Docket No. 02-0494
ICC Staff Exhibit 2.0
Redacted

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DIRECT TESTIMONY

OF

ERIC P. SCHLAF

Energy Division

Illinois Commerce Commission

Docket No. 04-0294

July 9, 2004

Q. Please state your name and business address.

A. My name is Eric P. Schlaf. My business address is 527 East Capitol Avenue, Springfield, Illinois, 62701.

Q. By whom are you employed and in what capacity?

A. I am employed as an Economist in the Energy Division of the Illinois Commerce Commission ("Commission"). My primary responsibility is to provide recommendations to the Commission about issues connected with the implementation of the “Electric Service Customer Choice and Rate Relief Law of 1997” (220 ILCS 5/16).

Q. Please state your educational background and professional experience.

A. I obtained a B.A. in 1982 from the University of Illinois at Champaign-Urbana. I received an M.A. in Economics in August 1984 and a Ph.D. in Economics in June 1991 from the University of Illinois at Chicago.

I joined the Commission in March 1990, serving in the Least-Cost Energy Program. In March 1992, I moved within the Commission to the Office of Policy and Planning. The Office of Policy and Planning was subsequently merged into the Energy Division. I have also taught numerous courses in economics and statistics at the University of Illinois at Chicago, Roosevelt University, and the University of Illinois at Springfield (formerly Sangamon State University).

Q. Have you testified previously before this Commission?

A. Yes. I have testified in approximately forty proceedings before the Illinois Commerce Commission, primarily on topics associated with the electric industry.

Q. What is the purpose of your direct testimony in this proceeding?

A. I am commenting on the Ameren Corporation ("Ameren") and Illinois Power Company ("Illinois Power" or "IP") (jointly, "Applicants") merger application, which was filed under Section 7-204 of the Public Utilities Act ("Act"). Specifically, I am addressing whether the Applicants have demonstrated that the merger would not have an adverse impact on retail competition in those markets over which the Commission has jurisdiction, as required by Section 7-204(b)(6) of the Act ("Criterion 6").

Q. Have you reviewed the Applicants' petition and direct testimony in this proceeding?

A. Yes.

Q. After reviewing this material, can you conclude that Criterion 6, as it relates to retail competition, has been met?

A. No.

Q. Please explain why you think the Applicant's petition does not meet Criterion 6 of the Act with respect to the merger's potential effect on retail competition.

A. The merger may result in two Dynegy affiliates, Dynegy Energy Services ("DES") and Illinois Power Energy, Inc., ("IPE") being forced to relinquish the Alternative Retail Electric Suppliers ("ARES") certificates they hold that permit them to provide power and energy service to retail customers. Since DES and IPE are successful retail suppliers, retail competition would suffer if these entities were to lose their ARES certificates. There would be substantial harm to the Illinois Power retail market where IPE currently operates as one of only two major suppliers, and a lesser amount of harm to the more vibrant Commonwealth Edison ("ComEd") retail market where DES is a relatively small market participant. As a result of the merger, the currently unaffiliated supplier in the IP market, Ameren Energy Marketing ("AEM"), will become an affiliated supplier. The net effect of the merger would be a move from a situation of two major suppliers, one of which is an affiliate, to a situation where there exists only one major active supplier and that supplier would be an affiliate. With little or no ARES competition, AEM would likely have little reason to compete against IP.

Q. Why might DES and IPE have to relinquish their ARES certificates if the merger is concluded?

A. It appears that DES and IPE will have difficulty in complying, or find it impossible to comply, with the "reciprocity requirements" of Illinois Administrative Code Part

451 (“Part 451”) and Section 16-115(d) of the Act. A Commission determination subsequent to the merger that the two ARES do not comply with reciprocity requirements would likely lead to a loss of their certificates.

Q. Please describe Part 451.

A. Part 451 sets out a list of requirements that prospective ARES must meet to obtain a certificate to sell electric power and energy to eligible retail customers in Illinois. Among these requirements is the requirement that every ARES comply with Section 16-115(d) of the Act. Part 451.730 also requires each existing ARES to certify annually that it continues to comply with Section 16-115(d)(5) of the Act.

Q. What is your understanding of Section 16-115 of the Act?

A. Section 16-115 is the section of the Act that lists the requirements that an applicant must meet in order to qualify for a certificate to sell electric power and energy to eligible retail customers. In particular, Section 16-115(d) of the Act requires the Commission to grant a certificate to an applicant if it determines that it can make certain findings based on the information presented by the applicant.

