotes from SPP, TVA, MISO or PJM as to how much those entities would charge to provide the Companies with reliability coordination services.[49] The Companies observe that: (1) several of the Companies' witnesses stated that the Companies would seek another entity to act as their reliability coordinator, so the Companies would have no need to replicate MISO's capabilities; (2) the Companies estimate that the required staff and reliability coordination contracts will cost the Companies $1 million per year;[50] and (3) Mr. Johnson stated that any of the reliability coordinators the Companies have proposed could provide NERC-approved reliability coordination services.[51] MISO itself appears to value NERC approval, as it noted in its brief that MISO's systems passed a NERC audit shortly before the August 14, 2003, blackout.[52]

Finally, MISO cites two quotes from Mr. Johnson that MISO suggests support the conclusions that seams degrade reliability and that the Companies' exit from MISO would create another seam.[53] Mr. Johnson's full quote, however, makes clear his belief that seams coordination agreements -- such as the one between MISO and PJM -- can significantly mitigate reliability concerns across seams:

> It [the Companies' exit from MISO] would, in fact, open another seam, but you would have to make the assumption that there would be a seam and then there would not be any subsequent coordination or any agreements on how things are to be managed between that seam.[54]

Because seams coordination agreements are important to maintaining reliability across neighboring transmission systems, the Companies testified that they will negotiate seams agreements and a reliability coordination contract to keep the Companies' system operating well

[49] MISO Brief at 14-16.
[50] Morey Direct, Ex. MJM-1 at 38-39.
[51] II T.E. 128.
[52] MISO Brief at 12.
[53] MISO Brief at 15-16.
[54] II T.E. 99.

within NERC standards.[55] Indeed, the Companies have expressed interest in having MISO provide them reliability coordination services, which would necessarily involve seams management.[56] This approach is consistent with MISO's own testimony before Congress indicating that MISO "is actively exploring additional agreements to ensure greater reliability."[57] The Companies are unable to reconcile MISO's congressional testimony with its testimony in this proceeding wherein MISO stated it simply is not in the business of providing services to non-members.[58]

Finally, the Companies respectfully observe that, from MISO's perspective, the Companies' departure would not open a seam, but would merely move the seam that currently exists between MISO and the systems on the Companies' borders.

b. MISO's claimed net operational benefits are either non-existent or the Companies have already accounted for them in their independent cost-benefit analyses

MISO claims that the Companies will enjoy four kinds of "net operational benefits" as continued MISO members: (1) increased transmission revenues; (2) increased Off-System Sales ("OSS"); (3) decreased costs of managing transmission constraints; and (4) revenue from sales of residual Financial Transmission Rights ("FTRs").[59]

i. Transmission revenues

The Companies showed in their initial brief that the additional transmission revenues they would receive as MISO members would be negligible at best.[60] 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

[55] II T.E. 128; Johnson Rebuttal at 4-6; Morey Rebuttal at 8.
[56] II T.E. 128; Johnson Rebuttal at 4-6; Morey Rebuttal at 8.
[57] IV T.E. 13.
[58] IV T.E. 91.
[59] MISO Brief at 18-19.
[60] Companies' Brief at 20.

configuration.[61] 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.[62]

Assuming that the magnitude of MISO's transmission revenue figure is correct for the sake of argument, it is irrelevant because MISO wrongly assumes that the Companies deliver their energy at the generator bus and then charge more to transmit the energy to the customer.[63] First, the Companies often do not sell energy that way; the Companies' energy price usually includes the cost of transmission to the customer's bus.[64] Second, if the Companies did sell power at the generator bus in a 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.

ii. Off-system sales

MISO relies upon erroneous 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,[65] for a total of $50.1 million from 2005-2010, should they remain in MISO instead of pursuing a standalone configuration.[66] The Companies discussed this issue at length in its initial brief and will not recount those arguments in detail here.[67] The erroneous assumptions on which MISO bases its claimed OSS benefit are, in short: (1) based solely on

[61] Morey Rebuttal at 7-8.
[62] Morey Rebuttal at 21-23.
[63] II T.E. 74-75.
[64] II T.E. 74-75.
[65] MISO Brief at 18.
[66] Morey Rebuttal at 7-8.
[67] Companies' Brief at 21-23.

"professional judgment,"[68] MISO assumes a $3 per MWh transaction cost for standalone OSS;[69] (2) again based solely on "professional judgment," MISO scales back its projections of the Companies' standalone OSS by over 30%, but does not perform a similar scaling back of its projections of the Companies' OSS as MISO members;[70] and (3) MISO posits certain costly "transmission constraints."[71] As the Companies showed in their initial brief, these assumptions are highly questionable.[72]

In addition to questionable assumptions, much about MISO's use of the ProMod IV computer costing model in its cost-benefit analysis is disturbing. In his live testimony, MISO's witness, Dr. Robert R. McNamara, told the Commission that nobody at MISO either ran or directly supervised the running of the ProMod IV model.[73] In addition, Dr. McNamara did not review all the inputs that were used in the model runs, but only those he thought "critical."[74] 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 nor what the results of such analyses might have been.[75] 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.[76] 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; indeed, MISO's

[68] III T.E. 22-23.
[69] III T.E. 22-23.
[70] III T.E. 22-23.
[71] MISO Case, Pre-filed Direct Testimony of Robert R. McNamara (12/29/2003) ("McNamara Direct") at 15-17, Ex. RRM-1 at 7-8.
[72] Companies' Brief at 21-23.
[73] III T.E. 24, 117-19.
[74] III T.E. 24, 117-19.
[75] III T.E. 24, 117-19.
[76] III T.E. 48-50.

apparent indifference to the sensitivity of its model's outputs to changes in its inputs suggests a results-driven, rather than fully objective, analysis.

iii. Managing transmission constraints

MISO claims that its application of centralized dispatch based on Locational Marginal Pricing ("LMP") will allow the Companies to enjoy $3.6 million annually in reduced costs associated with managing transmission constraints.[77] MISO bases its claim on the ProMod IV model runs that MISO witness Dr. McNamara admitted he did not supervise.[78] This is the same analysis that produced results for OSS under the standalone case that Dr. McNamara felt compelled to adjust downward by thirty percent on the basis of his "professional judgment" to account for shortcomings in the model.[79] It is noteworthy that the savings MISO claims here are less than 0.6% of total generation costs to serve native load.[80] Furthermore, Dr. McNamara acknowledged in live testimony that ProMod IV's predictions are subject to error, although he did not know the degree of such error.[81] Because MISO's projected transmission constraint management benefit is small enough to fall within reasonable forecast error bounds, the Commission will, no doubt, have concerns about how much it may be able to rely upon MISO's claimed benefit.

iv. Sales of residual FTRs

As MISO acknowledges,[82] the Companies accounted for $2 million from sales of residual FTRs as revenue that the Companies would forego as standalone entities.[83] Even accounting for

[77] MISO brief at 18-19.
[78] III T.E. 24, 117-19.
[79] III T.E. 22-23.
[80] McNamara Direct Ex. RRM 1-4.
[81] III T.E. 48-50.
[82] MISO Brief at 19.
[83] Morey Rebuttal at 8.

this foregone revenue, the Companies' cost-benefit analysis shows over $60 million in net benefit from pursuing standalone operation.

c. LG&E/KU merger benefits will flow to the Companies and ratepayers regardless of the Companies' MISO membership status, so they cannot be counted as net benefits of MISO membership

MISO notes that the Companies and ratepayers have enjoyed substantial LG&E/KU merger-related benefits in the past and will continue to enjoy them in the future.[84] Yet again, though, MISO's argument fails to address the important point that past benefits are irrelevant to this case. Even if they were relevant, MISO's own Chief Executive Officer ("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 MISO members, so MISO cannot plausibly claim credit for past merger benefits.[85]

What is relevant to this case is the question as to which Commission expressly asked the parties to provide evidence: namely, whether the Companies' continued, future MISO membership is in the public interest.[86] In answer to that question, the Companies observe that there is no evidence in this record that FERC would seek to unwind the merger as a condition of the Companies' exit from MISO, nor is there any evidence that there exists today the same kind of market power concern FERC addressed at the time of the Companies' merger.[87] Because there is no evidence that the LG&E/KU merger benefits will disappear or even diminish absent the Companies' continued MISO membership, MISO cannot claim the merger benefits as a net benefit of MISO membership.

[84] MISO Brief at 19-20.
[85] MISO Case, Pre-filed Direct Testimony of James P. Torgerson (12/29/2003) ("Torgerson Direct") at 10-11.
[86] MISO Case, Order at 3.
[87] Companies' Brief at 14-16.

d. There is no evidence that the Companies have avoided any labor or systems costs as a result of their membership in MISO

MISO erroneously states that the Companies have enjoyed $1 million annually in cost savings by not having to employ staff and operate certain equipment because MISO performed those functions, including regional transmission planning functions.[88] The Companies have testified that they have experienced no cost savings whatsoever resulting from the Companies' MISO membership for the very reason that MISO cites in its brief: namely, the Companies have required significant manpower just to interact with MISO.[89] Therefore, MISO is wrong to state that the Companies have avoided $1 million per year as a result of MISO membership.

