

# RESTRUCTURING MICHIGAN'S ELECTRIC INDUSTRY: WHAT'S WRONG WITH PUBLIC ACT 141

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## INTRODUCTION

Public utilities have historically operated as vertically-integrated monopolies, meaning here that a single utility company ensured delivery of electricity to the final consumer. In other words, the utility customer paid one monthly bill and received in return a complete electric service, including generation (or procurement) of energy, transmission of energy from a remote power plant to a local substation, distribution from the substation to the customer's point of service, and various administrative services – meter reading, billing, etc.<sup>2</sup> The customer had no opportunity to choose his electric company, but was simply assigned to the company holding the right to serve the geographic area in which the customer was located.<sup>3</sup>

The reasons for this monopoly structure were fairly simple: competition was viewed as undesirable because of significant economies of scale and scope in distribution, duplication of distribution facilities is wasteful and unsightly, and reliability could only be ensured through the oversight of a state regulatory body<sup>4</sup>. The grant of monopoly rights to the utility, however, came with several responsibilities – most notably the common law “obligation to serve.”

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<sup>2</sup> Roger Ridlehoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L. J. 307, 311 (1998).

<sup>3</sup> Stella E. Rubia and Robert E. Burns, *Unbundling the Concept of Obligation to Serve in a Competitive Electric Market: Sharing Responsibility for Reliability*, ¶ 1 (April 1998), at <http://www.nrri.ohio-state.edu>: “Electric utilities were granted either territorially exclusive franchises or certificates of public convenience and necessity. Those with exclusive franchise areas were granted the right to provide service in a designated service territory. Electric utilities that received certificates of public convenience and necessity were typically also granted an exclusive service territory and even when they did not have an exclusive franchise area, they were always provided some degree of freedom from competition.”

<sup>4</sup> *Id.* ¶ 2. See also Roger Ridlehoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L. J. 307, (1998), noting that in the early 1900s, it was widely believed that government regulation of utility markets would be superior to unrestricted, “cut-throat” competition. “Elimination of competition would prevent wasteful duplication of facilities and it would stabilize prices. Customers would benefit from lower costs, and therefore lower prices,

Recently, however, several states, including Michigan, have attempted to “deregulate” (or “restructure”) the electric utility industry, and to open electric retail markets to competition. While no two state deregulation plans are exactly alike, all plans call for an “unbundling” of the traditional electric service, functionally and on customer bills, allowing for both wholesale and retail competition.<sup>5</sup> The reasoning for this is fairly straightforward: state legislators have recognized that the product typically delivered by electric utilities is in fact a combination of numerous services – transportation, storage, meter reading, etc. - in addition to the power commodity itself.<sup>6</sup> It is plausible that “... many of these components, if produced separately, may not exhibit the natural monopoly cost conditions that have been the foundation of traditional utility regulation.”<sup>7</sup> In that case, consumers may be better served by a regulatory policy that requires utilities “... to price and offer each service separately, while at the same time permitting all of these services except delivery, believed to be the only true natural monopoly product in the bundle, to be subject to competition.”<sup>8</sup>

Once unbundled and deregulated, legislators hope that many suppliers will enter the retail market for electricity, vying to provide the non-natural monopoly products.<sup>9</sup> Roger Ridlehoover describes the predicted outcome:

In theory, costs and prices should fall, and innovations should appear as the forces of rivalry take hold. The utility, shrunk to the limited role of delivery system operator, will continue to provide this natural monopoly product under the supervision of a regulatory commission. The end result should be lower prices

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resulting from services provided by an entry-protected monopolist whose prices were subject to government-supervised, cost-based limitations.”

<sup>5</sup> A. John Armstrong, *Unplugged: The Effect of the New World Electric Power Order on Renewable Energy Industries*, 22 N.C. J. INT’L L. & COM. REG. 449, 467-68 (1997).

<sup>6</sup> Roger Ridlehoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L. J. 307, 310-11 (1998).

<sup>7</sup> *Id.* at 311.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

and enhanced efficiency for a substantial part of the previously regulated bundle of utility products.<sup>10</sup>

Likewise, under Michigan's plan for retail electric competition, the incumbent electric utility would continue to provide a regulated distribution service, but would be forced to allow competitors access to its distribution system. In other words, the incumbent would lose the right to exclusively serve its historic geographic area, and would have to compete with other electric suppliers for the right to sell the energy commodity to its distribution customers. Where customers fail to choose a supplier, however, or where no supplier opts to serve a particular class of customers, the incumbent public utilities in Michigan are required to provide a regulated "default service." This raises the question, then, of whether effective competition can reasonably be expected to develop where a statutorily mandated "obligation to serve" remains with the incumbent utility, while competitors are free to pick and choose customers to target and serve.

This paper is devoted to an analysis of a Michigan utility's traditional "obligation to serve," and what remains of that obligation after the enactment of the Customer Choice and Electric Reliability Act (hereinafter P.A. 141).<sup>11</sup> In addition, this paper will analyze the likelihood that P.A. 141 will eventually fail to achieve its stated goal of retail choice for all electric customers, and will recommend an alternative to the Michigan electric utility restructuring plan.

#### BACKGROUND – THE REGULATORY COMPACT

The rights and responsibilities of a regulated public utility, taken together, are frequently referred to as the "regulatory compact." The regulatory compact is a creature of state law, and is

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<sup>10</sup> *Id.*

<sup>11</sup> Customer Choice & Electric Reliability Act, Mich. Comp. Laws § 460.10 (2000).

neither a static legal concept nor an explicit contract.<sup>12</sup> Under the typically defined regulatory compact, public utilities enjoy the opportunity to collect a reasonable price for the services they provide the public - based on their prudently incurred expenses and a reasonable rate of return on investments that are used (or are useful) in providing electric service. The utilities also enjoy freedom from competition within their assigned service territories, and under certain circumstances, the right of eminent domain.<sup>13</sup>

In exchange for the aforementioned “rights,” regulated public utilities assume certain obligations. First, they have an “obligation to serve” all who apply for service (and are willing to pay) from within their assigned service territories.<sup>14</sup> This includes a duty to provide for adequate generation capacity, and to plan for current and future demand – to either build facilities to meet anticipated demand or to arrange for the purchase of energy in the wholesale market.<sup>15</sup> This also includes an obligation to extend lines to serve new customers within the assigned service area, even if doing so may prove unprofitable.<sup>16</sup> Second, public utilities have a responsibility to provide adequate, safe and reliable service, with a minimum of service interruptions, and within prescribed tolerance limits of voltage and frequency control. Third, public utilities must refrain from engaging in undue price discrimination: all similarly situated customers receiving identical service must be served on the same terms and conditions, and at the same price. Finally, regulated public utilities must only charge just and reasonable rates, and cannot earn monopoly profits.<sup>17</sup>

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<sup>12</sup> Stella E. Rubia and Robert E. Burns, *Unbundling the Concept of Obligation to Serve in a Competitive Electric Market: Sharing Responsibility for Reliability*, (April 1998), at <http://www.nrri.ohio-state.edu>.

<sup>13</sup> *Id.*

<sup>14</sup> *People of State of New York ex. rel. New York & Queens Gas Co. v. McCall*, 245 U.S. 345, 351 (1917).

<sup>15</sup> Jim Rossi, *Universal Service in Competitive Retail Electric Power Markets: Whither the Duty to Serve?*, 21 ENERGY L. J. 27, 29 (2000).

<sup>16</sup> *Id.*

<sup>17</sup> Roger D. Colton, *Electric Reliability and the Low Income Customer*, (October 1997), at <http://dls.state.va.us/groups/sjr91/81898/818LOWIN.HTM>.

