



201 N. WASHINGTON SQUARE • SUITE 810
LANSING, MICHIGAN 48933

TELEPHONE 517 / 482-6237 • FAX 517 / 482-6937 • WWW.VARNUMLAW.COM

ERIC J. SCHNEIDEWIND

E-MAIL ejschneidewind@varnumlaw.com

January 22, 2004

Ms. Mary Jo Kunkle
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

Re: Case No. U- 13989

Dear Ms. Kunkle:

Enclosed for filing in the above captioned matter please find the original and four copies of Energy Michigan, Inc.'s Initial Brief. Also enclosed is the original Proof of Service indicating service on counsel.

Please date stamp one copy of the above entitled document for my records and return it in the self-addressed stamped envelope provided.

Thank you for your assistance in this matter.

Very truly yours,

VARNUM, RIDDERING, SCHMIDT & HOWLETTLLP

Eric J. Schneidewind

EJS/mrr

cc: ALJ
parties

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the Application of)
 CONSUMERS ENERGY COMPANY)
 For Ex Parte Approval of a Special Contract)
 For Electric Service with the State of Michigan,)
 The Board of Trustees of Western Michigan)
 University, The Board of Trustees of Michigan)
 State University, and the Regents of the)
 University of Michigan on behalf of)
 The University of Michigan – Flint, and the)
 Board of Trustees on Michigan State University,)
 A Michigan Constitutional Corporation.)
 _____)

Case No. U-13989

ENERGY MICHIGAN, INC. INITIAL BRIEF

This Brief is filed on behalf of Energy Michigan, Inc. ("Energy Michigan") by Varnum Riddering Schmidt & Howlett LLP pursuant to a schedule established by the Commission in their Order dated January 5, 2004 in this matter.

I. Introduction and Summary of Position

A. Introduction

The Consumers Energy Company ("Consumers") Application in this matter caused a minor sensation in the energy community. A review of the Application determined that several State Universities had contracted for a discount of 7% off retail rates and the State of Michigan had signed Special Contracts for a 5% discount from retail rates as well as credits off Consumers amounting to an additional 2% reduction in return for accepting interruptible grade service. In addition, these customers and Consumers supported a contract provision which conditioned the reductions on agreement by the Michigan Public Service Commission ("Commission") to transfer the cost of these discounts to retail and ROA customers.

Consumers' motives in this matter were quite clear: They locked up a significant amount of business and hoped to create a precedent of forcing competitors to pay for the cost of Special Contract discounts. That precedent clearly would put competition out of business if extended across the board because competition cannot exist if your competitor can force you to pay for the discounts which they offer to your customers.

The motives of Michigan State University and Western Michigan University were also clear because the load to be served under the Special Contract is only that power which is purchased in addition to power self-generated by the Universities. This type of "supplemental" load is quite erratic and the discount offered by Consumers may have been competitive with the market.

All observers, however, were stunned by the position of the State of Michigan. Two percent of the claimed 7% discount was granted in return for accepting potential interruption of service. Thus, the 2% reduction was not so much a discount or credit as an exchange of lower price for lower grade service.

The claimed 5% discount on primary service was both inadequate in terms of known market alternatives and, worse, largely disappeared January 1, 2004. The Special Contract signed on December 18 or 19, 2003 provided a 5% discount from retail rates. Whatever the State of Michigan knew about the competitive virtues of Consumers' offer in comparison with the market on December 18 or 19, 2003 suddenly became obsolete January 1, 2004 when Consumers raised all electric rates including the rates applicable to the Special Contract by 1.79 mills/kWh pursuant to their PSCR Application U-13917. This same sort of price increase would not have applied to any Alternative Electric Supplier ("AES") long term prices if the State had obtained quotes during December 2003, yet the State chose Consumers. Thus, in comparison to the market, the 5% rate discount claimed by the State shrunk to a 2% discount within a period of two weeks.

