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

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I. INTRODUCTION

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

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

Q. Please summarize your educational background and qualifications.

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

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

Q. What is the purpose of your testimony?

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

II. EXPERIENCE WITH PROCUREMENT IN OTHER RESTRUCTURED STATES

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

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

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

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

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

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[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)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. The survey of procurement approaches in restructured states showed that: (1) nine states (including the District of Columbia)[3] use variations of the vertical tranche 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."

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

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

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

[4] See Table 2 in Resp. Ex. 7.2.

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

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

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

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

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

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

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

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

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

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

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

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

whitepaper, "Post-2006 Guidelines and Ameren Competitive Procurement Proposal" which formed the basis for Ameren's stakeholder discussions.

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

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

III. EXAMPLES OF PROCUREMENT APPROACHES USED IN OTHER RESTRUCTURED STATES

Q. Have you prepared summaries of how some of these "vertical tranche" states have structured their procurement approaches?

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

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

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

full requirements service for residential and three groups of non-residential customers.[5] Each load share was sized to represent an annual peak load of approximately 50 MW, with contract durations from one to three years. The PSC found that this procurement model represents a sound public policy choice, offering high transparency and giving customers price stability while also promoting reliability. The PSC also recognized that the majority of jurisdictions that have enacted retail choice have adopted this type of procurement model. Additionally, the PSC found that bidders are already familiar with this approach, which should lead to greater participation and more competitive bids. The District of Columbia commission issued an order on March 1, 2004, that largely adopted the Maryland model as the procurement process for standard offer service after the utilities' rate freeze periods end in 2005-06.[6]

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

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[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.

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

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

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

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

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

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

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

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

Q. Please summarize the procurement approach utilized in Massachusetts.

A. Massachusetts has two regulated service offers, "standard offer" for customers 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.

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

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

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

A. Based on an order by the Ohio Public Utilities Commission ("PUC"), the vertical tranche approach has been selected as the default procurement methodology for 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.

end of 2005.[12] Though alternative processes can be proposed by the utilities, this default methodology requires utilities to establish competitive procurement processes for load shares of full requirements service for residential, small non-residential, and large non-residential customers. These customer classes would be offered fixed- and variable-priced rate options based on overlapping supply contracts of one to three years in duration. The Ohio PUC encouraged independently-monitored auctions as the procurement process, though implementation details have been left to the individual utilities. The PUC noted improved risk allocation (by placing the risk on the winning bidder as reflected in bid prices) as a benefit of this approach.

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

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

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

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

Q. How is procurement handled in California?

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

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

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

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[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.

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

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

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

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

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

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

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

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

IV. CONCLUSIONS

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

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

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

Q. Does this conclude your testimony?

A. Yes, it does.