

ILLINOIS COMMERCE COMMISSION

DOCKET NO. _____

DIRECT TESTIMONY

OF

JOHANNES P. PFEIFENBERGER

Submitted On Behalf

Of

**CENTRAL ILLINOIS LIGHT COMPANY
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY
ILLINOIS POWER COMPANY**

February 28, 2005

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6 **I. INTRODUCTION**

7 **Q. Please state your name, title and business address.**

8 A. My name is Johannes P. Pfeifenberger. My business address is 44 Brattle Street,
9 Cambridge, Massachusetts, 02138. I am a Principal and Director of The Brattle
10 Group, an economic consulting firm with offices in Cambridge, Massachusetts;
11 Washington, D.C.; San Francisco, California; and London, England.

12 **Q. Please summarize your educational background and qualifications.**

13 A. I am an economist with a background in power engineering and over 15 years of
14 experience in the areas of regulated industries, energy policy, and finance. I
15 received a M.A. in Economics and Finance from Brandeis University and a M.S.
16 in Electrical Engineering with a specialization in Power Engineering and Energy
17 Economics from the University of Technology, Vienna, Austria. I am the author
18 and co-author of numerous articles, reports, and presentations on subject areas
19 related to electric utility restructuring and regulation, including retail access and
20 power procurement. I testified and submitted reports on the subject of electric
21 utility restructuring, retail access, transmission access, and tariff design in a
22 number of cases before the Federal Energy Regulatory Commission ("FERC"),
23 the Missouri Public Service Commission, and the Public Service Commission of

24 New York. I also submitted testimony and expert reports on industry
25 restructuring, antitrust issues, and economic damages to the U.S. House of
26 Representatives, the Federal Communications Commissions, and in U.S. District
27 Court. On June 3, 2004, I presented a summary of the competitive procurement
28 model used in Maryland at the Illinois Commerce Commission's ("Commission")
29 Post-2006 Initiative's Procurement Working Group meeting. Exhibit No. 7.1
30 contains a more complete description of my qualifications.

31 **Q. What is the purpose of your testimony?**

32 A. The purpose of my testimony is to give an overview of the experience with
33 competitive procurement methods used in other restructured states to provide
34 background and context for Ameren's Illinois distribution utilities' Post-2006
35 procurement proposal. Generally, when I refer to "Ameren," I mean Central
36 Illinois Light Company d/b/a AmerenCILCO, Central Illinois Public Service
37 Company d/b/a AmerenCIPS, and Illinois Power Company d/b/a AmerenIP. Mr.
38 Craig Nelson's testimony explains how this experience with procurement
39 approaches in other restructured states was used in developing a post 2006
40 framework for Illinois.

41 **II. EXPERIENCE WITH PROCUREMENT IN OTHER RESTRUCTURED**
42 **STATES**

43 **Q. Have you reviewed the experience in other restructured states in the context**
44 **of Ameren's development of a competitive procurement approach?**

45 A. Yes. To assist Ameren in its development of a competitive procurement approach
46 to supply its post-2006 regulated service obligations, I reviewed the procurement
47 approaches used in other restructured states. In doing so, I reviewed available

48 documentation of the various procurement approaches, interviewed industry
49 contacts and consulted with several colleagues who have first hand experience
50 with the procurement process in several of the restructured states. Based on this
51 work, I presented at the June 3, 2004 Procurement Working Group on Ameren's
52 behalf a summary of the competitive procurement model used in Maryland,¹
53 which in many ways is structured very similarly to the New Jersey model after
54 which Ameren's proposed procurement process is structured. This review of
55 procurement approaches in other restructured states was first summarized in a
56 report, "Experience with Retail Restructuring and Resource Procurement in Other
57 States," which Ameren shared with the Staff of the Illinois Commerce
58 Commission ("Commission") and other stakeholders during June through
59 September of 2004. My colleagues and I subsequently published our findings in
60 the *Electricity Journal*.²

61 **Q. What have you learned from your review of procurement approaches and**
62 **experience in other restructured states?**

63 A. Several states have had to address policy matters similar to those now faced in
64 Illinois. The experience in these other restructured states shows that regulated
65 service often has been offered first at capped rates during a "transition period."
66 During this period, during which utilities also often sold or transferred their
67 generation assets, power generally was provided through buy-back contracts with

¹ "Scenario 2: The Maryland RFP Process," Procurement Working Group Meeting, Chicago, June 3, 2004 (<http://www.icc.state.il.us/ec/docs/040608ecPostMtg1.pdf>)

² Pfeifenberger *et al.*, "Keeping up with Retail Access? Developments in U.S. Restructuring and Resource Procurement for Regulated Retail Service," *The Electricity Journal*, December 2004, pp. 50-63. (Attached as Resp. Ex. 7.2)

68 the distribution utilities' generation affiliates or new generation owners. After the
69 transition period, utilities generally are required to use competitive processes to
70 replace transitional buyback contracts and procure supply for their continuing
71 obligation to provide retail service at regulated rates. The end of this "transition
72 period" has already been reached in several other retail access states.

