STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Central Illinois Light Company d/b/a AmerenCILCO, Central Illinois Public Service Company d/b/a AmerenCIPS, Illinois Power Company d/b/a AmerenIP.	:	06-0447
Petition for Approval of Insurance Services Agreements with Affiliated Interests.	:	

PUBLIC
MOTION FOR LEAVE TO FILE *INSTANTER*

NOW COMES the Staff of the Illinois Commerce Commission ("Staff") through its undersigned attorney and moves for leave to file the Revised Direct Testimony of Dr. Thomas E. Kennedy, ICC Staff Exhibit 2.0R, *Instanter.* In support thereof, Staff states as follows:

1. Staff seeks to file a revised version of the Direct Testimony of Thomas E. Kennedy in both Unredacted and Redacted format. The changes are non-substantive.

2. The changes are found at:

   - Page 3, line 40;
   - Page 5, line 96;
   - Page 6, lines 108, 114, & 115;
   - Page 10, line 209;
   - Page 11, lines 221 & 232;

- Page 13, line 282;
- Page 16, lines 335 & 343.

2. Copies of the testimonies with the changes indicated by underline and strikethrough are attached to this Motion. Copies of the testimonies wherein the changes are not identified are being filed simultaneously with this Motion as “Testimony”.

3. No party will be prejudiced by the allowance of this Motion.

Wherefore, Staff respectfully prays that its Motion be granted, and that Staff be allowed to file said ICC Staff Exhibit 2.0R *instanter*.

Respectfully submitted,

Janis E. Von Qualen

JANIS E. VON QUALEN

Counsel for the Staff of the
Illinois Commerce Commission

January 25, 2007

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REVISED
REDACTED
DIRECT TESTIMONY

of

DR. THOMAS E. KENNEDY
MANAGER

POLICY PROGRAM
Energy Division
Illinois Commerce Commission

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

Petition for Approval of Insurance Services Agreements with Affiliated Interest

Docket No. 06-0447

January 25, 2007

Witness Identification

Q. Please state your name and business address.

A. My name is Thomas E. Kennedy. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

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

A. I am employed by the Illinois Commerce Commission ("Commission") as Manager of the Policy Program of the Energy Division.

Q. Please state your educational background.

A. I graduated from the University of California at Santa Barbara in 1969, receiving a Bachelor of Arts degree in Economics. I obtained a Master of Arts degree in Political Economy from Johns Hopkins University in 1974. I received my doctorate degree in Political Economy from Johns Hopkins University in 1975.

Q. Describe your professional experience.

A. Prior to coming to the Commission in August 1983, I was a member of the economics faculties of Kansas State University, University of Missouri at Columbia, and Northern Illinois University. I taught courses in microeconomics, industrial organization, and regulation. I was active in publishing in academic journals and presenting research at professional meetings.

From August 1983 until March 1985, I was a Senior Economist in the Policy Analysis and Research Division of the Illinois Commerce Commission. I specialized in market structure issues in the electric and natural gas industries. From March 1985 until May 1991, I was Director of the Energy Program. The Program had responsibilities in the areas of gas and electricity. From May 1991 until November 1997, I was Director of the Gas Program and Assistant Manager of the Policy Analysis and Research Division. When the Energy Division was formed in November 1997, I became Manager of its Policy Program.

Q. What are your primary responsibilities and duties as Manager of the Policy Program of the Energy Division?

A. I am responsible for developing and managing the Policy Program. The Program advises the Commission and other Staff on policy issues related to the gas and electric industries. The Program provides testimony on policy issues in Commission proceedings.

Q. Are you a member of any professional organizations?

A. Yes. I am a member and past Chairman of the Natural Gas Staff Subcommittee of the National Association of Regulatory Utility Commissioners. I am also a member of the American Economic Association.

