

Additional Question 14: *Why have Michigan's rates gone from below the national average to above the national average over the past several years? How have environmental capital improvements, deskewing, capital improvements for reliability, delivered fuel price increases, a sluggish economy, renewable energy surcharges, and energy efficiency surcharges impacted Michigan's rates?*

Executive Summary

1. Michigan's relative rate position moved from below the national average to above the national average in the last few years largely due to the effect of declining natural gas prices on the national average electric rate

- Michigan rates relative to the national average fluctuate depending on natural gas prices, which are a large driver of rates in other states and therefore the national average. During periods of rising natural gas prices, such as from 2000 to 2008, states more reliant on natural gas-fired generation experienced increasing rates, which increased the national average relative to Michigan. Conversely, when gas prices are low, Michigan rates compare less favorably to the national average because there are fewer natural gas plants in Michigan. The 2000-2008 period happened to also be the time of uncapped retail access in Michigan, but natural gas prices drove Michigan's favorable position relative to other states
- Michigan's electric rates are lower than most deregulated states
- Overreliance on one fuel source, such as natural gas, may have temporary benefits but can result in volatile rates and reliability issues, as seen recently in New England (predominately deregulated). Deregulated generators do not have the responsibility to ensure that a diverse generation portfolio is maintained; they build plants with the fuel source best positioned to earn the highest possible profit

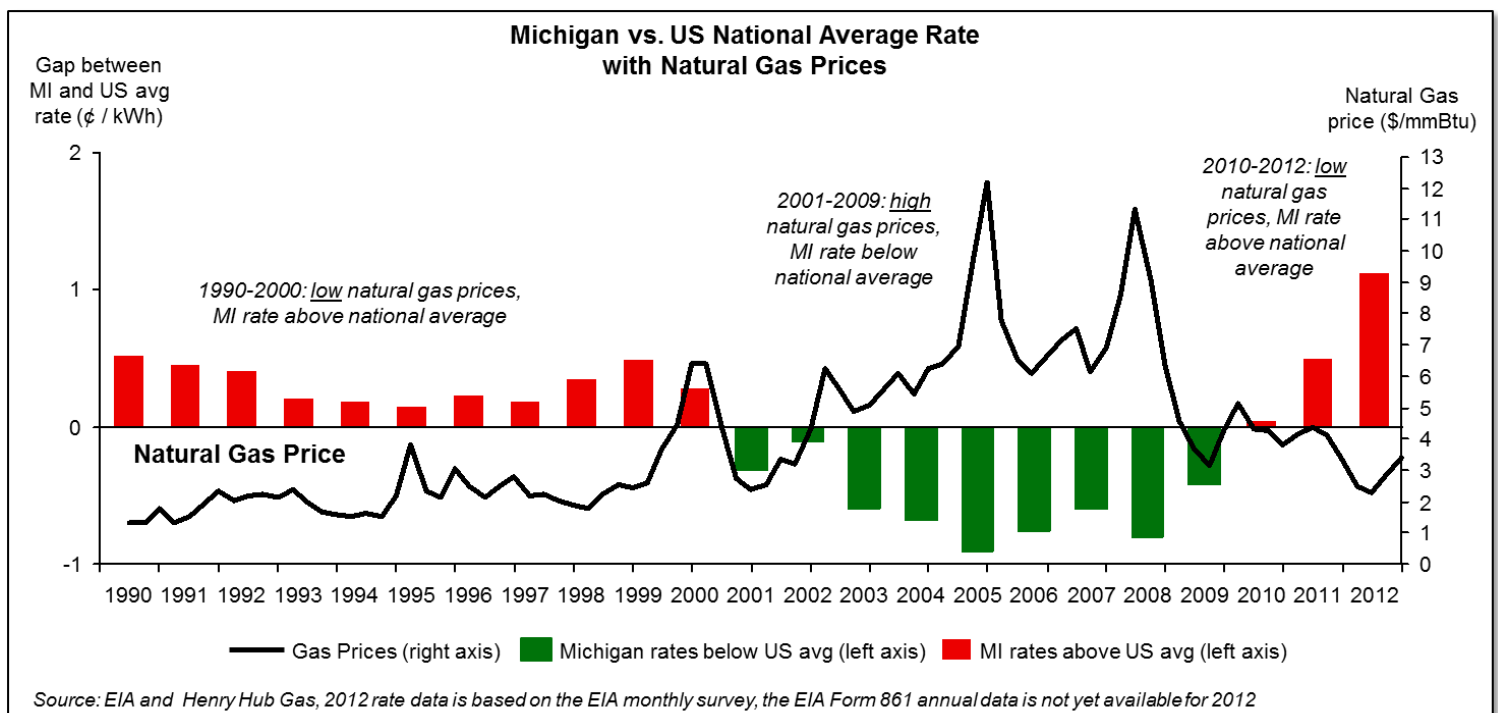
2. Michigan's absolute rate changes over the past few years have been driven largely by capital investments in clean, reliable electricity, and by declining electric load