73 The experience in other states also shows that the majority of total retail
74 load is still on the utilities' regulated service offerings. This is particularly true
75 for residential and small business customers. For example, while average state-
76 wide retail access penetration for non-residential customers ranges from 15% to
77 62% across restructured states, retail access penetration generally is still less than
78 10% for the residential class (The residential class typically represents about 30%
79 to 40% of total load.). The low level of switching in these states in part is
80 explained by regulated retail rates capped at levels below the market-based rates
81 that alternative retail suppliers could offer. Such below-market pricing is
82 generally not sustainable after the buy-back contracts expire. Policy makers and
83 market participants have generally agreed that the objective of supplying post-
84 transition regulated service options at market-based prices is best met through
85 transparent, commission-approved, competitive procurement processes that are
86 open to a diverse group of suppliers. Such procurement processes will not only
87 lead to appropriate pricing of the utilities' regulated service options, but also will
88 enhance wholesale market competition. It also maintains a level playing field in
89 which unaffiliated generation supplies are neither unduly advantaged nor

90 disadvantaged in the procurement process relative to utilities' own generation or
91 marketing affiliates.

92 **Q. How have other states structured such competitive procurement approaches**
93 **to supply utilities' post-transition regulated service options?**

94 A. Most restructured states use two general procurement models, which we labeled
95 the "standard offer approach" and the "portfolio management approach." Under
96 the standard offer approach, which is referred to within the Commission's Post-
97 2006 Initiative as the "vertical tranche" approach, the regulated utility
98 competitively procures power from suppliers under standardized full requirements
99 contracts. Each of these contracts either supplies a defined portion (*e.g.*, a fixed
100 percentage or "tranche") of the utilities' regulated service obligation for a defined
101 set of customers (*e.g.*, residential and small business customers). Wholesale
102 suppliers voluntarily undertake the day-to-day responsibility for the resource
103 procurement and portfolio/risk management functions for the distribution
104 company's regulated service load. The utility's role primarily involves
105 developing the competitive procurement process, obtaining state regulators'
106 approval of the plan, and executing the process on generally an annual basis.
107 They also continue to administer the resulting supply contracts, maintain
108 customer care and billing functions, and be the provider of last resort in case of
109 supplier default.

110 In contrast, under the portfolio management approach, the utility retains
111 the day-to-day responsibility for directly procuring resources, managing price and
112 volume risks, and providing full requirements, load-following service for its

113 regulated service customers. This generally would be done according to fairly
114 flexible but commission-approved procurement processes. The contracts within
115 the utility's portfolio could be a variety of energy and capacity products (*e.g.*,
116 baseload, peakload, capacity release option, load following, and ancillary service
117 contracts) of various durations and flexible pricing methodologies tailored to meet
118 the expected demand for regulated service at reasonably stable costs.

119 **Q. Ameren's procurement proposal is based on the "vertical tranche" or**
120 **standard offer approach. What are the advantages of the procurement**
121 **approach relative to the portfolio management approach?**

122 A. Based on my review of other states' experience, I find that the vertical tranche
123 approach offers a more transparent, less contentious process, provides a better
124 allocation of risk, and is used in more retail access states facing policy issues
125 similar to those in Illinois.

126 The vertical tranche approach is exceptionally transparent because the
127 procurement of standardized supply products (*i.e.*, shares of full requirements
128 service for different customer classes and varying contract durations) allows for
129 the full pre-specification and approval of the procurement and evaluation process
130 without the need to apply additional judgment or require additional negotiation
131 within the procurement process. This means all price, non-price, and bid
132 evaluation issues can be fully resolved and specified prior to conducting the actual
133 procurement process. This full pre-specification and pre-approval of the
134 procurement process not only increases transparency, which is particularly
135 important in the context of participation by affiliated suppliers, but it also

136 typically results in a less complex, less contentious regulatory process. As Mr.
137 Nelson further discusses in his testimony, the transparency and competitiveness of
138 the vertical tranche approach also have been able to avoid concerns over
139 compliance with FERC's affiliate sales requirements.

