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PUBLIC SERVICE
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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matters of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ADJUSTMENT OF BASE RATES	)	Case No. 2009-00548

-and-

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ADJUSTMENT OF ELECTRIC AND GAS BASE RATES	)	Case No. 2009-00549

ATTORNEY GENERAL'S POST-HEARING BRIEF

PUBLIC REDACTED VERSION

Comes now the intervenor, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention, and files the following Post-Hearing Brief in the above-styled matters.

I. INTRODUCTION

Kentucky Utilities Co. ("KU") and Louisville Gas & Electric Company ("LGE")[hereinafter jointly referred to as "the Companies" or "EON Companies"] filed their applications for increases in their respective electric and gas base rates on January 29, 2010. The companies' applications used historic test years for both electric and gas operations ending October 31, 2009. The companies' applications stated that the proposed increases in rates were required due in part to increases in maintenance and operations costs, among other factors.[1]

The companies requested increases to their base electric rates of approximately $94.6 mil., or 12.1% per year in the case of LG&E, and approximately $135 mil., or 11.5% in the case

of KU. LG&E also sought an increase in its base gas rates of approximately $22.6 mil., or 7.7% per year.[2]

The intervenors, with the exception of the Attorney General, entered into a partial proposed stipulation, filed of record, which among other things calls for KU to be allowed to increase its revenue requirements by $98 mil., and for LG&E to increase its electric operations by $74 mil., and its gas operations by $17 mil.

On June 8, 2010, a hearing was conducted in both cases in which the Attorney General advised that he would not oppose the rate design agreed upon in the partial stipulation. The companies made their witnesses Staffieri, Rives, Charnas and Avera available for cross-examination, and the Attorney General presented his witness Dr. J. Randall Woolridge for cross-examination.

II. ATTORNEY GENERAL'S PROPOSED ADJUSTMENTS FOR CONSOLIDATED TAXES AND SET-OFF AGAINST REGULATORY LIABILITY SHOULD BE GRANTED

The Attorney General has identified two pools of cash that Kentucky ratepayers have provided to the E.ON Companies, which the companies are not using for their intended purposes. First, ratepayers have provided $588.3 million (KU-$329.4; LGE-$258.9)[3] for plant removal costs that the E.ON Companies have not spent on removal costs. The E.ON Companies still have that money. Second, ratepayers have been paying, and the E.ON Companies propose to continue charging for Federal Income Taxes that they do not pay. Instead they transfer the

[1] *See, e.g.*, LG&E Application, Tab 1.
[2] *See* LG&E Application, Page 3.
[3] Responses to KU No. AG-171, LG&E No. AG-171.

money to their unregulated affiliates that are incurring operating losses. The present value of these excess collections is $450 million.[4]

Now, E.ON (AG) has executed an agreement through which EON (U.S.)(parent corporation of KU and LG&E) will be sold to PPL Corp. ["PPL"].[5] PPL will pay the E.ON Companies a premium allowing the E.ON Companies to keep the removal cost and tax money. PPL will retain the cost of removal money and tax money on its new affiliate's books, but it will be available for general consolidated corporate purposes. All of this will be collected from Kentucky ratepayers, and potentially flow out of the state, even though Kentucky has one of the highest unemployment rates in the country.

Recognizing these two sources of free cash flow from ratepayers, Attorney General witness, Michael J. Majoros proposed two adjustments that would mitigate the need to increase service rates. First, Mr. Majoros recognizes the ratepayers' responsibility for several regulatory assets claimed by the Companies. He merely proposes to offset the Companies' requested amortizations of the regulatory assets against their regulatory liabilities for unincurred cost of removal. Second, Mr. Majoros proposed a sharing of the Companies' collections from ratepayers for taxes that the parent transfers to its loss affiliates.

When these adjustments are considered independent of the transfer of control, the Attorney General believes that the Commission would be correct to adopt Mr. Majoros' adjustments. However, if the transfer of control receives full approval, and these adjustments are not accepted, Kentucky ratepayers will have funded an impressive windfall for the two companies while seeing no benefit in return. The Attorney General therefore asks that the

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[4] AG Hearing Exhibit___(R6)

[5] The Joint Applicants' notice of intent for transfer of control was filed on May 20, 2010 under Case No, 2010-00204, and is currently pending before the Commission.