Q. Have you testified in other proceedings before this Commission?

A. Yes. I have testified in eighteen cases: Dockets 85-0053, 85-0310, 88-0196, 86-0256, 87-0421, 89-0276, 90-0080, 90-0127, 91-0193, 91-0239, P91-0001, 93-0328, 96-0437, 98-0360, 98-0510, 98-0680, ~~and~~ 99-0013, and 99-0196. The first three cases involved local distribution company gas transportation rates. The fourth case concerned the formation of a utility holding company. The fifth case involved the certification of a common carrier pipeline. The sixth case was an electric rate case. The seventh case involved the statewide least-cost gas plan. The eighth and ninth cases were gas rate cases. The tenth case involved a local distribution company offering management services to transportation customers. The eleventh case involved an application to extend authority to operate as a common carrier by pipeline. The twelfth case was an investigation by the Commission into the appropriate recovery of “transition costs” associated with the Federal Energy Regulatory Commission’s Order 636. The thirteenth case involved market power issues in a merger between gas distribution companies. The fourteenth case dealt with a real-time pricing tariff for electric service. The fifteenth case concerned application for certification of a common carrier by pipeline. The sixteenth and seventeenth cases involved implementation of delivery services by electric utilities. The eighteenth case addressed approval of a gas distribution agreement between a utility and its generation affiliate under Section 7-101(3) of the Public Utilities Act.

Purpose of Proceeding and Testimony

Q. What is the purpose of this proceeding?

A. According to the Petition for Approval of Insurance Services Agreements with Affiliated Interest (“Petition”),

> 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 the “Illinois Utilities”) pursuant to Section 7-101(3) of the Illinois Public Utilities Act (the “Act”) 220 ILCS § 5/7-101(3), seek the approval of the Illinois Commerce Commission (“Commission”) to enter into certain Insurance Services Agreements (the “Agreements”) with Energy Risk Assurance Company (“ERAC”), an affiliate of the Illinois Utilities. (Petition, p. 1)

The Illinois Utilities are asking for permission from the Commission to purchase insurance from their captive insurance company ERAC. Ameren witness Thebeau states that ERAC will bid to provide coverage for Illinois Utilities along with other commercial insurers. (Ameren Ex. 1.0, p. 6)

Q. What is your assignment with respect to this proceeding?

A. My assignment is to evaluate the proposal to determine whether it is in the public interest.

Q. Have you come to any conclusions?

A. Yes. Establishment of an insurance relationship with the captive insurance company will result in incentives for the Illinois Utilities to make business decisions involving the captive that are not in the best interest of Illinois ratepayers. In particular, Illinois Utilities would have an incentive to acquire uneconomic insurance coverage from an affiliate in order to benefit the affiliate and ultimately Ameren Corporation, the parent company. The coverage would be uneconomic in the sense that the utilities’ customers would be better off having the utilities internalize the associated risks by not insuring against them.

A reason for this behavior would be to create a profit center for the holding company in the form of the captive. I recommend that the Commission reject the proposal to the Illinois Utilities to enter into the proposed affiliate agreements.

Evaluation of the Company Proposal

Q. How do Illinois Utilities obtain insurance currently?

A. According to Mr. Thebeau, the Illinois Utilities affiliate Ameren Services purchases insurance for them. Mr. Thebeau states that Ameren Services employs the two largest brokers in the world, Aon Insurance Managers, Inc. and Marsh Management Services, Inc., to help them. Ameren Services proposes improvements to existing insurance and determines desired attributes of new insurance. After meeting with brokers and underwriters, Ameren Services reviews underwriters' quotes from financially sound insurers and picks the best combination of coverage and price. (Ameren Ex 1.0, pp. 5-6) Based on Mr. Thebeau's testimony, Ameren Services appears to have primary control over the insurance purchased by Illinois Utilities.

Q. What is a captive insurance company?

A. The Insurance Information Institute defines captives as, "insurers that are created and wholly owned by one or more non-insurers, to provide owners with coverages. A form of self insurance." (http://www.iii.org/media/glossary/alfa.C/) A captive insurance company is created to insure the risks of the affiliated companies of the holding company that owns the captive.