140 The vertical tranche approach promises procurement efficiencies as the
141 difficult tasks of least-cost resource portfolio selection, risk management, and
142 day-to-day portfolio management utilize the experience and expertise of
143 wholesale suppliers in deregulated power markets, without the need to duplicate
144 these functions and capabilities within the regulated utility. In addition, the
145 approach allows for participation of a wide, diverse group of suppliers and
146 provides stable but market-based rates that customers can compare easily with
147 other retail market options. Such straightforward comparison of choices for
148 consumers furthers the development of retail competition.

149 In contrast, the portfolio management approach, which is more akin to
150 traditional integrated resource planning and "energy plans" used prior to the
151 introduction of retail access, would allow for somewhat more procurement
152 flexibility by the utility. It also may require less supplier sophistication, as single-
153 asset suppliers can sell directly to the utility and suppliers can bid traditional
154 energy and capacity products. However, the apparent accommodation of less
155 sophisticated suppliers does not appear to be a true advantage, as wholesale
156 markets already accommodate single-asset suppliers and the sale of traditional
157 energy and capacity products.

158 The drawbacks of the portfolio management approach, for example,
159 include significantly more complex resource selection and bid evaluation criteria
160 that reduce the transparency of the procurement process and can result in a
161 lengthy and more contentious regulatory process as procurement decisions are
162 second-guessed based on after-the-fact analysis. This aspect, when combined
163 with the need for rate adjustments (*e.g.*, due to variability in average costs driven
164 by factors such as customer switching, spot market sales and purchases, or plant
165 outages of single-asset suppliers), can result in more uncertainty for retail
166 customers as a more substantial portion of costs and retail rates may not be known
167 until after the fact. This uncertainty also can create significant procurement-
168 related regulatory risks for the utility (such as disputes over procurement
169 decisions and the potential for stranded costs due to unanticipated customer
170 switching) that are difficult to manage by a distribution company in the absence
171 of asset-based rates of return.

172 **Q. You noted earlier that the vertical tranche approach is used in more retail**
173 **access states facing policy issues similar to those in Illinois. How many states**
174 **use the vertical tranche approach compared to the portfolio management**
175 **approach, and how are the policy issues faced in these states similar to those**
176 **faced in Illinois?**

177 A. The survey of procurement approaches in restructured states showed that: (1) nine
178 states (including the District of Columbia)³ use variations of the vertical tranche
179 approach for the post-transition procurement of regulated service supplies; (2) six

³ For the purpose of counting restructured states and procurement approaches, I include the District of Columbia as a “state.”

180 states use variations of the portfolio management approach for such procurement;
181 and (3) six states either cannot easily be categorized into one of the two general
182 approaches or have not yet made a decision on post-transition competitive
183 procurement.⁴ As I will discuss further below, this review also shows that the
184 vertical tranche approach is the predominant procurement methodology for
185 utilities in states facing policy issues similar to those in Illinois, where: (1)
186 generation assets are no longer cost-of-service regulated; (2) retail access has not
187 been limited or suspended; and (3) restructuring has moved beyond the transition
188 period during which retail rates for regulated service generally were frozen.

189 **Q. Which are the restructured states that currently employ the vertical tranche**
190 **procurement approach?**

191 A. While implementation details differ, the nine states that already use variations of
192 the vertical tranche approach include Connecticut, the District of Columbia,
193 Maine, Maryland, Massachusetts, New Jersey, Ohio, Rhode Island, and Texas. In
194 Ohio the vertical tranche approach has been prescribed (but not yet implemented)
195 as the preferred methodology for post-transition procurement of regulated retail
196 service, though alternative approaches can be and have been proposed by the
197 utilities. Texas uses this approach only for its “provider of last resort service”
198 (the only safety net service for large customers and the backup service to the
199 price-capped “price-to-beat” service offered to smaller customers), which is in
200 place through January 2007.

⁴ See Table 2 in Resp. Ex. 7.2.

201 **Q. Which restructured states use the portfolio management approach and how**
202 **do these states' policy issues differ from Illinois?**

203 A. Variations of the portfolio management approach are used in Arizona, California,
204 Montana, Nevada, New York, and Oregon. The policy issues in these
205 restructured states differ significantly from those in Illinois. For example, in
206 some of these restructured states—Arizona, Nevada, and Oregon—the major
207 utilities still maintain cost-of-service regulated generation assets. Among states
208 where generation assets were generally removed from the utilities' rate base, the
209 portfolio management approach has only been implemented in California and
210 Montana. But both of these states suspended retail access for the majority of
211 customers. In New York, utilities apply a variety of portfolio management
212 approaches, but most still include heavy reliance on divestiture-related fixed- and
213 variable-priced contracts, supplemented with spot market purchases from the New
214 York ISO or hedging contracts.

