

Electricity Choice Policies in Michigan: Comment on "Readying Michigan to Make Good Energy Decisions: Electric Choice"

By Theodore R. Bolema, Ph.D., J.D.

Introduction*

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This comment is in response to the report issued on Oct. 15, 2013, by the Michigan Public Service Commission titled "Readying Michigan to Make Good Energy Decisions: Electric Choice," (the "Draft Report") written by Chairman John Quackenbush and Michigan Energy Office Director Steve Bakka.

The MPSC's current interest in electricity choice policies is timely and welcome. Michigan's last major change to policies regarding electricity choice was in 2008, so

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* Some language contained in this report also appears in a previously published work by the Mackinac Center. Theodore Bolema, "With Competition Diminished, Michigan Citizens Paying High Price For Electricity," *Michigan Capitol Confidential* (Mackinac Center for Public Policy, Oct. 18, 2013), accessed Oct. 29, 2013, <http://goo.gl/vDJiww>.

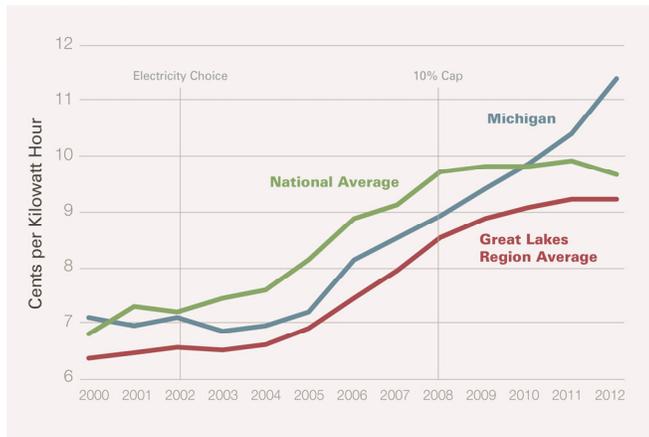
substantial information is now available to examine the results from two distinct periods. The first period is between 2000 and 2008, when new suppliers were allowed to start entering the Michigan market and competing with incumbent utilities, and the second is between 2008 and 2012, when competition was restricted to guarantee a 90 percent market share for the largest utilities.¹

Michigan once had a very successful electricity choice program. It had its flaws, but on balance Michigan's electricity choice program led to lower electricity rates for Michigan households, small businesses, schools and employers than they would have had otherwise. Before competition was introduced, Michigan's electricity rates were well above both the national average and the regional average among Great Lakes States. By 2004, or only two years after competition was introduced, Michigan rates were below the national average, and were narrowing the gap with nearby states. After the 10 percent cap and other restrictions on competition were imposed in 2008, rates rose much faster than the national average, and by the end of 2012 rates across all categories of customers in Michigan were 18 percent above the

1 The Mackinac Center has published three studies assessing electricity choice legislation and policies. Adam D Thierer, "Energizing Michigan's Electricity Market" (Mackinac Center for Public Policy, 1997), accessed Oct. 28, 2013, <http://goo.gl/B8lx8e>; Theodore R. Bolema, "Assessing Electric Choice in Michigan" (Mackinac Center for Public Policy, 2004), accessed Oct. 29, 2013, <http://goo.gl/0aixCb>; Diane S. Katz and Theodore R. Bolema, "Proposals to Further Regulate Michigan's Electricity Market: An Assessment" (Mackinac Center for Public Policy, 2008), accessed Oct. 29, 2013, <http://goo.gl/CKqEhn>.

national average and 23 percent above the regional average. Furthermore, while electricity rates on average in the United States had declined between 2008 and 2012, rates in Michigan on average were about 27 percent higher than they were when the 10 percent cap was imposed.

Graphic 1: Average Price of Retail Electricity in Michigan, 2000-2012



Source: U.S. Energy Information Administration, Form EIA-861 and Form EIA-826. Data for "2012" is for December of 2012.

Graphic 2: Change in Michigan Electricity Rates, 2000-2012

Region	2000-2008	2008-2012
Michigan	25.7%	27.2%
Great Lakes	33.4%	8.1%
U.S.	43.0%	-0.9%

Source: Energy Information Administration, Form EIA-861.

