STATE OF ILLINOIS

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Central Illinois Light Company d/b/a AmerenCILCO, **Proposal to implement a competitive procurement process by establishing Rider BGS, Rider BGS-L, Rider RTP, Rider RTP-L, Rider D, and Rider MV**	: : : : : : : :	**No. 05-0160**
Central Illinois Public Service Company d/b/a AmerenCIPS **Proposal to implement a competitive procurement process by establishing Rider BGS, Rider BGS-L, Rider RTP, Rider RTP-L, Rider D, and Rider MV**	: : : : : : : :	**No. 05-0161**
Illinois Power Company d/b/a AmerenIP **Proposal to implement a competitive procurement process by establishing Rider BGS, Rider BGS-L, Rider RTP, Rider RTP-L, Rider D, and Rider MV**	: : : : : :	**No. 05-0162** **(Consol.)**

REPLY BRIEF

OF

DIRECT ENERGY SERVICES, LLC

AND

U.S. ENERGY SAVINGS CORP.

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REPLY BRIEF OF
DIRECT ENERGY SERVICES, LLC
AND U.S. ENERGY SAVINGS CORP.

Direct Energy Services, LLC ("DES") and U.S. Energy Savings Corp. ("USESC"), by their attorneys DLA Piper Rudnick Gray Cary US LLP, pursuant to Section 10-101 of the Public Utilities Act (the "Act") and Section 200.800 of the Rules of Practice of the Illinois Commerce Commission ("Commission"), hereby submit their Reply Brief responding to the initial briefs filed by 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 (collectively, "Ameren") and Staff of the Commission ("Staff") in the instant proceeding.

I. <u>Executive Summary</u>: Price Stability Under Ameren's Proposal Would Come At Too High Of A Price

Direct Energy and USESC have set forth a simple and straightforward modification to Ameren's procurement proposal:

> **First,** customers with over 1 MW annual peak demand would have a default rate that is hourly;
>
> **Second**, customers that have under 1 MW annual peak demand and usage greater than 15,000 kWh a year would receive a default price that results from a monthly auction; and
>
> **Third**, customers that use 15,000 kWh or less a year would receive a default price that results from a quarterly auction.

Ameren and Staff were the only parties to comment on the Direct Energy and USESC proposal; both assert the Commission should emphasize price stability to consumers above providing proper price signals or promoting the competitive market. (*See* Ameren Init. Br. at 92-93; Staff Init. Br. at 82-92.) As explained in the Initial Brief of Direct Energy and USESC, price stability under Ameren's proposal would come at too high of a price for consumers. Ameren's plan ensures that customers on Ameren's default service would not be able to appropriately respond to market prices, and almost certainly would overpay for the service that they receive. The Commission should not endorse a policy that undermines the development of the competitive market and significantly risks locking in long-term contracts for default service that are well above the market price of electricity.

In order to advance the best interests of the citizens and businesses of Illinois, the Commission should direct Ameren to revise its auction proposal by promoting the development of an effective and efficient market for retail electricity service in line with the modifications proposed by Direct Energy and USESC. Accordingly, Direct Energy and USESC respectfully request that the Commission enter an Order in this proceeding amending Ameren's proposal consistent with the changes proposed by Direct Energy and USESC.

V. <u>Auction Design Issues</u>

A. General Effectiveness and Suitability

Ameren and Staff each assert that the Commission should reject the modifications proposed by Direct Energy and USESC based upon their proclaimed concern about price stability. As discussed in the Direct Energy and USESC Initial Brief at pages 12 to 15, and as further discussed below, this concern is overblown and misguided. Further, the criticism lodged by Ameren and Staff does not refute the testimony of Direct Energy Vice President James Steffes, which explained the benefits associated with the modifications advocated by Direct Energy and USESC.

There Is No Dispute That Shorter-Term
<u>Contracts Yield Substantial Consumer Benefits</u>

Based upon the positions outlined in the parties' initial briefs, it is clear that there are substantial consumer benefits associated with including shorter-term contracts in the auction process. Indeed, much can be gleaned from the fact that parties do not dispute the expert testimony sponsored by Direct Energy and USESC.

First, no party takes issue with the fact that contracts with durations of longer than one year are saddled with an elevated risk premium. (*See* DES/USESC Init. Br. at 12-13, DES/USESC Ex. 1.0 at lines 163-69.) Indeed, Staff seems to acknowledge as much. Staff witness Zuraski cites concern about "potential risk premiums associated with long-term contracts" and concludes that "long-term contracts may entail an excessive risk premium." (Staff Init. Br. at 83 *quoting* Staff Ex. 12.0.) It appears that residential and small business customers may pay approximately 10% higher default service prices under Ameren's proposal than they would under a model with shorter-term contracts. (*See* DES/USESC Init. Br. at 12.)

