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PROPOSED CHANGES TO MICHIGAN'S ELECTRIC RESTRUCTURING LAW

by

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INTRODUCTION

In the past, Michigan's electric industry was characterized by a monopoly structure under which a single electric utility in a given area had the sole right to generate power, send it over the electric grid via transmission lines, and distribute it from the grid to customers. Two utilities, Detroit Edison and Consumers Energy (the "incumbent utilities"), traditionally have serviced 90% of the market in Michigan. The Michigan Public Service Commission (PSC) regulates the rates the utilities charge and sets service standards.

In the late 1990s, rates were higher in Michigan than in most other states in the Midwest. These rates were particularly threatening to commercial and manufacturing customers. Many people feared that high electric rates were leading to the loss of businesses and jobs to other states, stifling economic development in Michigan. There also were concerns that the capacity to generate electric power in the State was inadequate. Concurrently with a nationwide trend toward deregulation across several industries in the 1990s, the Michigan Legislature began to examine introducing competition to the State's electric industry. Those discussions resulted in the enactment of Public Acts 141 and 142 of 2000, the Customer Choice and Electricity Reliability Act. Recently, legislation to amend the Act in a number of ways has been introduced in the Michigan Senate.

Below is an overview of the Act, the status of electric competition in Michigan, and what the proposed changes to the Act could mean for the electric industry and Michigan ratepayers.

THE CUSTOMER CHOICE AND ELECTRICITY RELIABILITY ACT

The framework for Michigan's transition to a competitive electric structure was laid out in the Customer Choice and Electricity Reliability Act. (The provisions of the Act related to competition apply only to the generation aspect of the electric industry. The transmission and distribution aspects remain under a regulated monopoly utility structure.)

Public Act (PA) 141 of 2000 required the PSC to issue orders allowing utility customers to choose an alternative electric supplier ("choice customers"), and required the orders to provide for full recovery of a utility's net stranded costs and implementation costs. Stranded costs are those utility costs that normally are recovered through regulated rates, which would not be collected in a competitive environment. Implementation costs are the expenses the utilities incur in modifying their metering and billing operations for the new competitive environment. Utilities recover their stranded costs and implementation costs by collecting a transition charge from alternative electric supplier (AES) customers.

The Commission may use any method it determines appropriate to determine net stranded costs, after considering the reasonableness and appropriateness of various methods. After a contested case proceeding, the PSC annually must issue an order approving for each utility a true-up adjustment to reconcile any overcollections or undercollections of the preceding 12 months to ensure the recovery of net stranded

costs. Generally, the Commission examines what the utility is authorized to earn versus what it actually has earned, taking into account various elements, such as the power supply cost recovery (PSCR) factor to determine the utility's net stranded costs.

Additionally, PA 141 required a 5% reduction in the residential rates that were in effect on May 1, 2000; froze those rates and a utility's other rates that were in effect on May 1, 2000; and prohibited the utility's rates from increasing until December 31, 2013, or until the utility met a market power test and transmission upgrade requirements. (Both Detroit Edison and Consumers Energy have satisfied these requirements.) The rate cap for large commercial and industrial customers (those using more than 15 kilowatts) was lifted on January 1, 2004. The rate cap for smaller business customers will be lifted on January 1, 2005; and the residential rate cap will be lifted on January 1, 2006. Utilities also were required to unbundle their commercial and industrial rate schedules, and either divest their transmission assets or join a regional transmission organization. Both utilities chose to sell their transmission assets to independent transmission companies.

Public Act 142 allowed the utilities to sell bonds to refinance outstanding debts at low interest rates through a process called "securitization". Detroit Edison gained access to \$1.77 billion in bond revenue by securitizing the debt on its Fermi nuclear plant and various employee-related costs determined to be unrecoverable in a market-based system. The bond revenue was used to reduce all customer rates by 5%, to give transition credits to customers who chose an AES, and to contribute to the Low Income and Energy Efficiency Fund (LIEEF). Consumers Energy securitized \$500 million, which also was used to cut rates by 5% for residential customers and provide smaller rate cuts for other customers.

Under the Act, customers who choose to leave their utility for an AES must pay market rates for their electric generation, while customers who remain with their utility continue to pay regulated rates. The incumbent utility continues to provide distribution services for all ratepayers, including AES customers.