The answer to this dilemma has become clear during the course of the hearing: The State evidently signed up for the Consumers Special Contract due to a lack of information. Even

though the State conducted talks with Alternate Suppliers as well as Consumers, Alternate Suppliers were never asked for a fixed price quote on the State's business and thus the State really had no basis to compare the price offered by Consumers with any relevant yardstick. Evidently, the State of Michigan stumbled into what appears to be a very bad deal because it did not explore competitive alternatives.

This conclusion was emphasized by the Dow Hemlock Special Contract filed by Consumers on January 8, 2004. See Case U-13999. Dow, which is a very sophisticated purchaser, got a 3.8 ¢/kWh rate which represents a huge discount off retail rates and did not have to support transfer of their discount to other Consumers retail and ROA customers.

B. Summary of Position

The proposed Special Contract should not be approved because it contains a clause (Section 5(d)) which requires the Commission to commit that it will not impute revenues under these contracts at tariff rates. Commission precedent requires that such a request will not be granted unless the Applicant demonstrates that a) the Special Contract is cost based or that b) the benefits to other customers outweigh the costs not collected and that c) the Special Contract does not impede competition.

The evidence of record shows that:

1. Consumers' position is not supported by a cost of service study.
2. Consumers has not demonstrated that non-participants will benefit from Consumers' proposal and, in fact, the weight of evidence on the record demonstrates that Consumers' proposal will harm non-participating retail and ROA customers as well as the competitive framework mandated by PA 141.
3. The record also demonstrates that the contract impedes competition by unduly limiting the subject customers' ability to choose Alternate Electric Suppliers and that the

absence of a bid process led the State of Michigan to execute a contract which is commercially unfavorable.

Based on Consumers' failure to carry its burden of proof, Energy Michigan recommends that the Application be rejected or that the Commission inform Consumers that it will approve the Application if Section 5(d) of the Special Contract is removed.

II. Detailed Discussion

A. Response to MPSC Questions

1. MPSC Questions.

In its Order of January 8, 2004 in this matter, the Commission asked two questions:

- a. Does the [proposed special] contract unduly limit the affected customer's ability to choose an Alternate Electric Supplier?
- b. Can Consumers demonstrate that the State of Michigan and the public University had adequate opportunity to explore competitive alternatives to the Special Contract? Order U-13989, January 5, 2004, p. 3.

2. Response.

- a. Limits on customer's ability to choose an AES.

The proposed Special Contracts limit the affected customer's ability to choose an AES by locking in Consumers Energy as the sole energy supplier for a period of two years. See Section 1, Exhibit A-1, page 10 of 28. Also the contract predesignates Consumers Energy as its preferred energy and energy services supplier for the next two years without considering other entities and by

prescribing a bid valuation methodology designed by Consumers. See Contract Section 7, Exhibit A -1, page 11 of 28. Finally, the Special Contract requires the Commission to approve pass through of rate discounts to non-participants including ROA customers. This provision will increase the price of competing ROA service thus limiting the attractiveness of alternative power supplies. See 5(d) Exhibit A-1, page 11 of 28. These provisions of the Special Contract unduly limit the State of Michigan and the Universities from choosing an AES and will indirectly limit the choices of future ROA customers by increasing the cost of ROA service.

b. Ability to explore competitive alternatives.

The State of Michigan and the Universities did not adequately explore competitive alternatives. The Universities engaged in some talks with electric suppliers but did not have an adequate opportunity to explore competitive alternatives because no price bids were solicited or received from an AES. 1 TR 69 (Boulus); 1 Tr 81 (Ellerhorst); 1 Tr 92 (Bourke). The State of Michigan admitted that it did not utilize bid procedures or get any specific price bids from AESs even though it talked in general terms with numerous energy providers (including AESs). 1 Tr 43 (Irwin). The failure to obtain actual price quotes from AESs to compare with Consumers Energy cost the State dearly when it signed an agreement for a 5% rate reduction which shrunk to 2% within a space of two weeks due to the Consumers PSCR increase implemented January 1, 2004. See Consumers Application, U-13917.