Q. What is your understanding of Section 16-115(d)(5) of the Act?

A. Section 16-115(d)(5) describes how an applicant can demonstrate that it meets the reciprocity standards.

Q. What is the basis of your belief that DES and IPE may fail to retain their ARES certificates if the merger is concluded?

A. Primarily, I believe that the two ARES could lose their certificates based on my understanding of the court's and the Commission's decisions in ARES application proceedings, including the 5th Circuit decision in Local Union Nos. 15, 51 & 702, International Brotherhood of Electrical Workers v. Illinois Commerce Comm'n, 331 Ill. App. 3d 607, 772 N.E.2d 340, 265 Ill. Dec. 302 (5th Dist. 2002) ("IBEW Decision"). After reviewing these decisions, I conclude that there is a strong likelihood that the Commission will ultimately find that the DES and IPE do not meet the reciprocity requirements.

Q. Has the Commission denied any ARES applications since the IBEW decision?

A. Yes. Lower Electric, LLC (Docket No. 04-0018) and Midwest Generation (Docket 02-0740)[1] were denied approval of their applications. Other companies have withdrawn their filed applications, presumably due to reciprocity concerns. These include: Power of Choice Holding Company (Docket No. 04-0188); Commonwealth Energy Corporation (d/b/a electricAmerica) (Docket No. 04-0060); and The Electricity Exchange (Docket No. 03-0321).

Q. Do you believe that other prospective applicants have declined to file due to reciprocity concerns?

A. Yes. It is typical for potential ARES interested in serving retail customers in Illinois to discuss the application and certification process with Staff prior to filing their applications. I have participated in some of these discussions. On more than one occasion, seemingly qualified potential applicants have declined to submit applications following a discussion of certification requirements.

Q. Do you have an understanding of the means by which an applicant or an existing ARES may meet the reciprocity standards?

A. Yes. An applicant will likely meet the requirements if it its corporate affiliates provide delivery services that are reasonably comparable to those offered by Illinois electric utilities in a geographic area to which Illinois electric utilities can economically and physically deliver power and energy. Thus, an applicant that has a corporate affiliate located in a state that has opened its retail markets to electric choice will stand a good chance of meeting the requirements. An applicant may also demonstrate that it has satisfied the reciprocity requirements if its "principal source of electricity" provides delivery services that are comparable and accessible to Illinois electric utilities. My understanding is that Section 16-115(d)(5) of the Act defines the term "principal source of electricity" to mean a single source that supplies at least 65% of the applicant's electric power and energy.

[1] Lower Electric, LLC, has appealed the Commission's denial of its application.

Q. After the sale of Illinois Power, will Dynegy be affiliated with any entity that offers delivery services that are reasonably comparable to those offered by Illinois electric utilities?

A. Not to my knowledge.

Q. Is it possible that Dynegy could demonstrate compliance with the reciprocity requirements by buying its power and energy from a principal source?

A. It is possible but unlikely that Dynegy would attempt to comply with the reciprocity requirements by relying on a principal source. The most obvious principal sources – i.e., the major Illinois electric utilities – no longer own generation, so Dynegy might have to use a non-Illinois supplier as its principal source. I am not sure that using a remotely located principal source is a viable business strategy.

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Illinois Power Energy

Q. Please discuss the IP retail market.

A. There is clearly interest in customer choice among Illinois Power's non-residential customers, particularly IP's largest customers.[2] As of May 31, 2004, 28 of the 226 eligible customers in IP's service territory (or 12.4% of eligible customers) with a demand greater than one megawatt have switched to a Retail Electric Supplier ("RES"). An additional 61 customers have switched to IP's offering of the Power Purchase Option ("PPO"), for an overall delivery services switching rate among IP's largest customers of about 40%. Together, the 89 large customers taking delivery services comprise about 47% of Illinois Power's non-residential load.

The switching rate among IP's smaller (less than one megawatt) customers has been considerably slower than the switching rate for the largest customers. About 1.5% of the smaller commercial and industrial customers have switched to a RES or to the PPO. The vast majority of the smaller customers that have

[2] No residential customers has switched to delivery services.

switched have moved to PPO service. Only 22 customers have switched to a RES, compared to the 928 that are taking PPO service.[3]

Q. How many retail suppliers are currently operating in the Illinois Power service territory?

A. Three suppliers are providing power and energy to retail customers in the IP service territory.[4] The two major suppliers are DES and Ameren Energy Marketing ("AEM"), an Ameren marketing affiliate. The other supplier ("RES A") currently has approximately x x x x x x x of the sales of DES and AEM.

