Docket No. 04-0294
ICC Staff Exhibit 1.0

REDACTED

DIRECT TESTIMONY

OF

Howard J. Haas

Policy Section

Energy Division

Illinois Commerce Commission

Application for Authority to Engage in a Reorganization, and to Enter Into Various Agreements in Connection Therewith

Illinois Power Company
Ameren Corporation

Docket No. 04-0294

July 14, 2004

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I. Witness Identification

Q. Please state your name and business address.

A. My name is Howard J. Haas. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

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

A. I am currently employed as a Senior Economist in the Policy Section of the Energy Division of the Illinois Commerce Commission ("Commission").

Q. Please describe your professional background and affiliations.

A. I received my Ph.D. in Economics, with dual concentrations in Industrial Economics and Public Finance, from Michigan State University in 1999. During my graduate studies I worked as a consultant with the Michigan Gas and Electric Association. I also worked for three years as a researcher at the Department of Resource Development at Michigan State University. I was a visiting professor and graduate teaching assistant at Michigan State University, as well as a guest lecturer on environmental and regulatory economics. As a visiting professor and graduate teaching assistant, I taught classes on Money and Banking, Industrial Organization, and Microeconomics. I have worked for the Illinois Commerce Commission in the Energy Division, Policy Section since the summer of 2000.

Q. Have you previously testified before any regulatory bodies?

A. Yes. I have testified on several occasions before the Commission and I have contributed comments to FERC.

II. Issues addressed

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

A. The purpose of my testimony is to present my position on Illinois Power Company and Ameren Corporation's ("IP" or "Ameren" or collectively, the "Company" or "Applicants") application for authority to engage in a reorganization and to enter into various agreements. Specifically, my testimony addresses Section 7-204(b) (6) and (7) of the Public Utilities Act ("Act") with respect to the reorganization application. In particular, I examine Ameren's proposal to purchase Dynegy Inc.'s ("Dynegy")interest in Electric Energy, Inc ("EEI") and whether this acquisition will have "a significant adverse effect on competition in those markets over which the Commission has jurisdiction." (Section 7-204(b) (6) and (7) of the Act) I also address the Company's asbestos rider ("HMAC") proposal to determine whether the proposed HMAC rider will likely, as part of the proposed the proposed reorganization, have "any adverse rate impact on retail customers." (Section 7-204(b)(7) of the Act) I also examine both issues with regard to general policy concerns.

III. Ameren's Acquisition of EEI

Q. (Pursuant to Section 7-204(b) (6) of the Act, is there a concern that Ameren's proposal to purchase Dynegy's interest in EEI, as part of the

overall proposed acquisition, will have "a significant adverse effect on competition in those markets over which the Commission has jurisdiction?"

A. Yes.

Q. What market is likely to see a significant adverse effect on competition as a result of this proposed acquisition of Dynegy's share of EEI??

A. The Ameren service territory (hereafter referred to as the "delivery market") will likely suffer a significant adverse effect on competition as a result of the proposed acquisition of Dynegy's share of EEI.

Q. How would Ameren's proposed acquisition of Dynegy's share of EEI create a significant adverse effect on competition in Ameren's delivery market?

A. Ameren's proposed acquisition would increase Ameren's market power in its own delivery market. Market power is the ability to unilaterally and profitably raise prices within a specified market. Generally speaking, market power exists in markets where market concentrations are high, particularly where one or two firms control a significant portion of the capacity in such a market. In the pre-proposed acquisition environment, Ameren's market is already heavily concentrated and Ameren has a dominant position in its own market. Ameren's current dominant share of the generation that can serve Ameren's delivery market raises concerns that Ameren has a measure of market power within that market. Ameren's proposed acquisition of Dynegy's share of EEI will increase Ameren's dominant share of the generation in the already heavily concentrated Ameren delivery market. The proposed acquisition of Dynegy's share of EEI would therefore exacerbate the market power that Ameren already has in its delivery market.

Q. Why should the Commission be concerned about the proposed acquisition's significant adverse effect on wholesale competition in Ameren's delivery market?

A. Section 7-204(b)(6) states:

> "In reviewing any proposed reorganization, the Commission must find that…the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction."

This proposed acquisition would have a significant effect on both the competitiveness of the Illinois retail electric market that the Commission does regulate and on the prices retail customers would have to pay. The levels of concentration in this wholesale market, and the impact this acquisition will have on the level of concentration, are such that there is, by accepted standard, a presumption that this acquisition will have a negative impact on competition in the wholesale market that can serve load in the Company's service territory.

This, in turn, is a significant concern due to the potential influence the wholesale suppliers in this market, specifically Ameren, will have over prices they can charge to retail customers. The less competition that exists in the wholesale market, the higher the prices will tend to be relative to a more competitive marketplace, all else held equal. By decreasing the amount of competition, the acquisition will tend to have a negative impact on retail customers relative to the status quo.

Section 7-204(b)(7) of the Act provides that in reviewing any proposed reorganization the Commission must find that "the proposed reorganization is not likely to result in any adverse rate impacts on retail customers." The proposed acquisition's significant adverse effect on competition in the Ameren's wholesale delivery market, is a significant concern due to the potential influence the wholesale suppliers in this market, specifically Ameren, will have over prices they can charge to retail customers. The less competition that exists in the wholesale market, the higher the prices will tend to be relative to a more competitive marketplace, all else held equal. By decreasing the amount of competition, the acquisition will tend, all else held equal, to have a negative impact on retail customers relative to the status quo.

Q. Will there be any significant adverse effects on competition in the IP delivery market as a result of Ameren's proposed acquisition of Dynegy's share of EEI?

A. No. Dynegy's share of IP's delivery market will be reduced by this proposed transaction.

Q. Would the reduction in concentration in IP's delivery market as a result of this proposed acquisition offset the increase in market concentration in Ameren's delivery market caused by the proposed acquisition?

A. No. These are two geographically separate markets. In examining the effect of the proposed acquisition, the effects have to be viewed within the context of each and every market affected by the proposed transaction, and the effects need to be measured in each of the markets on their own terms.