Even though the Companies would not have to incur costs to interact with MISO as standalone operators, the Companies' experts sought to be conservative in their cost-benefit analysis by assuming that the Companies would require additional staff to perform functions MISO currently performs at a cost of $300,000 annually.[90] The Companies further estimate that they would require approximately $700,000 annually for (1) a contract with a reliability coordinator; (2) OASIS; and (3) OATI software to assist in verifying OASIS requests.[91] The Companies have taken this $1 million annual net cost of standalone operation into account in their independent cost-benefit analysis, as MISO acknowledges,[92] which study still shows over $60 million in net benefit of standalone operation over the period 2005-2010.[93]

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[88] MISO Brief at 20-21.
[89] MISO Brief at 21; II T.E. 184.
[90] Morey Direct, Ex. MJM-1 at 38-39.
[91] Morey Direct, Ex. MJM-1 at 39.
[92] MISO Brief at 21.
[93] Morey Rebuttal at 8.

e. The Companies acknowledge that they will have to pay an exit fee if they withdraw from MISO

The Companies acknowledge that the MISO Transmission Owners Agreement ("TO Agreement") obligates the Companies to pay an exit fee on withdrawal from MISO.[94] The Companies estimate the exit fee would be $28.3 million;[95] MISO estimates it would be $38.2 million.[96]

Regardless of the amount, the exit fee is a net cost of standalone operation, not a benefit of MISO membership, as MISO mistakenly claims. As MISO members, the Companies are obligated to pay their share of MISO's capital obligations through Schedule 10, 16 and 17 fees.[97] The exit fee represents the Companies' portion of MISO's fixed capital costs as of the Companies' date of withdrawal.[98] The exit fee is not a net benefit of MISO membership, then, because the Companies would have to pay these capital costs regardless of their MISO membership.

2. The Costs of MISO Membership Outweigh the Benefits, and the TOs Have No Effective Way to Control MISO's Costs.

a. Schedule 10, 16 and 17 fees

Although it is unclear why, MISO notes that it recovers its costs for its current operations through Schedule 10 fees.[99] Conspicuously absent from its discussion of Schedule 10 fees is any mention of their amount or whether they are cost-effective relative to the benefits MISO provides in return. Indeed, as the above discussion demonstrates, MISO has produced no credible

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[94] 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.
[95] Response of LG&E and KU to the KPSC's Post-Hearing Data Requests (2/25/2004), Item No. 6.
[96] MISO Brief at 21 n.74.
[97] MISO Brief at 21; III T.E. 142.
[98] III T.E. 142.
[99] MISO Brief at 22.

evidence in this proceeding to dispute the fact that MISO membership over the period 2005-2010 will come at a net cost of over $60 million.[100]

In its notably short discussion of the implementation costs of the proposed Day 2 markets,[101] MISO does not substantively address the fact that it estimates that the Companies will pay $36.2 million in Schedules 16 and 17 costs[102] over the period 2005-2010 (the Companies estimate approximately $51 million).[103] Yet, as the Companies show in their brief, they will receive no additional net transmission revenue benefit, nor will they be able to make appreciably more OSS, if any, to offset the additional costs of the Day 2 markets.[104]

One reason why the Companies' costs for the Day 2 markets are so 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.[105] This method is inconsistent with the way MISO computes Schedule 16 charges, which are based only on sales TOs make into the markets, not what TOs use to serve their native load.[106] Were MISO to compute Schedule 17 charges as it computes Schedule 16 charges, the Companies' Day 2 markets costs might decrease significantly.

b. The TOs have no effective means to exercise control over MISO's costs

MISO states that there are adequate controls on its expenditures because: (1) its budgets are reviewed by an independent board of directors; (2) FERC is its regulator; and (3) it must file reports with FERC every sixty days concerning its expenditures for certain Day 2 market

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[100] Morey Rebuttal at 8.
[101] MISO Brief at 22.
[102] Holstein Direct at 14; Morey Rebuttal at 27-28.
[103] Morey Rebuttal Ex. MJM-4.
[104] Companies' Brief at 20-23.
[105] IV T.E. 30-33.
[106] IV T.E. 30-33.

The seminal question, however, is whether the alleged benefit outweighs the associated costs. MISO is unable to quantify the supposed benefits of its very expensive new dispatch (the Day 2 markets will cost over $190 million if they commence operation in December of this year).[117] Unless MISO can show that the Companies have overlooked or ignored over $60 million in gained efficiencies from MISO's proposed new dispatch, the Companies' independent cost-benefit analysis shows that standalone operation is superior to continued MISO membership.

C. Regional Resource Adequacy Requirements and Demand-Side Management Would Necessarily Require the Commission to Cede Certain Parts of Its Lawful Regulatory Jurisdiction to MISO.

In its Order initiating this investigation, the Commission asked the parties to submit testimony concerning "the appropriateness of, and jurisdictional basis for, MISO to provide services traditionally within the supervision and control of the Commission . . . ."[118] In their initial brief, the Companies answer the Commission's request by providing cites to the applicable law and other authority, including Federal Power Act § 201(b)(1) and the Federal Energy Regulatory Commission's ("FERC") Standard Market Design ("SMD") White Paper.[119] The Companies conclude that the Commission has strong legal ground on which to contest any attempt by MISO or other entities to set regional resource adequacy or demand-side management requirements, and that the Commission's control over Kentucky's resource adequacy requirements is in the best interest of the Kentucky ratepayers.[120]

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[117] 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").
[118] MISO Case, Order at 4.
[119] Companies' Brief at 31-32.
[120] Companies' Brief at 31-32.

MISO, on the other hand, does not cite a single statute or regulation to support its apparent claim of authority to set regional resource adequacy requirements.[121] Instead, MISO announces its "sensitivity to the interests of the various states" and asserts that it has "been responsive to the concerns of the individual states and has undertaken efforts to meet state objectives to the maximum extent possible."[122] What MISO does not address is the fact that Federal Power Act § 201(b)(1) grants jurisdiction over sales from the Companies' generation to native load, and regulation of that generation, to the Commission. Unless Congress acts to preempt Kentucky's laws granting this Commission plenary authority over resource adequacy inside Kentucky's borders, MISO owes the Commission more than "sensitivity": it owes strict deference to the Commission's regulation of retail sales and resource adequacy.

MISO cites Dr. McNamara's testimony to support its claim that Kentucky, through the Companies, would surrender no control over its low-cost generation resources to serve native load under its Energy Market Tariff ("EMT")[123] because the Companies would be able to self-schedule such resources.[124] There are several serious difficulties with Dr. McNamara's testimony on this topic. First, MISO had not yet filed its EMT at the time of his testimony, so Dr. McNamara's opinions were based upon draft language. There is no evidence in the record to

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[121] MISO Brief at 31-33.
[122] MISO Brief at 31.
[123] The Commission should note that the EMT is not evidence of record in this case. MISO filed its EMT on March 31, 2004, and no testimony was taken as to its contents, operational impact or meaning. MISO's statements about its EMT and Module E thereof are, therefore, either an attempt to introduce parts of the EMT into evidence without the opportunity for hearing, or they are completely unsupported assertions (indeed, MISO cites no authority in its discussion of its EMT). If an attempt to introduce evidence, the Commission should disregard MISO's comments about the EMT as violative of the Companies' due process rights to confront and rebut evidence in the record. Utility Regulatory Comm'n v. Kentucky Water Service Co., Ky.App., 642 S.W.2d 591, 593 (1982). If bare assertions, the Commission should disregard MISO's comments about the EMT as completely unfounded.

If, however, the Commission is inclined to consider MISO's EMT commentary, the Companies ask that the Commission give equal consideration to its comments here, as well as the Companies' comments regarding MISO's EMT filing, attached as Appendix I to this brief. The Companies also ask that the Commission take official notice of the TOs' comments regarding MISO's EMT filing. In re: Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER04-691-000, Protest and Motion to Intervene of the Midwest ISO Transmission Owners (5/7/2004).
[124] MISO Brief at 31-32.

show whether there have been changes in the tariff language since then, and if so, what the changes were by the time MISO filed its EMT on March 31, 2004. Second, the Commission can be sure that, as standalone entities, the Companies would be able to dispatch their generating units in merit order to provide native load the lowest-cost power possible, just as they do today; thus, the mere possibility that the Companies could do the same as MISO members can hardly be counted a benefit.[125] Third and finally, that the Companies would be able to sell power into or buy power from the MISO market as MISO members is no special benefit, either;[126] the Companies currently sell power off-system and, on rare occasion, purchase power off-system, all without impinging on the Commission's jurisdiction.