Q. Are captives generally regulated like other insurance companies?

A. Yes. In Ameren's case, Mr. Thebeau (Ameren Ex. 1.0, p. 2) states that ERAC will be incorporated, licensed, and regulated in the State of Vermont. He states, "Notably, Vermont law, rules and regulations will serve to ensure that the captive insurance company will fully comply with the capital and surplus requirements." (Ameren Ex.1.0, p. 2) However, as he implies, the thrust of Vermont's regulation is to ensure that a captive~~s are~~ is operated in a manner that maintains ~~their~~ its financial viability ~~of the company~~ and not to ensure ~~their~~ its insurance rates are fair to the policy holders.

In the present case, the Illinois Utilities' parent, Ameren Corporation, capitalizes and owns ERAC. To the extent that ERAC issues insurance to the affiliates without reinsuring the risks in the wholesale insurance market, Ameren Corporation will be self insuring for the affiliates' insured losses. An Ameren affiliate buying insurance from ERAC would transfer the risk of insured losses to ERAC and ultimately to the parent company in return for an insurance payment to ERAC. To the extent found prudent, an Illinois utility could recover the cost of this insurance as an expense in a rate case.

Q. Have other utilities in Illinois been given permission to enter into insurance agreements with a captive insurance affiliate?

A. Illinois Power Company, then a subsidiary of Illinova, received permission from the Commission to obtain insurance from an affiliated captive insurance company for non-nuclear operations in Docket 96-0291. It is my understanding that Illinois Power ceased buying insurance from the captive in 2000. Since Illinois Power's acquisition by Ameren Corporation in the fall of 2004, Illinois Power has not been an affiliate of the captive. Therefore, Illinois Power is no longer eligible to purchase insurance from its former affiliate captive insurance company.

In Docket 01-0796, MidAmerican Energy Company requested permission to enter into insurance transactions with its captive insurance affiliate. The Commission order denied that request. The Commission Order on Rehearing states,

> The Commission, however, remains concerned that with the captive insurance arrangement, MidAmerican will have an incentive to act in a manner that is more favorable to its parent MEHC, rather than in the best interests of its ratepayers. (p. 11)

I know of no currently applicable Commission approval for a public utility in Illinois to purchase insurance from a captive affiliate.

Q. How does Ameren Services propose to obtain insurance for the Illinois Utilities if the agreement with ERAC is approved?

A. According to Mr. Thebeau, commercial insurers will be informed of ERAC's existence. ERAC will submit bids to Ameren Services along with commercial insurers. Ameren Services will then choose the best coverage and price combinations between bidders. (Ameren Ex 1.0, p. 6) Mr. Thebeau also explains that each of the three Illinois Utilities will seek separate policies rather than Ameren buying coverage for the group and allocating those costs across the Illinois Utilities.

Q. What reasons does Ameren use to support the request for permission to deal with ERAC?

A. First, Mr. Thebeau states,

> The insurance market for electric utilities generally consists of only a few participants, so changes in loss experience or market conditions can have a significant effect on Ameren Services' costs of purchasing insurance. Since there are few competitors, insurance premiums can be volatile. The 9-11attacks and large losses from gulf hurricanes have caused significant increases in insurance premiums. (Ameren Ex. 1.0, p. 4)

However, this statement, of itself, does not support his position. He does not provide support for his assertions either about the number of suppliers or that the number of suppliers somehow caused volatility. Market changes such as the 9-11 attacks may be responsible for fundamental changes in perceived risks in the insurance industry. These fundamental changes will affect the risk to all insurers, including captives. It does not create an advantage to having a captive.