Q. Please describe Ameren's proposed acquisition of Dynegy's share of EEI.

A. As part of the over all proposed transaction, Illinova Generating Company ("IGC"), an indirect subsidiary of Dynegy has agreed to sell its 20% ownership of EEI to Ameren, which already owns a 60% share of EEI. EEI is an exempt wholesale generator that directly owns the 1,014 MW coal-fired Joppa Steam generating station and, through Midwest Electric Power, Inc. ("MEP") two 37 megawatt ("MW") combustion turbine generators (6B project). This purchase would give Ameren 80% ownership of EEI.[1]

Q. What are your concerns with regard to Ameren's proposed acquisition of Dynegy's share of EEI as part of the planned reorganization?

A. Dynegy's sale of its interest (218 MW) in the EEI to Ameren as part of the reorganization would increase the already high level of concentration in the generation market that can potentially serve Ameren's service territory. As Mr. Frame notes, "...that control area designation market…is highly concentrated under the joint US Department of Justice-Federal Trade Commission Horizontal Merger Guidelines..." (Applicants' Ex. 10. p. 11-12)

Q. Can you generally address why increases in wholesale market

[1] Both Joppa and project 6B are located in the "EEI" control area, which is electrically connected to Ameren, IP, and TVA.

concentration are a concern?

A. Heavily concentrated markets are a concern due to the potential influence the participants in that market can have over prices they can charge to end-use (retail) customers. Generally, markets with market concentrations that result in a Herfindahl-Hirschman Index ("HHI") in excess of 1800 are considered highly concentrated and in such a market there is a concern regarding the potential abuse of market power by some or all of the participants in that market.[2] In a market where the HHI is in excess of 1800, any increases in concentration, which would cause a corresponding increase in the HHI, becomes a matter of concern because the pre-merger HHI is already of sufficient level to potentially provide market power to some of the sellers in that market.

It is for this reason that the Federal Energy Regulatory Commission ("FERC") has set up HHI screen tests to examine mergers, and to determine when some market power mitigation may be appropriate to counteract any negative competitive outcomes of a merger or acquisition. This test is referred to as the FERC's Appendix A Screen Test. In the FERC screen tests, in markets

[2] The HHI is a commonly accepted measure of market concentration. The U.S. Department of Justice and the FERC, for example, use the HHI for evaluating mergers. An HHI calculation of less than 1,000 is considered to be a competitive marketplace, a result of 1,000 - 1,800 is considered to be a moderately concentrated marketplace, and a result of 1,800 or greater is considered to be a highly concentrated marketplace. As a general rule, mergers that increase the HHI by more than 50 points in concentrated markets raise antitrust concerns, and increase in HHI of more than 100 creates a presumption that market power would be enhanced or created by the merger. The HHI for a market is derived by squaring the market shares of the sellers in the market and summing them. The HHI can range from a minimum of close to 0 to a maximum of 10,000. An HHI of zero would indicate perfect competition, with many thousands of sellers with negligible market shares. One firm with 100% market share (a monopoly) would provide an HHI of 10,000 (HHI=100^2). The HHI is expressed as:

HHI = s1^2 + s2^2 + s3^2 + ... + sn^2 (where sn is the market share of the ith firm).

with HHI in excess of 1800, a merger or acquisition that causes the HHI to increase by 50 or more tends to raise concerns. Where a merger raises the HHI by 100 or more, there is a presumption that the merger is likely to create or enhance market power. (Order 642, FERC Stats & Regs ¶ 31,111 at 31,896, n. 62 (2000). At 31,896, n.62)

Q. What does Ameren's proposed acquisition of Dynegy's share of EEI do specifically to the level of concentration in Ameren's delivery market?

A. The Company's Pre 2006-Analysis exhibits show that, in terms of economic capacity[3], the pre-merger HHI in the Ameren delivery market, ranges from 3249 to 3941, depending on the season and whether or not Available Transmission Capacity ("ATC") is used instead of First Contingency Incremental Transfer Capability ("FCITC"). (Applicants' Ex. 10.3, Attachments 8 &10) The Post-2005 exhibits show, in terms of economic capacity, pre-merger HHI ranging from 3176 (assuming FCITC) to 3862 (assuming ATC), depending on season and transmission assumptions. (Applicants' Ex. 10.3, Attachments 12 & 14) In both the pre-2006 and post-2005 analysis, the Ameren market is shown to have concentration levels well in excess of the 1800 that typically indicate a heavily concentrated market.

The Post-acquisition scenarios show an increase in these HHI numbers

(..continued)

[3] Economic capacity is a term referring to all the generation capacity located in, or can reach (given transmission limitations, prices, and losses that is no more than 1.05 times the price (or cost) of power in the delivery market in question) a specified delivery market.

across the board, ranging from 1 (assuming FCITC) to 29 (assuming ATC) in the pre-2006 economic capacity cases, and from 117 (assuming FCITC) to 150 (assuming ATC) in the post-2005 scenarios. (Applicant's Ex. 10.3, Attachment 8,10, 12 & 14) Of particular concern is the significant increase in the HHI in the post-2005 scenario, as this shows a significant concentration effect after the transition period, when Ameren's tariffed rates will be dependent on the delivered price of power in its market. As Mr. Frame summarizes, "...adding the 218 MW of output rights from Dynegy's EEInc interest to the Ameren bucket clearly will result in screen violations in the Ameren market..." (Applicants' Ex. 10, p. 12) I discuss this issue further later on in my testimony.

Q. Do the Appendix A results raise concerns that the Company's proposed acquisition of Dynegy's share of EEI will likely harm competition in Ameren's post-2005 wholesale market?

A. Yes. As noted, in the Company's post-2005 Appendix A Economic Capacity analysis, the proposed acquisition projects increases in HHIs in excess of 100 in all time periods, under assumptions of either FCITC or ATC. Given that the pre-acquisition HHI (ranging from 3176 to 3862 for the post-2005 market) are well in excess of 1800, there is a presumption; by FERC standards that the proposed acquisition is likely to create or enhance market power in the post-2005 Ameren market. This is a concern, under the Commission's standards, as set forth in Section 204 (b) (6) of the Act, because an acquisition that creates a presumption of created or enhanced market power indicates an acquisition that will create a presumption of a significant adverse effect on competition.