Q. What factors are hindering the development of competition in the Illinois Power service territory?

A. A list of these factors hindering the development of competition in the Illinois Power service territory would include (1) the existence of transition charges; (2) operational issues and transmission business practices, particularly the energy imbalance provisions of IP's Open Access Transmission Tariffs ("OATT"); (3) retail tariffs requiring large customers to give one years' notice prior to leaving bundled service; and, (4) IP's ability, prior to its election of Integrated Distribution Company status, to sign customers to long-term, discounted rate contracts prior to the opening of the retail market.

[3] Monthly switching statistics are available on the Electricity page of the Commission's website at www.icc.state.il.us.

Q. What do you conclude about the development of competition in the Illinois Power service territory?

A. Retail competition is just beginning to gain a foothold in the IP market. A significant portion of IP's largest customers have indicated their interest in delivery services, so it appears possible that retail competition could begin to develop in the future should new unaffiliated suppliers appear to offer service to IP's customers.

Q. If IPE were to lose its certificate, would there be harm to the Illinois Power retail market?

A. Yes. Any backsliding due to the exit of any competitor would result in the loss of the momentum towards retail competition that has been slowly building over the past four and one-half years. Losing IPE as a competitor could be particularly damaging since the only major competitor left in the IP market would be an Ameren marketing affiliate. With only an Ameren affiliate serving the service area, few customers will be receiving offers until another active competitor appears.

Q. Would there be a negative effect on IPE's customers if it were to exit the market?

A. Losing IPE as a supplier would likely be detrimental to IPE's customers since they will have to arrange for new supply. Unless new competitors appear, and

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[4] Attachment 2.

begin to market aggressively, however, their supply choices may be limited to service from an Ameren company, either Illinois Power or the Ameren marketing affiliate. Each of these choices is likely to be inferior to service from an unaffiliated supplier.

<u>Mitigation Measures</u>

Q. If IPE were to lose its certificate, could the harm to the IP retail market be mitigated?

A. Yes, I believe it could. The key to mitigation is to encourage new, unaffiliated marketers to enter the market to replace IPE as quickly as possible and return the market to its former status.

Q. What would be necessary for the market to return to its former status following IPE's departure?

A. Simply to return the market to its former position would require that each of IPE's former customers receive service from new suppliers at rates, terms and conditions comparable to the rates, terms and conditions of their current contracts with IPE. Ideally, a marketer unaffiliated with the Ameren companies would absorb all of IPE's customers through a transfer or sale of IPE's retail contracts.

Q. What factors would a new supplier consider when deciding whether to enter the IP retail market?

A. Any new supplier considering a move into the IP market would likely consider such factors as (1) the possibility of obtaining a certificate, given the reciprocity requirements; (2) expected wholesale prices relative to existing bundled prices and prices subsequent to expiration of the rate freeze in 2007; (3) the availability of reasonably priced supply; and (4) whether the Midwest Independent System Operator's ("MISO's") tariffs would be more acceptable to retail suppliers than IP's current transmission tariffs.

Q. What is the significance of 2007 in this discussion?

A. First, IP will no longer be able to assess transition charges to customers after 2007. Removal of the transition charges may, by itself, significantly stimulate customer interest in delivery services. Second, customers presently taking PPO service may prefer RES service to the PPO-type service that IP apparently must offer after 2007.[5] Third, suppliers may have an opportunity to undercut IP's bundled prices if the wholesale market from which IP buys power for its bundled customers does not produce competitive prices. Fourth, most of the discounted rate contracts that IP signed with its customers should expire by 2007, so the largest customers may no longer be tied to IP.

Q. Would IP's entrance into the MISO encourage supplier entry?

A. It might. Once MISO begins operating day-ahead and real-time markets, suppliers operating in the IP market will be subject to MISO's tariffs. In particular, settlements will be based on Locational Marginal Price concepts, rather than on the settlement methods contained in IP's current OATT, which most suppliers apparently believe are not conducive to competitive retail operations. However, there is doubt as to when MISO will actually begin operation. The most recent estimate of the start-up date is March 1st, 2005, but the start-up date has been postponed more than once. Also, the Federal Energy Regulatory Commission has not yet approved MISO's tariffs, and matters of concern to suppliers have not yet been resolved. I do not expect that suppliers will consider entering the IP retail market until the current uncertainty concerning MISO's tariffs and policies is clarified.

Q. Would the separation of ownership of Dynegy's generating facilities from Illinois Power's transmission and distribution system tend to enhance retail competition?