The analysis of these two periods suggests that market competition tends to bring innovation and lower prices to Michigan electricity consumers, while monopolistic policies tend to raise prices. Further, the Draft Report can be improved to better describe the regulatory problem it is intended to address, the possible solutions, and the evidence that is available for evaluating these proposed solutions.

Analysis of 2013 MPSC Report

To explain the rise in the price of electricity in Michigan since 2005 shown in Graphic 1, the Draft Report points to one ill-conceived provision in the Michigan electricity choice program created by

P.A. 141 of 2000 — a temporary mandatory rate cut for residential customers that expired in 2005 — and asserts that this policy wholly explains these rising costs. This explanation is lacking, however, because it does not explain why electricity rates for commercial and industrial consumers, who were not subject to the temporary rate cut and who consume two-thirds of the retails sales of electricity in Michigan, also rose over this period. It also fails to take into consideration that the average price for electricity in surrounding states was also increasing at this same time and across the United States as a whole. Finally, the Draft Report’s explanation for rising costs after 2005 ignores important exogenous factors impacting the price of electricity, such as the increase in the price for coal and natural gas during this time period.

The Draft Report proposes four possible regulatory responses: “Full Deregulation,” “Full Customer Choice,” “Adjust the 10% Cap” and “Full Regulation.” Attempting to identify options for regulators and evaluating the options is a useful approach, but the options, especially the Full Deregulation and Full Customer Choice options, are vaguely defined. Even more problematic, these options are not defined until near the end of the report, and yet the terms are used frequently and inconsistently throughout. The Draft Report's recommendation section correctly identifies Full Customer Choice, or opening markets to competition, as different from Full Deregulation. However, these terms are not used in the same way in the other sections. In particular, the term "deregulation" is used to describe choice. Similarly, "deregulation" or "customer choice" are used to describe regulatory policies, especially those in other states that are inconsistent with the Draft Report's definitions. Defining these terms and using them consistently is important to provide useful guidance for policymakers.

The Draft Report also raises the possibility that additional "stranded cost" payments should be made to large utilities if Michigan changes its regulatory policies. In doing so, the Draft Report is too quick to assume that such payments are justified. As discussed below, the economic justification for requiring ratepayers to make stranded cost payments to large utilities is questionable at best. Moreover, Michigan utilities have already collected substantial stranded cost payments from Michigan ratepayers, and did not return any of their original stranded cost payments after they were insulated from competition in 2008.

The following comments address three specific sections of the Draft Report: "Possible Policy Outcomes" (Section IX), "Rates" (Section VI) and "Stranded Costs" (Section V).

Possible Policy Outcomes (Section IX)

This section appears to describe four possible policy outcomes. One option is to move to "Full Deregulation," although that term is not clearly defined, and this option is grouped with the "Full Customer Choice" option. It appears that the Draft Report is defining Full Deregulation as the opening of Michigan electricity markets to competition and the elimination of all rate regulations. The term "deregulation," however, is frequently used in other sections to describe past regulatory policies in Michigan and other states, and that usage of the term in other sections of the Draft Report is misleading.

As a general principle, competition is more effective than rate regulation in holding down prices over time, but Michigan's electricity choice program as it existed from 2002 to 2008 did not eliminate rate regulations for incumbent utilities. By defining Full Deregulation in Section IX as eliminating all rate regulation, the Draft Report turns all of its prior uses of the term in previous sections into mischaracterizations of the state of electricity competition in Michigan and other states. The Draft Report should be more careful in how it uses

the term "deregulation," and better terms are available to describe these policies, including "restructuring" and "introducing competition."

