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September 4, 2012

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

Re: Case No. U-17032

Dear Ms. Kunkle:

Attached for paperless electronic filing is Energy Michigan's Reply Brief. Also attached is a Proof of Service indicating service on counsel.

Thank you for your assistance in this matter.

Very truly yours,

VARNUM,^{LLP}

Eric J. Schneidewind

EJS/mrr

cc: ALJ
parties

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter, on the Commission's own motion,)
to initiate a proceeding to establish a state)
compensation mechanism for alternative electric)
supplier capacity in INDIANA MICHIGAN)
POWER COMPANY'S Michigan service territory.)
_____)

Case No. U-17032

REPLY BRIEF OF ENERGY MICHIGAN, INC.

September 4, 2012

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REPLY BRIEF OF ENERGY MICHIGAN, INC.

I. Introduction and Summary of Position

A. Introduction.

This Energy Michigan Inc. ("Energy Michigan") Reply Brief is filed in response to Briefs of Indiana Michigan Power Company ("I&M"), the Michigan Public Service Commission Staff ("MPSC Staff") and FirstEnergy Solutions Corp. ("FES"). Failure to respond to any argument or position in the Initial Briefs of I&M, MPSC Staff or FES should not be construed as agreement with that argument or position.

B. Summary of Position.

1. The I&M/MPSC Staff capacity rates will kill competition

Energy Michigan has proven that the AES capacity rates proposed by I&M/MPSC Staff will cause AES customer losses, rather than savings, of 15% to 35% which will end competition in the I&M service territory. I&M denies this conclusion by resorting to sophistry. I&M claims that you have competition when all customers pay the same rate. The fact that this rate is totally unaffordable to one group of customers makes no difference whatsoever to I&M. The mere fact that the capacity rate is the same for

Choice and Standard Service causes I&M to conclude that competition has been preserved.

The Commission should disregard this I&M exercise in rhetoric and use common sense: AES customers simply will refuse to lose more than 15% to 35% on their electric bills merely to patronize AES service. The capacity rates proposed by both I&M and MPSC Staff will kill competition.

2. I&M/MPSC Staff cannot restrict the scope of this proceeding

I&M and MPSC Staff have attempted to restrict the scope of this proceeding. I&M argues that methods of establishing capacity costs other than Cost of Service cannot be entertained in this proceeding. MPSC Staff argues that critical elements of the capacity process such as the treatment of Off System Sales ("OSS") cannot vary from the mechanisms adopted in I&M Rate Case U-16801.

These I&M/MPSC Staff positions cannot be accepted in view of the ruling of the ALJ and the agreement of both I&M and MPSC Staff that all proposals presented in this case "stand for scrutiny" and may not be presumed to be supported by precedent merely because they were adopted in Case U-16801. This principle applies not only to the I&M attempts to exclude all costing methods to price capacity other than Cost of Service as well as Staff's attempts to place details of the OSS mechanism and its impact on the PSCR clause off limits as well.

Nowhere in the Commission Order establishing this proceeding can one find a mandate that Intervenors and other parties may only present Cost of Service based capacity proposals. That limitation applies to I&M but has never been explicitly or implicitly applied to parties other than I&M. Similarly, Staff which claims that PSCR process for crediting OSS revenue as well as other rates may not be changed is the very party that proposed a relatively minor adjustment of \$244,000 to I&M revenue thereby changing all I&M rates under scrutiny. Staff cannot have it both ways. It cannot propose to change

I&M rates that were approved in Case U-16801 and then tell other parties that they may not exercise the same prerogative.

3. I&M/MPSC Staff did not present a valid Cost Of Service case

Michigan-specific ratemaking techniques require that capacity costs be allocated 75% on the basis of demand and 25% to energy. I&M/MPSC Staff have admitted that Choice customers use no energy at all supplied by I&M yet I&M/MPSC Staff have proposed capacity rates which nonetheless allocate 100% of capacity to the same Choice customers who use no energy. They present no rationale for their failure to follow the 75/25 formula.