Q. Why do you focus on Mr. Frame's economic capacity results, rather than the available economic capacity results?

A. While Mr. Frame performed a number of studies under both economic and available economic capacity, economic capacity provides a more accurate picture of all the generation that is available to serve a particular market, given transmission and other constraints. As Mr. Frame points out, "...economic capacity is all generation capacity located within the delivery market being examined, or that can be delivered there after accounting for transmission prices, losses and limits, at a delivered price that is no more than 1.05 times the competitive price in the market." (Applicants' Ex. 10.0, p. 8) Available Economic Capacity, on the other hand, is equal to Economic Capacity minus firm load commitments on the part of the existing generation. Of the two measures, economic capacity shows the full range of generation that would be available to bid to serve load in the Company's service territory. This is the more relevant measure for analysis in the state as the utility in question will not directly own any generation in Illinois, and, in the post transition period, the entire load in the Company's service territory will be subject to the prices derived from this market.

Q. Are the Company's HHI numbers a good indication of the level of concentration in the Ameren market?

A. Based on descriptions of Mr. Frame's methodology, and based on information that the Company has made available elsewhere, there is a concern that the economic capacity numbers used in the Company's exhibits may understate the level of concentration in the Ameren delivery market.

Mr. Frame's analysis presumes that the merchant power plants that exist in the regional power market are all capable of competing to serve load in the Ameren service territory, after controlling for transmission limitations captured in ATC and FCITC. The list of available resources, both affiliated and unaffiliated, appears in Mr. Frame's attachments 5 and 6. (Applicant's Ex. 10.3, Attachments 5 and 6).

While the Company has provided a list of potential competitors, the Company also provided evidence in FERC Docket EC03-53 that transmission constraints, reliability concerns, and other non-price considerations make the assumed pool of potential suppliers smaller than Mr. Frame's analysis would suggest. In explaining why arrangements with some non-affiliated generation were not considered to be as reliable or as attractive for meeting capacity requirements as more established, company owned generation, Mr. Nelson stated: "the highest reliability is achieved through proven, company owned generation assets…that can reliably deliver power during periods of peak demand…network resources with established firm outlet transmission capability are clearly more reliable than power suppliers that lack firm trans mission to the Ameren Border and/or within the Ameren control area." (Nelson, Rebuttal, EC03-53 p. 7) The network transmission requirement, in particular, appears to be more rigorous than the measures of available transmission captured in either the ATC or EITC measures used by Mr. Frame in determining the amount of generation that can compete in the Ameren service territory.

Mr. Nelson also points out that questions regarding the financial stability of a potential supplier are another non-price consideration when examining offers from potential suppliers. Mr. Nelson notes that “locked in prices are of little value if the resources either cannot be available when needed due to capacity constraints or because the supplier declares bankruptcy and rejects the contract…these non-price factors were properly considered by (the Company) in evaluating its options.” (Nelson Rebuttal, EC03-53 p. 9)

Mr. Nelson also indicated that operating limitations could limit the pool of considered potential suppliers of capacity in the Company’s market. Mr. Nelson notes, “any limitations on the availability of a generating facility’s output effectively disqualifies that asset.” (Nelson Rebuttal, EC03-53, p. 9) By this standard, Mr. Nelson disqualifies some of the generation assets listed in Mr. Frame’s exhibits as potential competitive suppliers to the Company’s market. Mr. Nelson specifically notes, “facilities such as NRG’s Audrain facility that lack adequate firm transmission outlet capability and are subject to an operating guide are not acceptable resources for purposes of satisfying regulated capacity requirements.” (Nelson Rebuttal, EC03-53, p. 9) It should be noted that, not only does the Audrain 640 MW facility appear in Mr. Frame’s list of potential suppliers; it resides in Ameren’s service territory, which would tend to imply that it should be a good candidate as a potential supplier in Appendix A type analysis.

Assuming that Mr. Nelson’s criteria more accurately reflects how Ameren, and other potential retail suppliers, judge potential wholesale suppliers, Mr. Frame’s methodology and analysis will tend to overstate the number and capacity of potential competitors, and thereby understate the HHIs and the level of concentration, that exist in the Company's market. A more detailed examination of the non-price considerations and of the transmission requirements/barriers would appear to limit the full participation of some of the listed players. This means that Ameren's system is even more concentrated than Mr. Frame's numbers indicate, which makes the proposed acquisition potentially even more troubling, in terms of its likely effect on competition.

Q. How does your concern regarding the acquisition's negative effect on competition relate to the requirement that, under Section 7-204(b)(6) and (7) of the Illinois Public Utilities Act, that the Commission find that, "the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction" and "the proposed reorganization is not likely to result in any adverse rate impacts on retail customers?

A. The proposed acquisition of Dynegy's share of EEI will increase market concentration in the Company's already heavily concentrated market. The levels of concentration in this market, and the impact this acquisition will have on the level of concentration, are such that there is, by accepted standard, a presumption that this acquisition will have a negative impact on competition in the wholesale market that can serve load in the Company's service territory. This, in turn, is a significant concern due to the potential influence the wholesale suppliers in the market will have over prices they can charge to all end-use bundled and unbundled retail customers. The less competition that exists, the higher the prices will tend to be relative to a more competitive marketplace, all held equal. By decreasing the amount of competition, acquisition will tend to have a negative rate impact on retail customers relative to the status quo.

Q. Does the Company recognize there may be some concern about the acquisition's impact on the competitiveness of the wholesale market that can serve Ameren's customers?

A. Yes. The Company quantifies its recognition, but it does recognize that the Commission (as well as FERC) may have some concerns given the levels of concentration that exist and the increase in concentration caused by this proposed acquisition of Dynegy's share of EEI. To wit, the Company is offering a mitigation measure to attempt to temporarily reduce the transaction post-2005 HHI impact by having the Company offer 125 MW of capacity from the Joppa plant to the wholesale market via competitive solicitation.