215 **Q. You also mentioned earlier that six states either cannot easily be categorized**
216 **into one of the two general approaches or have not yet made a decision on a**
217 **post-transition competitive procurement methodology. Which are these**
218 **states?**

219 A. The states that have not yet made a decision on competitive post-transition
220 procurement are Illinois, Michigan, Delaware, Virginia, and New Hampshire. In
221 Pennsylvania the utilities' regulated service option is provided at capped rates that
222 were determined for the entire transition period in the initial restructuring effort.
223 Pennsylvania restructuring law does not require utilities to competitively procure

224 generation for these regulated service offerings. While some competitive
225 solicitations to serve retail customers have been undertaken, much of the resource
226 requirements for these regulated service options are supplied under buyback
227 contracts from the utilities' unregulated generation affiliates.

228 **Q. What are common features of the vertical tranche procurement approaches**
229 **used in similarly-restructured states?**

230 A. The procurement approaches used in these states share several important
231 similarities, including: (1) the product procured is a full requirements, load
232 following service for a fixed share of the utilities' continued regulated service
233 obligation; (2) much of customer switching risk is transferred to bidders/suppliers;
234 (3) a tradeoff between rate stability and rates that are reasonably reflective of
235 market prices is typically achieved for small customers through overlapping
236 multi-year contracts, while regulated service for large customers, if offered at all,
237 is procured and priced on a much shorter-term basis; (4) pre-specified
238 procurement processes are approved by the regulatory commission, which
239 facilitates the almost immediate approval of procurement results, with costs fully
240 passed through in retail rates; and (5) with the exception of Maine and Texas,
241 where the selected suppliers directly serve individual retail customers, the
242 procurement in these states is generally based on wholesale contracts between
243 suppliers and the respective distribution companies.

244 In addition, all of these states bid out shares of their regulated service load
245 separately for different customer classes, though the degree of aggregation varies
246 by state and states have made different choices on how to tailor the service for

247 each group. For example, New Jersey, Maryland, the District of Columbia, and
248 Ohio provide some more price stability for small customers relative to larger
249 industrial customers, with overlapping one- to three-year contracts for small
250 customers. In contrast, Massachusetts uses six month procurement cycles with
251 overlapping one-year contracts for residential customers, but this apparently is in
252 part driven by a state law that exempts contracts of up to one-year from pre-
253 approval requirements.

254 Annual or even shorter-term contracts typically are used to procure
255 supplies for regulated service options offered to large customers, who may require
256 less price stability and who likely are more predisposed to opportunistic switching
257 between regulated and competitive service options in response to temporary price
258 differences. In this regard, Texas and New Jersey are the extreme examples, with
259 large customers being offered only hourly wholesale spot market pricing.
260 Massachusetts has moved to quarterly procurement and pricing of the regulated
261 service option available to large customers.

262 **Q. How has Ameren utilized this review of procurement processes in other**
263 **restructured states?**

264 A. As Mr. Nelson explains in his testimony, Ameren has used the review of the
265 experience in other restructured states in its contributions to the Commission's
266 Post 2006 Initiative, and in developing the Post-2006 framework for the Ameren
267 Companies that was presented to and discussed with Commission Staff and other
268 stakeholders. As Mr. Nelson also explains, this experience along with all other
269 guidance and insights obtained at that point was synthesized in Ameren's

270 whitepaper, “Post-2006 Guidelines and Ameren Competitive Procurement
271 Proposal” which formed the basis for Ameren’s stakeholder discussions.

272 **Q. Are there any examples of how a state’s renewable portfolio standard can be**
273 **integrated into a vertical tranche procurement process?**

274 A. Yes. New Jersey, Maryland, and the District of Columbia present good examples.
275 In all three examples, renewable resource requirements are simply passed on to
276 the suppliers of basic generation service by contractually requiring that each
277 supplier satisfy the renewable portfolio standards with respect to its supply
278 obligation.

279 **III. EXAMPLES OF PROCUREMENT APPROACHES USED IN OTHER**
280 **RESTRUCTURED STATES**

281 **Q. Have you prepared summaries of how some of these “vertical tranche” states**
282 **have structured their procurement approaches?**

283 A. Yes. I prepared summaries of the procurement approaches used in the District of
284 Columbia, Maryland, Massachusetts, Maine, New Jersey, and Ohio. These
285 summaries are included the Electricity Journal article attached as
286 Resp. Exhibit 7.2.