Moreover, there is reason to believe that the EMT, as actually filed, could indeed constrain the Companies' ability to serve their native load customers with their lowest-cost resources.[127] EMT Section 69.2 requires that Designated Network Resources must either be self-scheduled or offered in the day-ahead energy market and the Reliability Assessment Commitment ("RAC") short-term capacity market. This requirement precludes Load Serving Entities ("LSEs") with least cost supply obligations (such as the Companies) from self-serving load with their owned or acquired resources in the retail rate base. This is because, by definition, all such resources have been acquired or constructed to meet state planning and reserve requirements. In the case of LSEs, such resources would otherwise be available at cost, in real-time, and at the LSE's discretion. Under the EMT, to the extent the MISO has scheduled LSE-owned generation to serve non-LSE load, LSEs such as the Companies must now purchase "pool" resources in real-time at prices established in the wholesale markets. Such market prices

[125] See MISO Brief at 31-32.
[126] See MISO Brief at 31-32.
[127] In re: Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER04-691-000, Energy Markets Tariff (3/31/2004). The Commission should note that this document is not in the record in this case as further explained in n. 123, supra.

may be significantly higher than the cost of the Companies' owned resources, which would have been available in real-time to serve native load absent the MISO's "call" on such resources pursuant to the EMT. EMT Section 69.2 requires that an integrated utility's incremental resources, i.e., supply resources in excess of self-forecasted load, be made available to the market rather than available for meeting the supply owner's load. Such resources may very well have been, as in the Companies' case, built or obtained pursuant to a state-sanctioned planning process.

In addition to potentially increasing costs to the Companies' customers, the MISO has not demonstrated that Section 69.2 is consistent with the express language of FPA Section 201(b)(1), which reserves jurisdiction over generation supply and generation planning to the states. Indeed, 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 . . .."[128]

Lastly, MISO argues that its EMT Module E does not compromise the Commission's authority over resource adequacy, particularly its ability to set reserve margin requirements, because the level of MISO's requirement is "dictated by the applicable state authority."[129] This ignores the clear statement in Module E that "[t]he Transmission Provider [MISO] will determine reliability and resource adequacy standards, including operating and planning reserve requirements, applicable to Load served within the Transmission Provider Region."[130] Module E further provides that MISO will be the entity to review compliance with reliability and resource

[128] MISO Brief at 15.
[129] MISO Brief at 32-33.
[130] Module E § 68.2.1.

MISO, by design and its witnesses' admissions, represents the interests of a different constituency: its many members and the "market."[138] The Companies' departure could instigate a broader exodus of TOs from MISO.[139] If even a single TO departs, the result will be higher costs for those that remain.[140] Thus, consistent with its self-interest, MISO supports the status quo and recommends that the Commission do nothing.[141]

This Commission is tasked with acting in the interests of Kentucky ratepayers. The Commission should determine whether the costs of the Companies' membership in the MISO exceed the known and quantifiable benefits associated with that membership. The Companies submit the evidence of record supports a determination in the affirmative. Should the Commission make such a determination, transfer of the limited operational control from MISO back to the Companies meets the standard set out in KRS 278.218. The record before the Commission amply supports a determination that the Companies' standalone operation would benefit the ratepayers financially with no demonstrable adverse effect on service.

The Companies request the Commission issue an order (1) authorizing the Companies to pursue withdrawal under KRS Chapter 278 from MISO subject to the FERC issuing a lawful order authorizing the Companies withdrawal from MISO and establishing the appropriate amount of the MISO exit fee and (2) further authorizing the Companies to establish a regulatory asset in the amount of the MISO exit fee.

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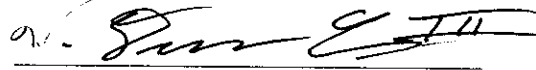
[138] III T.E. 13-15.
[139] III T.E. 208-09.
[140] III T.E. 141-43.
[141] MISO Brief at 37.

Dated: May 19, 2004

Respectfully submitted,

Kendrick R. Riggs



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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document was served upon the following parties by regular mail, postage prepaid, on this 19th day of May 2004.

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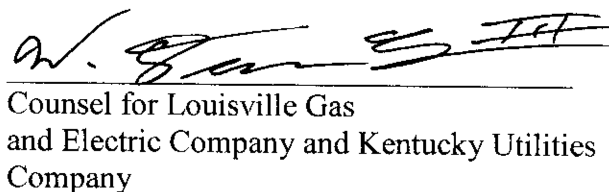

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APPENDIX I

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Midwest Independent Transmission System Operator, Inc.	))	Docket No. ER04-691-000

MOTION TO INTERVENE, COMMENTS AND REQUEST FOR SUMMARY DISPOSITION OR CONDITIONS OF LG&E ENERGY LLC

Pursuant to Rules 211, 212, 214, and 217 of the Federal Energy Regulatory Commission's ("Commission" or "FERC") Rules of Practice and Procedure, 18 C.F.R. §§ 385.211, 385.212, 385.214 & 385.217, and the Commission's April 2, 2004 Notice of Filing, LG&E Energy LLC ("LG&E"), on behalf of its utility operating companies (Louisville Gas and Electric Company and Kentucky Utilities Company) hereby submits a motion to intervene, comments and a request for summary disposition or conditions in the above captioned docket. LG&E and its utility operating companies are referred to herein collectively as "LG&E." In this proceeding the Midwest Independent Transmission System Operator, Inc. ("MISO") has tendered for filing a proposed Open Access Transmission and Energy Markets Tariff ("EMT"). The EMT filing would implement the so-called "Day 2" market within the MISO footprint.

For the reasons stated herein, LG&E requests that the Commission summarily reject the EMT, which contains a number of key provisions that are unjust and unreasonable, are flawed from a policy perspective, and/or violate Section 201(b)(1) of the Federal Power Act ("FPA").[1] In the alternative, the Commission should condition its approval of the EMT so that entities, such as LG&E, which seek to continue to self-serve

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[1] 16 U.S.C. § 824(b)(1) (2000).

native load pursuant to state-imposed obligations to serve, may voluntarily opt-out of the portions of the EMT that are: (i) unjust and unreasonable as applied to them; (ii) contrary to Commission policy; or (iii) inconsistent with state jurisdiction over retail sales and generation as provided for in Section 201(b)(1). Specifically, if the Commission decides not to reject the EMT, the Commission should condition acceptance of the tariff on the creation of flexible "opt-in/opt-out" provisions which will ensure that key aspects of the Day 2 markets are voluntary.

In support of this requested relief, LG&E states in Section V hereof that: (A) the EMT is beyond the scope of Order No. 2000,[2] and appears to propose a mandatory market structure that is even contrary to the Standard Market Design ("SMD") rulemaking;[3] (B) permitting LG&E to opt-out of Day 2 is consistent with LG&E's merger commitments; (C) the MISO has not demonstrated that significant aspects of the EMT are just and reasonable; and (D) the EMT fundamentally changes state-federal jurisdiction without support and aspects of the EMT violate Commission policies and FPA Section 201(b)(1).

I. COMMUNICATIONS.

LG&E requests that all correspondence and communications with respect to this filing should be sent to, and that the Secretary include on the official service list, the following:

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2 *Reg'l Transmission Orgs*, Order No. 2000, FERC Stats. & Regs. [Regs. Preambles 1996-2000] ¶ 31,089 (1999), *on reh'g*, Order No. 2000-A, FERC Stats. & Regs. ¶ 31,092 (2000), *petitions for review dismissed sub nom., Public Util. Dist. No. 1 of Snohomish County, Wash. v. FERC*, 272 F.3d 607 (D.C. Cir. 2001) ("Order No. 2000").

3 *Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design*, FERC Stats. & Regs. ¶ 32,563 (2002) ("SMD NOPR"). *See also White Paper Wholesale Power Mkt. Platform*, Docket No. RM01-12-000 (April 28, 2003) ("*SMD White Paper*").

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II. DESCRIPTION OF LG&E.

LG&E Energy LLC is an exempt public utility holding company under the Public Utility Holding Company Act of 1935 ("PUHCA").[4] LG&E Energy LLC's operating company subsidiaries, Louisville Gas and Electric Company and Kentucky Utilities Company, are primarily engaged in the generation, transmission, and distribution of electric energy in the Commonwealth of Kentucky. Louisville Gas and Electric Company also purchases, distributes and sells natural gas to customers within Kentucky. LG&E's operating companies are members of the MISO and are parties to the *Agreement of Transmission Facilities Owners to Organize the Midwest Independent Transmission System Operator, Inc.* ("TO Agreement"), which was approved by FERC in 1998 pursuant to its authority under Section 205 of the FPA.[5] In addition to the present filing,

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[4] 15 U.S.C. §§ 79 *et seq.* (2000).

[5] *See Midwest Indep. Transmission Sys. Operator, Inc.*, 84 FERC ¶ 61,231 ("September 16 Order"), *order on reconsideration*, 85 FERC ¶ 61,250, *on reh'g*, 85 FERC ¶ 61,372 (1998), *Initial Decision*, 89 FERC ¶ 63,008 (1999), *aff'd and clarified*, Opinion No. 453, 97 FERC ¶ 61,033 (2001), *on reh'g*, Opinion No. 453-A, 98 FERC ¶ 61,141 (2002).

LG&E is also participating in a filing by Midwest Transmission Owners ("TOs") that similarly calls for rejection of the EMT filing ("TO Group Filing").

III. BACKGROUND.

The MISO filed the EMT on March 31, 2004 pursuant to obligations imposed by the Commission. When the Commission granted MISO RTO status, it conditioned such status on the MISO's "commitment to file a Day 2 proposal for congestion management that will improve the efficiency of the markets in the Midwest region, including the real-time imbalance energy market."[6] The Commission has advocated implementation of Day 2 operations by RTOs, including the MISO.[7]

In approving the merger between Louisville Gas & Electric Company and Kentucky Utilities Company, the Commission stated that such approval was based on LG&E's participation in the MISO.[8] LG&E has committed to remain a member of a Commission-approved RTO after 2002 as part of the company's request for approval of the E.ON merger.[9]

On July 17, 2003, the Kentucky Public Service Commission ("KPSC") initiated an investigation concerning the costs and benefits of LG&E's continued participation in

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6 *Midwest Indep. Transmission Sys. Operator, Inc.*, 97 FERC ¶ 61,326 at 62,522 (2001) (granting RTO status and accepting supplemental filings). The Commission further directed MISO to coordinate its Day 2 congestion management efforts with the SMD rulemaking. *Id.* at 62,514.