Q. Please describe the reasons that Mr. Frame gives to support his assertion that the Commission should not be concerned about the screen violations that would be caused by the Company's proposed acquisition of Dynegy's share of EEI.

A. First, Mr. Frame notes that the proposed acquisition is only for 218 MW of capacity output rights, which he characterizes as "very small." (Applicants' Ex**.** 10.0 p. 13). Second, Mr. Frame notes that "...Ameren may already be presumed to have operational control of the EEI generation...” prior to the proposed acquisition, because of “...Ameren’s current majority ownership of EEInc.” (Applicants’ Ex. 10.0 p. 13) If Ameren was considered to have operational control, for purposes of the analysis, “...then the generation capacity already would be included in the Ameren bucket on a pre-transaction basis in an Appendix A analysis and therefore nothing would change as a result of the proposed transaction.” (Applicants’ Ex. 10.0, p. 13) Third, Mr. Frame states, “...regional power supply changes that occur between now and 2006 are likely to reduce potential concerns about competitive problems in wholesale electricity markets.” (Applicants’ Ex. 10.0, p. 13-14) Mr. Frame points to “Ameren’s participation (through GridAmerica) in the Midwest ISO, the implementation of the Midwest ISO’s formal energy markets and the initiation of its active market monitoring function.” (Applicants’ Ex. 10.0, p. 14)

Q. Do you agree with Mr. Frame that the Commission does not need to be concerned with the proposed acquisition of Dynegy’s share of EEI for the reasons articulated above?

A. No.

Q. Why do you disagree with Mr. Frame’s assertion that, even though the pre-acquisition market is heavily concentrated, the acquisition in question involves a “very small” amount of generation, and therefore, should not be a cause of worry?

A. The Company's argument that the MWs involved are insignificant, and therefore the Commission should not be concerned, does not hold up to scrutiny for several reasons.

First, the post-2005 HHI numbers, which are well above the 1800 HHI and indicate a market with considerable market concentration, shows a very clear problem exists in the Ameren delivery market. The Ameren delivery market is very heavily concentrated and dominated by Ameren's unregulated affiliate. As a result, competition is limited, and there should be real concerns about the competitiveness of that market. Under these circumstances, an increase in concentration, generated via acquisitions that decrease the numbers of competitors, should be avoided or prevented regardless of how small or how large the increment may be. As long as we accept the premise that competition in the electricity market is a good thing, increases in concentration through the consolidation of competitors under the circumstances evident in the Ameren market only serves to hurt competition, and, ultimately, retail customers. The Ameren market has a serious market concentration problem now and steps should be made to reduce the level of concentration that exists, rather than allow moves that make the situation worse.

Second, Ameren's market is so heavily concentrated that even this "very small" amount of capacity being added to Ameren's assets is enough to cause a significant screen violation in the Post-2006 market analysis—despite the use of an apparently overgenerous list of potential competitors. The tests are designed to show where the acquisition of competition is likely to cause harm to competition. The acquisition fails this test. The "very small" amount of capacity in question is not small enough to avoid failing the test given the level of concentration and given the relative amount of capacity in the marketplace.

Third, by Mr. Frame's proposed standard, the existing level of concentration in a market should be ignored; so long as the increments being acquired by the dominant company appear to be "very small." However, the acquisition is not "very small" by FERC's HHI standards, given the current level of concentration in Ameren's market and Ameren current share of capacity in that market. Additionally, ignoring "small" increment acquisitions is a dangerous path, because over time, such an approach would allow a dominant company to eliminate all the competition in its market via a series of "very small" amounts over an extended period of time.

Q. Do you agree with Mr. Frame's assertion that "...Ameren may already be presumed to have operational control of the EEI generation..." prior to the proposed acquisition, because of "...Ameren's current majority ownership of EEInc..."? (Applicants' Ex. 10.0, p. 13)

A. No. While Mr. Frame's perception of where to place Joppa's output based on ownership may fit the letter of the rules used by FERC, it does not fit the reality of the relationship between Ameren, Dynegy, and EEI. Ameren does not have operational control over the whole plant or its output. Instead, Ameren has a right to 60% of the output capacity of the plant. EEI has the right to 20% of the output capacity, and currently Dynegy has right to 20% of the capacity. If any one party was not going to take its share of the power, for whatever reason, the other parties can opt to take it for their own purposes. As Mr. Frame points out in his FERC testimony, "For the Joppa steam station, Section 2.08 of the September 2, 1987 Power Supply Agreement Between Electric Energy, Incorporated and the Sponsoring Companies (Sponsors' Agreement) provides that, if one of the sponsors does not take the energy to which it is entitled, the other sponsors or USEC's PGDP can take that energy…Section 3.01 states that the price for that energy will be a cost-based price." (Applicants' Ex. 10.3, p. 21) The procedure applies to the 6B project. Mr. Frame notes, "For the 6B project, Section 4.1 of the Amended and Restated Power Supply Agreement Between Midwest Electric Power, Inc. and the Purchasing Parties (6B PSA) provides that, if one of the parties with output rights does not take the energy to which it is entitled, the other parties with output rights can take that energy." (Applicant's Ex. 10.3, p. 21) It is, therefore, not appropriate to assume that Ameren has de facto operational control over the EEI properties.

Q. Do you agree with Mr. Frame when he argues that the increase in market concentration is not a concern because "...regional power supply changes that occur between now and 2006 are likely to reduce potential concerns about competitive problems in wholesale electricity markets"? (Applicants' Ex. 10.0, p. 13-14)

A. No. While I am hopeful that the long promised changes to the regional markets, in form of functional Regional Transmission Organizations ("RTOs"), would improve the market, the market will still be operating in the context of the underlying market structures. The promised liquidity that will come from financial markets for transmission, congestion hedging, and energy will help make regional competition more robust than it is today, but market concentrations will still cause concerns regarding the existence of market power. Transmission limitations will still exist. Initial Financial Transmission Rights ("FTR") allocations will still go to the parties that hold transmission rights now. The preferential treatment of grandfathered transmission rights, in terms of hedging against congestion, in the various RTO market designs will tend to maintain the current supplier/buyer relationships to the detriment of new entrants and existing potential suppliers in the various regional markets. These limitations maintain the importance of local power sources, and existing supply relationships, in a given market, as will concerns about non-price issues such as reliability. All of this will maintain the importance of the competitiveness of these localized sub-markets within the regional footprint in determining prices to end use customers.