I&M/MPSC Staff have also failed to justify their support for a division of OSS revenue that apparently never contemplated the sale of significant quantities of I&M energy freed up by Electric Choice service. I&M/MPSC Staff never recognized that allocation of OSS revenues to Standard Service customers is based on actual OSS results but OSS credits to Choice customers are based on a low fixed projected OSS volume which would effectively deprive Choice customers of any OSS revenue increases produced by increased Choice activity yet would deliver those increased revenues to Standard Service customers. Finally I&M/MPSC Staff did not recognize the basic inequity of allowing Standard Service customers to reap the full benefit of very low I&M energy costs while depriving Choice customers of all of the benefits of increased volumes of I&M OSS freed up by Choice service being sold into market. Thus the I&M OSS mechanism is discriminatory and totally inequitable as it affects Choice customers.

Also, the discriminatory 75/25 allocation mechanisms and OSS mechanisms were not adequately supported by I&M or MPSC Staff Testimony.

4. A Cost of Service capacity rate would incorporate alternate OSS and allocation proposals.

Energy Michigan has proposed that the mechanism to allocate OSS revenues be revised only as it applies to unanticipated, unprojected new volumes of OSS sales due to I&M energy freed up by increased OAD activity. This new revenue should be used to offset Choice capacity charges in much the same way as low cost I&M energy used by Standard Service customers tends to offset the relatively high I&M capacity rates. By restricting the OSS mechanism revisions to new unprojected, unanticipated volumes of OSS, existing PSCR rates, projected revenues and other rates may be left in place while the revised OSS mechanism would provide a fair and equitable offset to the I&M capacity charges paid by Choice customers.

Energy Michigan has also proposed that the 75/25 method of allocation, properly used, would not allocate 25% of capacity to Choice customers because Choice customers use absolutely no energy. Any other I&M rate with a very low energy rate compared to its capacity demand would qualify for reduced allocation of the 25% of capacity related to energy. This would be true of an I&M Standby Rate if one existed. A hypothetical I&M standby rate would have a much lower capacity component in its energy rate than conventional C&I rates used by energy customers with a much higher energy use. The same principle applied to Choice service would result in no energy related demand and thus a 25% reduction in the capacity charges proposed by I&M. This approach complies explicitly with the Michigan-specific 75/25 ratemaking principle and should be adopted in this case.

5. RPM pricing is appropriate.

FES Witness Robert Stoddard demonstrated that RPM pricing does allow I&M to recover the full cost of their generation investment. This is true because the relatively low RPM rate contributes only a portion of I&M capacity costs. The balance of these capacity costs is recovered by market rate energy sales which also include a significant capacity component. I&M is attempting to double recover capacity costs by charging a capacity rate that recovers 100% of its capacity costs while reserving the right to sell energy freed up by Choice activity at a market price which also includes a significant capacity

component. The I&M/MPSC Staff capacity proposal allows double recovery of capacity costs as it relates to Choice customers. RPM pricing prevents this inequitable result.

6. Phase in option.

Energy Michigan's proposed reductions in the I&M cost based capacity rate focus on two issues: adequate compensation for OSS of megawatt hours freed up by Choice and a reduction in the capacity cost to Choice customers from 100% of cost to 75%. This reduction of capacity charges by 25% could potentially create a revenue shortfall for I&M until the next General Rate Case at which time all capacity costs would be reallocated and thus fully recovered by I&M. In the meantime, the Commission could use a mechanism first used in Ohio where the Commission developed a Cost of Service capacity rate at \$188/MW-day but approved a much lower RPM capacity charge for actual implementation. The Ohio Commission deferred the difference between the higher cost based rate and the RPM rate to a future date when those monies would be collected from all customers. In this case, the Commission could authorize a capacity rate of \$99/MW-day and defer any difference between that rate and some higher capacity rate that recovered all I&M costs until the next rate case.

The Michigan Commission has the same opportunity to defer any temporary, unrecovered costs due to a reduction in Choice demand charges to the next rate case for recovery at that time.

7. Conclusion.

The Michigan Commission should adopt either RPM pricing or a Cost of Service price for AES capacity that uses a much higher OSS revenue credit to mitigate capacity charges and develop those capacity charges using the 75/25 allocation mechanisms which would not allocate 25% of cost to Choice service. Because Choice customers do not buy energy from I&M they would not pay the 25% of production costs normally allocated based on energy use.. To the extent that any legitimate I&M capacity costs are

unrecovered with this approach, those costs would be deferred until the next I&M General Rate Case at which time reallocation of costs would result in full recovery by I&M of all capacity costs.