B. The Consumers Application Fails To Meet Traditional MPSC Tests To Avoid Imputation Of Special Contract Revenue.

The Michigan Public Service Commission has set forth the three which must be met in order for a utility offering Special Contracts to avoid Commission imputation of the Special Contract revenue at retail tariff rates during rate making proceedings.

Most recently, two of the criteria were summarized in a December 18, 2003 Commission Order regarding the Consumers Energy request for transition charges. U-13380, p. 4. To avoid imputation the Commission requires that a utility bear the "substantial burden" of providing "clear convincing and unequivocal demonstration either (1) that the contract prices and terms are justified on the basis of the cost of service, or (2) that the benefits for other (non-participating) rate payers are substantial and have a value that outweighs the costs that are not recovered from contract customers." U-13380. Quoting Order dated October 25, 1995, Case U-10961 and Order dated March 23, 1995. In Case U-10646 the Commission also required that the proposed Special Contract not impede the development of competition. U-10646, March 23, 1995, p. 21. Adopted for Consumers in U-10961.

1. The Consumers position.

Consumers did not attempt to present a cost of service study to justify the Special Contracts. Rather, Consumers presented testimony of a witness claiming that the proposed Special Contract would not impact the rates of Consumers' retail, PSCR or ROA customers. In support of his position, Mr. Brockett testified that, "The Company doesn't anticipate a change in its retail electric rates prior to January 1, 2006". 1 Tr 101. As to ROA customers, Mr. Brockett merely pointed out that retaining a retail customer on Consumers retail rates by means of a rate discount, produced more revenue than if the customer left for ROA service and that this phenomenon would reduce stranded costs. Id. Mr. Brockett did not attempt to address the impact of the proposed Special Contracts on competition and, in particular, the impact of Section 5(d) on competition.

2. Energy Michigan's position.

Testimony of Staff and Intervenors, together with cross examination of Applicants, demonstrates that Consumers in fact has not carried its burden to satisfy the MPSC tests required to avoid imputation of Special Contract revenue at tariff rates.

a. Cost of service test.

As noted above, there is no cost of service study analysis supporting the Consumers position. In fact, if one assumes that the existing Consumers retail rates were formulated in an MPSC rate case process which allocates appropriate costs to each class of service, one could say that any rate reduction from these authorized levels is a departure from cost of service principles which must be justified by some overwhelming benefit. No overwhelming benefit has been demonstrated in the case of the Consumers Application.

b. Impact on non-participants.

Energy Michigan witness Polich reviewed the testimony of Consumers' witness Brockett and found that Consumers was unwilling to commit that it would not raise base rates during the term of this contract. Thus, Consumers holds open the potential of requiring other retail customers to pick up the cost of the discounts offered under the Special Contract. 1 Tr 108. ROA customers would meet the same fate. If Consumers raises retail rates using discounted revenues, both retail and ROA of customers would be disadvantaged by this contract. Finally, Mr. Polich has found that the Special Contracts would in fact increase ROA rates because the discounts be treated as unrecovered stranded costs by the utility which were assessable to ROA customers. Id, 140.

c. Impact on competition.

Mr. Polich also described the negative impact of Special Contract Section 5(d) on competition. Mr. Polich noted that, "Any competitive situation in which the utility is absolved of risk to its revenues or its economic performance due to a discounted rate provides the utility a free ride in the competitive marketplace." "...[Section 5(d)] will allow Consumers to use the competitive market to subsidize its discounts." "...This will encourage other customers to negotiate

similar contracts knowing the MPSC will approve the contract and transfer the discounts to stranded costs. Under such market conditions, AESs will discontinue providing competitive options and the Retail Open Access program will come to an end." Tr 141-42.