7 *Alliance Cos., et al.*, 103 FERC ¶61,274 at P 22 (2003) (noting Commission support for Day 2 market).

8 *Louisville Gas & Elec. Co., et al.*, 82 FERC ¶61,308 at 62,222-23 (1998)("*Louisville Gas & Electric*").

9 *E.ON AG, et al.*, 97 FERC ¶ 61,049 at 61,283 (2001) ("*E.ON AG*").

the MISO ("KPSC Proceeding").[10] The purpose of the KPSC Proceeding is to determine whether LG&E's continued participation in the MISO is in the public interest, *i.e.*, in the best interest of Kentucky ratepayers. Pursuant to the KPSC's instruction upon initiation of the investigation, LG&E commissioned an independent cost-benefit study of their membership in the MISO.[11] The study concluded that continued membership in MISO would not be cost-effective. The study showed that the costs of LG&E's MISO membership would exceed its benefits by over $60 million (nominal dollars) over the period from 2005-2010.[12]

In the KPSC Proceeding, LG&E has taken the position that, if the KPSC finds LG&E's continued MISO membership not to be in the public interest and if the KPSC orders LG&E to exit MISO, LG&E would seek Commission approval to that end.

IV. MOTION TO INTERVENE.

In this case, the MISO proposes to implement an EMT that will fundamentally alter the electricity operations of its transmission-owning members. Although LG&E is participating in the TO Group Filing, LG&E is an individual MISO member that is a party to the KPSC Proceeding, and sells electricity in the Midwest markets and elsewhere. Thus, LG&E has a unique interest in this proceeding and cannot be

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10 *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.*, Kentucky PSC Case No. 2003-00266 (July 17, 2003) ("KPSC Proceeding").

11 *Id.* at 3.

12 *KPSC Proceeding.*, Rebuttal Testimony of Mathew J. Morey, at 8 (filed Feb. 9, 2004) ("Morey Rebuttal").

adequately represented by any other party.[13] Accordingly, the Commission should grant LG&E's motion to intervene.

V. REQUEST FOR SUMMARY DISPOSITION, COMMENTS AND ALTERNATIVE REQUEST FOR CONDITIONS.

For the reasons stated below, LG&E requests that the Commission summarily reject the EMT or, alternatively, condition its approval on opt-out provisions for entities such as LG&E that seek to continue to self-serve native load pursuant to state-imposed obligations to serve (and other requirements). In support of this requested condition, LG&E states as follows:

A. THE EMT IS BEYOND THE SCOPE OF ORDER NO. 2000 AND WOULD EXCEED THE REQUIREMENTS OF SMD.

LG&E supports the principles of Order No. 2000; however, the EMT goes beyond the requirements of Order No. 2000. Order No. 2000 requires that RTOs ensure the development and operation of market mechanisms to manage transmission congestion. However, in Order No. 2000, the Commission never required that RTOs employ a centralized security-constrained economic dispatch model with day-ahead/real-time markets. Nor did the Commission require the use of locational marginal pricing ("LMP") or financial transmission rights ("FTRs").[14] In fact, the Commission carefully considered, and ultimately rejected, the notion that these functions should be requirements for RTOs.[15]

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13 *See* 18 C.F.R. § 385.214(b)(2)(ii).

14 *Order No. 2000* at 31,126-27.

15 *Id.* at 31,127.

Order No. 2000 was appropriately issued through a notice and comment rulemaking and was subsequently upheld by the courts.[16] In contrast, the Commission's requirement that the MISO file a Day 2 market tariff[17] affects a rule of general applicability, impacting utilities from South Dakota to Ohio. A requirement of this breadth and consequence is appropriately conducted through notice and comment rulemaking, not an adjudication.[18]

The Commission has previously attempted to implement EMT-type provisions by notice and comment rulemaking in its SMD NOPR. However, that initiative appears to most observers in the industry to have been discarded.[19] LG&E views the EMT as a vehicle for implementing the most controversial aspects of SMD, but without the key voluntary market participation feature the Commission included in the SMD NOPR. The Commission stated in the SMD NOPR:

> '[v]oluntary' means that market participants do not have to buy or sell in the day-ahead energy market. The day-ahead market we are proposing provides customers with additional supply choices. It is not intended to substitute for longer-term arrangements that customers may use to purchase supplies such as bilateral transactions or use of a customer's own generation.[20]

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16 *See Public Util. Dist. No. 1 of Snohomish County, Wash. v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

17 *See Midwest Indep. Transmission Sys. Operator, Inc.*, 97 FERC ¶ 61,326 at 62,522 (2001).

18 *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1166 (1985). The agency has discretion to initiate a rulemaking where "the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties." *See also Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968).

19 *See, e.g.*, DESPITE RECENT WOES, WOOD SEES A COMEBACK IN THE MAKING FOR POWER MARKET COMPETITION, *Inside FERC*, April 5, 2004, at 6 ("So we've got to customize ...[if regions do not want to adopt SMD] we have other tools besides SMD.").

20 SMD NOPR at P 269.

LG&E believes that a voluntary market participation option is essential, but such a provision is unfortunately missing from the EMT. Companies like LG&E must be afforded such an option so they can continue to fulfill their state-imposed obligations to serve at least cost, utilize owned resources to physically serve load and manage market risks, and continue to operate within the existing dual federal-state regulatory framework. Importantly, although taking a path which appears to have essentially shelved the SMD rulemaking initiative (which provided a carve-out for entities such as LG&E), it would be discordant for the Commission to now accept an EMT tariff that goes well beyond SMD and mandates day-ahead market participation.

Given the extent to which the EMT mandates that MISO members serve at least a portion and potentially the entirety of their retail native load customers through the MISO wholesale energy and capacity markets, the Commission should grant summary disposition and reject the tariff. The MISO should file a new EMT based on the fundamental principle of voluntary market participation. Rejection of the entire tariff is appropriate because LG&E fears that the structure of the EMT market integrally depends on mandatory participation and that, therefore, it may be unworkable to pursue any other course than to send the MISO and the parties "back to the drawing board."

Alternatively, if the Commission does not reject the entire tariff it should, at a minimum, condition approval of the EMT on the inclusion of an opt-out provision to permit entities such as LG&E to refrain from participating in aspects of the market that impose significant costs on the company, or encroach upon jurisdictional areas traditionally reserved for the states under FPA Section 201(b)(1).

B. PARTICIPATION IN DAY 2 IS NOT REQUIRED FOR LG&E TO MEET ITS MERGER COMMITMENTS.

As noted above, LG&E has made commitments to maintain membership in an RTO after 2002.[21] However, these merger commitments were made based upon LG&E's understanding of the framework of "an Order No. 2000 RTO" – not upon an RTO conducting and implementing a Day 2 market that is as far-reaching and untested as the EMT proposed by the MISO. LG&E initially collaborated with other TOs to form the MISO for two reasons: (i) to comply with and help shape emerging federal regulation and institutions, such as the MISO; and (ii) to achieve greater transmission system reliability.[22] LG&E continues to believe that these are important goals, which have been partly achieved through MISO membership. However, both the near-term and longer-term costs of the MISO, including Day 2, are projected to substantially exceed what LG&E contemplated at the time it signed the TO Agreement.[23] To be specific, there has been an 1100% increase in operating expenditures and a 311% increase in capital expenditures since 2000.[24]

LG&E strongly believes that its merger commitments – which have been overtaken by the MISO expanding its role and proposing such an unworkable Day 2

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[21] *See E.ON AG; Louisville Gas & Electric.*

[22] *KPSC Proceeding*, Testimony of Michael S. Beer, Vice President, Rates and Regulatory, LG&E Energy Corp (September 22, 2003) at 3; *KPSC* Proceeding, Testimony of Paul W. Thompson, Senior Vice President, Energy Services, LG&E Energy Corp. (September 22, 2003) at 2-3 ("Thompson Testimony"),; *KPSC* Proceeding, Response of LG&E and Kentucky Utilities Co. to the Initial Data Request of MISO (October 6, 2003) Item No. 18.

[23] *KPSC Proceeding*, Thompson Testimony at 9-10

[24] *KPSC Proceeding*, Response of MISO to the KPSC's Initial Data Requests (January 26, 20041/26/2004), Item No. 1.

market – can be met without LG&E's participation in Day 2. Accordingly, LG&E believes that any Commission order, either rejecting the EMT or conditioning the EMT with opt-out provisions (such as those advocated here by LG&E), would be consistent with LG&E's merger commitments.