Another point to note is that an Appendix A type analysis presumes an RTO type market, in terms of the number of potential competitors and their ability to move power. The HHI numbers found in Mr. Frame's analysis are more representative of the levels of concentration that will exist when the RTO and its promised market are actually in place. So, any assumption that the RTO will make the competitive situation look better than what is shown in the Appendix A analysis is illogical. Mr. Frame's analysis, for example, is based on a model of the energy market that is more open and competitive than fits the current, pre-

RTO regional market reality. The analysis assumes that all the listed generation capacity will have equal footing in bidding for business in Ameren's service territory. However, Ameren's testimony in EC03-53 is a testament to the fact that this is not the case under current pre-RTO market rules and considerations.

Q. Describe the mitigation proposal offered by the Company.

A. Ameren has proposed to sell "...by contract a sufficient portion of the additional Joppa steam station output that it will acquire under the proposed transaction to eliminate the screen violations that occur in the Ameren control area delivery market in the Post 2005 analysis…that amount is 125 MW." (Applicants' Ex. 10.0, p. 14) Ameren will make the power available via "...a competitive solicitation conducted by an out-of-control-area buyer, pursuant to some solicitation conducted by AEM or pursuant to some combination of these two." (Applicants' Ex. 10.0, p. 14) Ameren's proposal calls for the sales to continue for no more than 5 years, or until "Ameren or its subsidiaries installs sufficient new transmission system upgrades to increase import capability into the Ameren control area by 125 MW to eliminate the screen violations or until Ameren demonstrates to the satisfaction of the FERC that it should no longer be subject to such forced sales obligations." (Applicant's Ex. 10.0 p. 14) Mr. Frame notes, "In no case will those sales obligations extend past April 30, 2009." (Applicants' Ex. 10.0, p. 14-15)

Q. Is the mitigation proposal, as described, sufficient to address the presumed market power problems created by the proposed acquisition?

A. No. The proposed mitigation does not address the structural nature of the problem being introduced by this proposed acquisition of EEI. There is a structural problem in the Ameren delivery market in the form of the current heavy concentration of ownership of capacity. The proposed acquisition would exacerbate this structural problem. While correcting for the pre-existing market problems are beyond the scope of this proceeding, any problems exacerbated by the proposed transaction should be addressed. Any mitigation should address the structural nature of the problem by eliminating this increment in the concentration of capacity ownership in the delivery market. A temporary sale of power does not do this.

Q. Do you agree with Mr. Frame's suggestion that the 5-year power deal would allow the market time to fix the problem on its own via contracting or the building of new generation by third parties, and therefore further mitigation is unnecessary?

A. No. First of all, Mr. Frame has not provided evidence that potential entrants will enter the market and that these potential entrants will be able to deliver, on a firm basis, power to Ameren's delivery market in sufficient quantity and price to alleviate the problem caused by Ameren's proposed acquisition of Dynegy's share of EEI. Second, even if new generation is built, there are apparent barriers to entry in terms of transmission capacity, reliability, and financial solvency that limit the pool of current potential suppliers, let alone any new sources, as outlined in Mr. Nelson's testimony in EC03-53 (as referenced above). Third, the new generation that has been built in the region over the last few years has been gas fired. This is not the sort of generation that will compete directly with the output from a base load coal plant like Joppa. Fourth, Ameren is proposing to increase its already dominant share of capacity that can be economically delivered to Ameren's control areas. As such, Ameren should be responsible for correcting the problems that it is introducing to the market place. A policy that always assumes that potential entry will eliminate all the market power concerns created by consolidation of production capacity is not tenable in a market that has transmission limitations, market seams, and the absence of costless entry or exit.

Q. Does Ameren's proposed mitigation of 125 MW of new transmission import capability solve the structural problem that the proposed acquisition creates?

A. Building sufficient transmission import capacity to offset the increase in the HHI resulting from the capacity being acquired by Ameren (218 MW) would address the structural problem that the proposed acquisition would introduce, but Ameren has not committed to either building the transmission that it mentions in it is mitigation proposal (125 MW) or to building enough to eliminate the damage the purchase would do to competition. Instead, Ameren has simply stated that if it, or any of its subsidiaries, <u>does</u> install "...sufficient new transmission system upgrades to increase import capability into the Ameren control area by 125 MW to eliminate the screen violations..." then Ameren will cease, prior to the April 30, 2009 drop dead date, to offer 125 MW of power from the Joppa plant as a mitigation measure. (Applicants' Ex. 10, p. 14) Nor has Ameren made any effort to examine potential transmission projects that would provide the 125 MW. This is seen in Ameren's response to DR No. IIEC 1-17: "At this stage the 125 MW amount is not tied to any specific transmission project that in the future might be constructed. Accordingly, no such studies have been performed."

Q. What do you suggest in place of the Company's proposed mitigation?

A. Any mitigation would have to address the structural nature of the problem by eliminating this increment in the concentration of capacity ownership in the delivery market. If Ameren did not buy Dynegy's share of EEI or if Ameren sold off an equivalent portion of its ownership of EEI to a third party, that would solve the structural problem. Absent that, building sufficient transmission import capacity to eliminate the increase in the HHI caused by Ameren acquisition would address the structural problem that the proposed acquisition would introduce. There would have to be a commitment to build this transmission within a limited window of time. In the meantime, Ameren should provide its non-structural mitigation via the sale of power from the acquired capacity (218 MW) from the plant until the transmission in question is built. The terms of the sale of the power could otherwise be as Ameren proposed.