Second, no party takes issue with the fact that long-term contracts remove the impact of changes in market price driven by supply and demand, to the detriment of the competitive market. (*See* DES/USESC Init. Br. at 14-15; DES/USESC Ex. 1.0 at lines 312-19.) Again, Staff cites the testimony of Staff witness Zuraski: "if there is a significant expected upward or downward trend in market prices, the longer-term contracts will induce uneconomic retail switching activity." (Staff Init. Br. at 83 *quoting* Staff Ex. 12.0.)

Third, no party disagrees with the conclusion that a default service based on long-term contracts can contribute to a lack of demand-side reductions, and increased environmental harm due to increased energy consumption. (*See* DES/USESC Init. Br. at 13-14; DES/USESC Ex. 1.0 at lines 312-28.)

Finally, no party disagrees that if market prices decline substantially during the term of the default service contracts and consumers do not have competitive options, it could yield the worst of all possible scenarios: consumers locked into high rates with no real competitive option. (*See* DES/USESC Init. Br. at 12; DES/USESC Ex. 1.0 at lines 279-85.)

In short, no party has taken issue with the testimony of Direct Energy and U.S. Energy Savings Corp. that there are substantial benefits associated with an auction process that incorporates shorter-term contracts. Indeed, although Staff recommends that the Commission adopt Ameren's proposal, Staff makes the case for a revised process, relying upon shorter-term contracts, particularly for the first auction.[1] (*See* Staff Init. Br. at 83.)

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[1] Staff quotes the following passage from the testimony of Staff witness Zuraski: "[A]s with any new process, the possibility of discovering problems or errors is higher for the initial implementation of the auction and will diminish over the course of subsequent auctions as problems are discovered and remedied on a going-forward basis. However, the length of time that is required before any remedial measures can take effect generally will be tied to the length of the supply contracts. In this regard,

Nevertheless, Ameren and Staff suggest that the Commission should forgo these benefits due to an unsubstantiated concern about price stability. The Commission should put this concern in proper perspective, and understand that the Direct Energy and USESC proposal would not expose customers to unmanageable price variability.

The Concern Regarding
Price Stability Has Been Overstated

Although Direct Energy and USESC appreciate the need to balance the competing interests of mitigating price variability and sending meaningful price signals, the Ameren proposal goes too far in focusing upon price stability and fails to provide consumers with market sensitive pricing. Both Ameren and Staff assert that the Direct Energy and USESC proposal is inconsistent with the goal of achieving price stability. (*See* Ameren Init. Br. at 87; Staff Init. Br. at 84.) However, the Commission can achieve significant consumer benefits by endorsing the Direct Energy and USESC revisions to Ameren's proposal.

As an initial matter, the Commission should note that in terms of the frequency of price adjustments the modifications proposed by Direct Energy and USESC are not substantial. The following table illustrates the similarities:

it may make more sense to test the waters with shorter-term contracts until all the problems with the auction (if any) have been identified and, if possible, eliminated or ameliorated." (Staff Init. Br. at 83 *quoting* ICC Staff Ex. 12.0.)

Table 1:
Comparison of Ameren, ComEd and DES/USESC Proposals

	Large Customers	Medium-sized Business Customers	Small Business and Residential Customers
Ameren Definition	>1 MW	n/a	< 1 MW
Ameren Product	Semi-annual pricing based on annual wholesale supply product	n/a	Semi-annual pricing based on blended multi-year wholesale supply product
ComEd Definition	≥ 3 MW	3 MW to 400 kW	< 400 kW
ComEd Product	Hourly-priced product	Semi-annual pricing based on annual wholesale supply product	Semi-annual pricing based on blended multi-year wholesale supply product
DES/USESC Definition	>1 MW	1 MW to 15,000 kWh annually	< 15,000 kWh annually
DES/USESC Product	Hourly-priced product	Monthly-priced Product based on monthly wholesale supply product	Quarterly-priced product based on quarterly wholesale supply product

For the largest customers, Ameren agrees with Direct Energy and USESC that the line should be drawn at those customers with demands over 1 MW.