287 **Q. How did Maryland and the District of Columbia structure their procurement**
288 **approaches?**

289 A. The Maryland Public Service Commission (“PSC”) and the PSC of the District of
290 Columbia have implemented very similar approaches. The Maryland approach,
291 based on two PSC-approved settlements with a large group of stakeholders,
292 implemented a post-rate-freeze procurement model in which regulated service
293 load (called “standard offer”) is segmented into individual percentage shares of

294 full requirements service for residential and three groups of non-residential
295 customers.⁵ Each load share was sized to represent an annual peak load of
296 approximately 50 MW, with contract durations from one to three years. The PSC
297 found that this procurement model represents a sound public policy choice,
298 offering high transparency and giving customers price stability while also
299 promoting reliability. The PSC also recognized that the majority of jurisdictions
300 that have enacted retail choice have adopted this type of procurement model.
301 Additionally, the PSC found that bidders are already familiar with this approach,
302 which should lead to greater participation and more competitive bids. The
303 District of Columbia commission issued an order on March 1, 2004, that largely
304 adopted the Maryland model as the procurement process for standard offer service
305 after the utilities' rate freeze periods end in 2005-06.⁶

306 The Maryland utilities completed their first procurement cycle based on
307 this model using a sealed-bid auction format with four rounds of bidding spread
308 over approximately six weeks. As the PSC announced, the successful and "highly
309 competitive bidding process" involved twenty-five wholesale suppliers offering
310 four to five times the amount of supply solicited.⁷ The solicitation involved the
311 complete retail needs of two of Maryland's utilities, PEPCO and Conectiv, and
312 the non-residential load obligations of Baltimore Gas & Electric as of July 1,

⁵ See MD PSC, Order Nos. 78400 (dated 4/29/03) and 78710 (dated 9/30/03), *In the Matter of the Commission's Inquiry into the Competitive Selection of Electric Supplier/Standard Offer Service*, Case No. 8908.

⁶ See DC PSC, Order Adopting Wholesale Standard Offer Service Process in Case No. 1017, issued March 1, 2004.

313 2004. The load subject to procurement in this procurement cycle for the three
314 operating utilities represented about 5,700 MW of peak load, which is about 45%
315 of the Maryland total and 7% of PJM RTO peak load. This process resulted in
316 contracts being awarded to a group of 14 individual suppliers.

317 **Q. How did Maine structure its procurement for the utilities regulated service**
318 **offerings?**

319 A. Maine’s restructuring law, like that in Massachusetts, required divestiture of all
320 generation and Qualifying Facility supply contracts; but Maine also immediately
321 dispensed with the price-capped transition period found in other states. Under
322 Maine’s retail electric access rules, which opened up retail markets in early 2000,
323 the commission is tasked with ensuring that “standard offer service” is available.
324 The procurement for Maine’s regulated service thus had to precede the start of
325 retail access—at a time when the ISO New England was still in its infancy. The
326 restructuring laws required that the commission itself solicit suppliers of regulated
327 retail load through a competitive bid process. From the beginning, the Maine
328 commission conducted its own “retail” procurement for full-requirements service,
329 experimenting with annual and multi-year contracts.⁸ While small customers are
330 served through three-year contracts, in the most recent procurement cycle, bids to
331 supply medium and large customers were solicited for six-month and one year
332 terms. The commission selected six-month terms to allow regulated retail prices

⁷ MD PSC, “MD PSC Announces Successful Completion of Bidding for Electric Standard Offer Service,” April, 2, 2004: <http://www.psc.state.md.us>.

⁸ Maine Public Utilities Commission, Standard Offer Study and Recommendations Regarding Service After March 1, 2005, December 1, 2002, Appendix E: “Detailed Summary of Standard Offer Bid Processes and Results.”

333 to track more closely changes in market prices in two of its major utility service
334 territories for both medium and large customer classes. Like in many other states
335 using a vertical tranche approach, the Maine commission found that shorter term
336 pricing for large customers will facilitate service from alternative retail suppliers.