## THE OBLIGATION TO SERVE IN MICHIGAN PRIOR TO PUBLIC ACT 141

Unlike other states, there was no specific statute in Michigan mandating an obligation to serve prior to the enactment of P.A. 141. Nonetheless, it is clear there was an obligation to serve under the common law. In *Michigan State Telephone v. Michigan Railroad Company*, for example, the Michigan Supreme Court, in finding an obligation of a public utility to serve as an extension of the Railroad Act stated, "... the company whose business is subjected to the regulation ... may be required to perform service it would not perform except for the regulation; and to submit to losses which it would prefer to avoid."<sup>18</sup> The Michigan Supreme Court has also identified an obligation to serve as consideration for the grant to a public utility of the right to use the public streets for its distribution facilities. In *City of Lansing v. Michigan Power Company*, when the City of Lansing attempted to force the removal of Michigan Power Company's poles and electric lines from the public right of way to make room for its own competing facilities, the court alluded to the existence of a traditional regulatory compact, including the utility's obligation to serve:

The Legislature tendered the use of the streets for public utility purposes to such individuals and corporations as would provide the public with a necessary utility service, knowing that the creation of such a utility and its service would entail the expenditure of large sums of money and benefit the public by providing a common service of the utility, knowing also that as soon as it should be installed in the public streets it would become affected with a public interest, and that its owner would have to surrender the right to serve whom and where it willed, or to charge as it willed, and that it would become subject to the laws regulating public service corporations. This public interest, this right of regulation, and this public advantage constitute a valuable consideration for the use of the streets and remove the grant from the class of a mere license.<sup>19</sup>

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<sup>18</sup> *Michigan State Telephone v. Michigan Railroad Commission*, 193 Mich. 515, 524 (1916).

<sup>19</sup> *City of Lansing v. Michigan Power Company*, 183 Mich. 400, 410 (1914), *see also* *City of Traverse City v. Consumers Power Co.*, 340 Mich. 400 (1954), holding "Defendant, being a public utility, is under a duty to extend electrical service to the public within the area serviced upon reasonable demand."

More recently, the Michigan Supreme Court again affirmed its stance that public utilities exist under an obligation to serve in *Michigan Consolidated Gas Company v. Austin, Millbrook and Hinton Townships*. In *Michigan Consolidated Gas*, the court stated in no uncertain terms:

Plaintiff, as a public utility, is under an obligation to provide the needs of its customers.... Plaintiff is not a free agent. It is not at liberty to sell or withhold the sale of gas at its option. It is not engaged in the free marketing of a commodity. Within the various territories which it serves it is under obligation to furnish the needs of its customers.<sup>20</sup>

Finally, the United States Supreme Court cited the enforcement of the obligation to serve as one of the primary reasons for the existence of state regulatory commissions, and noted the duty to extend service lines as part of that obligation:

Corporations which devote their property to a public use may not pick and choose, serving only the portions of the territory covered by their franchises which it is presently profitable for them to serve and restricting the development of the remaining portions by leaving their inhabitants in discomfort without the service which they alone can render. To correct this disposition to serve where it is profitable and to neglect where it is not, is one of the important purposes for which these administrative commissions, with large powers, were called into existence....<sup>21</sup>

While it is clear that an obligation to serve applies to public utilities in Michigan, that obligation is not absolute. For example, in *Huron Portland Cement Co. v. Public Service Commission*, the Michigan Supreme Court held that a utility is only obligated to extend lines to serve new customers if service is possible and can be accomplished on a basis that is reasonable.<sup>22</sup> In *Huron Portland Cement*, the co-defendant utility, under a contract approved by the Michigan Public Service Commission, had undertaken to serve a large industrial facility in the vicinity of the City of Alpena, but had not professed to serve the city itself. Since the transmission line serving the industrial facility did not pass through the city, the Court held that

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<sup>20</sup> Michigan Consol. Gas Co. v. Austin, Millbrook and Hinton Tps., 373 Mich. 123, 138-39 (1964).

<sup>21</sup> People Ex Rel New York and Queens Gas Co. v. McCall, 245 U.S. 345, 351 (1917).

<sup>22</sup> Huron Portland Cement Co. v. Public Service Comm., 351 Mich. 255 (1958).

the Michigan Public Service Commission had no authority to (and it was in fact unreasonable to) compel the utility to serve the city itself.<sup>23</sup>

The Michigan Public Service Commission clarified the “reasonableness basis” requirement, however, in an opinion issued in favor of two prospective customers seeking to compel a Michigan utility to extend its gas mains distances of 8140 feet (to serve 27 residential customers) and 1276 feet (to serve one residential customer). Both of these customers were willing to pay contributions toward construction specified by the utility. In its Case No. U-5483, the Commission held that “... a main extension of 10 or 20 miles to serve one residential gas space heating customer might not be a reasonable project...”<sup>24</sup> The Commission continued, though, that “[i]n public service, there will undoubtedly be instances in where the investment necessary to provide service will result in a loss situation to the Company. In other cases, projects might provide immediate profits well in excess of its overall authorized rate of return.”<sup>25</sup> According to the Commission, as part of the obligation to serve, a utility must balance “... profits derived from serving some customers against losses derived from other customers within the same classification...” Only where the Company’s return on investment would result in more than a small annual loss may the utility refuse service.<sup>26</sup>

In a later ruling, though, the Michigan Public Service Commission reinforced the maxim that a public utility must be able to recover the costs associated with the installation of new facilities - from the customer(s) requesting the installation. Furthermore, the Commission does not have the authority to compel a utility to provide service to an area that it has not voluntarily undertaken to serve without just compensation. In considering a petition by 54 residents of the

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<sup>23</sup> *Id.*

<sup>24</sup> Michigan Power Company, Case No. U-5483 (Michigan Pub. Serv. Comm’n July 7, 1977).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

East Lake area of Mackinac County seeking to compel telephone companies to provide service to their remote area, the Commission issued the following opinion:

The commission cannot require a telephone utility to extend a service ... without allowing it to recover the costs associated with installation of the new facilities. To do otherwise would constitute an illegal confiscation of utility property. On the other hand, the Commission finds it equally unfair to force the utility to recover its costs from its existing customers. Neither a telephone utility, nor its existing customers have a legal obligation to subsidize non-customers seeking to obtain telephone service.<sup>27</sup>

On a final note, a Michigan utility may also refuse to serve a customer which fails or refuses to abide by reasonable and non-discriminatory requirements for service. In *Antisdel v. Macatawa Resort Co.*, for example, a customer refused to comply with impartially enforced regulations against using a resort's water service for sprinkling, and also refused to pay the costs to connect a winter electric service.<sup>28</sup> When the resort refused to supply the customer with the requested water and electric services until she signed an agreement to follow the rules against sprinkling and paid the construction costs for the electric service, the customer filed suit. In affirming the lower court's holding for the resort (which was deemed a utility), the Michigan Supreme Court found the resort's rules for service to be reasonable and uniform in application, and the resort's refusal to serve the customer justified.<sup>29</sup>

#### INTRODUCING RETAIL COMPETITION TO THE ELECTRIC INDUSTRY – AN OVERVIEW

Two general types of competition are frequently proposed for the electric utility industry, and several states have attempted to institute one form or the other. The first is wholesale competition. Under a typical wholesale competition structure, the incumbent utility is required to spin off, or divest, most or all of its generation facilities, and to compete for power on the open market. Unfortunately for the utility, some wholesale competition proposals also allow very large

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<sup>27</sup> M.P.S.C. Own Motion, Case No. U-8371 (Michigan Pub. Serv. Comm'n January 7, 1986).