The Draft Report describes Full Customer Choice as the option that existed in Michigan from 2002 to 2008. That term is also somewhat misleading, because Michigan's choice law contained several requirements that undermined the "choice" aspects of the regulation at that time. These requirements included:

- Price caps that locked residential rates (but not commercial and industrial rates) at 5 percent below 2000 levels until 2005. These price controls inhibited competition, innovation and efficiency by artificially distorting the market and probably discouraged entry by suppliers into this customer sector. Notably, according to the U.S. Energy Information Administration, commercial rates dropped by 3.5 percent and industrial rates by 4.2 percent between 2000 and 2004 in Michigan, so the residential price cap likely had little effect on residential prices.
- A requirement that the incumbent utilities alone must act as the suppliers of last resort. DTE Energy and Consumers Energy, for example, must reconnect customers at the regulated rate should they opt to leave a competing service provider. This requirement constitutes a competitive disadvantage because incumbent utilities must underwrite the costs of maintaining supply for phantom customers or purchasing more costly power that regulated rates would not cover.
- Incumbent utilities were required to provide home heating assistance programs. This program overlapped substantially with other assistance programs from public sources, including federal funds for home heating assistance programs, Michigan's home heating tax credit, and the Family Independence Agency (now the Department of Human Services) providing emergency heating assistance.

- Michigan ratepayers were paying various forms of substantial payments to the largest utilities to compensate the large utilities for the move away from "Full Regulation" (and which were not repaid when the utilities received their 90 percent guaranteed market shares in 2008). Some of these charges were imposed on the new entrants supplying electricity, so that they were collecting charges from their customers that were turned over to their largest competitors.

Nonetheless, the "Full Customer Choice" option comes the closest to describing competition in Michigan as it existed beginning in 2002, so that term will be used in these comments. As discussed below, the Full Customer Choice regime, while it lasted, was very successful in terms of making Michigan electricity rates more competitive with those of nearby states and the United States as a whole.

As a practical matter, the important difference between Full Deregulation and Full Customer Choice will occur if not enough entrants come to the Michigan electricity market. A fully deregulated market — one with no rate regulations — would create downward pressure on prices as both new entrants and incumbent utilities competed for customers. If sufficient entry occurs under Full Customer Choice, the large incumbent utilities will have to respond to downward pressure on prices, or else they will lose market share, so even regulated rates will have to reflect competitive pricing. If, however, too little entry occurs to sufficiently affect electricity rates, Full Customer Choice could preserve traditional rate regulation, while full deregulation would not.²

The Draft Report also lists "Adjust the 10% Cap" as an option. It appears that adjusting the cap to 100 percent

would be the same as the "Full Customer Choice" option. Any such cap is arbitrary and artificial, and Michigan is unique among all states in using its cap to guarantee a 90 percent market share for its largest utilities. Indeed, a 90 percent market share "is enough to constitute a monopoly," according to the U.S. Second Circuit Court of Appeals.³ That the cap was reached within months of being imposed by the 2008 legislation suggests both that the cap was too low and unnecessarily arbitrary.

The other option in the Draft Report is "Full Regulation," presumably as it existed before 2002. The Draft Report correctly noted that Michigan ratepayers paid compensation to the largest utilities for the move away from Full Regulation, and raised the issue of the large utilities paying back those charges. The evidence shows that rates in Michigan went down after competition was introduced and went up when competition was limited by the 10 percent cap. Eliminating all competition and turning back to Full Regulation will leave Michigan with no competition to hold rates in check, and will inevitably place Michigan at a greater competitive disadvantage with neighboring states and the rest of the country where rates are generally lower.

Section IX and earlier sections of the Draft Report generally describe electricity competition as something that has had little success when it has been tried. Many states have tried something that has been called "competition" or "deregulation," but actually have imposed new and often worse regulatory requirements that have undermined the introduction of competition. As noted above, Michigan also introduced new and inefficient regulatory requirements during its brief era of Full Customer Choice, but for the most part Michigan's electricity choice program was simple and clean compared to many other states that required utilities to sell-off assets and do business in certain ways that were mandated by regulators.

² Unlike other states that tried to force certain market outcomes as they restructured in the last decade, Michigan's Full Customer Choice approach did not attempt to force some form of new entry. Instead, Michigan's choice law opened the market to competition and invited any entrants to compete. If entrants believed they could provide electricity more efficiently than the incumbent utilities, they had the opportunity to do so, but none were required to do so.

³ *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 424 (2d. Cir. 1945); *Am. Tobacco Co. v. United States*, 328 U.S. 781, 813-814 (1946).

The Draft Report could also take a broader view of competition policies by looking to other markets where we can see the results from introducing competition to formerly regulated markets. Competition has been introduced in a wide range of other formerly monopolized markets with high fixed costs, including cable television, telephone service, airline travel, natural gas production and freight shipments over railroads. Today, each of these markets is characterized by competition and, for the most part, the absence of government price regulation.