Q. Why eliminate any increase in the post 2005 HHI as calculated by Mr. Frame, rather than just the 125 MW that would eliminate the screen violations according to Mr. Frame?

A. Accepting a solution that called for building just enough transmission import capability to alleviate the screen violations caused by the proposed acquisition would require ignoring the underlying issue in the Ameren market. The Ameren delivery market is so heavily concentrated, pre-merger, that even this “very small” amount of capacity being added to Ameren’s capacity base is enough to cause a significant screen violation in the post-2006 market analysis. As a result, pre-acquisition, competition is limited, and there should be real concerns about the competitiveness of that market. Under these circumstances, any increase in the level of concentration would cause harm. This being the case, any increase in concentration, and decrease in competitors, should be avoided or prevented regardless of how small or how large the increment may be.

Stated another way, if the HHI of the Ameren pre-acquisition delivery market was only 1800, and the proposed acquisition was going to bring Ameren’s HHI up to the “current” HHI of 3320 (Pre-2006, Economic Capacity, Base Case) to 3865 (Pre-2006, Economic Capacity, ATC sensitivity) that Mr. Frame shows in his Pre-2006 analyses (Applicant’s Ex. 10.3, Attachment 8 and 10), such an increase in concentration would clearly cause a screen violation. According to the screen tests, where a merger or acquisition raises the HHI by 100 or more when the starting HHI is 1800 or greater, there is a presumption that the merger is likely to create or enhance market power, which it would clearly do in this illustration. (Order 642, FERC Stats & Regs ¶ 31,111 at 31,896, n. 62 (2000). At 31,896, n.62) If such an acquisition would enhance (it already exists) or create market power, where the end result is an HHI of 3176 to 3862 (based on Mr.

Frame's analysis), it is illogical to argue that a pre-acquisition HHI of 3176 to 3862 does not presume the existence of market power. Mr. Frame is therefore incorrect when he suggests that the only concern should be the "presumed transaction induced ability to exercise market power." (Applicant's Ex. 10.0 p. 16) To the contrary, the current level of concentration provides a presumption of the ability to exercise market power, and therefore a concern. Therefore, at the HHI levels evident in Ameren's pre-merger delivery market, any increase in HHI should be avoided.

IV. HMAC Rider

Q. Have you reviewed Applicants' proposal to establish a Hazardous Materials Adjustment Clause ("HMAC") Rider (Applicants' Ex. 8.0, pp. 5-8, Applicants' Ex. 8.1)?

A. Yes, I have reviewed the HMAC Rider, with respect to policy issues. I understand that Staff witness Hathhorn has also examined the proposed HMAC Rider for rate impact and other issues.

Q. What is the intended purpose of the proposed Rider?

A. As stated in Mr. Jon R. Carls' testimony, "[t]he HMAC Rider is intended to track and recover the net cost of defending and resolving asbestos claims." (Exhibit 8.0, p.5) As presented, the proposed Rider is intended to pass any and all costs associated with defending and resolving asbestos claims, that are not otherwise covered by insurance, on to rate payers. "The rider will apply only to costs arising from asbestos claims that Illinois Power becomes legally obligated to pay after December 31, 2006." (Exhibit 8.0, p.7)

Q. Why is Ameren specifically asking for a rider, instead of including these costs in base rates, to deal with asbestos related litigation costs?

A. Mr. Carls claims that costs associated with defending and resolving asbestos claims "...are volatile, can vary significantly from year to year, and may be substantial in amount." (Exhibit 8.0, p.5) Additionally, the Company argues that the costs in any one-year associated with resolving these claims are outside the Company's control. Mr. Carls states, "Predicting when such [asbestos related] claims will be asserted is a nearly impossible task because the timing and volume of claims is wholly outside the utility's control." (Exhibit 8.0, p.6) Mr. Carls goes on to state, "[c]laims of damages for asbestos exposure are understandably unique from individual to individual, taken into account alleged damages associated with lost wages, medical bills, and pain and suffering, among just a few categories." (Exhibit 8.0, p.6)

Mr. Carls also argues that the Rider would benefit ratepayers as well, relative to base rate treatment of these costs. "Base rate treatment of these costs does not insure that recovery will approximate the actual level of costs incurred in any given year…the "test year" level of allowable asbestos-related costs may be higher or lower than actual costs in any given year, possibly by a wide margin, making the rider approach a better option." (Exhibit 8.0, p.6)

Q. **Can riders be a good way to pass through costs that are volatile and out of the control of the utility?**

A. Assuming, solely for purposes of discussion, that the costs in question are recoverable, and that the costs are hard to predict and completely out of the utility's control, riders might be a good way to recover costs and avoid the test year issues raised by Mr. Carls. However, the Company has not made a case that these characteristics are generally applicable to asbestos claim resolution costs. Where the utility has some control over costs, riders are not a good way to pass through costs.

Q. Should the costs associated with asbestos related claims and their resolution be recoverable?

A. Prudently incurred costs should be recoverable, but costs associated with injury due to negligence or punitive damages should not. Since the claims being brought appear to be based on charges of negligence or wrongful action on the part of Illinois Power, there is some concern that some or all of the costs associated with asbestos litigation should not be recoverable. ***x ***(Letter to IP from Joseph De Vito, April 29, 2004, p. 2, Sch. POL 1.02.4) To the extent that IP was following generally accepted safety procedures, following OSHA guidelines, etc., there is reason to believe that at least some of the costs in question might be recoverable. However, where the Company is found to be negligent, or cannot prove to the contrary, costs associated with claim resolution should not be recoverable to the extent that management decisions caused the harm. After all, utilities are typically permitted to include reasonable and prudent costs in their rates, but ratepayers should not be obliged to pay for economic consequences of utility actions that result in punitive damages or damages incurred as a consequence of management negligence. Where the Company's action was considered to be worthy of punitive damages for wrongdoing, these punitive charges should not be recoverable.