<sup>28</sup> *Antisdel v. Macatawa Resort Co.*, 243 Mich. 444 (1928).

<sup>29</sup> *Id.*

customers to directly participate in the wholesale market and to leave the utility's rate base - if they can arrange for a lower commodity price on their own.<sup>30</sup> The utility procures generation capacity for customers that remain, though, as well as a statutorily mandated reserve in case demand exceeds projections, or in case a competitive supplier fails to deliver on its contracts. The utility then resells the commodity to its remaining customers, typically at regulated retail prices.

Under wholesale competition, the utility maintains its exclusive service territory and its obligation to serve customers not large enough to deal with the power generator directly. And, in most cases, the utility also retains an obligation to serve as the "provider of last resort" for large customers that are unexpectedly dropped by wholesale suppliers. The utility also continues to serve as the exclusive *distributor* of electricity within its traditional service area. Cost savings are expected to result from competition to serve the utility's existing generation needs, however, and these savings would then be passed on to consumers in reduced rates for the commodity.<sup>31</sup>

The other type of competition widely proposed for the electric industry, and the type more pertinent to this paper, is retail competition. As of March 2000, 23 states and the District of Columbia had begun to introduce retail competition into electric markets.<sup>32</sup> Under retail competition, customers are no longer obliged to purchase power from the local electric utility company – instead, they can shop from amongst the suppliers offering the commodity to their customer class, and buy from the supplier offering the best deal.<sup>33</sup> While delivery of the commodity remains a regulated service provided by the incumbent utility company, the utility no

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<sup>30</sup> SALLY HUNT, *MAKING COMPETITION WORK IN ELECTRICITY* 47 (John Wiley & Sons 2002).

<sup>31</sup> Roger D. Colton, *Electric Reliability and the Low Income Customer*, (October 1997), at <http://dls.state.va.us/groups/sjr91/81898/818LOWIN.HTM>.

<sup>32</sup> Kenneth Gordon and Wayne P. Olson, *Open Entry, Choice, and the Risks of Short-Circuiting the Competitive Process*, 1 (March 2000), at [http://www.eei.org/industry\\_issues/electricity\\_policy/state\\_and\\_local\\_policies/state\\_restructuring\\_and\\_regulatory\\_policy/index.htm%20](http://www.eei.org/industry_issues/electricity_policy/state_and_local_policies/state_restructuring_and_regulatory_policy/index.htm%20)

<sup>33</sup> *Id.* at 7.

longer enjoys an exclusive territory for the sale of electricity under retail competition. And, under a typical retail competition plan, a public utility can decide to keep its generating facilities and compete for the commodity business of its existing customers, or it can opt to get out of the power generation business altogether, choosing to become solely a distribution company.<sup>34</sup>

#### MICHIGAN'S PLAN FOR IMPLEMENTING RETAIL COMPETITION – PUBLIC ACT 141

Public Act 141, commonly known as the “Customer Choice and Electric Reliability Act” is a fairly typical retail restructuring plan.<sup>35</sup> Signed into law on June 3, 2000, the law mandated choice for all retail customers of investor-owned utilities by January 1, 2002.<sup>36</sup> In anticipation of the introduction of competitive suppliers to the Michigan utility system, and to allow them to functionally participate in the retail electric market, the law directed the three largest utilities in the state (Consumers Energy, Detroit Edison, and Indiana Michigan Power Company) to file a joint plan by January 1, 2002 to permanently expand available transmission capacity by at least 2,000 MW by 2004; it directed *all* utilities serving the state to immediately take “all necessary steps” to connect merchant power plants with more than 100 KW to their transmission and distribution systems.<sup>37</sup>

In addition to improving the transmission system to accommodate competition, P.A. 141 calls for “general market power mitigation.” Market power mitigation is designed to “create an opening” for competitive suppliers to enter and serve the retail market. Specifically, P.A. 141 provides:

If, After subtracting the average demand for each retail customer under contract that exceeds 15% of the utility's retail load in the relevant market, an electric utility has commercial control over more than 30% of the generating capacity

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<sup>34</sup> Roger D. Colton, *Electric Reliability and the Low Income Customer*, 7 (October 1997), at <http://dls.state.va.us/groups/sjr91/81898/818LOWIN.HTM>.

<sup>35</sup> Mich. Comp. Laws § 460.10 (2000).

<sup>36</sup> Mich. Comp. Laws § 460.10(a)(1) (2000).

<sup>37</sup> Mich. Comp. Laws § 460.10(e)(1) (2000).

available to serve a relevant market, the utility shall do 1 or more of the following with respect to any generation in excess of that required to serve its firm retail sales load, including a reasonable reserve margin:

- (a) Divest a portion of its generating capacity.
- (b) Sell generating capacity under a contract with a nonretail purchaser for a term of at least 5 years.
- (c) Transfer generating capacity to an independent brokering trustee for a term of at least 5 years in blocks of at least 500 megawatts, 24 hours per day.<sup>38</sup>

In other words, existing utilities were required by the Act to relinquish commercial control over any generation exceeding 30% of relevant market<sup>39</sup> capacity, except for generation serving customers that remain under tariffed service.

With regard to residential customers of Consumers Energy and Detroit Edison, P.A. 141 called for an immediate 5 percent rate reduction,<sup>40</sup> and for a rate freeze until at least January 1, 2006.<sup>41</sup> Under the implementation rules filed by these utilities and approved by the Michigan Public Service Commission, customers that fail to choose an alternative supplier, or that are not offered service from another supplier, will retain total service from their existing utility company.<sup>42</sup> In addition, P.A. 141 imposes certain protections for residential customers, including increased winter shut-off protection for senior citizens and low-income customers.<sup>43</sup>

#### WHY PUBLIC ACT 141 WILL FAIL TO ACHIEVE ITS STATED GOALS

When Governor John Engler announced the signing of PA 141 during a ceremony on Mackinac Island, he said:

Today, electric customers are the clear winners. There's choice for those who want it and protection for those who need it. Customers get immediate relief through a rate reduction of at least 5 percent and the guarantee of more

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<sup>38</sup> Mich. Comp. Laws § 460.10(f)(3) (2000).

<sup>39</sup> There are two "relevant markets" in Michigan: the Upper Peninsula and the Lower Peninsula

<sup>40</sup> Mich. Comp. Laws § 460.10(d)(1) (2000).

<sup>41</sup> Mich. Comp. Laws § 460.10(d)(2) (2000).

<sup>42</sup> M.P.S.C. Own Motion, Case No. U-11290 (Michigan Pub. Serv. Comm'n November 20, 2000).

<sup>43</sup> Mich. Comp. Laws § 460.10(d)(7) (2000).

competition in the future. In addition, the state will get increased electrical generation and increased reliability of the power supply.<sup>44</sup>

And, the plain language of the Act states its purpose:

- (a) To ensure that all retail customers in this state of electric power have a choice of electric suppliers.
- (b) To allow and encourage the Michigan Public Service Commission to foster competition in this state in the provision of electric supply and maintain regulation of electric supply for customers who continue to choose supply from incumbent electric utilities.
- (c) To encourage the development and construction of merchant plants which will diversify the ownership of electric generation in this state.
- (d) To ensure that all persons in this state are afforded safe, reliable electric power at a reasonable rate.
- (e) To improve the opportunities for economic development in this state and to promote financially healthy and competitive utilities in this state.<sup>45</sup>

Presumably, when former Governor Engler made his announcement on Mackinac Island, and when the Michigan legislature set the above “purpose of the Act” to paper, they intended the benefits of retail competition to accrue to residential as well as commercial customers. Therein lies a problem, though, since as structured, P.A. 141 is highly unlikely to lead to any real competition in the residential sector. As such, residential customers in Michigan will likely *not* have any real choice of electric provider. In fact, given that “regulation of electric supply for customers who continue to choose supply from incumbent utilities” will be maintained under the Act,<sup>46</sup> electric restructuring in Michigan, at least from the perspective of the residential is simply “much ado about nothing.”