II. The Capacity Rates Proposed By I&M Eliminate Competition

A. I&M Denies That Their AES Capacity Proposal Will Eliminate Competition.

Energy Michigan submitted proof that implementation of the I&M/MPSC Staff proposed Alternate Energy Supplier ("AES") capacity rates for Choice will produce net losses among Choice customers ranging from 15% to 35% without assuming any profit to the AES. Energy Michigan Witness Boston testified that these results will eliminate competition. 3 TR 233.

I&M denied that customer losses ranging from 15% to 35% will eliminate competition. I&M supported this conclusion by the following reasoning:

1. Since I&M is the only supplier of capacity in its territory, there is no issue about competition among suppliers of capacity.
2. The I&M proposal is not discriminatory since all customers (AES and Standard Service) pay the same capacity rates.
3. Because all customers pay the same capacity rates, competition is not stifled, all members of Energy Michigan may compete for Choice customers and their fears that they might lose [the customers] are not relevant to the I&M proposal. I&M Brief, p. 9.

B. Energy Michigan Reply.

The chart below is Exhibit EM-2 and it illustrates how charging the I&M/MPSC Staff capacity rate would produce huge customer losses even if the AES does not charge a profit. Compare the

savings in Column (E) with RPM and the losses in Column (K) if the I&M/MPSC Staff capacity rate is charged.

Impact of the I&M/MPSC Staff Capacity Rate

(A) Rate Code	(B) Rate Description	(D) Utility Annual Cost	(E) Annual Cost (W RPM)	(H) % Savings	(J) Price (W/I&M Proposed Cap Rates)	(K) % Savings
211	Small General Service	\$ 730	\$ 460	37%	\$ 0.0836	-15%
215	Medium General Service - Secondary	\$ 32,385	\$ 23,772	28%	\$ 0.0947	-33%
217	Medium General Service – Primary	\$ 237,997	\$ 184,040	23%	\$ 0.0936	-36%
244	Large General Service – Primary	\$ 385.374	\$ 296,176	23%	\$ 0.0686	-29%
308	Large Power - Subtransmission	\$ 1,098,955	\$ 837,613	24%	\$ 0.0765	-29%

The I&M position is simply laughable. Does any rational person seriously believe that AES customers would endure losses exceeding 15% to 36% and still participate in the Choice program? Does any rational person seriously believe there is true competition when a completely unaffordable capacity rate is offered to Choice customers? Is this competition or, more accurately, is it reinstatement of a utility monopoly on retail service?

The answer is obvious. Competition will be eliminated in the I&M service territory if the I&M capacity proposal is adopted. No customer losing more than 15% to 36% will continue with Choice service.

III. I&M and MPSC Staff Proposals to Restrict the Scope of This Case Should Be Rejected.

A. I&M/MPSC Staff Position.

MPSC Staff has taken the position that key terms of I&M's proposed apportionment of OSS revenue between Choice and Standard Service customers "will remain unchanged until the next I&M rate proceeding and the base rates currently in effect must remain unchanged." Staff Brief, p. 9.

I&M has boldly asserted that the scope of this case may only include "a Cost of Service based compensation proposal adhering to Michigan-specific ratemaking principles". I&M Brief, p. 17.

B. Energy Michigan Reply.

Presiding Administrative Law Judge ("ALJ") Sharon Feldman ruled that the Settlement of I&M Rate Case U-16801 cannot be used "as a reason, authority, rationale or example... for approval of the proposal capacity rate in this proceeding...". 2 TR 76-77. Ms. Feldman also ruled that the submissions of Staff and I&M must "stand for scrutiny" rather than being accepted as precedent. Id.

The MPSC Staff argument that specifics of the OSS revenue apportionment mechanism and the base rates currently in effect must remain unchanged is contradicted by Staff's own position that the existing I&M capacity rate must be reduced to account for Staff's proposed \$244,348 disallowance. 3 TR 406. How can Staff advocate a change in the base capacity rates while at the same time stating that base rates and OSS revenue division mechanics must be left in place? Staff's position is inconsistent and incorrect. The proposed I&M/MPSC Staff capacity rates and OSS mechanism "stand for scrutiny" and may be changed.