Q. What are the general problems with using riders to recover costs?

A. To the extent that an economic agent has some influence over the costs that are to be recovered via a rider, full-pass-through-riders provide what is known as a moral hazard problem. A moral hazard problem refers to a situation where an economic agent has some control over it costs, yet has no, or limited, incentives to minimize its costs due to the fact that it does not bear the burden of the costs that it incurs. Under these circumstances, the costs that are passed on to those that do have to pay, whether that is society in general or rate payers in particular, will tend, all else held equal, to be higher than they would be in the case where the agent with the decision-making power bore some portion of the costs associated with the decisions being made. With a full cost-pass-through-rider, the incentives to keep costs down are limited and may not sufficiently encourage the agent (in this case, Ameren), to minimize the costs it imposes on other parties.

Q. Is moral hazard a problem with this proposed Rider?

A. As presented in the Company's exhibit, yes.

Q. Please explain why there is a moral hazard problem with the Company's proposed rider and what this would mean with regard to the costs of claim resolution, all else held equal.

A. In fulfilling their fiduciary responsibility to their shareholders, the utilities have an obligation to minimize costs borne by the shareholders. Companies have some control over the costs associated with asbestos litigation in any one year. While the Company does not have control over the timing of claims, it has some control over the timing of the process of resolving the claims once they are made. For example, a company can attempt to settle, or not to settle, any time between the time the complaint is filed and a court decision or final verdict is reached. A company could, for example, hold off settling some of its currently pending claims, until such time that the proposed rider goes into effect on December 31, 2006. A company, in fulfilling its fiduciary responsibility to its shareholders, will have an incentive to do this because any costs incurred before December 31, 2006 are at shareholder expense under the proposed arrangement. As such, the proposed rider would present a moral hazard problem from the start.

In addition to having some control over the timing of costs, a company also has control over the costs of resolving each case in terms of settlements, legal fees, and other costs. While, in the case of settlement, the claimant must decide whether or not to take the offer, the company determines whether or not a settlement is even offered and determines its terms. A company's cost burden affects its incentives to expend money to challenge claims on their legitimacy.

Bearing a portion of these settlement costs, as is the case right now, creates a direct monetary incentive for the Company to keep its costs down and to challenge illegitimate claims. The proposed rider would eliminate this direct monetary incentive, thereby reducing the overall incentives to keep settlement costs down and to challenge illegitimate claims.

In addition, the proposed rider, with its lack of direct monetary incentives to keep the costs of resolving claims down, may, all else held equal, increase the number of claims made and the settlement expectations of the prospective and actual claimants. Absent a direct monetary incentive to challenge claims, more claims, valid and invalid, may be made and more claims may result in settlements and other legal costs at ratepayer expense.

Q. Has the Company shown evidence that the costs for asbestos claim resolution are of greater magnitude than other liability based costs?

A. No. An examination of incurred costs of general liability claims, workers' compensation claims, and asbestos claims over a concurrent period (1999 through 2003 period) shows the annual incurred costs of the three types of claims are in the same ballpark. However, total costs associated with asbestos claim resolution were considerably lower than either worker's compensation or general liability incurred costs. Staff Exhibit 1.2 provides a graphical comparison of the annual costs of each category of liability claims. In terms of total incurred costs from 1999 through 2003, asbestos related claims incurred x x x x x x x x x, worker's compensation claims incurred x x x x x x x x x, and general liability claims incurred x x x x x x x x x x (POL 1.8, POL 1.9, POL 1.10, POL 1.12, Staff Exhibit 1.1)

Q. Is there any possibility that the number of asbestos claims along with the costs of resolving the claims could grow appreciably in the near future?

A. Yes. However, if the data from other forms of litigation risk are any indication, they can also fall unexpectedly. In general, based on the limited data that has been made available, the forecasts that have been made, as well as IP's own projections with regard to their foreseeable risks, and recent experience do not support Ameren's assertions regarding the potential magnitude or the volatility of the asbestos related litigation costs faced by IP.

The data provided in IP's response to Staff Data Request POL 1.10, for example, shows x x x x x x x x x x in the number of claims served or pending from 1999 to 2003, as well as x x x x x x x x x in asbestos related claim resolution costs (See Staff Exhibit 1.1 and 1.2) Most of this x x x x x x x was due to a x x x x x x in asbestos related claims resolution costs between 2002 and 2003, from x x x x x x x x x x x x x x x x x x x (See Staff Exhibit 1.1, 1.2 and DR response to Staff Data Request DLH 1.08) However, it must be noted that such x x x x x x in claims-based costs were seen over the same five years in both general liability incurred costs and workers compensation incurred costs, and IP does not have a rider to cover these costs. General liability incurred costs, for example, ***x x x*** from x x x x x x x x x x x x x x x x x x x x x x x x x x x x and from x x x x x x x x x x x x x x x x x x x x x x x x x (Staff Exhibit 1.1 and 1.2)

Other IP forecasts indicate, in less uncertain terms, that the annual risk to IP in terms of asbestos related claims and costs has likely already peaked. x

Q. Are the "expected" costs in the prepared study by MMC Enterprise Risk x x x x x x x x x x x x x x than IP's actual asbestos litigation related costs to date?

A. Yes. x

x x

Q. Has IP made its own projection of its foreseeable costs of asbestos related liability?

A. Yes. In DLH 4.07, IP stated, "x x.”

Q. Has IP presented evidence that expected asbestos litigation costs would endanger the financial state of the company under current cost recovery mechanisms?

A. No. In IP’s disclosure on asbestos exposure in its 2003 10-K filing, IP states, “We have recorded a reserve with respect to the pending lawsuits, however, we do not expect the outcome of any such pending lawsuits to have a material adverse effect upon our results of operations.” (DLH 4.07)

Q. Does IP have any form of insurance to cover the costs of asbestos related claims?

A. Yes. ***x xOctober 1, 1999 is the date at which point IP transferred ownership of the plants to its parent Illinova Corporation.

Q. Has IP received any reimbursement for asbestos claims related incurred costs from its third party insurers?

A. According to IP's response to Staff Data Request DLH-1.10, IP has not received any reimbursement for asbestos related liability costs from its insurance carriers.