Mr. Polich also testified that the discounts for the State of Michigan are not competitive with ROA service offered to other Michigan public and State agencies. Tr 137-38.

3. Staff position.

MPSC Staff witness Michel Hiser opposed Commission approval of Section 5(d) of the proposed Special Contract on much the same grounds as Mr. Polich. See Exhibit A-1, page 11 of 28. Dr. Hiser stated that this provision was contrary to established Commission policy on Special Contracts as set forth in Cases U-10646 and U-10961. 1 Tr 128. Dr. Hiser went on to say that the Consumers Energy language in Section 5(d) moves rate making determination regarding allocation of costs from the Commission to Consumers Energy Company by insulating Consumers' shareholders from responsibility for bearing any of the burden of revenue imputation. Also, Dr. Hiser defended the underlying policy of the Commission stating that this well crafted policy should not be overturned in a hasty proceeding and that to the extent Consumers believes it can offer detailed justification for the discounts, such proof should be forthcoming in the rate making arena which allows for deliberate consideration and action. Tr 130. If Section 5(d) were removed, Dr. Hiser would support the Special Contract. Tr 131.

III. Conclusion and Prayer for Relief

Consumers has failed its burden to prove that such revenue imputation should not take place. On the contrary, the overwhelming weight of evidence in this matter presented by Dr. Hiser and Mr. Polich demonstrates that the Special Contract clause is still bad public policy, is unjustified by economic data and would be harmful to competition.

The Commission has two choices: Either 1) reject the Special Contract outright or, per the recommendation of Dr. Hiser, 2) approve the contract subject to removal of Section 5(d). The evidence of record in the form of testimony from Mr. Irwin indicates that scenario #2 would likely result in renegotiation of these Special Contracts without Section 5(d) and resubmission to the Commission or use of a bid procedure allowing other suppliers to compete for the business of the State. 1 Tr 36—39. In the case of the State of Michigan this outcome would be a blessing in disguise. The testimony of record from expert Richard Polich, who has sterling credentials in the wholesale and retail competitive energy markets, indicates that the State struck a bad deal, probably through lack of information regarding the availability of far more competitive pricing. 1 Tr 137-38. In this instance, the Commission should save the State of Michigan from itself by rejecting this contract and allowing the State the opportunity to use competitive electric markets for the purpose envisioned in PA 141 of 2000: Lower prices and better service for all customers.

B. Prayer for Relief

WHEREFORE, Energy Michigan respectfully requests that the Commission:

1. Reject the Application of Consumers Energy in this matter for approval of Special Contracts; or
2. Reject the Consumers Application and indicate approval will be granted upon removal of Section 5(d) from the contracts.

Respectfully submitted,

VARNUM, RIDDERING, SCHMIDT & HOWLETT LLP
Attorneys for Energy Michigan, Inc.

January 22, 2004

By: _____
Eric J. Schneidewind (P20037)

The Victor Center, Suite 810
201 N. Washington Square
Lansing, Michigan 48933
(517) 482-6237

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 _____)

Case No. U-13989

PROOF OF SERVICE

Monica Robinson, duly sworn, deposes and says that on this 22nd day of January, 2004 she served a copy of Energy Michigan's Initial Brief upon those individuals named on the attached service list.

Monica Robinson

Subscribed and sworn to before me
this 22nd day of January, 2004.

Eric J. Schneidewind, Notary Public
Eaton County, Michigan
Acting in Ingham County, Michigan
My Commission Expires: April 24, 2006

SERVICE LIST

Raymond E. McQuillan
Consumers Energy Company
One Energy Plaza
Jackson, MI 49201

Don Erickson
Special Litigation Division
6th Floor, G. Mennen Williams Bldg.
525 W. Ottawa
Lansing, MI 48913

Bob Strong
ABATE
255 S. Woodward Avenue, 3rd Fl
Birmingham, MI 48009

David Voges
MPSC Staff
6545 Mercantile Way, Suite 15
Lansing, MI 48911