- Increases in Michigan cost of service rates have been driven by a number of structural and regulatory factors including mandated capital investments for clean electricity, cost of fuel increases, and declining load. Lower operating costs and cost of capital have helped to mitigate these increases
 - Load loss was the largest driver of the electric rate increase. As load decreased in Michigan due to the economic downturn and increased participation in retail access, rates increased for utility customers
 - In spite of the rate increases, Michigan's residential bills remain well below the national average and Michigan families spend a smaller portion of their income on electricity
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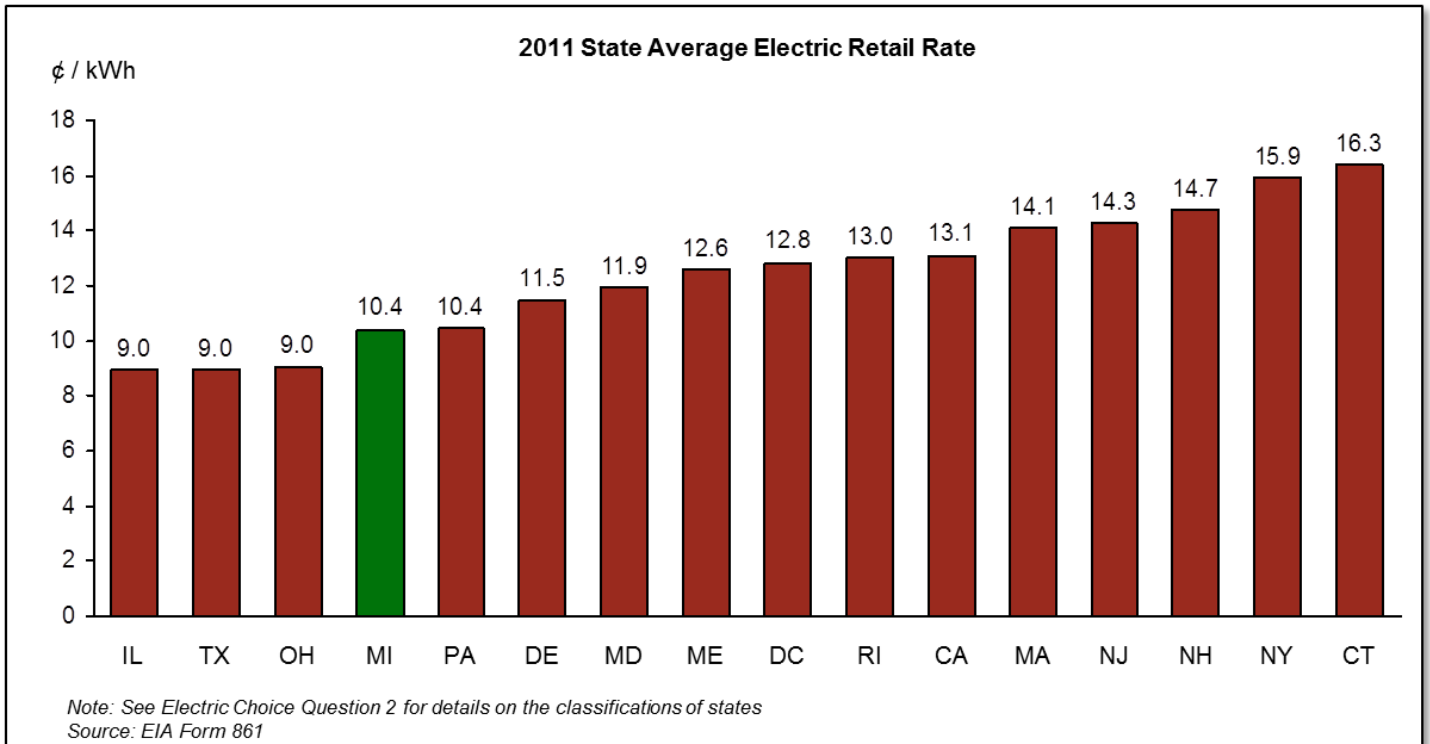
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States with significant electric generation fueled by natural gas see their rates affected by natural gas fuel costs. Deregulated states are the most affected by natural gas prices due to market pricing that is based on the highest fuel cost unit.