337 **Q. Would you please summarize the procurement approach used in New**
338 **Jersey?**

339 A. In 2004, the New Jersey utilities completed their third annual auction for post-
340 transition period “basic generation service.”⁹ In this procurement approach, the
341 four New Jersey electric distribution companies simultaneously auction off shares
342 of full requirements service for two product classes and two contract durations.
343 Each load share is sized to represent an annual peak load of approximately 100
344 MW, with contract durations of one and three years. The two products are Fixed
345 Price (“FP”) for residential, small and medium non-residential customers and
346 Commercial Industrial Electric Pricing (“CIEP”) for large non-residential
347 customers with peak loads greater than 1,500 kW. Bids for FP were a fixed, all-in
348 price (cents/kWh) while bids for CIEP included only a capacity charge (\$/MW-
349 day) under which suppliers would provide energy charged at the hourly energy
350 price of the PJM spot market. Under the NJ auction process, an internet-based,
351 multi-round “descending clock” auction format was used to determine a single
352 market clearing price that is applied to all winning bids within each contract type
353 (*i.e.*, utility, customer class, and contract duration). The New Jersey Board found

⁹ See New Jersey Board of Public Utilities, “New Jersey Board of Public Utilities Certifies Results of the Basic Generation Service Auction”, February 11, 2004. The NJ procurement processes were pre-approved by the Board of Public Utilities: Decisions and Orders in Docket Nos. EX01050303 (dated 12/11/01), EX01110754 & EO02070384 (dated 12/18/02), and EO03050394 (dated 12/2/03).

354 that this procurement process worked well and provided the best prices possible.
355 New Jersey commissioner Butler also noted other advantages during his
356 presentation at the Post-2006 Symposium: (1) proper risk sharing (risk is borne by
357 those who can manage it at lowest cost); (2) transparency (leads to more
358 aggressive bidding); and (3) objective and fair (attracts more bidders and
359 minimizes post-auction challenges).¹⁰

360 In the February 2004 auction, a total of 10,000 MW of FP load was
361 auctioned off to twelve winning bidders. These winners were primarily
362 traditional power marketers, but also included Morgan Stanley Capital Group and
363 J. Aron—illustrating the increasing presence of financial services firms in
364 wholesale energy markets. Also, for the first time Public Service Enterprise
365 Group (“PSEG”) affiliate PSEG Energy Resources and Trade participated and
366 secured tranches in the auction process. In addition, a total of 2,460 MW of CIEP
367 load was auctioned off to six winning bidders, all of whom were traditional power
368 marketers. When combined, approximately 12,500 MW, which is 64% of New
369 Jersey’s retail load and 15% of PJM’s, was contracted for during the most recent
370 auction. Another 23% of New Jersey’s retail load is still being supplied by
371 winners from previous auctions and the remaining 13% is being supplied by
372 alternative retail providers.

373 **Q. Please summarize the procurement approach utilized in Massachusetts.**

374 A. Massachusetts has two regulated service offers, “standard offer” for customers
375 that have never switched and “default service” for new customers or customers

¹⁰ Frederick Butler, Presentation at the Illinois Commerce Commission Post-2006 Symposium, April 29, 2004, p. 8.

376 returning from alternative retail suppliers. The “standard offer” service has been
377 supplied by buy-back contracts from divested generation with the price based on a
378 pre-set schedule and a fuel-price-index adjustment. It expires at the end of
379 February 2005 and all remaining regulated service customers will move to default
380 service.¹¹

381 For several years, the procurement of default service supply has been
382 undertaken using a vertical tranche approach based on a six month cycle with
383 overlapping one year contracts. In 2003, the six month cycle was shortened to
384 three months (procuring all supplies with quarterly contracts) for medium-sized
385 and large commercial and industrial customers with monthly demands greater
386 than 10 MWh and peak loads in excess of 200 kW. This modification to shorter-
387 term market-based pricing was made to further the development of retail
388 competition for large customers. The Massachusetts D.T.E. found that the
389 overlapping contracts for smaller customers provide protection against spot
390 market volatility, thereby providing stable market-based prices that customers can
391 compare to other supply options.

392 **Q. How has Ohio structured its post-transition procurement approach?**

393 A. Based on an order by the Ohio Public Utilities Commission (“PUC”), the vertical
394 tranche approach has been selected as the default procurement methodology for
395 Ohio utilities as some of them may transition out of their rate freeze period at the

¹¹ Massachusetts D.T.E. Orders 02-40-A, 02-40-B, and 02-40-C, *Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service*, dated 2/13/03, 4/24/03 and 9/12/03.