Suppose Michigan's current approach to electricity requirements was applied to other markets. In cable television, local cable firms would be guaranteed a 90 percent market share and customers wanting to switch to DirecTV or Dish Network would be placed on a waiting list until a spot opened up for them under the 10 percent cap. AT&T landline service would also have a 90 percent guaranteed share of customers, and those wanting cell phones or to switch to an alternative provider like Comcast or Vonage would also be placed on a waiting list. Such policies seem absurd today, but 25 or so years ago, these caps on access to alternative service providers may not have seemed unreasonable for monopolized telephone or cable television services operating under traditional natural monopoly regulations.

Rates (Section VI)

Section VI of the Draft Report starts with a comparison of prices in states with and without "deregulation." As noted above, the use of this term is misleading, but to the extent the Draft Report is comparing states that have and have not introduced some form of competition, the Draft Report correctly acknowledges the difficulty of making such comparisons. The Draft Report also correctly notes that the states described as "deregulated" had higher rates before introducing competition, and presumably more incentive to introduce competition. Despite these qualifications at the beginning of the section, the

Draft Report then goes on to present data from utility groups that similarly lump states together as "regulated" and "deregulated" when the "deregulated" states have forms of restructuring that vary greatly and mostly do not fit the definition of Full Deregulation from Section IX of the Draft Report.

When Michigan businesses and potential employers are making decisions on where to locate, and Michigan residents are considering relocating to a state with lower costs of living or better job prospects, they probably are not basing their decision on whether a state has regulated electricity rates. Instead, to the extent that electricity prices affect cost of living and costs of doing business in a state, what matters is how those rates compare with those in other states, and especially the states in the same region. Indeed, part of the lore surrounding the initial passage of electricity choice legislation in 2000 is that the 1997 decision by Northstar Steel to locate a plant near Toledo, just over the Ohio border, due in large part to lower electricity costs in Ohio, is the event that triggered much of the momentum for the electricity restructuring legislation.

The Draft Report includes comparisons between Michigan and the national average for rates in all categories and residential rates. It also jumps between the residential rates and the rates across customer categories in ways that do not show a useful picture of how Michigan rates compare across customer categories.

In 2000, Michigan electricity prices were high relative to other states. The Energy Information Administration, part of the U.S. Department of Energy, tracks retail electricity prices for several categories of customers, the most important of which are industrial (e.g., manufacturing plants), commercial (e.g., retail stores) and residential. As shown in Graphic 1, before competition was introduced, Michigan's electricity rates across all categories were 5 percent higher than average prices in the rest of the nation and 11 percent

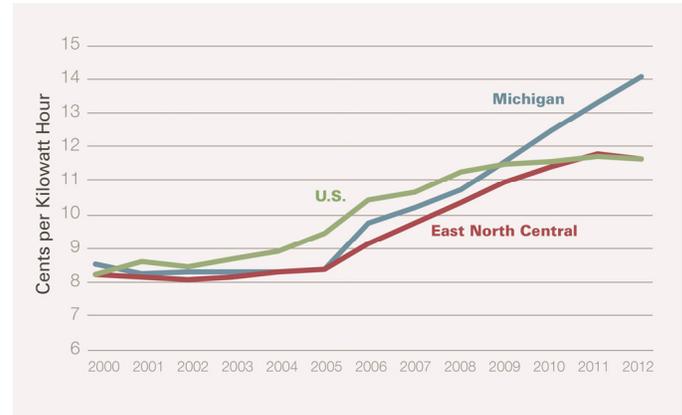
higher than the average price in the Great Lakes States.⁴ By 2004 — only two years after competition was introduced — Michigan rates were below the national average and were narrowing the gap with the other Great Lakes States. After the 10 percent cap and other restrictions on competition were imposed in 2008, rates increased much faster than the national average, and by the end of 2012, rates in Michigan were about 18 percent above the national average and 23 percent above the regional average. Furthermore, while electricity rates on average in the United States had declined between 2008 and 2012, rates in Michigan on average were about 27 percent higher than they were when the 10 percent cap was imposed.