C. THE MISO HAS FAILED TO DEMONSTRATE THAT THE EMT IS JUST AND REASONABLE AS APPLIED TO LG&E.

The EMT has been filed by the MISO pursuant to FPA Section 205. As such, MISO must demonstrate that the rates, terms and conditions of the EMT are just and reasonable as applied to all affected parties, including LG&E.[25] In addition, even if the EMT could facilitate an efficient market in theory, the Commission is required to assure LG&E and other MISO customers that rates subject to the Commission's jurisdiction are just and reasonable. Indeed, in *Duquesne Light v. Barasch*,[26] the Supreme Court found that the <u>end result</u> of a rate proposal (such as the EMT) must be just and reasonable.[27]

The MISO has not demonstrated that the end result of this rate change will be just and reasonable for LG&E and its customers. In particular, the MISO has not demonstrated that commodity and capacity prices will decrease for LG&E and its ratepayers such that rate increases associated with Day 2 will be offset or exceeded. It is true that the courts have found that this Commission need not demonstrate that competition will necessarily produce lower prices in order to support its orders, *i.e.*, this

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[25] 16 U.S.C. § 824d (2000); *see Indiana & Michigan Elec. Co.*, 59 FPC 1383, 1426-27 (1977) (indicating that the Commission has the responsibility to set just and reasonable rates under Section 205 for all affected customers) (citing Staff reply brief, p. 29), *reh'g*, *Indiana & Michigan Elec. Co.*, 59 FPC 2343 (1977).

[26] 488 U.S. 299 (1989).

[27] *Id.* at 307-16.

Commission need not prove that an "unsupported stone will fall."[28] However, this completely new structure adds significant structural costs[29] with no reasonable assurance that commodity and capacity prices will decrease for LG&E's customers. In fact, LG&E is not aware of any definitive empirical evidence that EMT structures will necessarily produce lower commodity and capacity costs. Furthermore, the California experience demonstrates that there could be reliability problems and even higher prices associated with Day 2-type market structures.[30]

Importantly, Day 2 is unlike the open access and transmission initiatives undertaken by the Commission in Order No. 888[31] and Order No. 2000. Those initiatives proposed regulatory changes to implement structural industry fixes without significant cost increases on ratepayers. This situation is vastly different.

In the KPSC Proceeding – a case in which the Kentucky Public Service Commission has initiated an investigation into LG&E's continued membership in MISO -- LG&E commissioned an independent cost-benefit analysis to assess its RTO membership options. The study demonstrates that the MISO's costs, including the EMT, outweigh its benefits to LG&E's ratepayers. LG&E believes that the MISO has failed to

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[28] *See Associated Gas Distributors v. FERC*, 824 F.2d 981, 1008-09 (D.C. Cir. 1987) ("[a]gencies do not need to conduct experiments in order to rely on the prediction that an unsupported stone will fall; nor need they do so for predictions that competition will normally lead to lower prices."); *see also Atlanta Gas Light Co. v. FERC*, 140 F.3d 1392, 1399 (11th Cir. 1998).

[29] These costs include: (i) unit commitment and uplift costs; (ii) increased credit risks; (iii) loss factor payments; and (iv) inadequate indemnities.

[30] *See. e.g., San Diego Gas & Elec. Co.*, 93 FERC ¶ 61,121 (2000).

[31] *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 75 FERC ¶ 61,080 (1996), *on reh'g*, Order No. 888-A, 78 FERC ¶ 61,220 (1997), *on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *on reh'g*, Order No. 888-C, 82 FERC 61,046 (1998).

refute persuasively the results of LG&E's cost-benefit study,[32] and, therefore, has not met its burden of demonstrating that the EMT, as applied to LG&E, is just and reasonable.[33]

The Commission has previously approved the use of cost-benefit studies in evaluating RTO options. In its *SMD White Paper*, the Commission acknowledged that regional differences exist and stated that RTOs and/or ISOs need not perform certain functions if, based on a cost-benefit study, the region can establish that the costs of implementing those functions outweigh any benefits associated with the functions' implementation.[34]

Below is a discussion of the specific facets of the EMT that LG&E believes has not been shown to be just and reasonable and may, in fact, be unjust and unreasonable. In addition, as noted below, the MISO has not demonstrated why certain aspects of the EMT do not violate FPA Section 201(b)(1) (*see also* Section V.D. *infra*). The Commission must either summarily reject these sections of the EMT for violating policy and applicable law, or accept the tariff conditioned on the creation of provisions that permit entities such as LG&E to opt-out of certain aspects of the Day 2 market.

1. Self-Scheduling and Day Ahead Must Offer Requirements.

EMT Section 69.2 requires that Designated Network Resources must either be self-scheduled or offered in the day-ahead energy market and the Reliability Assessment Commitment ("RAC") short-term capacity market. This requirement precludes Load

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[32] *Investigation Into The Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator*, Joint Post-Hearing Brief of Louisville Gas and Electric Company and Kentucky Utilities Company, Case No. 2003-00266 (April 26, 2003), at 35-36.

[33] *Morey Rebuttal*, *supra* n. 11.

[34] *SMD White Paper* at 2.

Serving Entities ("LSEs") with least cost supply obligations (such as LG&E) from self-serving load with their owned or acquired resources in the retail rate base. This is because, by definition, all such resources have been acquired or constructed to meet state planning and reserve requirements. In the case of LSEs, such resources would otherwise be available at cost, in real-time, and at the LSE's discretion. Under the EMT, to the extent the MISO has scheduled LSE-owned generation to serve non-LSE load, LSEs such as LG&E must now purchase "pool" resources in real-time at prices established in the wholesale markets. Such market prices may be significantly higher than the cost of LG&E's owned resources, which would have been available in real-time to serve native load absent the MISO's "call" on such resources pursuant to the EMT. EMT Section 69.2 requires that an integrated utility's incremental resources, *i.e.*, supply resources in excess of self-forecasted load, be made available to the market rather than available for meeting the supply owner's load. Such resources may very well have been, as in LG&E's case, built or obtained pursuant to a state-sanctioned planning process.

In addition to potentially increasing costs to LG&E customers, the MISO has not demonstrated that Section 69.2 is consistent with the express language of FPA Section 201(b)(1), which reserves jurisdiction over generation supply and generation planning to the states (*see infra* Section IV.D.). Thus, LG&E recommends that the Commission reject this section of the EMT filing or, at minimum, condition its approval of the EMT on an opt-out provision under which generation owned by utilities with a state-imposed obligation to serve may be exempted from the EMT's Day-Ahead and RAC must-offer requirements.

2. Alternative Capacity Resources.

EMT sections 70, 70.1.1 and 70.1.2 use the term "Alternative Capacity Resource" ("ACR"), which is generally defined as either interruptible demand or behind-the-meter generation supply. With respect to either of these resources, the MISO has the discretion under the EMT to determine whether such resources "satisfy the criteria to be counted toward state or RRO resource adequacy standards." Under these sections of the EMT, LSEs would be required to provide the MISO with certain information, including price and "any other information deemed necessary," and the MISO would commit and dispatch ACRs for reasons of economy or emergency.

LG&E asserts that the EMT inappropriately interposes the MISO between state-regulated integrated utilities such as LG&E and their retail customers. Many integrated utilities, including LG&E, serve retail interruptible customers as part of state-regulated Demand Side Management ("DSM") programs. In addition, such interruptible load (as in LG&E's case) may have been planned as part of a state's integrated resource planning process for the utility.

There are several reasons why these ACR-related sections of the EMT are not appropriate. First, direct MISO control over the dispatch of ACR resources will affect retail rate design and integrated utilities' service to retail customers – matters that Congress determined are within the exclusive jurisdiction of the states under FPA Section 201(b)(1). Second, in controlling ACR resources, the MISO will have an obligation to deploy ACRs for the benefit of regional wholesale energy or capacity markets – not for the benefit of the retail customers of state-regulated LSEs. This framework is unworkable and counter-productive from a policy perspective. There will be little reason for a state regulator to implement demand-side measures such as retail interruptible rates

if savings to in-state retail ratepayers will be siphoned to regional ratepayers. Retail interruptible service and other demand-side programs save LSEs from investing in and rate-basing new peak-serving capacity. To the extent MISO controls the schedule of interruption, those savings may very well be diverted away from retail ratepayers and into the pockets of third parties.[35]

Accordingly, LG&E requests that the Commission reject this section of the EMT or, at a minimum, condition its approval of the EMT on permitting entities such as LG&E to opt-out of the ACR-related sections. State-regulated LSEs should be the only parties committing and scheduling interruptible retail load because such entities are intimately familiar with the terms and conditions of their own retail tariffs. Indeed, to the extent that the Commission is concerned about RTOs imposing unacceptable cost shifts on TOs, market participants and stakeholders, the Commission should ensure that LSEs such as LG&E retain the ability to control ACRs that are a part of state-imposed demand side programs.

3. Reliability Assessment Commitment.

EMT Sections 40.1.2 through 40.1.6 set forth the RAC processes that the MISO proposes to conduct beginning seven days prior to the Operating Day. As proposed these RAC processes would continue throughout the Operating Day to "ensure that [the MISO] can serve forecasted Load and Capacity requirements."[36] EMT Section 40.1.1 provides

[35] The potential for this outcome may be heightened in the MISO footprint. Unlike smaller, tighter pools, the proposed MISO Day 2 market will have greater load and resource diversity than New England, for instance. Thus, potentially, there is an increased likelihood of ACR benefits being shifted from local loads toward non-local and perhaps diverse loads.