Finally, I&M repeatedly asserts that the scope of this case is limited to Cost of Service proposals yet does not cite any Commission language from the Order initiating this case which mandates that result. See Commission Opinion & Order U-17032, May 24, 2012. To accept the I&M version of the scope of this case, one must assume that the Commission's Order for I&M to submit a Cost of Service type proposal adhering to Michigan-specific ratemaking principles applies to all parties to this matter. Yet that mandate cannot be found in the May 24, 2012 Order. If I&M's assumption is true, then this entire hearing becomes unnecessary because the

conclusion is preordained: simply adopt the existing I&M capacity rate approved in Case U-16801 with no adjustments except as proposed by I&M.

Not even MPSC Staff and I&M have limited the scope of their presentations to this extent. Staff proposed a disallowance of over \$244,000 and adjusted the I&M capacity rate accordingly. 3 TR 406. I&M adjusted the rates for \$188,000 of security expenditures as well as agreeing to the Staff adjustment. I&M Brief, p. 2-3. The I&M and Staff base rate adjustments illustrate that this is a case in which all proposals must "stand for scrutiny" rather than being a case where all the Case U-16801 assumptions must be accepted and may not be changed. For this reason, the inadequate proofs and undocumented proposals offered by I&M/MPSC Staff can be challenged and rejected if FES or Energy Michigan meet their burden of proof by producing competent, material and substantial evidence on the record. *In re Complaint of Pelland*, 254 Mich App 875, 985 (2003).

IV. Staff and I&M Did Not Present a Valid Cost of Service Case

A. Neither I&M nor MPSC Staff Presented Witnesses Who Could Support The I&M Cost Of Service Study That Was The Basis For The Proposed I&M Capacity Rates.

1. There was no support for 75/25 allocation of costs.

Neither I&M nor MPSC Staff performed a COSS for this case. Janssen, 3 TR 429-36; Heimberger, 2 TR 121-24. Nor was any COSS performed for the OAD rate. 2 TR 146.

The I&M Cost of Service Witness Heimberger testified that at least eight other witnesses testified in support of the basis for the Cost of Service Study in U-16801, none of which appeared in this proceeding. 2 TR 21-24.

MPSC Staff Witness Janssen agreed that the I&M filing in this case was based upon a Cost of Service allocation study arising from the Settlement Agreement of

that case. However, I&M did not submit any documentation to support the Cost of Service allocation in this case. 3 TR 452. Also, but for the Settlement Agreement of Case U-16801, Staff would have required I&M to submit supporting documentation for the Cost of Service Study. Id, 453. Thus, I&M submitted an inadequately supported Cost of Service Study based upon the U-16801 Settlement that cannot be used as a precedent or as a reason for adoption of the Cost of Service Study supporting the I&M AES capacity rate. 2 TR 76-78.

2. The I&M position on OSS was not adequately justified.

There were no Choice sales included in the assumptions or forecasts used in the U-16801 Settlement. 2 TR 146. Thus the impact of an increase in Choice sales from 0% to 10% as of the June 14, 2012 filing of this case was not even contemplated in the Settlement of Case U-16801. Id. From this fact it also follows that the OSS credit mechanisms and specific amounts of OSS credit could not have contemplated the increased OSS revenue that would be caused by an increase of Choice volume from 0% of I&M sales to 10%. Id.

Conclusion

Facts unearthed in this case show the most critical elements of the I&M filing including the Cost of Service Study and the mechanism to share OSS revenue were inadequately supported and based upon assumptions which are not accurate.

MPSC Staff claims that these deficiencies (particularly with OSS) can be remedied if "...the capacity rate established [in this case] can be reevaluated when the Company files its next general rate case proceeding". Staff Brief, p. 14.

Unfortunately, the I&M capacity charge proposal will quickly eliminate Choice service in the I&M territory. Boston, 3 TR 233. By the time the Commission gets around to processing a new rate case, it will be too late to save the I&M Electric Choice program.