STATUS OF ELECTRIC COMPETITION IN MICHIGAN

Under the Act, the PSC is required to submit to the Legislature an annual report on the effects of the electric restructuring law. According to the report of February 1, 2004, more than 13,000 customers chose to purchase their electricity from an AES, an increase of over 100% from the previous year. Choice customers accounted for approximately 10% of sales in Detroit Edison's and Consumers Energy's service territories, up from 7% in 2002. The PSC licensed one new AES in 2003, bringing the total licensed in the State to 26. At the time of the report, 19 of the AESs were actively serving customers in Consumers Energy's and Detroit Edison's service territories. The PSC stated that it was in the process of implementing various provisions of the Act, and had no recommendations for legislation.

According to the Commission's quarterly update, issued in April 2004, there were 28 licensed AESs in Michigan, 18 of which were actively serving customers in the Detroit Edison service territory, and eight of which were actively serving former Consumers Energy customers.

Additionally, while the Commission reported in 2004 that no significant non-utility generating capacity was added in the previous year, in its 2003 report the PSC stated that more than 2,000 megawatts of new in-State, non-utility generation capacity became operational in 2002.

DETROIT EDISON RATE CASE

In June 2003, Detroit Edison filed an application seeking to raise its rates to cover the company's increasing pension and environmental compliance costs, and recover its stranded costs. Overall, the company requested \$536 million. On February 20, 2004, the PSC issued an interim order in the case (U-13808), granting interim relief in the amount of \$248 million. At the same time, the PSC ordered Detroit Edison to reduce its power supply cost recovery rate by \$126 million, for a net increase of \$122 million. (The PSCR factor covers the utility's cost of obtaining fuel.) Because small business and residential rates are still frozen, \$71 million of that amount will be deferred until the rate caps are lifted. Under the interim order, large commercial customers will see about a 3.9% increase, while industrial customers' rates will increase by approximately 2.3%. Residential rates will not be affected.

Additionally, the PSC established a transition charge for choice customers of four mills per kilowatt-hour. The interim order also established a permanent funding source for the LIEEF, by requiring Detroit Edison customers to contribute collectively \$40 million per year. Previously, the LIEEF was funded with the savings Detroit Edison obtained through securitization; that funding, however, was eliminated as a result of the rate case.

The Commission is expected to issue its final order in October 2004, at which time it will determine whether the interim rate relief remains just and reasonable, and make any necessary adjustments.

PROPOSED CHANGES IN THE ACT

Four years after the law's enactment, the two incumbent utilities have identified aspects they consider problematic. Consumers Energy officials so far have called for changes in the PSC's policy in implementing the Act. Detroit Edison, however, has advocated for a legislative solution. A package of bills was introduced in July 2004 to amend the law, and has been referred to the Senate Committee on Technology and Energy. The bills are tie-barred to each other (i.e., all would have to be enacted before any could take effect).

Senate Bill 1331, the cornerstone of the package, would require AES customers who decide to return to their former utilities after December 31, 2005, to pay market rates, rather than regulated rates. The bill also would establish a method for the calculation of the transition charge; allow a utility to recover transition charges retroactive to 2002; require a utility to unbundle its existing rate schedules; gradually eliminate the subsidization of residential ratepayers by commercial and industrial customers; and allow a utility providing low income and energy efficiency funding to recover that funding from all customers in its service area.

Senate Bill 1332 would require the PSC to establish electric supply reliability standards for all electric utilities and AESs, including standards to maintain a minimum 15% planning reserve margin over peak demand, and meet the utility's or AES's supply resource requirements through self-supply and contracts to purchase generation supply. The bill also would require the PSC to establish financial reliability standards for AESs, including a requirement that an AES complete an audited financial statement demonstrating that it has a net worth of at least \$5 million, or obtain a letter of credit of at least \$1 million or 20% of the amount of the supplier's revenue for the sale of electricity for the most recently completed fiscal year, whichever was greater.

Senate Bill 1333 would require the PSC to approve a low income and energy efficiency factor payable by every customer receiving distribution service from a gas or electric utility, regardless of the identity of the customer's gas or electric generation supplier, and would limit the funding to 2% of each utility's commercial and industrial revenue.

Senate Bill 1334 would require each electric utility to file a tariff that would enable schools to purchase electric power and energy at a discounted rate. The bill provides that the PSC could not disallow recovery of these rates in a rate-making adjustment.

Senate Bill 1335 would include in the term "qualified costs" an electric utility's capital and operating and maintenance costs of complying with State and Federal mandates regarding emissions (thereby allowing the utility to securitize these expenses).