The Draft Report shows rates across all categories consistent with the rates above, but then asserts an interpretation that is based on a major factual misstatement and easily demonstrated to be wrong when the data is broken down into the appropriate categories. The Draft Report, in its analysis of the rates across all categories of customers, states:

This perspective may not tell the entire story. P.A. 141 [the 2000 electricity choice legislation] included a five percent rate cut and a rate cap until late 2005. The rate cut may have placed Michigan below the national average and the rate cap may have kept Michigan below the national average. After the rate cap expired, Michigan's rates rose extremely fast and four years later would exceed the national average.

Graphic 3 shows the historical trend for residential rates and does indeed show Michigan residential rates rising after the cap was lifted.

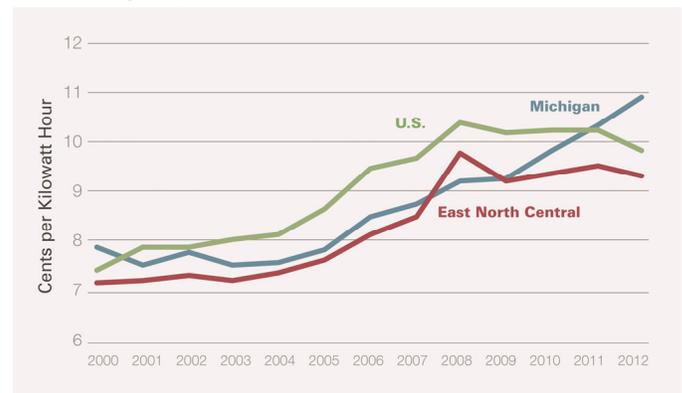
Graphic 3: Residential Electricity Rates in Michigan, 2000-2012



Source: U.S. Energy Information Administration.

However, Michigan industrial and commercial rates were never subject to a rate cap, and these sectors consume about two-thirds of the retail sales of electricity in Michigan.⁵ Thus, the Draft Report errs when it implies that the historical rates for all categories of customers was subject to a rate cap. Moreover, industrial and commercial rates in Michigan also declined between 2000 and 2004, by about the same amount as residential rates. Even without a rate cap, these categories of Michigan rates fell below the national average, and were falling relative to the regional average from nearby states (see Graphics 4 and 5).

Graphic 4: Commercial Electricity Rates in Michigan, 2000-2012



Source: U.S. Energy Information Administration.

⁴ The EIA tracks average electricity rates for the East North Central Region, which is Michigan, Indiana, Illinois, Ohio and Wisconsin. This region is called the "Great Lakes States" in this comment and the graphics.

⁵ Author's calculations based on "Annual Electric Power Industry Reports (EIA-861 Data File)" (U.S. Energy Information Administration, 2013), <http://goo.gl/0TJ8fs>.

Graphic 5: Industrial Electricity Rates in Michigan, 2000-2012



Source: U.S. Energy Information Administration

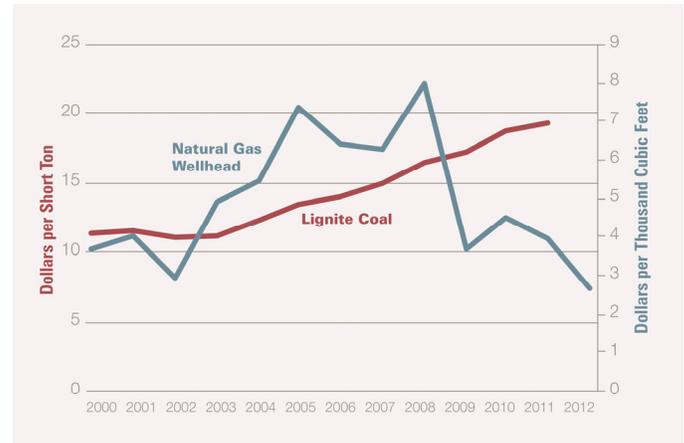
Thus, this price data provide no support for the asserted interpretation that the rate cap was driving the drop in Michigan rates at a time when rates elsewhere were rising. Rates in two of the three major customer categories were falling even without a rate cap. Although no market test is available for the residential category, these rates probably would not have risen and may have declined by about the same amount without the rate cap.