B. The I&M/MPSC Staff AES Capacity Rates Are Not Consistent With Michigan-Specific Ratemaking Principles.

1. The I&M/MPSC Staff position.

MPSC Staff recognized that the I&M Cost of Service Study ("COSS") and, more particularly, the allocation of costs under that study, were made at a time when it was assumed that there would be no Choice service on the I&M system. Staff Brief, p. 14. "Consistent with the base rates currently in place the Cost of Service Study utilized by the Company is based on 2012 test year assumptions and forecasts." Staff Brief, p. 11 which "did not account for customers taking service from AESs". Staff Brief, p. 14.

2. Energy Michigan reply.

A Hypothetical Example Illustrates How Michigan-Specific
Ratemaking Principles Should Have Been Applied

Under Michigan-specific ratemaking principles I&M should have developed a Choice capacity rate by using a COSS to apportion the Company's costs using an average 12 monthly peak demand and assigning production and transmission plant as 75% demand related and 25% energy related. I&M Brief, p. 11.

Using the 75/25 allocation method, 75% of production capacity costs would be allocated based on the 12 monthly peak demands of each rate class and 25 % of the production costs would be allocated based on the actual energy use of the class each month.

A hypothetical example shows what could and should have happened if proper costs were assigned to Choice service using the 75/25 model.

Standby Service Example

Standby service provides backup electric supply to a customer when the customer's generation stops operating due to an emergency or for scheduled maintenance. Standby Service is typical of an electric service that is used infrequently throughout the year and therefore has a very low load factor (energy use per kW of capacity), which is much lower than tariffs serving larger more steady users such as I&M Tariff LP. The LP rate has a capacity energy charge (reflecting the allocation of 25% capacity) of 5.39 ¢/kWh and a non-capacity energy charge at 2.8 ¢/kWh. However, assume that the hypothetical standby load class has 1 MW of scheduled maintenance demand each month on the day of the I&M monthly peak, for, say, 12 hours, or 12 MWhs per year. Assume that the standby class has no other energy use.

In these circumstances, the standby class would be allocated 75% of production costs for the 1 MW of demand each month, as would an LP class of the same size. The LP class might use 500 MWh each month for each 1 MW of demand, but the standby class would use only 12 MWh each month for each MW of demand. The extremely low energy use (12 MWh/month) compared to a typical 500 MWh would mean that the 25% energy allocation of production costs to the standby class would be only 12/500 of that to the typical LP class, or 2.4%. Thus, relative to the LP class that would receive an allocation of 25% of production costs based on energy, the standby class would receive only an allocation of 0.6% of production costs based on energy – the standby class's entire allocation of production costs would be just a fraction above 75%, based almost entirely on demand.

If this is a logical result for a hypothetical standby rate, why would it be illogical to assume that the proper energy capacity rate for Choice service which uses no I&M supplied energy would include 25% less demand charge in its total charges than Standard Service? Wouldn't this be a logical outcome of Michigan-specific ratemaking procedures? Of course that is exactly what one would expect from a

properly established Choice capacity rate: At least 25% less total capacity charges than Standard Service rates.

Indeed, this result is supported by Energy Michigan Witness Alex Zakem who testified that no production costs should be allocated to the OAD rate because OAD customers do not use I&M demand or I&M energy. 3 TR 234-35.

Staff's Proposal To Address Improper Cost Allocation
In The Next Rate Case

Staff claims that any allocation inequities could be corrected "when the Company files its next general rate case proceeding". Staff Brief, p. 14. However, the next rate case will be too late. Energy Michigan Witness Roy Boston has testified, that adoption of the proposed I&M capacity charges will eliminate Electric Choice almost immediately and certainly well before any new I&M rate case can be filed and completed. 3 TR 233.

In fact, the Zakem proposal incorporates this self-correction feature urged by Staff. This is because any revenue shortfall created by allocating only 75% of capacity costs to rate OAD instead of 100% will be recovered in the next rate case when this "shortfall" is reallocated to other rate classes.

If the Commission wishes to protect I&M from even this temporary under recovery between rate cases, it could defer the under collected revenue for collection in the next rate case. A similar technique was used by the Ohio PUC when formulating an AES capacity rate for I&M. 3 TR 352.