396 end of 2005.¹² Though alternative processes can be proposed by the utilities, this
397 default methodology requires utilities to establish competitive procurement
398 processes for load shares of full requirements service for residential, small non-
399 residential, and large non-residential customers. These customer classes would be
400 offered fixed- and variable-priced rate options based on overlapping supply
401 contracts of one to three years in duration. The Ohio PUC encouraged
402 independently-monitored auctions as the procurement process, though
403 implementation details have been left to the individual utilities. The PUC noted
404 improved risk allocation (by placing the risk on the winning bidder as reflected in
405 bid prices) as a benefit of this approach.

406 So far, however, most Ohio utilities have submitted alternative processes
407 under which the initial transition period essentially is extended for several years.
408 Nevertheless, the state commission has continued to demonstrate its preference
409 for its competitive procurement approach by requiring First Energy to conduct an
410 auction in order to ensure that FirstEnergy's proposed rate plan does not result in
411 above-market rates. This auction was completed in late 2004, confirming that
412 FirstEnergy's proposed rates did not currently exceed the market prices resulting
413 from the auction.¹³ The FirstEnergy auction successfully solicited sufficient
414 supplies despite adverse conditions: FirstEnergy itself did not participate in the

¹² See Ohio PUC, order dated 12/17/03, *In the Matter of the Commission's Promulgation of Rules for the Conduct of a Competitive Bidding Process for Electric Distribution Utilities Pursuant to Section 4928.14, Revised Code*, Case No. 01-2164-EL-ORD.

¹³ See Ohio PUC, order dated 12/9/04. *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company for Approval of a Competitive Bid Process to Bid Out Their Retail Electric Load*, Case No. 04-1371-EL-ATA.

415 auction, the auction was held more than one year ahead of the contracts' delivery
416 date, and it was conducted before MISO implemented its Day 2 energy markets
417 and related market designs.

418 **Q. Have you also prepared summaries of restructured states' procurement**
419 **processes that are based on the portfolio management approach?**

420 A. Yes, I have prepared summaries of the procurement process in California and
421 Montana, both of which provide good examples of a comprehensive portfolio
422 management approach.

423 **Q. How is procurement handled in California?**

424 A. Having sold most of their natural gas and oil generation plants and having been
425 required to purchase all supplies through the California Power Exchange's and
426 ISO's spot markets, the major California utilities were devastated by the Energy
427 Crisis of 2000-01. Pacific Gas & Electric ("PG&E") filed for bankruptcy and
428 Southern California Edison ("SCE") watched its credit rating drop from A to
429 CCC. In early 2001, the California Department of Water Resources ("DWR")
430 was forced to step in and take over all procurement functions for PG&E and SCE.
431 In September 2002, Bill AB 57 became law, which was designed to put the
432 utilities back into the resource procurement business, using the portfolio
433 management approach and guidelines that would promote regulatory stability and
434 keep the IOUs credit worthy. Under this law, the California commission must
435 review and approve detailed utility procurement plans that clearly define selection
436 criteria for subsequent utility purchases. The resource plans must cover: an
437 assessment of price risk, definitions of resources to be procured, duration of

438 procured products, details of a competitive bid system, inclusion of performance-
439 based rates (if at all), general transaction cost recovery, procedures for updating
440 the plan, compliance with renewable and demand-side programs, risk
441 management strategy, promotion of supplier diversity, and procurement-related
442 administrative cost recovery. Of these elements, the commission has pressed
443 utilities for the most detail on risk management strategies and the types of
444 products to be procured over particular timeframes. The commission has also
445 promulgated minimum standards, including: use of a competitive, arms-length
446 procurement process; a clear code of conduct for all employees involved in the
447 process; and prudent administration of resources coupled with least-cost
448 dispatch.¹⁴ Transactions that meet the pre-approved resource plans and
449 procurement processes are automatically approved by the commission, are
450 presumed to be just and reasonable, and are fully recoverable in rates.

451 The California experience to date has shown that this process is quite
452 involved. The utilities had to hire significant staff and expend substantial
453 resources to develop portfolio/risk management capabilities. The complexity of
454 this subject area also presents a significant challenge for the commission and its
455 staff. There is a clear tension between the utilities' need for flexibility in
456 procurement decisions in the face of rapidly changing market conditions or
457 unique procurement opportunities on one hand and the commission's desire to
458 manage carefully and pre-specify the entire procurement process on the other.

¹⁴ California Public Utilities Commission, *Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development*, Decision 02-10-062, October 24, 2002.