Senate Bill 1336 would allow an electric utility to apply to the PSC to recover its costs of complying with emissions mandates via an environmental compliance recovery surcharge, which would be payable by every customer receiving distribution service from the utility, regardless of the identity of the customer's electric generation supplier.

(A detailed description of the content and potential fiscal impact of the legislation is available on the Senate Fiscal Agency's website: www.senate.michigan.gov/sfa.)

Two main groups have emerged in the debate over the legislation to amend PA 141. Backing the bills is Consumers for Long-Term Energy Affordability and Reliability, or the CLEAR Coalition. The group includes DTE, various trade associations, small businesses, and economic development groups. Opposing the legislation is the Customer Choice Coalition, which includes AESs, business and petroleum industry organizations, and school groups.

CLEAR COALITION

According to the CLEAR Coalition, the way PA 141 has been implemented has had unintended, potentially devastating consequences. The group says that the Act has created two separate and incompatible electric markets in the State, and that the law essentially forces the utilities to let their rivals use the network the utilities have paid to build and maintain over the last 100 years. If substantial changes in

the law are not made, warns the group, Michigan could experience an energy crisis similar to California's, including skyrocketing rates, bankrupt utilities, a loss of jobs, and service and reliability problems.

Since competition was introduced, the utilities' customer bases have declined more quickly than their fixed costs. Under the completely regulated structure, utilities made infrastructure investments based on the demands of a fixed market share. Utilities had the opportunity to recover those costs through regulated rates. Furthermore, utilities must build and maintain infrastructure to meet the peak demand of a hot summer day. Demand might reach this point only a few days out of the year; the rest of the time, only between 50% and 60% of a utility's assets actually are working.

The CLEAR Coalition points out that, as regulated entities, utilities are obligated to ensure that power reaches all customers, even those who purchase their electricity from an AES. Under PA 141, customers may switch back and forth between regulated and unregulated rates, depending on what is the more favorable option at any given time. This makes it difficult for the incumbent utilities to plan their loads and enter into long-term contracts for power. They either must retain adequate reserves for customers who decide to return, or pay higher prices on the spot market. According to the Coalition, customers cannot expect to enjoy the financial benefits of competition without the element of risk that accompanies it. The Coalition claims that the return-to-service provisions under Senate Bill 1331 would mitigate the burden utilities face because of demand uncertainty.

The CLEAR Coalition also maintains that the electric choice law has not provided the promised benefits to all ratepayers. Over the years, the rate structure gradually has been skewed so that residential customers now pay less than their true cost of service, while commercial and industrial customers pay more. Due to this imbalance, AESs have targeted the high-usage, most profitable business customers, a practice the incumbent utilities call "cherry-picking". Although major commercial and industrial facilities have realized significant savings, four years after the enactment of the restructuring law fewer than 100 residential customers in the State buy their power from an AES. Detroit Edison officials have expressed concern that if the company continues to lose its most profitable customers, it might have to shut down or sell power plants, which would result in the State's increased dependence on out-of-State power and, therefore, decreased reliability.

Senate Bill 1331 would require the gradual elimination of the subsidization of residential customers by large business customers, which the CLEAR Coalition hypothesizes would provide a disincentive for competitors to cherry-pick the utilities' most profitable customers and would encourage the expansion of choice among all customer classes. If the rate structure is not deskewed, warns the Coalition, Detroit Edison could be forced to raise its residential rates by 30% to 40% when the rate cap is lifted.

The bill would delete the true-up accounting currently used to determine the transition charge, and replace it with a specific calculation similar to one used in Illinois. No method for determining stranded costs is specified in the current law; therefore, DTE and the PSC, in the past, have disagreed on the utility's stranded

costs. The PSC did not authorize the assessment of a transition charge against choice customers until the February interim order because, in previous cases, the PSC determined that DTE did not yet have any stranded costs. Under the bill, the calculation would be based on how much the utility would earn if it did not lose customers to AESs.

Senate Bill 1332 would require the PSC to establish supply and financial reliability standards to ensure that all electric suppliers, not just the incumbent utilities, are able to fulfill their obligations to ratepayers. Currently, Detroit Edison maintains a 15% reserve margin, while Consumers Energy maintains 11%. The CLEAR Coalition contends that alternative suppliers maintain only 4%. The CLEAR Coalition asserts that the slim reserve margin AESs keep means that power increasingly must be imported from other states, further taxing Michigan's transmission system and compromising reliability.