The state's renewable energy standard, which has been phased in since 2009, may have also contributed to higher prices, including a surcharge currently in effect to fund generation of electricity from certain renewable sources. It should be noted, however, that neighboring states and most other states have renewable energy standards similar to Michigan's, so the current renewable energy mandate is at most a small factor in explaining why Michigan's rates are rising relative to other states.

One might note that even though Michigan rates were below the national average until at least 2009, the increase in rates in Michigan started about 2005, or three years before the 10 percent cap was imposed. Various actions by the MPSC between 2004 and 2007 impeded the emerging competition in electricity in various ways, and the regulatory uncertainty during that time almost certainly discouraged entrants from investing in Michigan at a time when the large

utilities were lobbying (successfully, as it turns out) for protection from competitors.⁶ Another important factor in explaining why both competition declined and rates rose in Michigan, as well as in surrounding states and the U.S. as a whole, beginning about 2005, is the unusual spike in natural gas prices that occurred at this time.

Graphic 6: Natural Gas and Coal Prices in the United States, 2000-2012



Source: U.S. Energy Information Administration.

Many of the early entrants in 2002 to 2004 were selling electricity generated from natural gas.⁷ Natural gas prices had been low and relatively predictable for over 20 years before 2005, but from 2005 to 2008 natural gas wellhead prices spiked to their highest level since before they were deregulated in 1984. The market adjusted, however, and natural gas prices have since declined to their lowest levels in more than a decade. At the same time, coal prices are now much higher than they were a decade ago, so that natural gas is even more attractive in terms of cost (not to mention emissions) compared to coal. Thus, Michigan timed the 10 percent cap to take effect just as natural gas became an attractive alternative for electricity generation, and other states that allow competition without a cap are receiving the benefits that Michigan has missed.

⁶ Diane S. Katz and Theodore R. Bolema, "Proposals to Further Regulate Michigan's Electricity Market: An Assessment" (Mackinac Center for Public Policy, 2008), accessed Oct. 29, 2013, <http://goo.gl/CKqEhn>.

⁷ Ibid.

The Draft Report's attempt at attributing Michigan rate increases to the expiration of the 2005 rate cap on residential customers does not hold up under close examination. While the Draft Report is correct in pointing out that Michigan rates began to rise before the 10 percent cap was imposed in 2008, it fails to note how that increase in Michigan rates between 2005 and 2008 is consistent with rate increases in other states at that time. Where Michigan rates diverge from those in other states is after 2008, after the 10 percent cap was imposed. As shown in Graphic 1, since 2008, average rates in the United States actually dropped slightly from 9.74 cents per Kilowatt hour in 2008 to 9.65 at the end of 2012. During the same time period, Michigan rates increased over 27 percent, from 8.94 cents per Kilowatt hour in 2008 to 11.37 at the end of 2012.⁸ The major change in Michigan regulatory policies that explains why Michigan rates shot up while national rates stayed the same is the arbitrary cap Michigan imposed on competition, with the predictable result of less competition leading to higher prices.

Stranded Costs (Section V)

Probably the most contentious issue in the negotiations leading up to the restructuring legislation was how to deal with “stranded costs.” Stranded costs are defined as capital investments by the regulated utilities that are contained in the regulated rate base but not collectable in the future if consumers switch to other suppliers. Public Act 142, passed as a package with P.A. 141 in 2000, gave state guarantees of \$2.2 billion in utility refinancing to lower incumbent utility costs. In addition, the two utilities, DTE Energy and Consumers Energy, were

guaranteed compensation if electric restructuring required them to close facilities.⁹

Some investments and commitments by utilities may well have been unrecoverable outside of regulation. For example, regulated utilities across the country were required to purchase power from independent power producers (known as “qualifying facilities”) under federal law, and entered into long-term contracts with such suppliers that are still in effect. Other costs defined as “stranded” were probably not unique to the regulatory environment, but nonetheless were eligible for recovery under P.A. 142. Further, P.A. 141 required that customers switching to alternative suppliers pay an extra charge for stranded cost recovery by incumbent utilities. Thus, a portion of rates paid to alternative suppliers went directly to their competitors. Even though competition was later restricted, the utilities were never required to pay back those stranded costs. Instead, Michigan ratepayers paid these costs and were not repaid when the utilities were protected from competition by the 2008 legislation.