Consolidated Tax Adjustment and Cost of Removal Adjustment be accepted, both because they are supported by the preponderance of evidence, and because equity demands it.

A. Consolidated Tax Adjustment

The cross examination of company witness Rives revealed that the stand-alone approach results in a subsidy from ratepayers to the Loss Affiliates, and that the AG's proposal for a Consolidated Tax Adjustment ("CTA") is only proposing to reduce the subsidy to a reasonable level.

AG Hearing Exhibit R_1 , which consists of the Companies' responses to PSC 1-40 (KU) and PSC 1-12 (LG&E), indicates that the two companies have a combined total of $108.3 million in unadjusted income tax expense, which Mr. Rives acknowledged will be charged to ratepayers.[6] While the company will in fact be charging its customers for these tax items, nonetheless as demonstrated in CONFIDENTIAL AG Hearing Exhibit R_2 (copies of the front pages of KU and LG&E's {BEGIN CONFIDENTIAL} [redacted] {END CONFIDENTIAL}.

Mr. Rives' pre-filed rebuttal testimony indicates that the companies' holding company files consolidated federal and state income tax returns.[7] In preparing the consolidated returns, the companies allocate income tax liability among all subsidiaries, both regulated and unregulated.[8] If an entity were to incur a tax loss, the stand alone method would allocate a negative tax liability to that entity.[9] The parent company makes cash transfers to the subsidiaries (if needed) when the

[6] V.R. at 1:32:16; 1:34:38.
[7] Rives Rebuttal Testimony, Ex. 1, p. 4 (identical for both cases).
[8] V.R. beginning at 1:54:20.
[9] V.R. at 1:54:00.

parent files the consolidated tax return.[10] The companies' Amended and Restated Tax Allocation Agreement ("TAA") continues in force today.[11]

Mr. Rives was shown a Consolidated Tax Flow Chart entered into the record as AG Hearing Exhibit R_4,[12] which he agreed accurately depicted the flow of cash described in the Companies' TAA (although he stated that the amounts depicted in the boxes are not necessarily the same amounts going into other boxes).[13] Under the companies' existing policies, all of the consolidated tax benefits flow to the loss affiliates.[14] He agreed that under the AG's proposal, cash would still flow to the loss affiliate, but less cash than under the company proposal.[15]

Mr. Rives agreed in his rebuttal testimony, p. 14, that the PSC previously required a CTA in a KWA rate case,[16] and on that same page described special circumstances the PSC considered in making that decision. AG Hearing Exhibit R_5 is a press release from PPL which describes $450 mil. in tax benefits PPL will receive from the proposed transaction. Mr. Rives did not think the proposed transaction would constitute such special circumstances as would warrant making the CTA the AG proposes.[17] Even if the proposed purchase does not receive approval, the tax benefits identified in that exhibit will remain with the EON Companies on a carry-forward basis.[18]

As noted above, the Commission in Case No. 2004-00103 did in fact order a consolidated tax adjustment proposed by the Attorney General, finding:

> "Having previously indicated the savings resulting from the filing of a consolidated tax filing would be viewed as a merger benefit, subject to

[10] V.R. at 1:56:00.
[11] V.R. at 1:59:10.
[12] V.R. beginning at 2:02:15.
[13] V.R. beginning at 2:02:59.
[14] V.R. at 2:04:07.
[15] V.R. at 2:04:58.
[16] In re: *Adjustment of Rates of Kentucky-American Water Co.*, Case No. 2004-00103, Order dated Feb. 28, 2005.
[17] V.R. beginning at 2:09:40.
[18] V.R. beginning at 2:25:00.

> allocation, we do not believe that acceptance of the AG's proposal represents a radical departure from past regulatory practice."[19]

As indicated at the hearing in this matter, and in particular in Attorney General Hearing Exhibit R_6, PPL and the EON Companies have widely touted the tax benefits that will flow from the proposed change of control from EON to PPL. Mr. Rives acknowledged that one of the reasons the Commission allowed the CTA in the KAW case was because there was going to be a tax benefit to the companies.[20] Regardless of whether the proposed transfer of control is approved, tax benefits will inure to either PPL or the EON Companies, and some may be used on a carry-forward basis, which would increase their value beyond their present value of $450 million as stated in Exhibit R_6. But for the tax adjustment proposed by Attorney General expert witness Majoros, massive tax benefits would be transferred from Kentucky ratepayers to either Pennsylvania or Europe, depending on whether the transfer of control petition is approved. As such, a consolidated tax adjustment in the instant cases is just as appropriate as it was in the KAW case when that utility was undergoing a transfer of control.