A. It is possible that the merger could improve the prospects for wholesale competition in the downstate region and the Illinois Power region in particular by providing an independent competitor in the wholesale market. The existence of Dynegy's generation, unaffiliated with a utility, could provide some assurance to RESs that at least one supply source is available should transmission constraints prevent RESs from bringing power purchased from remote sources into the Illinois Power service area. However, it is not certain that any particular RES will

[5] Sections 16-110(c) and (d) of the Act.

be able to turn to Dynegy for reasonably priced power, as presumably IPE could do.

Q. Do you have an estimate of the amount of time it would take for at least one new supplier to enter the IP market under current conditions and replicate the success already achieved by IPE?

A. My best estimate for any new supplier to acquire the amount of load already served by IPE is sometime after 2007. After four and one-half years of delivery services, very few suppliers have even exhibited any interest in serving the IP market. With the exception of IP's pending entrance into the MISO and the small reductions in transition charges due to increases in the mitigation factor component of the transition charge,[6] very little will change in the IP market between mid-2004 and 2007 that might encourage new entry.

Q. Is it possible that RES A could replace IPE?

A. It is possible. However, I do not know whether RES A has the intention or interest to begin aggressively marketing in the IP service area, as it appears that it has only recently begun marketing in the IP market.[7] It is hard to predict whether an entity that currently has only a small amount of sales will expend the resources necessary to acquire enough new customers to duplicate the sales achieved by IPE.

[6] Section 16-102 of the Act.

Q. Do you have any recommendations for addressing the harm that could result from IPE's exit from the IP market?

A. Yes. I believe there are measures that could encourage new supplier entrance into the IP market. First, I recommend that IP construct new transmission, or upgrade existing transmission lines to permit power imports into IP's service territory equal to the amount of RES load lost when IPE exits the market. New transmission could enable retail suppliers to access remotely generated power rather than relying on the generation located in the IP service territory. Additionally, should no supplier emerge to serve IPE's customers and those customers return to bundled service, the new transmission would enable IP itself to obtain access to a wider set of generators than those generators now located in IP's service territory. Second, IP could reduce or eliminate transition charges until such time that each of IPE's customers obtain a new supplier at comparable rates, terms and conditions. Third, IP could conform its delivery service tariffs to those of the other Ameren companies, just as Central Illinois Light Company ("CILCO") was required to do after Ameren acquired it.[8]

Q. As a condition of Commission approval for the CILCO-Ameren merger (Docket No. 02-0428), AmerenCIPS offered market-priced power into the

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[7] I reach this conclusion by looking at the monthly statistics of the number of customers who have switched to RESs in the IP service area in 2004.
[8] Commission Order, Docket 02-0428, Appendix A, Paragraph D.

CILCO service area. Do you think a similar power offering would be useful as a temporary mitigation measure?

A. Ameren's power offering has produced no sales.[9] I am not confident a similar offering would produce different results.

Dynegy Energy Services

Q. In which service territories is DES currently operating?

A. DES is operating only in the ComEd service territory.[10]

Q. Would the ComEd retail market be significantly harmed if DES were to exit the market?

A. The ComEd market would suffer a little setback, but it would likely recover fairly quickly since several other marketers are actively serving the ComEd market. DES' customers, however, may suffer a loss of service and may be forced onto ComEd's market-based temporary service known as Interim Supply Service and eventually onto bundled service or PPO service should no RES wish to serve them.

Q. How could DES' former customers be compensated should they have to move onto a higher-priced service offered by ComEd?

[9] Attachment 3.
[10] Attachment 4.

A. Given existing rules, I am not aware how IP could compensate them if they must pay additional supply costs should DES lose its certificate.

Q. Please summarize your direct testimony.

A. Dynegy's sale of Illinois Power could result in a loss of Alternative Retail Electric Supplier status for its two marketing affiliates DES and IPE, causing a significant degree of harm to the Illinois retail market. I therefore conclude that the merger will adversely affect retail competition. The harm to the Illinois Power market could be mitigated if Illinois Power were to institute measures designed to attract retail suppliers capable of achieving the success attained by DES.

Q. Does this conclude your direct testimony?

A. Yes.

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ATTACHMENT 1

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ATTACHMENT 2

ATTACHMENT 3

Illinois Power Company and Ameren Corporation
ILLINOIS COMMERCE COMMISSION
DOCKET NO. 04-0294
DATA REQUEST NUMBER: EPS-2

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EPS-2 Please refer to Paragraphs C & D of Appendix A of the Order in Docket No. 02-0428, under which the Ameren companies must offer at least 100 MW of power and energy to unaffiliated buyers. Have any of the Ameren companies made any power and energy sales pursuant to Paragraphs C and D?

Response: None

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ATTACHMENT 4