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Recent weather variability combined with the closure of coal plants has highlighted New England's overreliance on natural gas and the potential consequences of not having a diverse generation portfolio:

“Electricity prices in New England have been four to eight times higher than normal...as the region's extreme reliance on natural gas for power supplies has collided with a surge in demand for heating”

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"During the storm last week, with transmission lines being knocked out by snow and high winds, ISO [system operator] asked some gas-fired generators to start running in the middle of the night... and found they could not. We were sitting here, 3 in the morning, trying to get gas generators to start up, and we started seeing where they couldn't access that market in the overnight hours" – Dr. Chadalavada, ISO New England

"Last year, natural gas provided 52 percent of New England's electricity, and that share is expected to grow... the lower [natural gas] costs have spurred the retirement of aging coal generators and nuclear reactors. The six-state New England region and parts of Long Island are the most vulnerable now to overreliance on gas... officials worry that similar problems could spread to the Midwest"

Source: The New York Times, "In New England, a Natural Gas Trap", February 2013

Despite these recent price spikes and reliability concerns from overreliance on natural gas, deregulated generators continue to shut down coal plants in New England, as the owners cannot earn a profit.

"We've seen in this market [New England] three coal-fired power plants out of eight exit the market already... the Somerset power plant in Bristol County, Mass., the Thames power plant in Montville, Conn., and the Salem Harbor Power Station, in Salem, Mass." –Jonathan Peress, Conservation Law Foundation Clean Energy and Climate Change Program

Thomas Farrell, CEO of Dominion, a company in the process of selling financially distressed deregulated generation in the Northeast, warns of a continued overreliance on natural gas:

"If you want to see the price of natural gas rise ... replace the entire fleet — all coal and all nuclear over the next 20 or 30 years — with gas. You are going to regret it." Farrell said that in the long term, it is "foolhardy" to rely just on natural gas power plants.

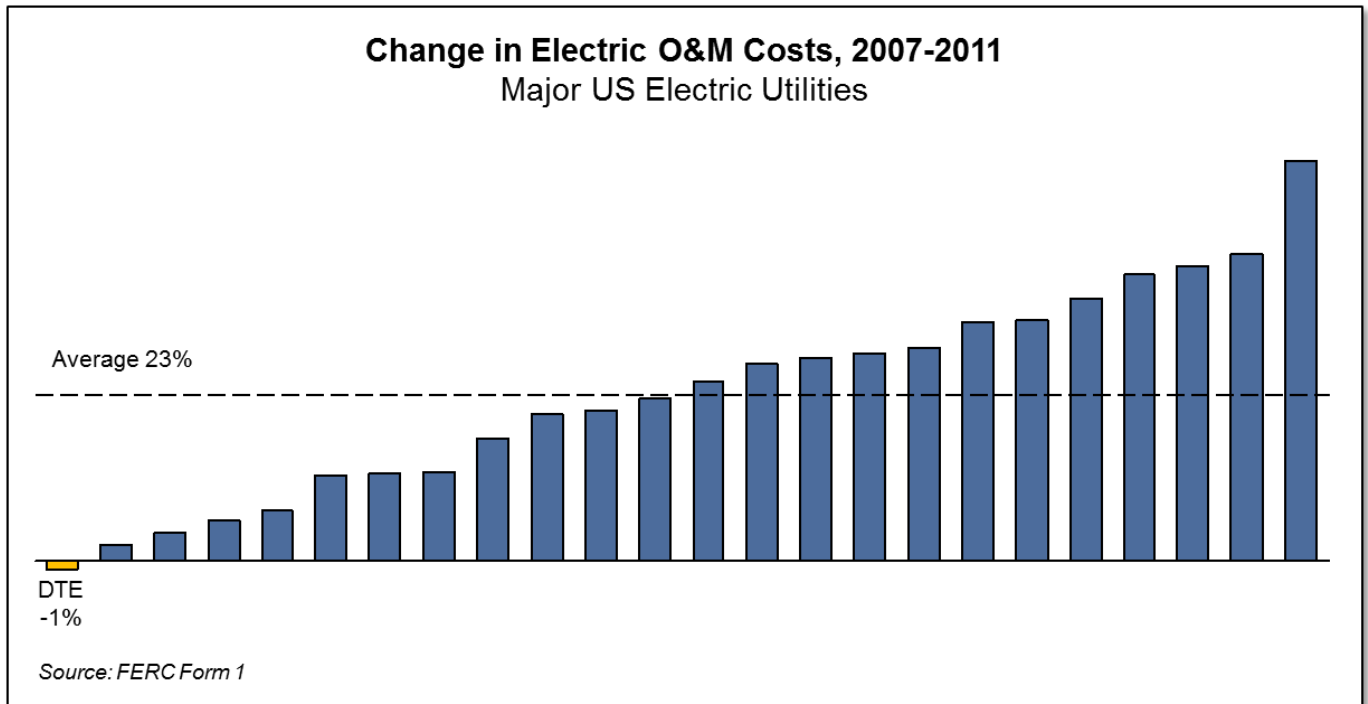
[Dominion will] invest in new power plants, but those will be investments through its regulated business, which Farrell said provides investors with more reliable, steady returns than merchant facilities.