According to the Coalition, Senate Bill 1333 would create a fairer mechanism for contributing to and administering the Low Income and Energy Efficiency Fund, which is administered by the PSC to provide low-income people and senior citizens with shut-off protection and to fund alternative energy projects. Currently, only Detroit Edison customers pay into the LIEEF; however, the money is distributed to people all over the State. Under the bill, all electric customers would have to pay into the LIEEF, and the money could be used only in the service area from which it was collected.

Senate Bill 1334 provides for a discount of either 10% or 20% off the standard tariff rate for schools, and would prohibit the PSC from adjusting rates so as to interfere with the discount. The Coalition claims that the bill would help schools contain costs during tight budget times.

Senate Bills 1335 and 1336 would allow the utilities to recover the costs of mandated pollution control equipment, either by financing the equipment at a low interest rate through the standard finance tool of securitization, or by adding a surcharge to all customers' bills, respectively. The bills would ensure that all customers, regardless of electric supplier, did their part to help keep the air clean for everybody, according to the Coalition.

Overall, says the CLEAR Coalition, the bills would level the playing field for the incumbent utilities, which are responsible for maintaining the electric system, meeting environmental standards, maintaining adequate reserves in case generation or transmission problems arise, and providing power to all customers. Arguably, the package would correct flaws in the original restructuring law while upholding the components of the choice program that are working for Michigan ratepayers.

CUSTOMER CHOICE COALITION

The Customer Choice Coalition (CCC) claims that the proposed legislation would negate PA 141, a carefully crafted deal resulting from months of negotiations between the utilities, AESs, the PSC, and consumer and business advocacy groups. According to the CCC, the securitization authorized under PA 141 allowed the

utilities essentially to mortgage more than \$2 billion in unprofitable assets onto the backs of Michigan customers; in exchange, the utilities were to cooperate in efforts to expand competition.

As the CCC points out, merchant generators and independent transmission companies invested billions of dollars in Michigan based on the terms of the restructuring law. Businesses of all sizes made decisions about locating in the State and creating jobs. Educational institutions and governments at all levels made long-term budgeting decisions. The CCC asserts that no customer class would be better off under the proposed legislation, and that the bills would further harm the State's manufacturing sector, which already has been described by some as "hemorrhaging".

According to the Coalition, the narrow timeline for an AES customer to return to his or her former utility at regulated rates under Senate Bill 1331 would serve only to scare people away from choice. While the utilities might experience long-term planning problems if customers continually switch between regulated and unregulated rates, arguably it would be quite drastic to prevent someone from ever receiving regulated rates again after trying another provider that proved to be less affordable. If the utilities feel that a specific deadline must be set, some suggest that a three-year window would be more appropriate.

Under Senate Bill 1331, for every dollar Detroit Edison lost to competition, it would get 92 cents back through the transition charge, according to the CCC. With an 8% margin both for an AES customer to realize savings and for the AES to make a profit, presumably it would not be worthwhile for an AES to operate or for a ratepayer to switch to an alternate provider.

The CCC says that the reliability requirements under Senate Bill 1332 are unnecessary and significantly would increase costs for AESs, discouraging competitors from entering the market and defeating the purpose of the restructuring law. Although a reserve amount is not specified in law, the PSC sets reserve requirements for individual utilities and AESs, and utilities and AESs also must meet standards set by the Michigan Independent System Operator. The bill's opponents say that the 15% specified in the bill appears to be arbitrary, as do the financial reliability standards. Currently, the PSC may require a letter of credit of at least \$40,000, if it would be in the public's best interest. In practice, the PSC sometimes does not require a letter of credit; other times, it requires a letter of credit of \$100,000. According to the CCC, the \$1 million requirement under Senate Bill 1332 is both too high and unnecessary, as no AES ever has defaulted on a power purchase in Michigan.

The CCC states that Senate Bill 1332 further would increase costs for AESs by providing that, if a utility or supplier could not generate enough electricity to meet its demand, it would have to contract with a specific power plant to purchase additional electricity. Currently, utilities typically own enough generation to serve their customers, and rely on purchases from independent power plants only during peak times. Alternative suppliers, however, generally have a portfolio of suppliers, which the bill would preclude. The bill would require that a utility's or AES's electric supply resources be tied to physical generating assets, until the PSC determined

that a proper market existed. An AES would have to contract for a particular power plant's entire output, which smaller suppliers typically do not need in order to meet demand. The CCC claims that this requirement also could compromise reliability if the one plant with which an AES contracted went down unexpectedly.