The more appropriate remedy is to adopt the Energy Michigan proposal in this case to develop a Choice capacity rate which assumes no allocation to AES customer capacity of the 25% of capacity costs related to energy usage. This is because Choice customers do not use energy provided by I&M. Energy Michigan Brief, p. 18-19.

Mr. Zakem's proposal can be adopted on the grounds that neither I&M nor MPSC Staff filed testimony challenging his conclusions regarding proper allocation of costs and because both Staff Witness Janssen and I&M Witness Heimberger agreed that OAD customers use no energy (3 TR 410, Staff; 2 TR 114, I&M). Hence, under Michigan-specific ratemaking principles, OAD rates cannot be assigned the 25% of capacity costs associated with energy use. Zakem, 3 TR 235-36.

C. The I&M/MPSC Staff Position on OSS Revenue Allocation Must Be Rejected.

1. I&M/MPSC Staff position.

It is important to understand how I&M set up the OSS revenue sharing in a way that discriminates against Choice service:

- a. At the time that the OSS revenue sharing mechanism was instituted it did not include assumptions of any OAD sales. 2 TR 146.
- b. Prior to the split of the OSS revenue that "returns" to I&M, OSS revenues are divided among all AEP companies in a pool and the total I&M share is then divided within three I&M entities (FERC, Michigan and Indiana). The modest level of projected OSS revenues flowing back to the Michigan part of I&M were assumed in Case U-16801 to be split with 20% of that revenue going to I&M and 80% of the remaining revenue spread among all other Standard Service and OAD customers. Allen, 2 TR 178-79.
- c. Of the 80% of the OSS revenue to be split among all I&M customers, I&M used the modest projected OSS to produce a slight (\$13 MW-day) capacity reduction for OAD customers which would not change regardless of OSS increases. However, I&M

flowed OSS credits to standard sales customers through the PSCR mechanism in a manner that would increase if there was an increase in OSS. I&M Brief, p. 11-12.

Thus, the rate case did not assume any OAD activity and it locked in a specific, very low amount of OSS revenues for Choice but flowed the actual (higher) results to Standard Service customers through the PSCR. Thus, the large amount of MWh freed up by an increase in OAD activity would produce increased revenues which in turn would only flow to Standard Service customers and not to Choice customers.

The Staff Brief argues that this inequitable capacity rate structure plus U-16801 PSCR based rate and loss factors and the base rates produced by these inequitable mechanisms must remain unchanged. Staff Brief, p. 9. This position is totally illogical in view of Staff's argument that the Commission should change the I&M capacity rates to implement their modest \$244,000 reduction in assumed revenue. Staff Brief, p. 13 agreed to by I&M Brief, p. 3-4.

2. Energy Michigan reply.

Both Alex Zakem and Robert Stoddard have proposed a solution which will effectively leave I&M PSCR factors and procedures intact as well as projected credits for both Standard Service and OAD customers. Both Mr. Stoddard and Mr. Zakem proposed that net revenue from OSS equal to the additional Mwh of I&M energy freed up by an unanticipated, unprojected increase in OAD sales of 10% be used to offset the 75% of I&M capacity that may be allocated to OAD customers. Zakem, 3 Tr 236-38; Stoddard, 3 TR 367. Because these new OSS revenues produced by the Mwh of I&M energy freed up by increased OAD sales were not anticipated or projected in Case U-16801, their use

would not change the current PSCR factors or OSS credits projected for Standard Service or Choice customers.

Moreover, use of additional unanticipated Choice produced OSS revenue to offset Choice capacity charges eliminates a fundamental and glaring discrimination in the I&M OSS proposal: I&M OAD customers receive an OSS credit based on a tiny fraction of pro rata OSS while Standard Service customers are given exactly the same credit plus a credit related to all of the additional OSS revenue produced by increased OAD sales. The other inequity in the I&M OSS position is that Standard Service customers pay full capacity charges and get their pro rata share of all OSS revenue plus the economic benefit of low cost I&M energy. I&M would have OAD customers pay exactly the same capacity charges and get only the pro rata share of the tiny amount of projected OSS revenue and none of the benefits of low cost I&M energy and none of the benefits from the significant increase in OSS produced by greater Choice activity than projected.