Source: SNL Financial summary of Thomas Farrell interview following The Wall Street Journal's ECO:nomics conference

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2. Michigan's absolute rate changes over the past few years have been driven largely by capital investments in clean, reliable electricity, and by declining electric load.

- Increases in Michigan cost of service rates have been driven by a number of structural and regulatory factors including mandated capital investments for clean electricity, cost of fuel increases, and declining load. Lower operating costs and cost of capital have helped to mitigate these increases.

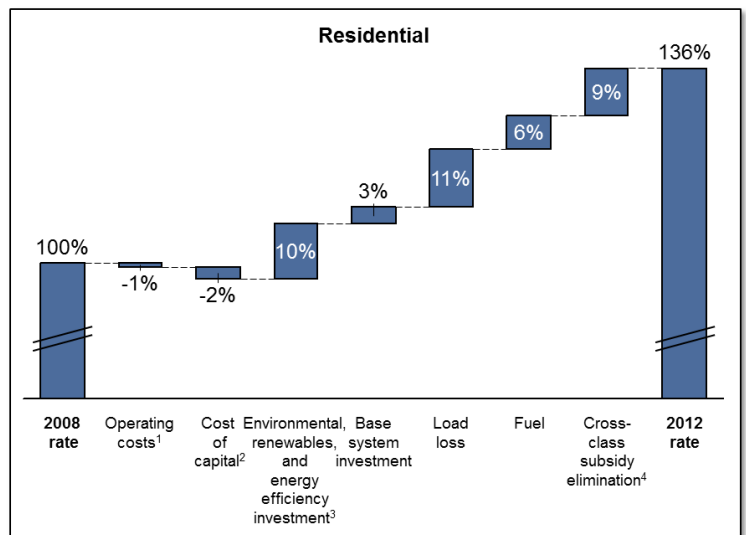
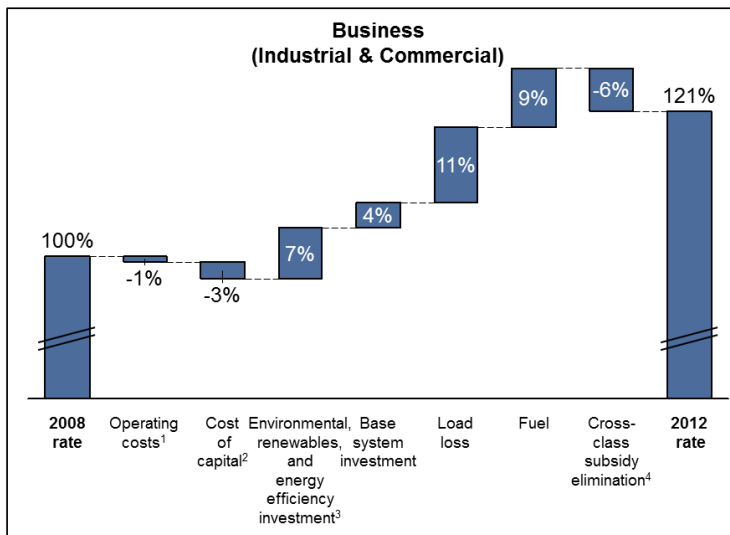