According to the CCC, one-fourth of the public and private K-12 schools in the State participate in choice, and now are experiencing between 15% and 25% savings--more than the 10% or 20% discount they would receive under Senate Bill 1334. The CCC asserts that any savings customers would see under the bill would be wiped out by the implementation of the transition charge, low income and energy efficiency factor, and environmental compliance recovery surcharge. The money schools save currently is not paid for by other customers; the CCC sees Senate Bill 1334, however, as creating a subsidy for schools that would be borne by all other ratepayers.

Along these lines, some wonder why K-12 schools should get a discount if universities, local governments, small businesses, manufacturers, and residential customers would not. Some are also concerned that the bill's definition of the term "school", which would include property used directly or indirectly for school purposes, is too broad. If the State deems providing assistance to schools, or low-income people under Senate Bill 1333, a worthwhile social goal, funding for such programs arguably should come from the State's General Fund, not ratepayers.

Under Senate Bills 1335 and 1336, the incumbent utilities would be allowed to recover the expenses they incur in complying with State and Federal emissions mandates. Senate Bill 1335 would provide them with a low-interest financing mechanism to install pollution control equipment, while Senate Bill 1336 would allow for a direct "environmental compliance recovery surcharge" on ratepayers' bills. Under either method, all customers, including AES customers, would pay. According to the CCC, the bills would hamper competition by not affording AESs the same low-cost financing opportunities to meet mandates. Additionally, since AESs also must comply with pollution control mandates, their customers essentially would have to pay for environmental compliance costs twice.

The package's opponents have expressed concern that the bills significantly would reduce the PSC's authority to implement the choice law as it determines appropriate. First, under Senate Bill 1331, the utility would calculate its own transition charge. The bill provides for no recourse if the PSC disagreed with the utility's calculation. Furthermore, under several sections of the bill, the PSC would be required to approve tariffs filed by the utility if the tariffs met the sections' requirements. The bill does not specify, however, whether the PSC could modify tariffs that did not conform to the requirements. The opponents also complain that the PSC would have to approve tariffs that met the requirements even if the tariffs contained anticonsumer terms, such as unrealistic payment time frames. At the same time that the bills would reduce the PSC's authority, they also would create more work for the Commission.

The CCC disagrees with the CLEAR Coalition's claim that Michigan is heading for an electricity crisis, like the one California experienced. First, says the CCC, many of the factors that contributed to California's situation simply are not present in

Michigan. Second, Michigan's law was written specifically with California in mind, so the problems that occurred in that state would be avoided here. Choice *is* working, says the CCC. Although residential participation in choice is negligible right now, that is because those customers enjoy savings under the rate cap beyond what they would receive from an AES. When the rate cap is lifted in 2006, the CCC believes, many of those customers will choose to leave the traditional utilities in search of a more affordable supplier.

The legislation's opponents also take issue with Detroit Edison's claims of potentially disastrous financial losses, which the company says are due largely in part to the loss of its most profitable customers to competition. Opponents claim that "cherry-picking" is a perfectly rational behavior for new players in any industry. They say it simply is good business sense to focus early efforts on attracting and retaining the most economical customers, and, once a foothold has been gained in the market, expand service to all customers.

The Coalition asserts that any financial hardship DTE, Detroit Edison's parent company, is experiencing is due mostly to poor performance in its unregulated activities and its acquisition of MichCon. Arguably, any troubles related to the electric aspect of the company can be attributed more to an unusually cool summer in 2003 and lost sales during the August 2003 blackout, than to competition. Reportedly, the price of DTE stock has risen by more than 30% since January 2000. The company's electric profits reportedly are up as well, from \$35 million in the first quarter of 2003 to \$41 million in the first quarter of 2004.

CONCLUSION

The bills are being considered by the Senate Committee on Technology and Energy. The Committee Chairman, Senator Bruce Patterson, has announced the formation of a workgroup on the bills to carry out a thorough examination of the relevant issues, including identifying characteristics that would signal the presence of a truly competitive market. Whether lawmakers will determine that the proposals represent a necessary measure to ensure the viability of the State's critical utilities, or an attempt by one company to suppress competition in the State, remains to be seen. What is certain is that the outcome of the legislation will be significant to residents, school districts, investors in the electric industry, and businesses of all sizes.