The Zakem/Stoddard proposal to use the increased OSS revenue produced by I&M energy freed up by increased OAD activity is consistent with prior MPSC case precedent which in essence recognized the same principles. When Choice activity increases, a large amount of Mwh are freed up to be sold in the market for an OSS "profit". This increased "profit" should first be attributed to Choice customers as a means of mitigating any net stranded costs. See Case U-12639 which used OSS "profits" to mitigate the difference between market rate and Cost of Service rate for the production facilities that were no longer used by Customer Choice customers. Opinion and Order of the Commission U-12639, December 20, 2001, p. 10. In this case, like U-12639, net stranded costs, defined as "costs that would have been recovered under regulation that cannot be recovered under competition offset by mitigation" could be significantly reduced using revenue from the new OSS created by new customer Choice activity. Also see Energy Michigan Brief, p. 12.

D. Conclusion.

As shown above, I&M/MPSC Staff have failed to propose OAD capacity rates that are based on sound Cost of Service principles incorporating the required 75/25 allocation of costs. Application of Michigan-specific ratemaking principles requires that OAD customer capacity rates include, at most, 75% of capacity costs related to demand but not include any of the 25% of capacity costs that would typically be allocated based upon energy use.

Furthermore, the OSS mechanism proposed by I&M/MPSC Staff could be left in place except that new OSS revenue attributed to Mwh freed up by increased OAD activity should be used to offset proposed OAD capacity charges. The recommendation by I&M that none of this OSS revenue freed up by OAD activity be allocated to OAD customers is inadequately supported and is contradicted by the factual and legal positions advanced by Energy Michigan Witness Zakem and FES Witness Stoddard. Zakem 3 TR 236-38. Stoddard, 3 TR 367.

V. I&M/MPSC Staff Failed To Show That RPM Pricing Is Not The Appropriate OAD Capacity Rate

A. I&M/MPSC Staff Position.

I&M has listed numerous reasons why RPM pricing should not apply to OAD capacity rates:

1. I&M is an FRR entity so its load and capacity weren't in the RPM auction.
2. I&M made long term investments in power plant and RPM is a short term price which doesn't cover I&M's long term capacity costs.
3. RPM pricing causes volatility.
4. RPM pricing is not a true market price based on actual demand.

5. RPM does not reflect actual I&M costs.
6. PJM does not rely on FRR resources. I&M Brief, p. 8-9.

B. Energy Michigan Reply.

The Testimony of Robert Stoddard successfully contradicts the erroneous assertions of I&M listed above. Mr. Stoddard testified that the AES capacity cost computed by I&M is a fundamentally different concept than the capacity price emerging from the PJM markets. In PJM markets, capacity suppliers receive the market price for energy and for capacity so they potentially recover fixed costs and earn profits from both energy and capacity sales. Indeed, for large nuclear, coal and hydroelectric facilities such as those in I&M's fleet, capacity market earnings are typically much smaller than energy market earnings. 3 Tr 357.

By contrast, I&M has computed a capacity charge that includes all of its fixed costs and a rate of return. I&M, however, has no responsibility to provide energy or ancillary services to AES customers so I&M can sell this "excess energy" and make an additional profit. Thus, the I&M capacity filing allows I&M to make a full return on its power plant investment through the approved capacity rate while also selling excess energy into the market and recovering additional capacity related charges. Thus, the I&M proposal allows it to receive a double profit from the sale of capacity. Id.

RPM pricing is preferable because it awards a specific rate for capacity and then the utility is allowed to dispose of excess energy on the PJM market and recover substantial portions of capacity related costs through the energy market. FES Witness Stoddard has demonstrated that the combined recovery of RPM capacity charges and market energy charges are likely to produce an adequate total return for I&M on its production plant investment. 3 TR 367-68.

In conclusion Mr. Stoddard showed that the combination of RPM capacity and market sales of energy and ancillary services are likely to equal or exceed the \$394/MW-day rate that I&M proposed to collect for its capacity at the FERC. Id.