B. Attorney General's Proposed Adjustment For Set-Off Against Regulatory Liability

Company witness Charnas agreed that SFAS-71 constitutes GAAP.[21] Although she did not agree that SFAS-71 reconciled GAAP with regulatory accounting, she believes it allows utilities to conduct accounting functions in accordance with rules and guidelines set by their governing utility commission.[22] She agreed that under SFAS-71, GAAP considers a regulatory

[19] Case No. 2004-00103, *supra*, Order dated Feb. 28, 2005, p. 30.
[20] V.R. beginning at 2:48:34.
[21] V.R. at 3:07:25; 3:07:56.
[22] V.R. beginning at 3:08:00.

liability a financial obligation to customers if monies collected for a specific purpose are not spent for that purpose.[23]

Ms. Charnas affirmed that documents attached to the companies' responses to AG 1-171[24] in both cases were in fact excerpts from the companies' respective financial accounting statements.[25] Those statements were prepared in conformance with GAAP.[26] She also agreed that SFAS-143 required the companies to report costs for legal costs of removal.[27] In AG Hearing Exhibit C_3,[28] the companies acknowledged that implementation of this accounting standard produced regulatory assets and regulatory liabilities for GAAP purposes.

Indeed, the existence and amount of this regulatory liability is well-documented throughout the companies' own records, which are now part of the record in the instant proceedings. In the documents attached to AG Hearing Exhibit C_2, the companies acknowledge that KU's regulatory liability for accumulated cost of removal of utility plant totals $329 mil. as of the end of 2008, and that same liability for LG&E totals $251 mil.[29] The companies' financial statements indicate that these sums were previously in accumulated depreciation. Ms. Charnas did not refute either the existence of the liabilities, or the amounts thereof.[30]

Ms. Charnas acknowledged that each year, the companies collect money for future cost of removal from ratepayers through depreciation expense,[31] and that over time they have

[23] V.R. beginning at 3:09:44.
[24]Relevant portions of those responses were attached to AG Hearing Exhibit C_2.
[25] V.R. at 3:12:18.
[26] V.R. at 3:12:38.
[27] V.R. beginning at 3:12:51.
[28] Letter from Mr. Kent Blake to the then-Executive Director of the Kentucky Public Service Commission, which the company provided in response to AG 1-164 (d).
[29] KU Financial Statement, p. 35, and LG&E Financial Statement p. 37, both of which were attached in response to AG 1-171; *see also* V.R. beginning at 3:15:00.
[30] V.R. at 3:19.
[31] V.R. at 3:19:52.

collected more money than has been spent,[32] although she could not be certain whether that has happened every year. The process by which the companies collect these sums from the ratepayers and retain the excess amounts not spent on cost of removal is depicted in the attached AG Brief Exhibit_1. It should also be noted that Ms. Charnas acknowledged in her testimony that although she does not know exactly where these excess sums are spent, they are indeed spent in the company's overall business operations and are not segregated.[33] Attorney General Brief Exhibit_2 compiles company-provided data in summary format to reveal the amount of funds that the companies have collected but not spent on cost of removal.

Furthermore, the company has submitted responses to data requests indicating that the trend of over-collecting for cost of removal will continue for at least the next ten (10) years. Attorney General Hearing Exhibit C_6, consisting of company responses to AG 1-172, shows that between 2009-2019, KU will collect an additional $116 mil. over and above what it actually spends for cost of removal, and that LG&E forecasts a similar over-collection of $101 mil. Therefore, by 2019 KU will have collected a total of $450 mil. in excess of what it spends for cost of removal, and LG&E by that year will have collected a total of $363 mil. in excess of the amount it will actually spend for cost of removal. These sums are depicted on Attorney General Hearting Exhibits C_7 and C_8, both of which were admitted into the record. Ms. Charnas did not refute these figures, saying only that "a lot can happen in ten years."[34]