There are several reasons for this assertion, most of them centered on the lack of any “obligation to serve” in competitive markets. As stated earlier, the obligation to serve all who

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<sup>44</sup> Michigan Public Service Commission, *Governor Signs Electric Restructuring Bills Giving at Least 5 Percent Rate Cut*, (February 26, 2004) at <http://cis.state.mi.us/mpsc/electric/restruct/gov6-3pr.htm>.

<sup>45</sup> Mich. Comp. Laws § 460.10(2). While the plain language of the code indicates that Subsection (2) is inapplicable after December 31, 2003, it is assumed here that the effort to deregulate the electric industry in Michigan continues. It is also assumed that reducing prices for residential customers is still a goal, as well.

<sup>46</sup> *Id.*

apply (and who are willing to pay) is premised on the assumption that utilities enjoy monopoly power in the form of an assigned service territory free from competition. As competition is introduced, however, this assumption becomes increasingly less and less valid, especially in the retail market. While it is true that incumbent utilities continue to hold an obligation to *deliver* power to the end customer through still-regulated distribution facilities, it is equally true that in a free market situation, there is no mandatory obligation to serve (or sell) your product to anyone.<sup>47</sup> Thus, in the context of the typical utility deregulation plan, where distribution remains regulated but generation is open to competition, the traditional obligation to serve becomes more of an obligation to connect and deliver, at least as it relates to the incumbent utility.<sup>48</sup>

Furthermore, there is a fundamental dichotomy between retail competition and the obligation to serve.<sup>49</sup> Firms operating in a competitive environment are required to maintain low unit costs if they are to remain competitive, so it is only natural that they would be attracted to serving customers who have large purchases relative to the cost to serve them. Conversely, competitive firms have little desire to serve customers who have a large cost of service relative to the purchases they are likely to make.

Looking first to the most fundamental tenet of economics and market price setting – the law of supply and demand – it is apparent that lower prices for electricity cannot be guaranteed to Michigan electric customers. Simply stated, a basic requirement for an efficient competitive market is to have many buyers (and in particular, many buyers who are responsive to price) and many sellers (preferably where every seller is a price taker who cannot effect price in the

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<sup>47</sup> Joe D. Pace, *Wheeling and the Obligation to Serve*, 8 ENERGY L.J. 265, 269 (1987).

<sup>48</sup> Michigan Public Service Commission Staff, *Case No. U-11290, Electric Restructuring, Customer Focus Issues and Recommendations*, 38 (Oct. 13, 1997)

<sup>49</sup> Joe D. Pace, *Wheeling and the Obligation to Serve*, 8 ENERGY L.J. 265, 283 (1987).

competitive market – if they raise the price, the buyer will go elsewhere).<sup>50</sup> In a highly efficient market, no buyer or seller has the ability to influence price individually, and new sellers and buyers can freely enter and exit the market.<sup>51</sup> Assuming this to be true, either side of the supply vs. demand equation might cause retail electric competition to fail to reach the Michigan residential sector, due to a general reluctance of residential buyers to participate in the market, and a corresponding reluctance of sellers to enter the market to serve them. (These issues will be discussed separately below, since the impact of each situation deserves further analysis.)

Furthermore, the residential electric market is a relatively strange animal. On one hand, demand is thought to be virtually inelastic, due in major part to the essential nature of the commodity.<sup>52</sup> And, the fact that no adequate substitutes exist for electricity reinforces this argument. Noting that energy conservation should be encouraged, one author explains,

“... the fact remains that small consumers have very limited ability to significantly reduce demand, particularly at certain peak times. Heat waves to which high price apologists point to justify prices increases result in serious illness and deaths when consumers, in particular the elderly and ill, are forced to cut back air conditioning use in order to reduce electric bills.”<sup>53</sup>

Another author confirmed this: “Our dependence, as consumers, upon these utilities is such that we will continue to demand almost the same amount of service even if the price increases.”<sup>54</sup>

Complicating the responsiveness of demand in the Michigan residential electric market, and assuming Michigan follows the trend set by other states, virtually all demand will be met by a

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<sup>50</sup> SALLY HUNT, MAKING COMPETITION WORK IN ELECTRICITY 71-119 (John Wiley & Sons 2002).

<sup>51</sup> PETER FOX-PENNER, ELECTRIC UTILITY RESTRUCTURING: A GUIDE TO THE COMPETITIVE ERA 181 (Public Utility Reports, Inc. 1997).

<sup>52</sup> Sue Lott, *Utility Reconnection Services: A New Threat to Vulnerable Consumers?* 20 (October 2002) at <http://www.piac.ca/4001.utility.pdf>.

<sup>53</sup> Dr. Mark N. Cooper, *Reconsidering Electric Restructuring: Do Market Problems Indicate a Short Circuit or a Total Blackout?* 13–20 (November 30, 2000) at <http://www.consumerfed.org/backpage/electricity.cfm>.

<sup>54</sup> Sue Lott, *Utility Reconnection Services: A New Threat to Vulnerable Consumers?* 20 (October 2002) at <http://www.piac.ca/4001.utility.pdf>.

continuing obligation of the incumbent utility to serve - and the obligation to serve “becomes a virtual edict to avoid blackouts at all costs.”<sup>55</sup>

There are issues on the supply side, too, though. Electricity can’t be stored – it must be instantaneously generated and matched to demand. The only effective supply response to peak demand is the maintenance of excess capacity.<sup>56</sup> Barriers to entry are substantial, as well. By most estimates, it takes at least two years to build a power plant, and in a competitive marketplace, this is a multi-million dollar risk. It is also true, however, that P.A. 141’s mandates requiring open access to transmission and distribution, as well as divestiture of excess generating capacity, break down barriers to entry to an extent. In the short term, though, the market is likely to be dominated by only a very small number of suppliers, leaving the door open for the possibility that one or two suppliers may be able to obtain sufficient market power to enable them to raise prices and capture economic rents.<sup>57</sup>

Furthermore, no matter what P.A. 141 says it will do for *all* customers, there will be no choice for *residential* customers in Michigan if energy suppliers are not willing to enter the market and offer them competitive service. Undeniably, it is true in any competitive market that suppliers are not interested in offering service if there is little or no opportunity to profit. Roger Riddlehoover explains:

Firms normally enter a market anticipating an acceptable return on invested capital. That expectation is based on a perception that incumbent firms' prices and profits are high, or on a belief that the entrant can operate more efficiently than some or all incumbents.... In the "typical" market, absent an efficiency or profit reason for doing so, entry by a new firm would appear to be irrational.<sup>58</sup>

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<sup>55</sup> *Id.* It is worth noting here that most retail restructuring plans, including Michigan’s, include some sort of reliability standard.

<sup>56</sup> *Id.* at 13.