459 Though a “Procurement Review Group” process established by the commission
460 has been a constructive forum for various stakeholders to discuss key issues, the
461 utilities’ major procurement decisions have been fairly contentious. While the
462 commission has approved 2003 and 2004 short-term plans for the utilities, a full
463 reasonableness proceeding under the new rules has been significantly delayed and
464 even the “expeditious” review of quarterly compliance filings has been a
465 somewhat slow and difficult process.

466 **Q. Would you please summarize the portfolio-management procurement**
467 **process used in Montana?**

468 A. Montana’s initial restructuring legislation would have opened all customer classes
469 to retail access by July 2002. However, in the face of the California energy crisis,
470 retail access for small customers was first postponed through July 2004. More
471 recent legislation then essentially suspended retail access for small customers
472 until 2027. After Montana Power Company’s (“Montana Power”) divestiture of
473 its generation assets, the expiration of a transitional buyback arrangement with
474 PP&L Montana, and the acquisition of Montana Power by Northwestern Energy,
475 the regulated utility faced the task of assembling a portfolio of resources to meet
476 its regulated service obligation. Regulatory rules and state legislation
477 implemented in 2003 provide “guidelines” under which the regulated utility: (1)
478 should procure the supply for its regulated service customers; and (2) can ask the
479 commission to pre-approve specific contracts, thus avoiding the risk of ex-post
480 prudence review. These guidelines specify facts, analyses, and principles the

481 utility should consider but do not mandate specific terms for how the portfolio
482 should be structured.¹⁵

483 In response to this regulatory framework, Northwestern Energy recently
484 filed its “Electric Default Supply Service Resource Procurement Plan” with the
485 Montana commission. The plan contains an extensive comparative risk
486 assessment of twelve different portfolios, each reflecting a different mix of
487 baseload, intermediate, and peaking contracts, along with renewable resources
488 and demand-side management options. After ranking these portfolios based on
489 cost/risk tradeoffs, the filing concludes that the current combination of baseload
490 purchase agreements with PP&L (due to expire in 2007) and spot purchases are
491 high cost/high risk, and that spot market purchases should be largely replaced
492 with increased reliance on dispatchable gas-fired generation or other firm
493 contracts. This is the utility’s second attempt to obtain the commission’s
494 endorsement of its supply strategy. (Some of the utility’s proposed modifications
495 of its supply portfolio were previously filed in 2001, but rejected by the
496 commission.) After the commission endorses the proposed supply strategy, the
497 utility would assemble the supply portfolio through a series of RFPs and then seek
498 approval of the selected contracts in separate filings.¹⁶ Similar to California, the
499 experience in Montana suggests that obtaining regulatory pre-approval of supply

¹⁵ See Administrative Rules of Montana, Sub-Chapter 82, “Default Electric Supplier Procurement Guidelines,” 6/30/03.

¹⁶ See Northwestern Energy’s “Electric Default Supply Resource Procurement Plan,” January 2004.

500 strategies and contracts under the portfolio management approach can be a
501 complex and often contentious undertaking.

502 **Q. Please summarize the salient findings with regard to those states that are**
503 **implementing the portfolio management approach?**

504 A. The portfolio management approach is more akin to the integrated resource
505 planning approaches used under traditional regulation. Not surprisingly, it is used
506 mostly in states that have either suspended retail access or continue to provide
507 regulated service through rate-based generation. The experience in California and
508 Montana shows that portfolio management by the regulated utilities can be a quite
509 involved and contentious process.

510 **IV. CONCLUSIONS**

511 **Q. Based on your review of competitive procurement approaches in other**
512 **restructured states, what conclusions do you draw with respect to Ameren's**
513 **proposed procurement approach?**

514 A. Ameren's competitive procurement proposal, based on the "vertical tranche"
515 approach, is a well-tested approach that has been utilized successfully in nine
516 other restructured states, including New Jersey, Maryland, and the District of
517 Columbia. In fact, the vertical tranche approach is the predominant procurement
518 methodology for utilities in states facing policy issues similar to those in Illinois:
519 (1) where generation assets are no longer cost-of-service regulated; (2) where
520 retail access has not been limited or suspended; and (3) where restructuring has
521 moved beyond the transition period during which retail rates for regulated service
522 generally were frozen. Ameren's proposed auction process, modeled after New

523 Jersey's multi-round "descending clock" auction, also has been used successfully
524 for several years to procure basic generation service for a number of utilities.
525 Ameren's proposed process thus constitutes a "best practice" approach that should
526 result in the efficient, competitive procurement of supplies for the post-2006
527 regulated service obligations of Ameren's distribution companies in Illinois.

528 **Q. Does this conclude your testimony?**

529 **A.** Yes, it does.