Mr. Stoddard's analysis and Testimony answer virtually all the substantive points raised by I&M above. RPM provides adequate compensation for the long term investment of I&M, avoids volatility through forward auctions and links the price of capacity and energy to a market level which over time will produce compensation equaling or exceeding the levels claimed by I&M to be required.

VI. Phase In Option

Proposed Capacity Rates

There is a gap between the capacity rates requested by I&M/MPSC Staff and the capacity rate proposed by Energy Michigan in this case.

The I&M/MPSC Staff proposal amounts to about \$588/MW-day. Lesser, 3 TR 302.

Energy Michigan proposes that the I&M/MPSC Staff proposed AES capacity rate would be reduced by an OSS credit of \$342.20/MW-day and by a 25% reduction in the allocated cost of capacity equaling \$147. The net capacity rate proposed by Energy Michigan would be \$99/MW-day. In the alternative, the RPM rate of \$89/MW-day over the next four years could be used.

Of the \$499 of reductions proposed by Energy Michigan, \$342 are credits funded by OSS revenue which would go to I&M. The remaining \$147 reduction would not be covered by revenue until the next I&M rate case when these unrecovered costs, if not covered by revenues in total, would be allocated to other customer classes as with any other rate.

Thus there is a temporary gap of \$147/MW-day between the total capacity payments proposed by I&M/MPSC Staff and the rate proposed by Energy Michigan.

Phase In Mechanism

The Staff Brief presents a way that this gap may be bridged. Staff has observed that the current I&M capacity rate was developed at a time when it could not take account for customers taking services from AESs. In view of this fact, Staff recommended that the capacity rate be reevaluated when the Company files its next general rate case. Staff Brief, p. 14. Energy Michigan has pointed out that I&M Choice customers cannot wait for the next case to correct or reduce the I&M/MPSC Staff proposed capacity rate since implementation of that rate would almost immediately terminate participation in Electric Choice. Boston Testimony, 3 TR 233.

The Staff concept of waiting to the next case to correct the problem, however, does fit in with a mechanism used in Ohio to bridge the gap between RPM or RPM-like pricing and a higher Cost of Service based Choice capacity rate. In Ohio the capacity rate determined by the PUC at \$188/MW-day significantly exceeded the RPM rate. 3 TR 356. The Commission implemented the RPM rate and deferred the difference between the RPM rate and the \$188/MW-day cost based rate for collection at a later date. 3 TR 352.

In this case, it is true that establishment of a capacity rate that does not include the 25% of capacity normally allocated on the basis of energy may create a temporary revenue shortfall for I&M between rate cases. On the other hand, the assumed greater revenue from OSS due to Choice activity would be available immediately to reduce or mitigate AES capacity charges.

The Commission could determine that under their authority in MCL 460.11(6) the temporary shortfall in revenue due to the failure to allocate 25% of capacity cost to Choice customers (given that they do not use energy) could be deferred until the next rate case when the shortfall would be offset by any additional revenues and/or by reallocation of those costs to other customer classes. In that same case a mechanism could be developed to recover the unrecovered 25% during the years between rate cases.

VII. Conclusion and Prayer For Relief

WHEREFORE, Energy Michigan respectfully requests that the Commission

- A. Reject the capacity charges applicable to OAD service which are proposed by I&M and the MPSC Staff;
- B. Adopt a State Compensation Mechanism charge for capacity applicable to AES customers equal to the prevailing RPM rate as described above or, in the alternative, a rate of \$99/MW-day as a cost based rate; and
- C. If the capacity charge adopted by the Commission exceeds \$99, the charge should be deferred as described above.

Respectfully submitted,

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September 4, 2012

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STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter, on the Commission's own motion,)
to initiate a proceeding to establish a state)
compensation mechanism for alternative electric)
supplier capacity in INDIANA MICHIGAN)
POWER COMPANY'S Michigan service territory.)
_____)

Case No. U-17032

PROOF OF SERVICE

STATE OF MICHIGAN)
) ss.
COUNTY OF INGHAM)

Monica Robinson, the undersigned, being first duly sworn, deposes and says that she is a Legal Secretary at Varnum LLP and that on the 4th day of September, 2012, she served a copy of the Energy Michigan, Inc.'s Reply Brief upon those individuals listed on the attached Service List by email at their last known addresses.

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