[36] EMT, § 40.1.2.

that the MISO will "commit additional Resources beyond those selected for the Day-Ahead energy Market if needed..."

First, LG&E believes this language creates a "disconnect." Since the MISO does not serve load, LG&E finds it curious that the MISO will be in the position of acquiring "needed" capacity. It is not clear to LG&E how the MISO's procurement role will dovetail with LG&E's procurement to meet load as an LSE. Second, LG&E has concerns regarding the mechanics of the RAC process. If the MISO conducts the RAC process such that it retains the authority to commit additional resources "beyond those selected for the Day-Ahead Energy Market," it is unclear how this authority can be meaningfully or appropriately exercised six days before the start of the Day-Ahead Energy Market.

Third, it is unclear how the MISO's RAC process improves the operations of the various control areas, which still must comply with their respective Reliability Region's implementation of NERC Operating Policy 9A.[37] Given the continued effectiveness of Policy 9A, it is unclear why the RAC is necessary for reliability purposes. In accordance with Policy 9A, control areas today report to NERC regions on capacity available and planned to meet next day forecasted load. Currently, this process is reviewed and audited by the Reliability Authority, which in LG&E's case is MISO.

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[37] Policy 9A requirements include the following: "Perform security analysis. The Reliability Coordinators shall ensure that next-day reliability analyses are performed simultaneously for all Control Areas and Transmission Providers in its Reliability Area to ensure that the bulk power system can be operated in anticipated normal and contingency conditions." NERC Policy 9A (Feb. 7, 2000). Policy 9A provides further that, "Each Control Area in the Reliability Area shall provide information required for system studies, such as critical facility status, load, generation, operating reserve projections, and known Interchange Transactions. This information shall be available by 1200 Central Standard Time for the Eastern Interconnection, and 1200 Pacific Standard Time for the Western Interconnection." *Id.*

Moreover, in assessing the EMT, the Commission should assure Market Participant-LSEs such as LG&E that the RAC processes are truly designed to enhance reliability and are not constructed and implemented with the purpose of enhancing Real-Time Market liquidity. Indeed, as designed, the RAC provides generators with a stream of revenue to recover the MISO's accepted market-based startup and no-load offers that would otherwise have to be included in the generator's energy market offers, thus increasing Real-Time Energy Market liquidity through a separate, socialized revenue enhancement mechanism. The RAC should not be a pretext for a market design feature that is intended to enhance market liquidity by mandating participation of resources owned by state-regulated, vertically-integrated utilities, and by subsidizing merchant-owned resources. Thus, the Commission should ensure that the RAC ultimately serves reliability needs rather than any perceived need to enhance market liquidity.

LG&E's concern about the purpose of the RAC is accentuated by the fact that the EMT now provides for a seven-day-prior-to-Operating-Day RAC process. In contrast, in initial discussions with stakeholders during the development of the EMT, the RAC was proposed as a post-Day-Ahead process. Until the Day-Ahead Energy Market closes, the MISO cannot possibly "commit additional Resources beyond those selected for the Day-Ahead Energy Market," as is now proposed in the EMT. The purpose of a RAC process that occurs prior to the opening of the Day-Ahead market is unclear to LG&E. Indeed, it is also not clear how the MISO will be clairvoyant enough to determine what resources will be selected in future Day-Ahead Energy Markets.

In sum, the EMT RAC processes appear to have been developed based on the theory that revenue sufficiency guaranties will ensure recovery of accepted market-based

no-load and startup offers, and that this recovery, in turn, will ensure Real-Time unit availability. However, recovery of no load and start-up costs is already provided for with regard to retail rate base resources. Accordingly, the EMT should provide an option for entities such as LG&E to continue to self-provide capacity to meet their own forecasted native loads. The EMT should also provide that entities, which self-provide capacity, should not be forced to pay the costs of the MISO's proposed RAC revenue sufficiency guaranty. Self-providing entities should be required to demonstrate to the MISO the capability to self-provide load following service. However, LG&E believes that entities with over a century of operating history (such as LG&E and others) should receive rebuttable presumptions that they will adequately self-provide load following capability.

Accordingly, LG&E recommends that the Commission reject the RAC-related sections of the EMT filing or, at minimum, condition acceptance of the EMT on a RAC-related opt-out provision. State-regulated LSEs should at least be afforded the option of continuing to self-provide day-ahead capacity without risk of incurring a share of the day-ahead capacity costs of other parties.

4. Credit Policy.

The EMT's credit provisions are unjust and unreasonable and should be summarily rejected on policy grounds. As discussed herein, LSE's will become credit providers of last resort and LG&E opposes the imposition of this duty. According to EMT Section 7.8, whenever a Market Participant defaults on its obligations, the MISO will first pay itself, and then will reduce *pro rata* payments the MISO owes to non-defaulting Market Participants. The MISO proposes to reimburse such non-defaulting Market Participants when funds "attributable to a Past Due Amount" become available, including any financial security provided by the defaulting party. Section 7.10 sets forth

the methodology by which the MISO will declare that an unpaid invoice has matured into an "Uncollectable Obligation." Uncollectable Obligations are then allocated to "each Market Participant that had been invoiced by the Transmission Provider during the same period of time as the unpaid invoice(s)," and the proceeds from these invoices are then used to reimburse Market Participants who had earlier been distributed reduced payments as a result of the unpaid invoice. This allocation is based on the percentage of each Market Participant's participation, *i.e.*, charges and credits, in the market.

In order to limit the amount of unpaid invoices and minimize the financial size of Uncollected Obligations, the MISO proposes to seek Commission approval to terminate service to defaulting Market Participants. Upon such approval, the defaulting entity would be denied access to the marketplace and have any/all of their FTRs terminated and settled. The proceeds from this FTR settlement along with any MISO accounts payable and Financial Security will be used to off-set outstanding MISO obligations.

The EMT's credit provisions are unjust and unreasonable and should be summarily rejected on policy grounds. LG&E believes that mandatory market participation, as described above, carries significant risks for its ratepayers and has not been demonstrated to be consistent with FPA Section 201(b)(1). The EMT's credit provisions exacerbate these risks considerably by socializing the market's credit risk and forcing LSEs to subsidize entities such as marketers. In effect, under the EMT, LSEs such as LG&E will become credit providers of last resort through the EMT's credit policies, which amount to terms of adhesion that LG&E would not otherwise accept.

The EMT's credit provisions are also unclear in a number of respects. The EMT does not address circumstances in which the Commission rejects the MISO's request that

an entity be terminated from market participation. In addition, the EMT does not address how a defaulting LSE would cover its load obligations in the event of a default, particularly if the defaulting LSE is a provider of last resort or, like LG&E, is an LSE with a state-imposed obligation to serve. LG&E assumes that non-defaulting Market Participants will share the burden of continued default costs.

The EMT's credit provisions should be rejected because it is unreasonable to assume that Market Participants must be bound to adhesion terms which subject them to unlimited financial risk. Market participation should be voluntary so that this risk can be managed. Furthermore, any uplift associated with Uncollected Obligations should be limited to suppliers in the form of reduced payments. In a voluntary market, suppliers are best positioned to mitigate or avoid credit risk by managing the extent to which they transact with unknown parties in the energy market pool, or bilaterally transact with creditworthy counterparties.

Accordingly, LG&E recommends that the Commission reject this provision of the EMT filing or, at a minimum, condition approval of the EMT on a modification of the EMT credit policy provisions.

5. Revenue Sufficiency Charges.

EMT Sections 39.2.9.f and 40.2.13 provide that generators committed during MISO's Day-Ahead clearing process ("SCUC") and Operating-Day RAC processes, respectively, shall be assured recovery of any MISO accepted market-based no-load and startup offers though "Revenue Sufficiency Charges." These charges act as subsidies to generators to whatever extent such costs are not recovered from Day-Ahead or Real-time energy sales. Sections 39.3.1.c and 40.3.3.a.ii set forth the Revenue Sufficiency Charge cost allocation for Day-Ahead market settlement and Real-Time market settlement,

respectively. In both instances, the costs of guaranteeing revenue sufficiency will be borne by load – without regard to whether that load has already incurred startup and no-load costs (as in the case of retail loads supplied by integrated utilities).[38]

Under the MISO's proposed RAC cost allocation methodology, integrated utilities wishing to self-commit generation in order to meet forecasted native load obligations will incur their own startup and no-load costs, and will also be assessed a share of uplift that results from the unit commitment process. It is inequitable and contrary to cost causation principles for the MISO to assess integrated utilities that self-commit generation (and thereby incur their own no-load and startup costs) additional SCUC and RAC-related no-load and startup charges. By contributing to recovery of uplift costs, vertically integrated utilities that self-schedule and self-commit generation effectively lower that portion of SCUC and RAC uplift costs paid by loads that require MISO unit commitment. Integrated utilities that self-commit generation in a manner that complies with NERC Policy 9A in order to meet their own native load requirements do not cause the MISO to commit additional RAC resources to meet forecasted load.

