



To: Marty Cohen, Illinois CUB

From: Bruce Biewald

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Subject: Comments on Electricity Procurement Related to Ameren Requirements

Introduction and Summary

In this memo I outline some key points to consider in designing and implementing a good procurement process for Ameren customers in Illinois. My understanding is that both of the regulated utility companies, AmerenCILCO and AmerenCIPS, have divested their generating facilities to a non-regulated affiliate generating company that is owned by AmerenEnergy Resources (which also has marketing, fuels, and other subsidiaries). Both of the regulated utilities have contracts in place with the non-regulated affiliates to provide generation through 2006.

I begin with important cautions about market power and affiliate transactions, and then discuss specific aspects of portfolio management, including slicing the total requirement, lead time, contract terms, commitment dates, and diversification of suppliers. Much of this discussion is based on the report "Portfolio Management: How to Procure Electricity Resources to Provide Reliable, Low-Cost, and Efficient Electricity Services to All Retail Customers," October 10, 2003, available on Synapse's web site.

Understand and Address Market Power

Before deciding whether and how to procure electricity, it is essential to understand whether and to what extent generators have and can exercise market power in the relevant electricity markets, for each of the products, as well as the time frames for purchasing and delivery locations for those products. Market power studies can apply the "Supply Margin Assessment" (SMA) test or can calculate measures of market concentration (typically the HHI index), or take other approaches.¹ Whatever the analytical framework and modeling techniques, the fundamental questions relevant to procuring power are (1) whether a request for proposals will result in a reasonable number of credible offers, and (2) whether those offers are likely to be reasonably competitive? And if the answer to these questions is unacceptable, the market power analysis would then address the possible remedies: what, if anything, can be done to design a procurement process with an acceptable chance of succeeding?

¹ Examples of market power analyses in the Illinois context include William Hieronymus's analysis for Exelon (dated Nov 6, 2003, in FERC Docket No. ER00-3251-005, etc.) and Rodney Frame's analysis for Ameren (dated July 19, 2002). These were not conducted for purposes of designing a procurement approach, but some of the data, techniques, and conclusions may be relevant to procurement.

In the Illinois context, one thing to bear in mind is that procuring 3,000 MW is one thing and procuring 12,000 MW is quite a different matter. It may well be that there are ways to design a procurement process that will obtain a reasonably competitive response for serving Ameren’s bundled service customers (on the order of 3,000 MW) but that there is literally no possible way to obtain a reasonably competitive response for serving ComEd’s bundled service customers (on the order of 12,000 MW).² Indeed, it is almost certainly true that what works for Ameren will *not* work for ComEd, given the difference in scale.

If there is, in fact, a serious market power problem then no clever procedures for procurement will produce a reasonable result. The market power will have to be addressed directly by divestiture to reduce market concentration and/or constraints on market pricing (e.g., requiring cost-based pricing for suppliers with market power).

Recognize and Address Problems with Affiliate Transactions

Whenever a supplier³ that is an affiliate of the purchasing utility participates in an RFP process to procure power there are questions about self-dealing and whether the process is fair and reasonable. In any particular instance it may be that an affiliate generating company is the only supplier in a position to respond to an RFP since it may be the sole company with the amount of available capacity freed up at exactly moment of the initial delivery requirement. This is a general concern with procurement – that the incumbent supplier will be typically be in a unique situation of having the needed amount of generating resource freed up from the current delivery contract at the time of the new delivery contract. Some of the techniques recommended below can help to address this, but if the current supply arrangement is under one contract with a single termination point (rather than a phasing down of deliveries over time) or if the existing power contracts all expire simultaneously, then this will be a daunting challenge to the procurement design.