Second, Mr. Thebeau states that availability of and changes in coverage will be enhanced. The Illinois Utilities Petition states, "Certain types of insurance are simply unavailable in the commercial market, such as for storm or earthquake damage to Transmission & Distribution ("T&D") lines or for mold or asbestos in buildings." (Petition, p. 2) Mr. Thebeau also points to exclusion of "coverage of the costs to recover customer records, computer systems, and programs that might be lost because of fire or water damage to data processing centers." This may be a particularly good example of uneconomic insurance – it is likely more cost effective to have backup records, etc., at remote locations to "self insure" against and minimize the cost of this eventuality rather than buy insurance for it. In other words, it is possible that the costs for commercial insurers to provide the above mentioned coverages are above the values of these coverages to customers so that potential customers retain the risk of the associated losses rather than pay the required premiums. In such instances, purchase of such insurance from a captive raises the issue of whether such insurance should be purchased at all. The possibility that an Illinois Utility would buy from its captive affiliate insurer, even if it were the low cost provider, a product that is not worth its cost is not comforting. Such purchases would not be in the ratepayers' interest.

Third, he suggests that, with the captive, each Illinois Utility would have individual policies paid directly by each operating company, and this would result in more accurate operating costs for Illinois Utilities than is now the case with insurance purchased for affiliates as a group with the costs then allocated among them. (Ameren Ex. 1.0, p. 12) However, this benefit could be achieved without dealing with a captive insurance company. If the current approach does not provide cost savings without insurance purchases from of a captive insurance company, it should not be being done now. On the other hand, if aggregating affiliates for purposes of acquiring insurance provides cost savings absent a captive insurance company, it should also provide savings with a captive.

Fourth, Mr Thebeau states that ERAC will have access to the reinsurance market. He states, "Reinsurance may provide an opportunity to displace some insurance currently procured through the commercial insurance markets at a cost savings, with improved terms, with fewer exclusions and with smaller deductibles. " (Ameren Ex. 1.0, pp.10-11) He does not explain or support his assertion that the reinsurance market would allow ERAC to provide products that are not provided by commercial insurers. The basis for this assertion is unclear since the re-insurers' customers are primarily commercial insurance providers.

Fifth, Mr. Thebeau estimates the savings due to the establishment of ERAC for all Ameren companies, of which Illinois Utilities are a part, would be an amount approaching $5 million annually. He attributes the savings to lower premiums from both ERAC and commercial insurers. He claims ERAC's lower premiums would be due to its direct access to reinsurance markets, while commercial insurers' lower premiums would be due to increased competition from ERAC (thus improving Ameren's bargaining power). (Ameren Ex. 1.0, p. 11) While such savings may be possible, there is ***no requirement*** that ERAC's savings will be passed on to the Ameren utilities, particularly the Illinois Utilities. It is entirely possible that the savings would rather shift to the owner of the captive insurance company, the Ameren holding company. Money from premiums in excess of that needed to maintain surplus at an adequate level could be paid out as dividends to Ameren Corporation.

Q. Why might Ameren Corporation ~~by~~ be interested in establishing a captive insurance company as a profit center?

A. Ameren Corporation has a fiduciary responsibility to its stockholders to benefit them by maximizing its profits. Ameren Corporation has major holdings in regulated utilities including Illinois Utilities and Union Electric of Missouri. Generally, regulated utilities' rates are established to recover normal expenses including insurance premiums and normal uninsured losses. Regulated utilities' transactions with unregulated affiliates, including captive insurance companies, provide a potential avenue to transfer profits from the regulated utilities to the unregulated affiliates. The Commission recognized this concern in its order involving MidAmerican Energy Company's petition to enter into an agreement with its affiliated captive insurance company~~,~~ concluding,

> The Commission is concerned that with the captive insurance arrangement, MidAmerican will have an incentive to act in a manner that is more favorable to its parent, MEHC, rather than in the best interests of its ratepayers. MidAmerican has an incentive to file fewer claims with the captive and pursue claims less aggressively than if it obtained insurance from commercial insurers. This incentive exists since filing and aggressively pursuing claims could result in lower profits for the parent. (Order Docket 01-0796, p. 9)

While the discussion above involves benefiting the affiliate by not fully taking advantage of benefits offered under a contract, profits could also accrue to the captive (and thus the parent) by purchasing insurance products which otherwise would not be cost effective.