ComEd agrees with Direct Energy and USESC that there should be a separate customer grouping for medium-sized business customers, who should have a price that is reset more frequently than residential customers.[2] For many of the customers that Direct Energy and USESC consider medium-sized business customers (with demands of less than 1 MW), Direct Energy and USESC suggest that their price be adjusted monthly rather than semi-annually as suggested by ComEd, whereas Ameren has proposed to group those customers in the same multi-year blended product auction as small commercial and residential customers. Direct Energy and USESC recommend that business customers with demands of less than 1 MW and with usage of more than 15,000 kWh[3] annually be included in a monthly auction, allowing the market to reflect changing market conditions throughout the year.

Finally, for the residential and small business customers, rather than have a regulatory construct reflect seasonality by translating multi-year contracts on a semi-annual basis as suggested by Ameren, Direct Energy and USESC's recommended quarterly adjustments in price based upon quarterly auctions. Despite the reasonable revisions that Direct Energy and USESC have proposed, Ameren asserted that the Direct Energy and USESC proposal "cannot be procured efficiently using auctions." (Ameren Init. Br. at 87.) However, Ameren misses the ultimate point of the Direct Energy USESC proposal: to provide rates that accurately reflect market costs. The Staff Report regarding the post-2006 Workshop process (upon which Ameren so heavily relies) recognized that the procurement process should "result in market-based rates for customers." The Post 2006 Initiative, Final Staff Report to the Commission at 6, consensus item 4 (Dec. 2, 2004) ("Staff Report"). Ameren's proposal fails in this regard. As stated repeatedly in the instant proceeding, the primary concern of Direct Energy and USESC is that a procurement methodology be implemented that would ensure that the retail rates ultimately

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[2] The Direct Energy and USESC proposal also achieves the substantial consumer benefits associated with establishing separate customer groupings for the small commercial and residential customers. That is, under the Direct Energy and USESC proposal, no migration risk premium associated with larger customers would be attributed to small commercial and residential customers.

[3] Direct Energy and USESC have established the 15,000 kWh defining line to comport with the definition of "small commercial retail customer" in the Public Utilities Act. (220 ILCS 5/16-102.)

provided to customers accurately reflect the wholesale costs of the market. (*See* DES/USESC Init. Br. at 11; DES/USESC Ex. 1.0 at lines 139-46.)

The Staff Report also highlights that the procurement process "should facilitate and encourage supplier participation of all types in the wholesale market. (*Id.* at 6, consensus item # 6.) As Direct Energy and USESC explained, there likely would be more participation in the auction under the Direct Energy and USESC proposal, given that the supplier risks would be lower in supplying monthly or quarterly products versus selling long-term contracts. (*See* DES/USESC Ex. 2.0 at lines 315-19.)

Moreover, Direct Energy and USESC have made it clear that their proposal does appropriately "mitigate rate volatility for applicable customers for relevant time periods." (*See id.*) Direct Energy and USESC also note that under their proposal the frequency of price variations is set based upon the sophistication of "applicable customers."

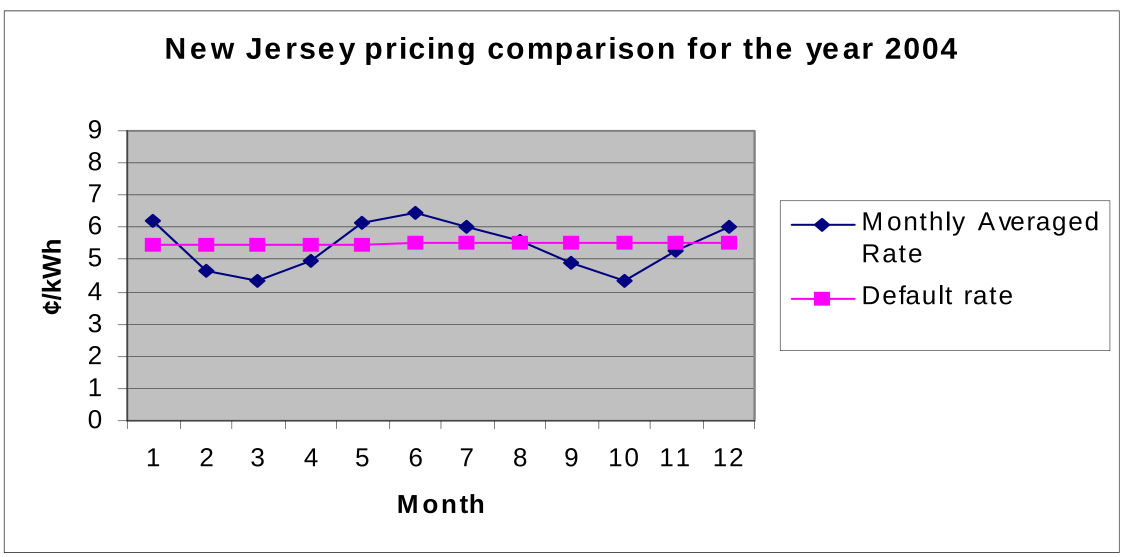
Although Direct Energy and USESC have proposed four quarterly and twelve monthly auctions a year, if that number of auctions were deemed to be too administratively burdensome (a point with which Direct Energy and USESC do not agree), Direct Energy and USESC note that it would be possible to create a mechanism that would deliver monthly and quarterly prices with fewer auctions. (*See* Steffes Tr. at 527.) Ameren offers nothing to support its assertion that holding regular auctions with a standardized product is infeasible, more expensive or more time-consuming than the Ameren proposal. (*See* Ameren Ex. 11.0 (Revised) at lines 775-84.) The Commission should anticipate that the time and expense associated with monthly auctions would diminish with experience and would not be greater than the benefits that accrue to consumers from a robust retail market.