Also, if affiliate suppliers can bid in the RFP process, it will be important to have a somewhat “mechanical” process with considerable regulatory oversight. That is, regulators and intervenors will need to review details of the RFP design, the evaluation of responses, and any negotiations with suppliers. Indeed, “negotiations” may have to be precluded from the process (or limited

² The Illinois Commerce Commission’s “Comparison of Electric Sales Statistics for Calendar Years 2002 and 2001” puts the 2002 bundled service sales of Ameren and ComEd as follows:

Ameren CILCO	6,118,668 MWh
Ameren CIPS	8,109,528 MWh
Ameren UE	3,454,931 MWh
Com Ed	64,204,875 MWh

In rough terms, at typical load factors, these MW sales would represent peak demands in the neighborhood of 3,000 MW for Ameren’s Illinois customers and 12,000 MW for ComEd’s. For discussion purposes here, I will use these rough and rounded MW figures for procurement – but for actual procurement design and for any rigorous analysis of market power more accurate figures should be used.

³ I use the term “supplier” here to mean the generator and/or marketer who could bid in response to a regulated utility company’s RFP.

significantly) in order to avoid inappropriate favoritism of the affiliate, or the perception of such favoritism (which can itself be a problem). Competitive suppliers who expect an unfair process may be disinclined to participate.

The converse of this is also true. That is, if affiliate suppliers are not a part of the process, then the procuring utility can be left to run the process with less regulatory oversight than would otherwise be necessary. And the utility can be allowed or even encouraged to negotiate aggressively with the bidders, in order to provide the best possible price and terms.

Slice the Total Requirement

It can be beneficial to slice the total power requirement into smaller pieces in order to allow more potential suppliers to bid, and to provide for some version of laddering (discussed below). For example, if the total requirement for power is 3000 MW, then it can be beneficial to slice it into smaller pieces, say three 1000 MW slices, or six 500 MW slices. It may be that there are only one or two companies that can credibly bid to supply 3000 MW to the required delivery points for three years starting on January 1, 2007 – but that there are a dozen capable of supplying 500 MW.

Procure with Sufficient Lead Time

In order to maximize the number and competitiveness of potential competitive supply offers, it can be useful to procure power several years ahead of the requirement. The lead time could be such that in principle, a new generating facility could be constructed in time to provide the service, so that such “new market entrants” can, in practice or in theory, compete. In the current situation, with a regional surplus of capacity, the lead time requirement is less important than it would be in a tight capacity situation. In any event, it is positive that the process is in progress now for 2007 needs.

Include Long Term Contracts

There is no single “best” length for power contracts. In the context of the Ameren requirements, it would be ideal to have a mix of contract durations, with some of the contracts for delivery periods of about a decade. Having a mix of durations will help in several ways. It will offer a place for bidders who prefer the longer contract period. It will provide some price stability. And it will avoid a situation in the future where the full requirement expires all at the same time.

Of course, because long term contracts involve a significant commitment of expenditures over time, it is particularly important that the procurement of these contracts be fully competitive, transparent, and untarnished by market power and affiliate abuse.

Stagger the Commitment Dates

The date at which a contract is signed (the “commitment”) is distinct from the dates for which the product is to be provided (the “delivery period”). With a requirement of several thousand MW and a lead time of several years available, it would probably be wise not enter into all of the contractual commitments at the same time. That is, some of the commitments should be made soon, but it

would be reasonable to develop a schedule whereby the full position would be filled over time. This is a form of “price averaging” which avoids a situation in which the full amount of the product is purchased at a temporary peak in prices. Price averaging also dampens the possibility of locking into the full requirement during a short-lived price dip, but the goal of reducing the consequences of locking into an overpriced contract for more than a small portion of the total requirements is a worthy objective for procurement, that makes price averaging with staggered commitment dates desirable.

Diversify Suppliers

Given the experience with bankruptcies and financial problems in the energy industry, checking the viability of counterparties for electricity transactions is clearly a necessary aspect of prudent procurement. But credit checks and financial evaluations in the present may inevitably miss some future problems that affect the financial viability of a supplier. Because of these risks, there is value to the buyer in having some diversity in the mix of companies responsible for providing essential generating services. If, for example, the portfolio includes three different generating companies rather than one, then the chances of having a supplier default will be greater than with one supplier, but the consequences of such a default will tend to be more manageable than if the sole full requirements supplier were to default.