The intent of these EMT provisions is to essentially levy a "tax" on self-providing LSEs. The MISO intends to use these "tax revenues" to then subsidize loads that obtain their capacity and energy requirements from the MISO wholesale markets. In order to avoid the tax and enjoy the subsidy, an integrated utility such as LG&E would have to participate fully in the MISO wholesale market without any self-supply. This approach

[38] Section 40.3.3.a.ii employs the undefined term "uncovered Load." Though this term implies that self-supplied Load would not be assessed RAC commitment costs, it is LG&E's understanding from MISO staff that all self-supplied load will be included in both the SCUC the RAC Commitment uplift cost billing determinants.

not only creates risk for ratepayers, but it needlessly creates impediments to LG&E's ability to fulfill its state-imposed obligation to self-serve its native load.

In sum, LG&E recommends that the Commission reject these sections of the EMT filing, or at a minimum, condition approval of the EMT on modification of the Revenue Sufficiency Charges to properly reflect long-standing principles of cost causation. Such costs should be borne fully by loads that do not elect to self-provide capacity and energy requirements.

6. Demand Response Resources.

The EMT provides for participation of Demand Response Resources ("DRRs") in the Day-Ahead and Real-Time energy markets. However, there is no provision in the EMT that prevents an individual end use customer residing in a non-retail access jurisdiction (such as Kentucky) from asserting a "federal right" to direct participation in the Day 2 markets. This potential loophole is contrary to the FPA[39] and the Commission's own precedent.

For instance, when the Commission approved PJM's load response program it noted that the PJM states had assisted in the development of the program, and that no PJM state objected.[40] In contrast, it is LG&E's understanding that few if any MISO states, and certainly not the Organization of MISO States, have actively participated in the stakeholder Demand Response Task Force facilitated by the MISO. That Task Force developed the DRR definition. It is not clear whether any MISO state will voice objection, or are even aware of the issue.

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39 16 U.S.C. § 824j (2000).

40 *PJM Interconnection, L.L.C.*, 99 FERC ¶ 61,227 at 61,947 (2002).

LG&E recommends that the DRR definition set forth in EMT Module A, Sec. 1.66 should be modified as follows:

> Demand Response Resource - An LSE located within the Transmission Provider Region whose withdrawals are monitored by the Transmission Provider and who is both capable of following Dispatch Instructions in the Real-Time and permitted to participate in Transmission Provider-administered markets under the laws and regulations of the State in which the monitored withdrawals occur.

Also, given the definition of "LSE" in Section 1.171 of Module A, loads in retail access states who procure their own end use energy requirements should be considered LSEs. The modification to the DRR definition proffered above would permit such loads to directly participate in the MISO energy markets, and would facilitate indirect participation of loads in non-retail access states participating through their LSEs (in accordance with applicable law and regulations).

Accordingly, LG&E recommends that the Commission reject this section of the EMT filing or, at minimum, condition approval of the EMT on adoption of the DRR definition set forth above.

7. Market Clearing Procedures.

In EMT sections 39.2.10 and 39.2.11, the MISO sets forth the steps it will use in clearing the Day-Ahead market under shortage and surplus conditions. According to Section 39.2.10, the MISO will first employ the high emergency range of all on-line generation and DRRs to clear a Day-Ahead market that is short on supply. Next, the MISO will employ off-line generation and DRRs designated as available for Maximum Generation Emergency. If both of these steps fail to clear the Day-Ahead market, the MISO will reduce all bids, which allegedly would include load provided as part of a Day-

Ahead bilateral schedule. This section virtually ensures that entities seeking to self-schedule all of their own load and resources will effectively be drawn into the Day 2 market.

Similarly, in Day-Ahead Market surplus supply conditions, the MISO proposes, in Section 39.2.11, to first cut Dispatchable External Bilateral Transaction Schedules to zero. Next, the MISO will employ the low emergency range of all on-line generation. If these two steps fail, the MISO will reduce supply, including, LG&E has been informed, supply included as part of a Day-Ahead bilateral schedule submitted to avoid market participation. Here again, load that is scheduled in the Day-Ahead market in order to avoid the market will now end up in the market on a mandatory rather than voluntary basis.

In both surplus and shortage conditions, the financial implications of the MISO's approach are less troubling than the fact that a balanced, bilaterally scheduled transaction designed to avoid market participation, *e.g.*, in order to avoid credit risk or perhaps to retain the retail nature of utility native generation, will be forced into market participation.

Maintaining generation capacity adequacy to meet forecasted load, regulation and contingency reserve requirements is central to an LSE's fulfillment of its obligation to serve. The MISO's proposal effectively creates a structure in which the MISO will likely direct generation owned by vertically integrated utilities to "serve" non-utility load and direct vertically integrated utilities' loads to be "served" by non-utility owned generation. This circumstance is inconsistent with obligations of state regulated electric utilities, such as LG&E, which have a state-imposed obligation to serve their own retail

customers. It is not clear to LG&E whether the arrangement proposed by the MISO will ultimately be found to be consistent with LG&E's obligation to serve its customers under state law. The only way LG&E can be assured that a transfer to the MISO of the state imposed obligation to serve is consistent with state law is if the transfer is accomplished at the behest of the Commonwealth of Kentucky. Approval for such a transfer has not happened here.

In sum, LG&E believes the MISO should exempt balanced, bilaterally scheduled transactions from the Day-Ahead surplus and shortage clearing methodologies. This will ensure that the market is voluntary and that companies like LG&E have the option to forego entirely their participation in the MISO's energy markets. If the Commission does not condition the tariff on a provision providing for such option, the Commission should reject this section of the tariff.

D. THE EMT CHANGES STATE-FEDERAL JURISDICTION WITHOUT ADEQUATE SUPPORT, AND PROMULGATES REQUIREMENTS WHICH ARE INCONSISTENT WITH FPA SECTION 201(B).

The EMT changes current state-federal jurisdictional responsibilities because it does not fully accommodate integrated utilities' ability to continue to serve their native loads directly. Utilities must become "Market Participants" under the EMT by "scheduling" generation into the MISO "pool" even if such utilities use their generation resources solely to self-serve their native loads. In addition, the EMT would expand this Commission's jurisdiction over retail sales of electric energy to bundled load by making these sales subject to the EMT, which would be a tariff accepted by and subject to the jurisdiction of this Commission. Under the EMT, certain retail sales of electric energy, *i.e.*, from LG&E generation facilities for delivery to LG&E's native load, will henceforth

be required to be scheduled in the MISO-administered wholesale energy markets. Also, the MISO's Day 2 tariff essentially mandates at least some participation by LSEs such as LG&E in the MISO power pool, effectively requiring that a portion (and potentially the entirety) of current retail sales be converted into FERC-jurisdictional wholesale transactions between: (1) LG&E's generation and other MISO loads; and/or (2) non-LG&E generation and LG&E's retail load.

The EMT thus changes the structure of various components of an integrated utility's supply chain, shifting the current jurisdictional divide between state and federal jurisdiction.[41] LG&E submits that such a major change in jurisdictional "business as usual" must be supported by substantial evidence.[42] Here, no such evidence has been tendered, either with respect to LG&E and its ratepayers or in general. Accordingly, LG&E submits that this drastic change in the jurisdictional divide must be conditioned upon an opt-out arrangement in which traditional jurisdictional responsibilities may be preserved (particularly for entities such as LG&E for whom Day 2 costs appear strongly to outweigh Day 2 projected benefits).

Furthermore, LG&E asserts that the provisions of the EMT noted herein will violate FPA Section 201(b)(1) unless the state in question affirmatively cedes jurisdiction to the Commission. There has been no such state determination in this case. In *New*

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[41] The FPA reserves to the states exclusive jurisdiction over a regulated utility's generation facilities and the utility's retail sales to native load. Under the FPA, "Congress meant to draw a bright line easily ascertained, between state and federal jurisdiction," and "denied state power to regulate a sale 'at wholesale to local distributing companies' and allowed state regulation of a sale at 'local retail rates to ultimate consumers.'" *FPC v. Southern California Edison Co.*, 376 U.S. 205, 214-15 (1964).

[42] *See, e.g., Pub. Serv. Comm'n of the State of New York v. FERC*, 813 F.2d 448, 451 (1987).

York v. FERC,[43] the Supreme Court let stand the Commission's decision in Order No. 888 to continue permitting the states to regulate the transmission component of bundled retail sales, notwithstanding the plain language of the FPA granting jurisdiction over transmission to this Commission.[44] Similarly, LG&E believes that a reviewing court would find that an affirmative state decision ceding authority reserved to such a state under Section 201(b)(1) would likely be consistent with the FPA. However, because there is no such state determination in this case, the Commission risks a reversal of any decision accepting the EMT. An opt-out provision, as discussed herein, would ensure that the EMT does not violate the FPA because affected public utilities could refrain from participating in the Day 2 market in cases where their state commission has not accepted the change in jurisdiction proposed by the EMT.

One of the most troubling jurisdictional issues raised by the EMT relates to the fact that state regulated entities may be subject to conflicting state and federal resource adequacy requirements. For instance, EMT Module E appears to provide that the MISO (not the state) will be the final arbiter as to how state or RRO resource adequacy requirements are interpreted, and whether state or RRO resource adequacy requirements are being met. In addition, and as discussed at greater length above, EMT Section 69.2 of Module E provides that an integrated utility's Network Resources must either be scheduled or offered into the MISO Day-Ahead energy market and RAC capacity market. EMT Section 70 requires that retail interruptible loads, which are deemed as satisfying

[43] 535 U.S. 1 (2002).