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The following table lays out the different factors that drove changes in electric rates:

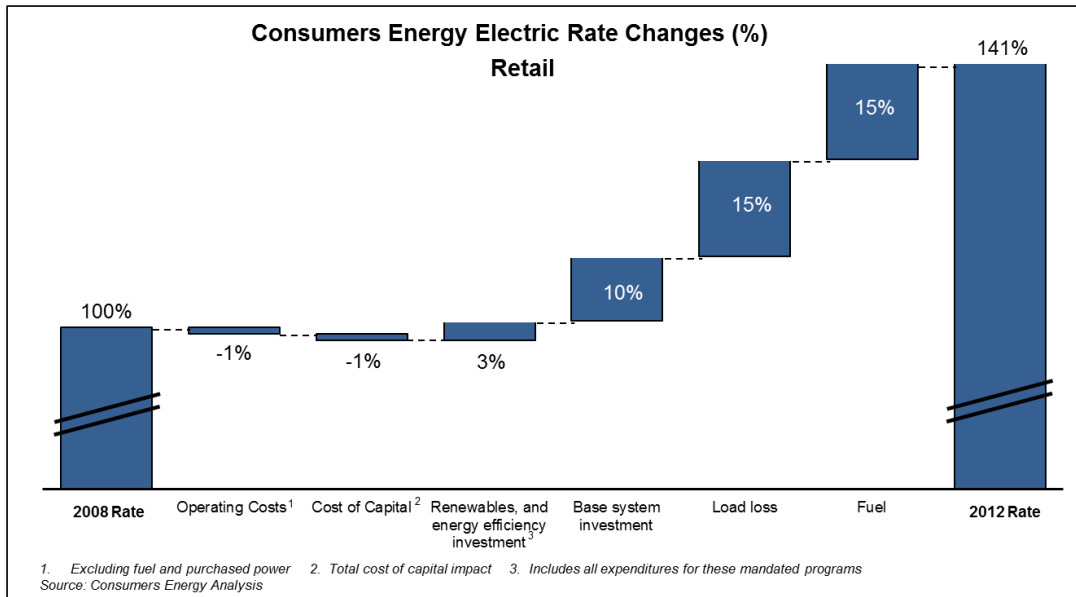
Drivers of Michigan Electric Rate Changes	
Operating costs	Reduced operating costs, through Continuous Improvement efforts, helped to lower rates
Cost of capital	Cost of capital has decreased as Michigan utilities refinanced to lower borrowing costs and authorized return on equity in Michigan was decreased
Environmental, renewables, and energy efficiency investments	Michigan utilities have invested billions of dollars for environmental capital improvements driven by EPA legislation, and for renewable energy and energy efficiency driven by targets in state law
Base system investment	Michigan utilities continued to invest in the electric system to ensure reliability
Load loss	A sluggish Michigan economy along with increased retail access have resulted in decreased consumption and therefore higher rates <i>(see next section for detail)</i>
Fuel	Michigan utilities have seen increased delivered fuel costs over the past several years as contracts expired
Cross-class subsidy	The Michigan Public Service Commission required that the utilities implement deskewing, a reversal of a prior rate subsidy for residential customers. The deskew has increased rates for residential customers and decreased rates for business customers. Deskewing shifted costs between rate classes but did not increase overall rates

DTE Energy Electric Rate Changes (%)



1. Excluding fuel and purchased power 2. Total cost of capital impact 3. Includes non-capital (operating) expenditures for these mandated programs 4. Increase for residential customers; decreased rates for business customers
Source: DTE Energy Analysis