Apparently the companies will not commit to cease this over collection, and are thus reserving the right to over-collect even more sums. However, the Commission has previously ruled that expenses, even those having a minimal effect on operating income, must be borne by shareholders unless such expenses are proven to be beneficial to ratepayers in furnishing utility

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[32] V.R. at 3:20:19 through 3:21:00.
[33] V.R. at 3:25:30.

service.[35] Since the company has been over-collecting for this purpose for a number of years, and will continue to so over-collect into the foreseeable future, the Commission should order the adjustment the Attorney General proposes regarding this regulatory liability, and should also examine the reasonableness of both companies' depreciation rates with heightened scrutiny when they next come up for review. In each new filing of depreciation rates, the burden rests with the company to prove those rates to be reasonable and appropriate. The evidence presented at the hearing of these matters clearly establishes a fundamental inequity in those rates.

Ms. Charnas testified that although in her opinion GAAP requires cost of removal funds to be used solely for removal of capital assets,[36] upon questioning she could not identify a specific aspect of GAAP that carries this requirement. However, Ms. Charnas had previously read into the record[37] a paragraph from AG Hearing Exhibit C_1, which is SFAS-71, p. 7, § 11 (b), which provides in pertinent part:

> ". . . If current rates are intended to recover such costs [those that are expected to be incurred in the future] and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred."

Finally, Ms. Charnas committed that as long as the companies are under EON's control, they will commit to using those funds solely for retirement of capital assets.[38] However, she frankly acknowledged that she has no authority to bind PPL to that same commitment.[39]

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[34] V.R. at 3:44:44.

[35] *In Re: Adjustment of Rates of Kentucky-American Water Co.*, Case No. 9482, Order entered July 8, 1986, as reduced by Order on Rehearing entered Oct. 15, 1986, p. 22; *see also, In Re: Adjustment of Rates of Columbia Gas of Kentucky, Inc.*, Case No. 10498, Order entered Oct. 6, 1989, p. 30.

[36] V.R. beginning at 3:49:40.

[37] V.R. 3:08:50.

[38] V.R. beginning at 3:49:35; 3:51:00; 3:55:21.

[39] V.R. beginning at 3:55:48.

If the situation were the opposite – that the company had been under-collecting for removal of capital assets, the company surely would quickly take all appropriate measures to insure it was collecting sufficient funds for this purpose. As a matter of symmetry, the company should under the current facts take all appropriate measures to return the excess funds it has been collecting for that purpose to the ratepayers. The adjustment proposed by Attorney General Witness Majoros takes that symmetry into consideration by recognizing the regulatory assets the Commission has established, while also recognizing the significant regulatory liability which the Companies to date have failed to address in any meaningful manner. Attorney General Brief Exhibit_3 summarizes Mr. Majoros' adjustment, and is based on the companies' responses to data requests, and upon Mr. Majoros' testimony.

III. ATTORNEY GENERAL'S PROPOSED RETURN ON EQUITY SHOULD BE GRANTED

Company witness Dr. William E. Avera proposes[40] that KU and LG&E be allowed to earn an 11.5% return on equity[41] in both cases based upon the companies' common equity ratio of 53.86%.[42]

The cross examination Dr. Avera at the June 8th hearing was brief. However, Dr.Avera did testify that the companies' cost of debt was actually lower[43] since the companies are issuing asset-backed debt going forward.[44] This would seem to indicate the "mirror image" to the situation proposed by staff in their cross examination of Dr. J. Randall Woolridge, the Attorney

[40] As the Testimony of Dr. Avera is substantially similar in both cases, the Attorney General will cite solely to his LG&E testimony.
[41] See LG&E Testimony of Dr. William E. Avera, Page 5, line 5.
[42] See LG&E Testimony of Dr. William E. Avera, Page 6, line 7.
[43] June 8th Hearing Video, 5:15:29 pm.
[44] June 8th Hearing Video, 5:15:15 pm.

General's witness, such that the lower capital costs noted by Dr. Avera would mean the companies will need less revenue going forward.