<sup>57</sup> Kenneth Gordon and Wayne P. Olson, *Open Entry, Choice, and the Risks of Short-Circuiting the Competitive Process*, 1 (March 2000), at [http://www.eei.org/industry\\_issues/electricity\\_policy/state\\_and\\_local\\_policies/state\\_restructuring\\_and\\_regulatory\\_policy/index.htm%20](http://www.eei.org/industry_issues/electricity_policy/state_and_local_policies/state_restructuring_and_regulatory_policy/index.htm%20).

<sup>58</sup> Roger Riddlehoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L. J. 307, 313 (1998).

So, to attract suppliers to the residential sector, there needs to be sufficient room between the incumbent utility price and the price the new entrant can offer, in order to justify the cost of entry. Public Act 141, however, mandated an immediate 5 percent reduction in residential rates, and then froze those rates for several years, effectively reducing the already narrow “room” for entry existing in the residential electricity market.<sup>59</sup>

Along similar lines, it is worth repeating here that competitive suppliers will have no obligation to serve customer classes that fail to pique their interest. Therefore, although the market as a whole stands to enjoy a wider spectrum of electricity providers from which to choose, a question remains as to whether any of those providers will be interested in serving the residential market. Absent a *duty* to serve, new electricity providers will most likely “‘cherry pick’ the most financially attractive customers, such as large industrial customers, and will have little incentive to provide service to small customers, such as residential customers. Consumers will be segregated and classified by electric power providers, and large and small customers will receive different treatment.”<sup>60</sup> One author warned:

... a system that allows power suppliers and customers to choose to deal with each other, especially if left unregulated, may allow suppliers or distributors to elect never to serve certain classes of customers, such as low-income residents, or to cease service however they wish consistent with retail power sales agreements. In at least one state, concerns over the implications of competition for the duty to serve and for service quality more generally were cited as reasons not to pursue retail competition for the present.<sup>61</sup>

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<sup>59</sup> Mich. Comp. Laws § 460.10.

<sup>60</sup> Michael Evan Stern, J.D., LL.M, P.E. and Margaret M. Mlynczak Stern, J.D., LL.M., *A Critical Overview of the Economic and Environmental Consequences of the Deregulation of the U.S. Power Industry*, 4 ENVTL. LAW. 79, 127 (1997). See also Roger Ridlehoover, *The Role of Entry in Deregulating Gas and Electricity*, 19 ENERGY L. J. 307, 310-11 (1998), who warns “[e]ntering firms will seek to serve high-profit markets and customers first. This is natural and rational but may have important impacts on the costs of incumbent firms, especially those that remain under a regulatory mandate to serve high-cost customers.”

<sup>61</sup> Jim Rossi, *The Common Law ‘Duty to Serve’ and Protection of Consumers in an Age of Competitive Retail Public Utility Restructuring*, 51 VAND. L. REV. 1233, 1290 (1998).

Dennis Weisman explained how this can happen, particularly when the incumbent utility retains responsibility for providing default service:

Statewide average pricing for the regulated carriers' services provides competitors with economic incentives to selectively enter markets in which operating costs are low relative to the statewide average rate. Since these competitors are not subject to a carrier-of-last-resort (COLR) obligation, they are free to deploy plant and equipment only in the most profitable markets ....<sup>62</sup>

After a full year of open access in Michigan, statistics reported by the Michigan Public Service Commission bear witness to the truth of this prophecy. By the end of 2003, there were 26 licensed Alternative Electric Suppliers in Michigan (up from 12 in 2001 and 25 in 2003), eight serving the customers of Consumers Energy, and 18 serving the customers of Detroit Edison.<sup>63</sup> The report continued:

For Consumers Energy customers, nearly 7% of commercial sales and 16% of industrial sales are presently met through ROA [(Retail Open Access)]. By customer class, the mix is about 30% commercial and 70% industrial. *There is no residential customer participation in the Consumers Energy service territory at this time. ... Sales levels of customers opting for the ROA program are presently estimated at 20% of Detroit Edison commercial sales (measured in kWh) and 16% of Detroit Edison industrial sales. By customer class, approximately 37% of ROA sales are to industrial customers and 63% to commercial customers. Residential customer participation is still negligible.*<sup>64</sup> (emphasis added)

Even if suppliers eventually seek out the residential market, other concerns exist. Absent an obligation to serve, for example, the potential exists for “redlining”- defining geographic service areas primarily on the basis of racial/ethnic or socio-economic factors.<sup>65</sup> Possible redlining decisions that might be expected from a competitive electric industry include:

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<sup>62</sup> Dennis L. Weisman, *Competitive Markets and Carriers of Last Resort*, 124 NO. 1 PUB. UTIL. FORT. 17 (July 6, 1989).

<sup>63</sup> Michigan Public Service Commission, *Status of Electric Competition in Michigan*, 4 (February 1, 2004) at [http://www.michigan.gov/mpsc/0,1607,7-159-16377\\_17111-61010--,00.html](http://www.michigan.gov/mpsc/0,1607,7-159-16377_17111-61010--,00.html).

<sup>64</sup> *Id.* at 4-7. The MPSC report also indicated there was no choice activity in any Michigan utility service territory, other than the territories served by Consumers Energy and Detroit Edison.

<sup>65</sup> Roger D. Colton, *Electric Reliability and the Low Income Customer*, 19 (October 1997), at <http://dls.state.va.us/groups/sjr91/81898/818LOWIN.HTM>.

Refusal to serve: Electric service providers could decide not to serve particular geographic areas. These might be inner cities, where heavy concentrations of poverty might threaten the easy collection of revenue. They might include various areas where lower incomes are viewed as associated with lower use and thus lower profit potentials. This refusal to serve could be evidenced not simply by a refusal to serve (as in the home mortgage industry), but by the cherry-picking found in telecommunications. A decision to serve *only* high income suburban areas, in other words, excluding every other place, would be a type of redlining.

Territorial pricing: Electric service providers could decide to vary the price for service based on geographic location. Like insurance companies who increased prices based on “territorial ratings,” electric companies could allege that the cost of serving particular geographic areas (such as low-income and minority neighborhoods) is higher and thus merits correspondingly higher prices.

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Level and type of service: Electric service providers could refuse to provide the same quality of service based on geographic considerations. A decision to offer certain neighborhoods or communities service based only on prepayment meters or service limiter adapters would be a type of redlining.<sup>66</sup>

Public Act 141, though, re-imposes the traditional obligation to serve (to an extent) by requiring incumbent utilities to serve as the “default service” provider, despite the dampening effect this might have on competition. (By allowing customers to choose to retain regulated default service, pure competition is effectively prevented.) Default service is defined as service made available to any residential customer who chooses not to choose competitive electric service, who is unable to obtain competitive service, whose service has been cancelled, or whose supplier becomes unable to provide service. Some states have separated the rates for default service based on how the customer ended up default service, offering different prices for different reasons for taking service from the incumbent utility.<sup>67</sup> Every state that has pursued

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<sup>66</sup> *Id.* at 20

<sup>67</sup> B. Alexander, *Default Service: Can Residential and Low Income Customers be Protected when the Experiment Goes Awry?* 3 (April 2002) at <http://www.ncat.org/liheap/dereg.htm>.

retail competition has provided for some sort of transitional default service, though, and usually in the form of a regulated service supplied by the existing electric company.<sup>68</sup>

Public Act 141's particular brand of default service is set forth through the tariffs filed by Michigan's public utilities with the Michigan Public Service Commission. In other words, when asked to submit implementation plans for retail open access, all public utilities in Michigan voluntarily assumed the role of default provider. Essentially, customers choosing not to choose and customers who are unable to obtain competitive service will see no change to their electric service initially. That is, while electric rates are frozen, these customers will continue to receive electric service provided by their existing electric utility company at currently filed rates. Barbara Alexander, a former Director of the Consumer Assistance Division of the Maine Public Utilities Commission, notes, however, "... states that have relied on statutory or regulatory price caps and rate reductions for residential customers have yet to confront how to transition from these price protections to other mechanisms when the transition period is over."<sup>69</sup> Assuming P.A. will not be amended before the residential rate freeze is lifted in 2006, it is intuitively very likely that regulated residential rates will increase.<sup>70</sup>

This raises another issue, though. Under P.A. 141, no distinction is made between "good" utility customers who choose to remain with the incumbent utility even though they may have the opportunity to participate in the retail market, and "payment troubled" customers who remain because they have no alternative but to remain. Given that some, or perhaps even many,

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<sup>68</sup> Sue Lott, *Utility Reconnection Services: A New Threat to Vulnerable Consumers?* 13 (October 2002) at <http://www.piac.ca/4001.utility.pdf>.