A 1997 Mackinac Center report discussed the lack of economic justification for most if not all stranded cost recoveries by the large utilities. The following excerpts from that report apply equally well today:

The bottom line on this divisive issue is that stranded cost compensation is almost never justified ...

8 Author's calculations based on “Annual Electric Power Industry Reports (EIA-861 Data File)” (U.S. Energy Information Administration, 2013), <http://goo.gl/0TJ8fs>; “Electric Utility Sales and Revenue - EIA-826 Detailed Data File” (U.S. Energy Information Administration, 2013), <http://goo.gl/vwbx5y>.

9 This comment uses the term “stranded costs” loosely, and notes that the utilities also received “transition cost” payments to compensate them for the transition to having to compete and “securitization” charges to help them lower their debt. The charges are explained further in Theodore R. Bolema, “Assessing Electric Choice in Michigan” (Mackinac Center for Public Policy, 2004), accessed Oct. 29, 2013, <http://goo.gl/0aixCb>; Diane S. Katz and Theodore R. Bolema, “Proposals to Further Regulate Michigan’s Electricity Market: An Assessment” (Mackinac Center for Public Policy, 2008), accessed Oct. 29, 2013, <http://goo.gl/CKqEhn>.

A good test that regulators can employ to determine if any compensation should be considered is the following: If a utility can show that it made an investment at the insistence of regulators, and resisted the action but was forced to move forward anyway, then it has a better case for compensation. In a recent study advising Pennsylvania regulators, Dr. Jake Haulk, research director for the Pittsburgh-based Allegheny Institute for Public Policy, concurs but adds important qualifications to this simple test that are applicable for all state and federal regulators.

Any utility which can show that it was ordered to make expenditures that it would not have undertaken on its own, and which other utilities were not ordered to make, should be given some opportunity to recover those outlays. The guiding principle here must be this; to what extent has the utility been uniquely disadvantaged by regulators or government agencies? If all utilities have been treated the same by regulators, the playing field will remain level after competition is introduced and hence there is no reason to allow stranded cost recovery ...

Rarely have utilities fought proposals by regulators to mandate the construction of new facilities or requirements to undertake other activities. If utilities showed no reluctance to move forward with the projects regulators urged them to pursue, then they clearly have no grounds for recovery. And even in those few cases where limited recovery might be approved by policy makers, utilities should be asked to do everything in their power to mitigate these costs before they are absorbed by third parties. Regulators might even want to encourage utilities to divest themselves of certain assets for which they are claiming compensation. This

would at least allow the utility to recoup some of the costs associated with the asset and would simultaneously ensure that customers or new competitors are not stuck footing an unnecessarily large bill.¹⁰ [Citations omitted, and are available in the original report.]

By this economic standard, the stranded cost recoveries following the 2000 legislation were excessive. A strong argument can be made that the large utilities should have been required to pay back a large share of these stranded costs to Michigan ratepayers when the 10 percent cap was imposed in 2008. Looking forward, any claims that large utilities are entitled to even more compensation for stranded costs or other cost related to a transition to greater competition should be viewed with great skepticism.

Conclusion

The Draft Report has the potential to be a helpful contribution to the public debate on future electricity choice policy for Michigan. The first draft, however, falls short in ways that should be corrected before a final report is made available to policymakers.

Michigan can recapture the benefits of competition in electricity supply by removing the 10 percent cap and undoing other restrictions on electricity sales that allow its largest utilities to charge unnecessarily high prices to Michigan's residents, businesses and government service providers. Michigan should once again embrace opening its electricity market to more entrants to see if they can perform better than the incumbent firms, which will drive down prices for electricity consumers. Michigan allowed such competition to start to emerge during its brief era of Full Customer Choice, and the early results were promising. The initial results from a more tightly regulated and protectionist experiment have been by contrast disappointing.

¹⁰ Adam D Thierer, "Energizing Michigan's Electricity Market" (Mackinac Center for Public Policy, 1997), accessed Oct. 28, 2013, <http://goo.gl/B8lx8e>.

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