In direct testimony in both the KU and LG&E cases,[45] Dr. J. Randall Woolridge recommended that the companies earn a return on equity of 9.5% on their electric operations[46] and 9.0% on LG&E's gas operations.[47] Dr. Woolridge's recommendation presumes that the Commission will not adopt LG&E's proposed Straight-Fixed Variable ("SFV") rate design proposal.[48] However, if the rate design proposal concerning SFV were to be adopted, Dr. Woolridge recommends that the Commission consider making a downward equity cost rate adjustment to reflect the risk reduction attributes of rate design.[49]

Concerning the companies' common equity ratio, Dr. Woolridge testified that he utilized the debt cost rate of 4.61%[50] as developed by the companies' witness, Mr. S. Bradford Rives.[51]

Dr. Woolridge's pre-filed testimony summarizes the capital structures of his proxy group Companies' in Panels B and C of Exhibit JRW-5 over the past four quarters.[52] The results of his analysis indicated that the average common equity ratios over the past year are 42.63% for the Electric Proxy Group and 49.43% for the Gas Proxy Group[53] and that the Company's capital structure ratios, which include a common equity ratio of 53.86%, have more common equity and less financial risk than the capitalizations of electric utility and gas distribution companies.[54] Therefore, he recommends a downward adjustment in the common equity ratios to make the

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[45] As the Testimony of Dr. Woolridge is substantially similar in both cases, the Attorney General will cite solely to his LG&E testimony.
[46] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, line 23.
[47] See LG&E Testimony of Dr. J. Randall Woolridge, Page 3, line 1.
[48] See LG&E Testimony of Dr. J. Randall Woolridge, Page 3, lines 2-4.
[49] See LG&E Testimony of Dr. J. Randall Woolridge, Page 3, lines 4-6.
[50] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, line 20.
[51] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, lines 10.
[52] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, lines 1-2.
[53] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, lines 3-4.
[54] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, lines 4-7.

capital structure more in line with those of typical electric and gas utilities.[55]

Dr. Woolridge recommended a 50% debt and 50% equity capital structure for both the gas and electric operations of the companies[56] and testified that this represented a balance between the Company's proposed capitalization and the capitalizations of the Electric and Gas Proxy Groups. He further stated that this capitalization is closer to the capitalizations of the electric and gas companies that he used to estimate an equity cost rate for both companies. Dr. Woolridge testified that he believed that this adjustment was fair since his analysis did not include short-term debt in the proposed capitalization despite the fact that the Company normally uses short-term debt financing.[57] Dr. Woolridge's recommended capital structure is summarized in Exhibit JRW-5, page 1, Panel D of his pre-filed testimony.

Dr. Woolridge testified that he estimated individual equity cost rates for the companies using the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") to a proxy group of publicly-held electric utility and gas distribution companies.[58] Dr. Woolridge testified that his analysis indicates an equity cost rate in the range of 7.8%-9.5% is appropriate for both the KU and LG&E electric utility operations and in the range of 7.6%-9.0% for LG&E's gas utility operations,[59] and that his recommendation is based on the upper end of those ranges because he gives primary weight to the DCF approach.[60] Using his recommended capital structure and debt and equity cost rates resulted in his recommendation of an overall rate of return of 7.06% for both the KU and LG&E electric utility operations[61] and 6.81% for

[55] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, lines 13-16.
[56] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, lines 11-12.
[57] See LG&E Testimony of Dr. J. Randall Woolridge, Page 14, lines 16-18.
[58] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, lines 16-20.
[59] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, lines 20-23.
[60] See LG&E Testimony of Dr. J. Randall Woolridge, Page 2, lines 23, Page 3, lines 1-2.
[61] See Testimony of Dr. J. Randall Woolridge, LG&E, Page 3, lines 7-10: KU, Page 3, line 2.

LG&E's gas distribution operations.[62] These findings are summarized in Exhibit JRW-1 of Dr. Woolridge's testimony.

The cross-examination of Dr. Woolridge at the June 8th hearing was brief and his recommendations concerning the appropriate rate of return and the capital structure for the companies were not disputed at the hearing. The Attorney General asserts that the recommendations of Dr. Woolridge should be adopted by the Commission with regard to return on equity and capital structure of the companies.