<sup>69</sup> B. Alexander, *Default Service: Can Residential and Low Income Customers be Protected when the Experiment Goes Awry?* 8 (April 2002) at <http://www.ncat.org/liheap/dereg.htm>.

<sup>70</sup> When the residential rate freeze mandated by P.A. 141 is lifted in 2006, public utilities will undoubtedly seek, and likely receive, a residential rate increase. The reasoning behind this assertion is simple: prior to the implementation of P.A. 141, utilities charged retail rates approved by the Michigan Public Service Commission. Public Act 141 cut these previously approved rates by 5% across the board for residential customers. It follows, then, that having done so before, public utilities will be able to justify a restoration of the 5% when the rate freeze is lifted, at a minimum.

large customers will leave the incumbent utility in response to competitive offers, this failure to distinguish between “good” and “risky” customers will also likely lead to higher utility prices for the remaining rate base.<sup>71</sup> Barbara Alexander puts it this way:

To date, most states have not isolated or segregated low-income or “payment troubled” customers compared to other residential customers in the provision of Default Service. As a result, the cost to serve, bill, collect, and interact with payment troubled customers has been integrated into the rates charged for all residential customers. ... As long as there are a substantial number of residential customers receiving Default Service, for any reason, the higher costs associated with serving customers who need more attention in the form of payment arrangements and payment difficulties will be spread among all residential customers or included in the distribution (regulated) utility rates. ... The more segmented this market becomes, the more likely that Default Service will be priced higher than that available in the competitive market if customers can pay their monthly bill on time and do not need more expensive customer care in the form of payment arrangements, medical emergencies, collection notices, and contract termination procedures.<sup>72</sup>

It follows, then, that the only way for residential customers to reap the lower prices promised by competition is to affirmatively *choose to choose* – to actively participate in the retail market. Unfortunately, though, experience with deregulation in other states indicates that this is not likely to happen. According to Barbara Alexander:

Whatever the motivations and decisions concerning Default Service, the early experience demonstrates clearly that this service will provide electricity service to the vast majority of residential and small commercial customers in the near future. This is because in most states residential customers have not shopped or selected an alternative provider... . An exception may be Pennsylvania, where the highest levels of residential customer shopping has been recorded of any state that has adopted full scale retail electric competition. Even in Pennsylvania, however, the percentage of customers who are shopping varies widely from 16% in PECO Energy’s service territory to less than 1% in Allegheny Energy’s.<sup>73</sup>

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<sup>71</sup> While these costs have always been borne by the rate base as a whole, residential customers will likely face a proportionately larger share of the burden than they did prior to P.A. 141.

<sup>72</sup> B. Alexander, *Default Service: Can Residential and Low Income Customers be Protected when the Experiment Goes Awry?* 3 (April 2001) at <http://www.ncat.org/liheap/dereg.htm>.

<sup>73</sup> *Id.* at 3

Even when viable competitive options are available, lower use customers do not seek to move to alternative providers and are unlikely to benefit from competition in the form of lower prices. One industry consultant notes: “[e]ven when the market price dips below the [default service] rates, a residential customer with a small (absolute) monthly bill may view switching as an option that has only a small upside gain, administrative hassles, and considerable price uncertainty relative to [default service].”<sup>74</sup> “Another way of saying this,” the analyst continues, “is that small customers exhibit extremely ‘sticky’ switching behavior, staying with the [default service] offer under circumstances in which it would appear economic to switch.”<sup>75</sup>

And, this is exactly the evidence from the deregulation of the long-distance telephone market. Kenneth Rose reports:

We know from experience ... that even after many years an incumbent monopolist can retain a substantial share of the market. This customer inertia appears unique to this type of case: It occurs where competition has been introduced to a product market in a geographical area in which an incumbent utility has long retained close to a 100 percent market share.... [B]y 1996, AT&T’s market share of operating revenues for long-distance carriers had dropped only to about 48 percent. It took 12 years for share to fall from a figure of 90 percent, where it had stood in 1984, the year of AT&T’s breakup.<sup>76</sup>

According to the author, “[t]his same pattern is beginning to emerge in state retail electric markets, ... and may be especially true for residential and small commercial customers.”<sup>77</sup>

Another reason P.A. 141 will fail to deliver lower electricity costs for all customers, is that a significant percentage of residential customers will not even have the *option* to participate in the competitive market. The reason for this is simple: Public Act 141 does not

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<sup>74</sup> Frank C. Graves and Joseph B. Wharton, *New Directions for Safety Net Service – Pricing and Service Options* 8 (May 2003) at [www.eei.org/.../state\\_restructuring\\_and\\_regulatory\\_policy/new\\_directions\\_safetynet.pdf](http://www.eei.org/.../state_restructuring_and_regulatory_policy/new_directions_safetynet.pdf).

<sup>75</sup> *Id.* at 33.

<sup>76</sup> Kenneth Rose, *Using Auctions to Jump-Start Competition and Short-Circuit Incumbent Market Power*, 137 NO. 3 PUB. UTIL. FORT. 48, 48-49 (February 1, 1999).

<sup>77</sup> *Id.* at 49.

apply to Michigan's 41 municipally-owned utilities, which currently account for roughly 8% of the state's electric demand.<sup>78</sup>

Finally, if reliable residential retail competition is really a goal of P.A. 141, the market structure proposed is inherently flawed and unlikely to achieve that end. The reasons for this are several. First, experts in the industry are quick to point out that efforts to micromanage the transition to competition, usually in the name of protecting the residential customer, do little more than hinder the process.<sup>79</sup> Authors J. Gregory Sidak and Daniel F. Spulber note:

The temptation is to "manage" the competitive transition to determine the outcome of competition. Thus, paradoxically, deregulation often brings increased regulatory intervention in the marketplace and correspondingly greater administrative costs and market inefficiencies. The result is neither fish nor fowl, neither a regulated market nor a competitive one. The benefits of competition do not materialize. Partial deregulation distorts economic incentives far worse than do traditional rate-of-return regulation or newer forms of incentive regulation.<sup>80</sup>

Thus, by maintaining a regulated sector for customers preferring not to partake of competition (default service provided by the incumbent utility), legislators must consider the impact on the development of competition. By failing to do so, "we may end up with a mixed system of competition and regulation that may be the worst of both possible worlds."<sup>81</sup>

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<sup>78</sup> Mich. Comp. Laws § 460.10(y) (2000). See also *Michigan's Electric Restructuring, Public Act 141 Q & A*, available from the Michigan Municipal Electric Association, [mmea@mpower.org](mailto:mmea@mpower.org): Only if one of three conditions are true may a customer petition the Michigan Public Service Commission to allow him to connect to a different utility's distribution system: 1) the customer began taking service from the municipal utility after June 5, 2001 and is located outside the boundaries of the municipality that operates the municipal utility or another utility has the right to serve customers inside the municipal boundaries, or 2) the municipality does not implement a customer choice program by 2008, and you are located outside the boundaries of the municipality that operates the utility or another utility has the right to serve customers inside the municipal boundaries, or 3) the municipality gives its written consent.