[44] *Id.* at 25-27.

state or RRO resource adequacy criteria by the MISO, may be committed and dispatched by the MISO, not the LSE.

In addition, EMT Section 38.2 provides for broad MISO authority over the operation and control of electric generation facilities. In particular, under EMT Section 38.2.5.ii generation-owning Market Participants must operate "in a manner consistent with the standards, requirements or directions of" the MISO.

The MISO also proposes that before any existing generating facility may be retired, the owner must first seek and obtain MISO approval.[45] The MISO will review the proposed facility retirement to determine if it is needed to maintain system reliability. It is easy to foresee a situation in which a vertically integrated utility desiring to retire a plant has concluded that there are no adverse impacts on the capability of the system to serve that utility's customers, but the MISO potentially reaches an opposite conclusion when evaluating the plant's retirement impact. Given the MISO's fiduciary duty to maximize transmission owner revenue, the MISO's criteria will likely entail whether the unit is necessary to support the transmission system's ability to support third party wholesale transactions.[46]

LG&E believes that the EMT provisions discussed above conflict with state resource adequacy directives. Specifically, the MISO's resource adequacy provisions violate FPA Section 201(b), which provides that the Commission lacks jurisdiction over

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[45] EMT, § 38.2.7.

[46] Because the MISO, under Section 38.2.7.h of the EMT, is assigning the costs of compensating the SSR unit owner to "Market Participants serving Load that benefits from the operation of the SSR Unit," LG&E believes the determination of SSR unit compensation set forth in Section 38.2.7.g is woefully inadequate. This "cost" determination by the MISO should be an open process akin to a cost-based ratemaking proceeding open to intervention from those who will ultimately be paying the costs.

facilities used for the generation of electric energy. By accepting a tariff that includes resource adequacy provisions, this Commission will be exercising jurisdiction "over facilities used for the generation of electric energy," an area reserved to the states. Although it is likely that reviewing court would find that the Commission may exercise such jurisdiction where a state has ceded authority to the Commission, there has been no such state action here.

Accordingly, LG&E believes the Commission should reject the resource adequacy sections of the EMT to ensure that the terms and conditions provided for therein are consistent with the FPA. Alternatively, at minimum, the Commission should include an opt-out provision that permits entities such as LG&E to opt-out of the resource adequacy requirements.

The Commission's April 28, 2003 SMD White Paper acknowledged that resource adequacy remains within the province of the states:

> 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.[47]

Aware of these facts, on January 6, 2004 the MISO stakeholder Markets Subcommittee voted by over a two to one margin to approve the motion set out below:

> MISO Stakeholders do not support the Resource Adequacy Proposal presented by MISO Staff at the Market Subcommittee meetings of November 20, 2003, December 3, 2003, and December 18, 2003. As a result, the Market Subcommittee will reactivate the Supply Adequacy Working Group (SAWG) for the purpose of recommending

[47] *SMD White Paper* at 5.

> a more appropriate solution for inclusion in MISO's March 31, 2004 Energy Markets Tariff filing. The SAWG will work together with the Organization of MISO States to develop a solution. In the event the SAWG cannot provide a recommendation for inclusion in MISO's upcoming tariff filing, the SAWG will provide a definitive work plan for developing a solution and this work plan will be included in MISO's tariff filing.

The Resource Adequacy Proposal presented by the MISO staff at the MISO Market Subcommittee meetings of November 20, 2003, December 3, 2003, and December 18, 2003 set forth most if not all of the controversial provisions LG&E now cites in this filing.

In addition to the legal infirmities (discussed in greater detail below), the EMT's provisions regarding resource adequacy are not just and reasonable from either a market or operational perspective. LG&E believes that a two-pronged market and operating approach is called for with respect to maintaining resource adequacy within the MISO footprint. LG&E's proposal as set out herein demonstrates that the Day 2 market may be structured to accommodate LSEs such as LG&E which are subject to state law obligations to serve.

First, the energy offer cap should be set at $5,000/MWH, as the MISO proposed in its initial EMT filing. Second, whenever the MISO experiences a generation deficiency within its Reliability Area, the MISO Reliability Authority should have in place procedures that allow an LSE to demonstrate, within a set time frame[48] and with

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[48] Section 40.2.15 of the MISO Day 2 EMT provides that MISO will issue a "Maximum Generation Emergency" warning whenever demand within MISO cannot be satisfied with all available offers. Following the warning MISO will proceed through a four-step process to address the emergency, Step 4 being load-shedding. Section 40.2.17 states that MISO will endeavor to provide at least 60 minutes during a "Maximum Generation Emergency" before MISO begins purchasing "Emergency Energy." LG&E/KU

(*continued*)

reference to a predefined standard of proof, that the LSE is, in fact, resource adequate. Any subsequent load shedding would then be limited only to those Control Areas with load served by LSEs that fail to timely demonstrate real-time supply adequacy.

LG&E believes this two-pronged approach would properly incentivize LSEs (and the states that regulate them) to maintain resource adequacy in order to avoid exposure to high energy prices, and to avoid being the subject of targeted load shedding. At present, where retail access and non-retail access states coexist, in LG&E's view, there is no incentive for retail access states to ensure that retail electricity providers maintain an appropriate amount of operating and planning reserves. In the EMT, the incentives are in fact just the opposite, and a $1,000 MWH energy bid cap will exacerbate these perverse incentives. The two-pronged approach that LG&E advocates provides incentives in a non-intrusive manner and promises to eliminate the jurisdictional disputes generated by other proposals presented to date.

LG&E recognizes and discusses in turn below three concerns parties have raised in the past regarding proposals similar to the two-pronged approach LG&E sets forth herein.

a. Seams.

Any "seams" issues related to differing energy bid caps within the MISO and PJM are self-manageable. To the extent PJM generators are required to offer capacity into the PJM markets, any seam created by the different bid caps within the MISO and PJM is addressed by the recallable nature of energy being offered into the MISO by a

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maintain that it is practical to provide a method for LSEs to demonstrate real-time supply adequacy during the time period implied by Sections 40.2.15 and 40.2.17.

PJM capacity resource. Alternatively, to the extent PJM generators are not required to offer capacity into PJM, PJM capacity prices will necessarily increase as generation otherwise destined for PJM is diverted to the MISO. Higher capacity prices will, in turn, make PJM capacity markets attractive to generation in both the MISO and PJM.

b. Netting.

In its order accepting withdrawal of the MISO's July 2003 proposed EMT,[49] the Commission stated that implementation of a long-term resource adequacy program is a necessary prerequisite to allowing the netting of short-term capacity costs, *e.g.*, start-up/commitment costs, against the revenues a committed generator receives from contemporaneous sales into the energy markets. LG&E believes that the two-pronged operational and market approach to resource adequacy discussed above constitutes an effective long-term resource adequacy program that would accommodate the needs of both the retail access and non-retail access states within the MISO footprint. LG&E notes that while the $5,000/MWH bid cap featured prominently in the July 2003 MISO EMT, the targeted load shedding called for by LG&E did not. Taken in combination, these two market and operating design elements provide the missing long-term resource adequacy program deemed necessary by this Commission.

LG&E believes that the MISO's proposed recovery of short-term capacity costs raises more than just "netting issues" – indeed, the fundamental issue is who bears these costs, however calculated. LG&E has no objection to allowing for separate payment of such costs, provided that LSEs are afforded the opportunity to avoid these costs by self-providing generation and self-following load.

c. Load Shedding Implementation.

LG&E submits that each LSE should bear the burden of demonstrating real-time supply adequacy, and a failure to do so within the predefined time period should subject that LSE's entire control area(s) to MISO-directed *pro rata* load curtailments. The MISO stakeholder Load Shedding Task Force is currently evaluating various methods by which an LSE can demonstrate real-time supply adequacy. Adoption of this approach would allow each state to establish the penalties applicable when load is so shed.

Accordingly, for the reasons set out above, the Commission should reject the EMT or condition any approval on inclusion of resource adequacy provisions like that proposed herein that recognize and accommodate existing, and in most instances, longstanding and successful state resource adequacy initiatives. LG&E's proposal is one example of how a Day 2 tariff can be structured so as to accommodate the circumstances of state regulated LSEs such as LG&E.

VI. CONCLUSION.

For the foregoing reasons and as specified above, LG&E requests that the Commission summarily reject the EMT because the filing contains a number of key provisions which are unjust and unreasonable, are flawed from a policy perspective, and/or violate Section 201(b)(1) of the FPA. In the alternative, the Commission should condition its approval of the EMT to ensure that entities, such as LG&E, which seek to continue to self-serve native load pursuant to state-imposed obligations to serve, may voluntarily opt-out of the portions of the EMT. Specifically, if the Commission decides not to reject the EMT in its entirety, the Commission should condition acceptance of the

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[49] *Midwest Ind. Transmission System Op., Inc.*, 105 FERC ¶ 61,145 (2004).

tariff on flexible "opt-in/opt-out" provisions which will ensure that key aspects of the Day 2 markets are voluntary.

Respectfully submitted,

/s/

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated in Washington D.C., this 7th day of May, 2004.

/s/

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Amie V. Colby