Q. Can you give an example where this is a possibility?

A. Yes. I mentioned previously that Mr. Thebeau discussed a number of types of insurance and coverage terms not available from commercial insurers, including insurance for T&D. Mr. Thebeau states that Ameren Services expects to obtain $50 million of coverage of T&D lines through ERAC. Assuming Mr. Thebeau is correct that commercial insurers will not now offer this insurance, ERAC could charge an exorbitant price for this coverage. If commercial insurers decide to change their practice and offer this coverage to Ameren alone, one could expect that they would require a special “premium” for this “boutique” coverage. ERAC would only need to beat the “premium” price.

Similarly for other types of insurance and coverage levels not ordinarily offered because their benefits to customers do not justify their general provision, Ameren Services may buy them for Illinois Utilities from ERAC to benefit Ameren Corporation.

Q. Can you give another example of proposed actions by Ameren that would be consistent with using ERAC as a profit center?

A. Yes. As I mentioned before, Mr. Thebeau suggests that after Illinois Utilities have permission to deal with ERAC, each utility will have individual policies paid for directly by each operating company. (Ameren Ex. 1.0, p. 12) Assuming that Ameren Services is now acting prudently by buying insurance for Ameren affiliates as a group and allocating those costs, the total cost of this approach would be expected to be lower than the total cost of buying separate policies for each Illinois Utility. This is because commercial insurers may bid higher prices for the individual policies because of their concern that, as unaffiliated bidders, no one of them may win the coverage for all the Illinois Utilities. This factor would allow ERAC to safely increase its bids top supply coverage.

Q. Could the link between Ameren Services and ERAC create other undesirable effects of bidding for the Illinois Utilities coverage?

A. Yes. The link between ERAC and Ameren Services (which determines the winning bidders) may give ERAC both an informational advantage and provide the possibility of favoritism vis-à-vis commercial insurers. Commercial insurers may be concerned about these factors. Ameren Services' employees, as employees and officers of ERAC and as purchasers of insurance for the Illinois Utilities, would further exacerbate the likelihood of an increase in costs by making commercial insurers wary of bidding on the coverage and likely to bid only at higher prices even if they decided to bid anyway.

Q. How could profits of ERAC be transferred to Ameren Corporation?

A. The first and most direct way would be for ERAC to transfer to Ameren Corporation the surplus above that necessary to keep ERAC financially solvent. A second possibility is for ERAC to loan funds to unregulated Ameren Corporation affiliates. . **Begin Confidential** * * * **X X X X X X X X X X X X X X X**
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[redacted] *** **End Confidential** (Staff Data Request, BCJ 1.16)

Q. Would Ameren Corporation be in a position to control such transactions?

A. I believe they would. Ameren Services personnel dominate the decision making responsibility of ERAC. Of the nine ERAC corporate officers, eight are employees of Ameren Services. The one non-Ameren Services member is James Murray of Aon Insurance Managers, one of five ERAC Assistant Secretaries. For the six-member Board of Directors, Mr. Murray is again the only non-Ameren Services member. The three-member Investment Advisory Group (IAG) consists entirely of Ameren Services personnel. (Data Response BCJ 2.08) Furthermore, according to **Begin Confidential** * * * [redacted] *** **End Confidential** (Staff Data Request, BCJ 1.16) Thus, although affiliated loan transactions are supposed to be appraised and approved through an “arm’s length,” the management structure and ownership of the captive makes this unlikely.

Q. Do you have other concerns about the degree to which the appraisal and approval of such transactions would be conducted at “arm’s length”?