<sup>79</sup> Kenneth Gordon and Wayne P. Olson, *Open Entry, Choice, and the Risks of Short-Circuiting the Competitive Process*, 13 (March 2000), at [http://www.eei.org/industry\\_issues/electricity\\_policy/state\\_and\\_local\\_policies/state\\_restructuring\\_and\\_regulatory\\_policy/index.htm%20](http://www.eei.org/industry_issues/electricity_policy/state_and_local_policies/state_restructuring_and_regulatory_policy/index.htm%20).

<sup>80</sup> J. Gregory Sidak and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. ON REG. 117, 118 (1998).

<sup>81</sup> *Id.* at 11, quoting Alfred E. Kahn, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* xxxv (MIT Press 1992).

While this “hybrid” model of retail competition presents some advantages from the consumer’s perspective: consumers are not forced to accept the risks, volatility and transaction costs of a competitive market, there are anti-competitive issues with it as well.<sup>82</sup> These issues stem from the incumbent utility serving as the default service provider. Dennis Weisman explains the problem:

The [default service] obligation essentially provides competitors and in turn their customers with a de facto ‘free insurance policy’ for service provisioning with the premiums paid by customers remaining with the regulated utility. This cost burden serves to inflate regulated carriers’ rates even further above economic cost and drive additional customers to competitors’ services who in turn must also be backed up by the regulated carrier.... What is known is that competition fostered under these nonuniform regulatory rules distorts the standard risk-return incentive mechanisms and thereby results in an artificially reduced level of market risk for competitive entrants and a symmetrically exaggerated level of market risk for the regulated carrier.<sup>83</sup>

Other authors emphatically note that the benefits of competition and entry will only accrue if all companies, including incumbent utilities, have an equal opportunity to compete.

According to Sidak and Spulber,

The market cannot be expected to discover the best competitors unless all companies begin on an equal regulatory footing....[t]he incumbent [utility] is an important competitor with technological experience, management expertise, knowledge about customers in its service regions, ready access to financial capital, and transmission facilities. To deprive the market of the incumbent [utility’s] services and expertise would reduce competition, disadvantage consumers, and reduce the competitive stimulus to entrants. Moreover, it is not necessary to limit the incumbent [utility’s] ability to compete as a means of encouraging new entry. As in any other business, the market returns that can be earned by providing [utility] services are reward enough to encourage entry. Placing restraints on the incumbent [utility] that confer an advantage on entrants will only impede competition.<sup>84</sup>

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<sup>82</sup> Frank C. Graves and Joseph B. Wharton, *New Directions for Safety Net Service – Pricing and Service Options* 13 (May 2003) at [www.eei.org/.../state\\_restructuring\\_and\\_regulatory\\_policy/new\\_directions\\_safetynet.pdf](http://www.eei.org/.../state_restructuring_and_regulatory_policy/new_directions_safetynet.pdf).

<sup>83</sup> Dennis L. Weisman, *Competitive Markets and Carriers of Last Resort*, 124 NO. 1 PUB. UTIL. FORT. 17, 5 (July 6, 1989).

<sup>84</sup> J. Gregory Sidak and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. ON REG. 117, 126 (1998).

However, Public Act 141 further hinders eventual market efficiencies and potentially increases costs to customers forced to remain with the utility in its attempt to stimulate competition by requiring divestiture of generation. And, it does nothing to prevent a small number of powerful suppliers from quickly regaining near-monopolistic control over electric supply. As Peter Navarro notes:

The major advantage of divestiture is that it truly breaks up the generation market into competitive pieces - providing, of course, that the pieces are sold to a number of smaller buyers rather than one large one. ... [T]his option also has an added advantage in that it provides a market valuation of any stranded assets.

However, one major disadvantage of divestiture is that it removes a player from the market with arguably the best knowledge of how to actually generate electricity, i.e. vertical integration is efficient. A second potential disadvantage is embodied in a "fire sale" argument. The concern, here, is that divestiture will result in a flood of generating plants onto the market and a resulting undervaluation of the assets. This undervaluation, in turn, will result either in a large loss to shareholders or, if stranded costs are recovered on the basis of the sale price in the market, an undue burden on ratepayers who will be forced to make shareholders whole.

A third disadvantage arises if the generation market is still characterized by economies of scale. Specifically, there is nothing to insure that once divestiture breaks the market up into smaller pieces that it will not revert back to a concentrated market over time, albeit with a different set of oligopolists.<sup>85</sup>

Furthermore, whereas the provision of default service by the incumbent utility is intended to be a safety net, it will in fact be anti-competitive in the long term, and will lead to an eventual deterioration of service to those customers forced to accept it:

The regulated incumbent would not undertake significant expenditures to perform its regulatory service obligations or continue to incur such expenses without economic incentives. Preserving economic incentives requires cost recovery for past, present, and future regulatory obligations. Eliminating cost recovery for regulatory obligations will induce free riding by entrants and regulators .... The consequences of reducing or eliminating those economic incentives would be to raise the incumbent firms' cost of capital, to reduce the quality of their service, to

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<sup>85</sup> Peter Navarro, A Guidebook and Research Agenda for Restructuring the Electricity Industry, 16 ENERGY L. J. 347, 361-62 (1995).

discourage their innovation and investment, and, ultimately, to deprive markets of their competitive effort and technology.<sup>86</sup>

On the other hand, while retail market entrants must amass a large number of residential customers in order to “play” in Michigan, incumbent utilities are permitted to retain a huge volume of customers without the expenditure of a single cent in marketing. Evidence from the telecommunications sector suggests that competitors may “incur customer acquisition (marketing) costs of \$75 and up per customer.”<sup>87</sup> Furthermore, “[s]uch costs would overwhelm any potential generation efficiencies available from competition – the entire average residential electricity generation bill is only about \$300 per year so it is difficult to produce sufficient efficiencies to even cover marketing costs.”<sup>88</sup> Clearly, this is not a level playing field, either.

Second, industry analysts writing for the Edison Electric Institute<sup>89</sup> warn that a pre-competition rate cut “can distort the operation of competitive retail markets, leaving little incentive for a customer to switch from “an artificially low default, standard offer service.”<sup>90</sup> A rate freeze is equally prohibitive, especially where fixed price standard offer service is offered at a regulatory-driven low cost relative to competitive alternatives.<sup>91</sup> Barbara Alexander points out:

... consumer advocates have pushed primarily for rate caps or rate decreases for residential customers ... as the ‘price’ for the move to retail competition. This approach complements the desire for stability by residential customers who may not be ready to jump into the competitive market, but this approach also carries

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<sup>86</sup> *Id.* at 119.

<sup>87</sup> Jerrold Oppenheim, *Assuring Electricity Service for all Residential Customers after Electricity Industry Restructuring* 17 (November 10, 2001), at [http://www.ksg.harvard.edu/hepg/Wholesale\\_and\\_retail\\_competition.htm](http://www.ksg.harvard.edu/hepg/Wholesale_and_retail_competition.htm).