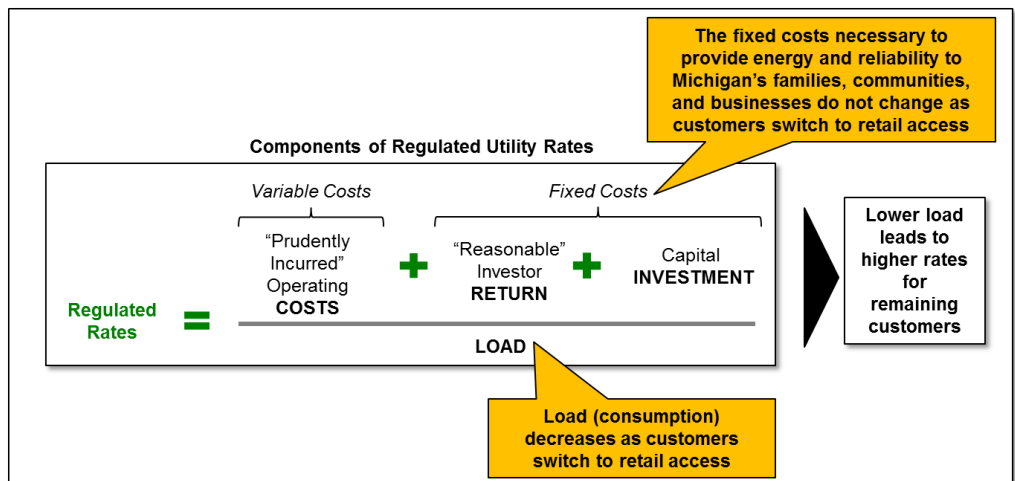
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Operating costs are the driver of rates over which utilities have the most control. Efforts by both DTE Electric and Consumers Energy to reduce operating costs led to rate reductions for their customers of 1% from 2008-2012.

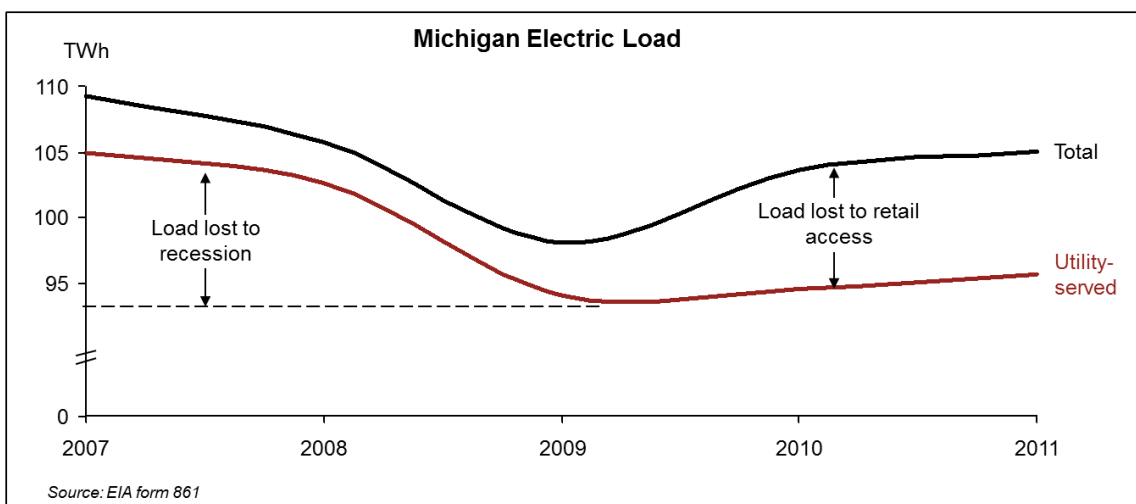
- Load loss was the largest driver of the electric rate increase. As load decreased in Michigan due to the economic downturn and increased participation in retail access, rates increased for utility customers.

A certain level of fixed costs is required to ensure the reliability of power generation. When some customers move to retail access, these fixed costs do not change. However, the load over which these costs are divided decreases, resulting in higher rates for the remaining utility customers.



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Retail access has caused a decrease in load for the utilities, on top of the load loss suffered during the economic downturn. Michigan lost 10% of its load in the recession, and has since recovered a little over half of that. However, utility-served load has barely increased, because some customers are being served by energy marketers on retail access.



- In spite of the rate increases, Michigan's residential bills remain well below the national average and Michigan families spend a smaller portion of their income on electricity.