A. Yes. It appears that Ameren would be willing to entrust insurance needs to ERAC that it would be unwilling to entrust to unaffiliated carriers with the same financial and risk profile. That is, I doubt that Ameren would buy any significant portion of its insurance needs from a commercial insurer with a capitalization of as little as $75 million dollars, which Mr. Thebeau indicates is ERAC's anticipated capitalization (Ameren Ex. 1.0, p.13), and a customer portfolio limited to a single company.

When Mr. Thebeau describes the insurance selection process currently in effect he states,

> Ameren Services selects those **financially sound** insurers who provide the best combination of coverage and price. (Emphasis added) (Ameren Ex 1.0, p. 6)

In contrast, when Mr. Thebeau explains how the ERAC agreement would affect insurer choice, he states,

> At each renewal, the best coverage and price combinations between ERAC and commercial insurers will be sought. (Ameren Ex. 1.0, p. 6)

Notably absent from the proposed new selection process is the phrase "financially sound." This omission is consistent with my expectation that Ameren would be unlikely to accept quotes for significant amounts of insurance from an insurance company other than ERAC with a capitalization of as little as $75 million dollars or a coverage portfolio limited to providing insurance to a single company. A different standard is to be applied to ERAC than commercial insurers.

Q. Ameren witness Evan R. Busman outlines certain customer protections and other safeguards as part of the Illinois Utilities' proposal. Would you review these purported protections and safeguards?

A. Yes. First, he points to the insurance contract as defining the claims to be paid by ERAC. While this is undoubtedly true, it is also true of commercial insurance polices in general. I would be very surprised if Ameren Services employees would admit to purchasing any commercial policies today that do not clearly define the associated coverages. However as noted above, ERAC is dominated by Ameren Service personnel. One result of this close association of ERAC and Ameren Services, a subsidiary of Ameren Corporation, is that contracts could be written to benefit ERAC as a profit center for the holding company.

Second, he states, "An independent captive manager and actuary will ensure that these [objective commercial] standards will be adhered to in order to avoid any controversies or disputes." This statement is interesting because one of the concerns of the Commission in the MidAmerican case was basically that the regulated insured entity would not press its rights sufficiently with its captive insurance affiliates. If the utility does not press its claims, there are no controversies or disputes to be concerned about. In any case, both the independent captive manager and the actuary report to ERAC which is dominated by Ameren Service employees. This close subordinate relationship could impact their behavior.

Third, he points to a third-party claims administrator used to submit claims and pay claims to the Ameren affiliates. (Ameren Ex. 2.0, p. 3) However, the provision of insurance through a captive insurance company creates an incentive, not present with a commercial insurance policy, to refrain from filing claims. Even a third-party administrator cannot make claims appear. Further, the administrator could be influenced if the Illinois Utilities were less aggressive than other affiliates in encouraging the administrator to press their claims with ERAC. I must point out that, the Illinois Utilities attempt to address the issue of the regulated companies being less likely to file claims (Petition, pp. 4-5, and Exhibit B). Specifically, Exhibit B is a corporate policy that Ameren commits its CFO to issue requiring Ameren Services Insurance Operations Group to annually provide a description of insurance coverage to Ameren operating personnel who might be responsible to file claims. The policy would require these personnel to ensure all possible claims are filed. This would be a positive step, but the profit incentive to under report claims still exists, and the policy does not address the issue of pursuing the highest settlements to Illinois Utilities of claims against their affiliated insurer.

Fourth, Mr. Busman discusses ERAC management and regulatory oversight that “ensures the ERAC will be a suitably capitalized and financially viable company.” (Ameren Ex. 2, p. 5) However, such management and regulatory oversight will not prevent ERAC from being a profit center to Ameren Corporation at the expense of rate payers. In fact, overcharging or selling unneeded coverage to the Illinois Utilities would help ERAC remain well capitalized and financially viable.

Q. Does this conclude your prepared direct testimony?

A. Yes, it does.