Direct Energy and USESC have demonstrated that the price variability associated with their proposed modified auction structure is manageable and that consumers likely would pay less under their proposal.

In particular, Direct Energy and USESC presented a detailed analysis of how a residential customer in New Jersey would have fared using a monthly default rate rather than the blended rate that was generated through the New Jersey Basic Generation Service ("BGS") wholesale auction. (*See* DES/USESC Ex. 1.0 at 430-50.) Looking at 2004 data, the analysis concluded that residential customers would have saved $6 million over the course of the year, even assuming that there was no demand-side response to the price signals.[4] (*See id.*) Moreover, while prices would have fluctuated from month-to-month, the price movements were not substantial, and were the result of seasonality in the underlying wholesale market. (*See id.*)

Mr. Steffes presented the following graphic illustration of the results of his analysis:

Table 2



[4] Direct Energy and USESC presented a similar analysis using data for the periods 2001 through 2004, comparing a monthly pricing model against the tariffed service of ComEd's affiliate PECO, and concluded that residential customers would have experienced a savings of approximately 10% under the monthly price, even assuming no demand-side response. (*See* DES/USESC Init. Br. at 21; DES/USESC Ex. 2.0 at lines 228-33.)

(*Id.* at lines 445-46.) As Mr. Steffes concluded, "using a monthly pricing model not only creates demand side management and environmental benefits, it also does not expose customers to undue fluctuations in price." (*Id.* at lines 448-50.)

Finally, Direct Energy and USESC pointed to numerous examples of customers in Illinois and throughout North America capably managing their response to monthly energy pricing. (*See id.* at lines 453-515.) No party challenged the detailed examples of customers managing monthly and quarterly electric pricing in New York, Texas and Alberta, Canada; likewise no party disputed that Illinois consumers already successfully manage monthly pricing for natural gas. (*See id.*)

By ordering the modifications to Ameren's procurement proposal in line with the proposal set forth by Direct Energy and USESC, the Commission can appropriately set the stage for significant and substantial competition that would benefit all Illinois retail customers without exposing customers to unmanageable price volatility.

<u>CONCLUSION</u>: The Commission Should Order Modifications To Promote The Development Of The Competitive Market

As one door closes, the Commission must open the next door. The Commission should take the opportunity to establish a fully competitive retail electric market that benefits all Illinois consumers. The Commission should be wary of locking residential and small business customers into a series of long-term wholesale supply contracts that would have the unintended effect of denying those customers the advantages associated with a competitive retail electric market. Direct Energy and USESC have put forth straight-forward modifications to Ameren's procurement proposal that would enhance the development of a robust competitive retail electric market and benefit all Illinois consumers.

Direct Energy and USESC respectfully request that the Commission enter an Order directing Ameren to modify the products and customer groupings included in its procurement proposal as follows:

1. For customers with an annual peak demand over 1 MW, establish an hourly default rate.

2. For customers with an annual peak demand under 1 MW and usage greater than 15,000 kWh per year, establish a default price based on a monthly auction.

3. Customers consuming 15,000 kWh or less per year, establish a default price based upon a quarterly auction.

Without exposing customers to unmanageable price volatility, the Direct Energy and USESC proposal would yield just and reasonable default rates for electric service that better reflect the true cost of producing electricity. As a result, default service consumers would receive more timely and accurate price signals that encourage more efficient energy use and energy efficiency improvements.

Respectfully submitted,

DIRECT ENERGY SERVICES, LLC
U.S. ENERGY SAVINGS CORP.

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