Q. Has IP pursued reimbursement for asbestos claims from any of its third party insurers?

A. According to IP's response to POL 1.02, IP provided x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x in a letter x x x x x x x x x x x x x x x (POL1.02.1-6)

Q. How have insurance carriers responded to IP?

A. From the correspondence IP received from its insurers, the insurers were unclear as to their responsibility for IP's costs associated with asbestos related claims. ***x x, POL 1.02.4)***

Q. Has IP investigated the possibility of obtaining current insurance for past exposure to asbestos?

A. No. In IP's response to POL 1.04, IP stated: "Illinois Power is aware that insurance products that would provide coverage for claims based on previous exposure to asbestos may be available from time to time in the marketplace. Illinois Power has not investigated the availability, cost or overall economic benefits, if any, of such products."

Q. Based on your previous answers, does it appear that IP has determined that asbestos related litigation costs do not present sufficient risk to pursue third-party insurance for the period x x x x x x x x x x x x x x x x x x x x x x given the current cost recovery mechanisms?

A. Yes.

Q. Is the possibility of a sudden change in costs a sufficient reason to make use of the proposed HMAC Rider instead of putting the costs in base rates or other recovery mechanism?

A. No. Even assuming away the issues of possible negligence and allowable recovery, the possibility of a sudden increase in costs still does not mean that the Company's proposed HMAC Rider is the best way to address the problem. Assuming the costs are recoverable, the Company could, for example, come in for a rate case in the event that asbestos related costs were unexpectedly high. IP could also pursue insurance to cover these potential costs.

Q. Could IP's lack of insurance, and failure to pursue or investigate insurance products to cover its risk, be an issue if IP were suddenly to plead for recovery of asbestos related cost through a rider or base rates?

A. Yes. To the extent that IP appears to have let its third-party insurance coverage lapse, and that indicates that it was, in effect, self-insuring between x x x x x x x x x x x x x x x x x x x x x x x. This being the case, IP appears to have taken a calculated risk to cut costs in the form of insurance premiums. IP has had a continuing responsibility, however, to act prudently. If there is an expectation of exposure to asbestos related claims, to the extent that IP was self-insured, IP should have been setting aside money to cover its expected risk. If it has not set aside such funds, there would be questions about IP's prudence.

Q. Assuming the asbestos-related costs are recoverable, are there advantages to recovering these costs in base rates?

A. Yes. To the extent that the costs in question are allowable costs, and ignoring the issues of picking a "representative test year" for the time being, base rate treatment would eliminate the morale hazard problem if there were any regulatory lag. Between rate cases, the utility has incentives to minimize its costs so that it can maximize its profits given the fixed base rate revenue requirement. Customers do not benefit from this incentive to the extent that the utility's ability to keep costs below the "representative year" are not shared with customers on an annual basis, but on the flip side, they do not suffer higher rates when the utility fails to keep costs from exceeding the "representative year."

Q. Assuming the asbestos-related costs are recoverable, are there disadvantages to recovering these costs in base rates?

A. Yes. There can also be a moral hazard problem when it comes to incurring costs and choosing a representative year when recovering costs through base rates.

Since the utility has some control over its costs and timing related to claims, it has some control over the costs it incurs in a given year. The utility has an incentive to include a high level of costs in a year it intends to use as a "representative test year". However, unlike the moral hazard problem found under the proposed HMAC Rider, the Commission would have the ability to judge whether the costs found in the "representative test year" were out of line relative to other years or projections, and disallow some of the costs in the base rates.

Q. Has the company provided sufficient evidence to support the use of a full cost pass through rider to cover its asbestos related litigation costs?

A. No. First, there are too many unanswered questions regarding the nature of the cost risk, and whether these costs are or should be recoverable. To the extent that IP was following generally accepted safety procedures, following OSHA guidelines, etc., there is reason to believe that some portion of the costs in question might be recoverable. However, x (Letter to IP from Joseph De Vito, April 29, 2004, p. 2, POL 1.02.4). Where the Company has been negligent, depending on the nature of the negligence, the costs associated with claim resolution should not be recoverable for reasons I've mentioned above. In order to recover such costs, the Company needs to demonstrate prudent behavior to the Commission, regardless of how it resolves the asbestos related claims against it. At no point should punitive damages be recoverable. Second, the moral hazard issue of any proposed recovery mechanism should be addressed. The Company's proposed HMAC rider creates a moral hazard problem that would, all else held equal, remove direct monetary incentives for the Company to keep the cost of asbestos claim resolution minimized.

Third, Ameren and IP need to show that a rider is necessary or preferable to recovery through base rates. IP has not shown the claim resolution costs to be out of line with other litigation risks. IP has not shown that it is unprepared or unable to cover these costs under current cost recovery mechanisms. IP and Ameren have not shown that asbestos claim resolution costs will materially affect IP's solvency absent a rider.

Fourth, IP and Ameren have not shown that insurance products are unavailable to mitigate cost variability. Both Ameren and IP need to provide evidence that they have investigated insurance options to provide protection against IP's past exposures.

Fifth, to the extent that Ameren has tied approval of this proposed Rider to its willingness to carry through with proposed acquisition of IP, Ameren and IP have not shown that the inclusion as part of this merger, will not have an adverse rate impact on customers. Absent such a showing, the proposed rider would cause the proposed acquisition to violate Section 7-204(b)(7) of the Act, which requires that a proposed reorganization not negatively impact ratepayers. IP has not made the case that it would need or seek a rider; over and above it's rate base amounts, to cover its Asbestos claim resolution costs. **x x x x x x x x x x** x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x

x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x x

(DLH 4.07)

The proposed Rider would have an adverse rate impact on customers to the extent that 1) the HMAC rider is only needed to alleviate Ameren of its concerns regarding asbestos related litigation costs, 2) the current rate base covers IP's expected asbestos related costs, and 3) the moral hazard issue of the proposed Rider tends to increase the costs of claim resolution.

Q. Does this conclude your testimony?

A. Yes.

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04-0294
ICC Staff Exhibit 1.0
Exhibit 1.2

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