IV. CONCLUSION

The Attorney General has presented sufficient evidence to warrant the adjustments his expert witness Majoros proposed regarding consolidated income taxes and offsets against the massive regulatory liabilities the companies are carrying on their books with regard to cost of removal of capital assets. The consolidated tax adjustment is warranted and indeed necessary because the companies are going through a transfer of control, just as KAW did in Case No. 2004-00103, *supra*, in which the Commission ordered a consolidated tax adjustment. Ms. Charnas' testimony at the hearing only served to verify the data the companies provided in response to data requests, which clearly indicate both the existence of regulatory liabilities for removal costs of capital assets, the amounts thereof, and the fact that the companies will continue to over-collect funds from their ratepayers into the foreseeable future. As such, Mr. Majoros' adjustment that would return only a portion of those funds to the ratepayers should be granted.

Finally, Dr. Woolridge's rate of return recommendation has established that the Companies' proposals would produce excessive revenues, and as such, should not be adopted.

[62] See LG&E Testimony of Dr. J. Randall Woolridge, Page 3, lines 7-10.

Respectfully submitted,

JACK CONWAY
ATTORNEY GENERAL OF KENTUCKY

DENNIS G. HOWARD II
LAWRENCE W. COOK
PAUL D. ADAMS
ASSISTANT ATTORNEYS GENERAL
FRANKFORT KY 40601-8204
(502) 696-5453
FAX: (502) 573-8315

Certificate of Service and Filing

Counsel certifies that an original and ten photocopies of the foregoing were served and filed by hand delivery to Jeff Derouen, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; counsel further states that true and accurate copies of the foregoing were mailed via First Class U.S. Mail, postage pre-paid, to:

Lonnie E Bellar
E.ON U.S. LLC
220 West Main Street
Louisville, KY 40202

Honorable David C Brown, Esq.
Stites & Harbison, PLLC
1800 Providian Center
400 West Market Street
Louisville, KY 40202

Honorable Frank F Chuppe
Wyatt, Tarrant & Combs, LLP
500 West Jefferson Street, Suite 2800
Louisville, KY 40202-2898

Honorable Kendrick R Riggs
Stoll Keenon Ogden, PLLC
2000 PNC Plaza
500 W Jefferson Street
Louisville, KY 40202-2828

James T Selecky
BAI Consulting
16690 Swingley Ridge Road, Suite 140
Chesterfield, MO 63017

Iris G Skidmore
415 W. Main Street, Suite 2
Frankfort, KY 40601

Holly Rachel Smith
Hitt Business Center
3803 Rectortown Road
Marshall, VA 20115

Honorable Allyson K Sturgeon
E.ON U.S. LLC
220 West Main Street
Louisville, KY 40202

Honorable Gardner F Gillespie
Hogan & Hartson, L.L.P.
555 Thirteenth Street, N.W.
Washington, DC 20004-1109

Honorable Robert M Watt, III
STOLL KEENON OGDEN PLLC
300 West Vine Street; Suite 2100
Lexington, KY 40507-1801

Honorable Michael L Kurtz
Boehm, Kurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, OH 45202

Carroll M Redford III
Miller, Griffin & Marks, PSC
271 W Short Street, Suite 600
Lexington, KY 40507

M. Malone
Hurt, Crosbie & May PLLC
The Equus Building
127 West Main Street
Lexington, KY 40507

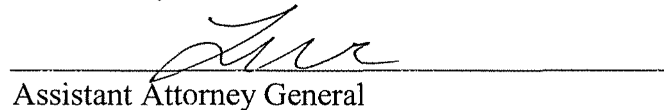
Tom Fitzgerald, Director
Kentucky Resources Council
PO Box 1070
Frankfort KY 40602

Steven A Edwards
Office of the Staff Judge Advocate
1320 Third Avenue, Room 215
Fort Knox, KY 40121-5000

Honorable Lisa Kilkelly
Legal Aid Society
416 West Muhammad Ali Boulevard, Suite 300
Louisville, KY 40202

Robert A Ganton, Esq.
U.S. Army Legal Services Agency
Regulatory Law Office
901 North Stuart Street, Suite 525
Arlington, VA 22203

this 29th day of June, 2010



Assistant Attorney General