<sup>88</sup> *Id.*

<sup>89</sup> The Edison Electric Institute is an association of shareholder-owned electric companies, international affiliates, and industry associates.

<sup>90</sup> Kenneth Gordon and Wayne P. Olson, *Open Entry, Choice, and the Risks of Short-Circuiting the Competitive Process*, 13 (March 2000), at [http://www.eei.org/industry\\_issues/electricity\\_policy/state\\_and\\_local\\_policies/state\\_restructuring\\_and\\_regulatory\\_policy/index.htm%20](http://www.eei.org/industry_issues/electricity_policy/state_and_local_policies/state_restructuring_and_regulatory_policy/index.htm%20).

<sup>91</sup> *Id.*

with it the implication that the creation of a competitive market is less of a priority than providing basic service at an affordable price.<sup>92</sup>

Third, if required to serve as the default service provider, the incumbent utility's ability to meet demand may suffer, resulting in unacceptable consequences. "To allow eligible customers, especially very large customers, to choose without restriction between the regulated price for bundled utility service [(default service)] and the price offered by the generation services market may severely reduce the utility's ability to plan for, and reliably serve, its remaining customers."<sup>93</sup> This is not a problem for market entrants without an obligation to serve, however, and represents another competitive inequity in Michigan's plan:

Mandating that the incumbent [utility] alone act as the carrier of last resort forces the firm to hold capacity in reserve to meet demand at peak load. An entrant, however, need not hold capacity in reserve because it does not serve as the carrier of last resort; the entrant can simply purchase capacity for resale from the incumbent [utility] at peak demand. The entrant thus benefits from the implicit form of insurance provided to its customers without charge by the incumbent [utility's] standby service.<sup>94</sup>

#### WHY OBVIOUS ALTERNATIVES TO PUBLIC ACT 141 WON'T WORK EITHER

Two obvious alternatives to full-scale retail competition come to mind, given the obstacles to achieving an efficient, fully competitive electric market: 1) developing a competitive retail market for large commercial and industrial customers only – and retaining a regulated

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<sup>92</sup> B. Alexander, *Default Service: Can Residential and Low Income Customers be Protected when the Experiment Goes Awry?* 4 (April 2002) at <http://www.ncat.org/liheap/dereg.htm>. See also J. Gregory Sidak and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. ON REG. 117, 125 (1998): "To achieve the economic benefits of competition, regulators must give the incumbent [utilities] an opportunity to compete that is equal to that given entrants.... Therefore, regulators should modify or eliminate rules that prevent incumbents and entrants alike from exercising flexibility in pricing, service offerings, investment, and choice of technology."

<sup>93</sup> Jim Rossi, *The Common Law 'Duty to Serve' and Protection of Consumers in an Age of Competitive Retail Public Utility Restructuring*, 51 VAND. L. REV. 1233, 1290 (1998). See also Frank C. Graves and Joseph B. Wharton, *New Directions for Safety Net Service – Pricing and Service Options* 43 (May 2003) at [www.eei.org/.../state\\_restructuring\\_and\\_regulatory\\_policy/new\\_directions\\_safetynet.pdf](http://www.eei.org/.../state_restructuring_and_regulatory_policy/new_directions_safetynet.pdf)., noting that there have been several supplier defaults in the last two years.

<sup>94</sup> J. Gregory Sidak and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. ON REG. 117, 133 (1998).

market for small commercial and residential customers, or 2) abandoning the idea of retail competition altogether. Neither of these alternatives is viable, however, given the realities of the American politics.

The main problem with the first option - purposely developing a competitive retail market for large commercial and industrial customers, while retaining regulated electric service for smaller customers – is that larger customers would then be removed from the incumbent utility’s customer base, and would therefore be unavailable to help subsidize the provision of service to customers more expensive to serve. Traditionally, operating under the “obligation to serve,” utilities provided service to all customers who were able to pay, regardless of the cost of providing the service.<sup>95</sup> In order to achieve socially desirable goals,<sup>96</sup> however, a system of cross-subsidization developed under regulation, forcing some customers to pay more for electric service than it cost the utility to serve them, while others paid less than their respective cost of service.<sup>97</sup> For example, under a typical rate structure, “... urban customers typically subsidize rural customers, and business customers typically subsidize residential customers.”<sup>98</sup> Under competition, though, these business customers are bound to leave the regulated utility, and the residential customer base will be left to support the incumbent utility’s entire cost of service burden, inevitably resulting in significantly higher residential rates.

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<sup>95</sup> This statement applies only to “reasonable” costs to provide service, as described earlier in this paper. A regulated utility is under no obligation to serve where the cost of providing service is “unreasonable,” as defined by the Michigan Supreme Court and the Michigan Public Service Commission.

<sup>96</sup> Here, “socially desirable goals” means those programs put in place based on the idea that the availability of low-cost electric service is essential to an acceptable quality of life. Examples of these programs include initiatives to ensure universal service (the availability of service to all customers desiring to be served, particularly customers who are expensive or undesirable to serve), and assistance programs for low-income or elderly customers. These programs are almost always funded by some sort of a cross-subsidy – the cost to provide them is spread over the utility’s entire customer base, with lower-cost customers bearing some of the cost to serve higher-cost customers and customers unable to afford service without subsidization.

<sup>97</sup> Laura R. Starling, *Don’t Be Shocked! Electric Utility Deregulation CAN Benefit Low-Cost States*, 74 TUL. L. REV. 1519, 1529 (2000).

<sup>98</sup> *Id.*

The political backlash that would result from significantly higher residential rates, however, renders a “commercial and industrial only” plan for retail competition unworkable. The reason for this is simple: “[b]ecause regulators are politically appointed, they often encourage cross-subsidization to benefit the more populous class.”<sup>99</sup> The same logic applies to legislators tasked with drafting and enacting electric restructuring laws – any proposal to restructure the electric industry is destined to fail where its inevitable outcome is an increase in rates to the majority of the voting population.<sup>100</sup>

The second “obvious” alternative – abandoning the idea of retail competition in Michigan altogether - is impracticable for a similar reason: large commercial and industrial electric customers also have significant political clout and are demanding access to competitive energy providers. In fact, several major industrial consumers in Michigan are members of a powerful lobbying group, ELCON (the Electricity Consumers Resource Council), organized to promote retail competition nationwide.<sup>101</sup> One scholar also notes, “[w]holesale power producers provide a second potent political force for retail competition, which lets them reach new customers. They are already proving to be remarkably creative in devising ways to sell power to large customers within the current regulatory structure.”<sup>102</sup>

In other words, residential customers will be unwilling to tolerate a plan for retail competition that accrues all benefits to commercial and industrial customers, but all burdens to

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<sup>99</sup> Scott F. Bertschi, *Integrated Resource Planning and Demandside Management in Electric Utility Regulation: Public Utility Panacea or a Waste of Energy?*, 43 EMORY L. J. 815, 828 (1994).

<sup>100</sup> It is ironic that P.A. 141 was passed at all, given the political ramifications of increased rates to voters, and given that its actual result will be very similar to this first alternative. This could well explain why P.A. 141 was presented as a retail competition plan for *all* electric customers in Michigan, despite the fact that retail competition for residential and small commercial customers is highly unlikely to actually develop.

<sup>101</sup> Bernard S. Black & Richard J. Pierce, Jr., *The Choice Between Markets and Central Planning in Regulating the U.S. Electricity Industry*, 33 COLUM. L. REV. 1341, 1353 (1993). *See also*, The Electricity Consumers Resource Council, *Who We are*, at <http://www.elcon.org/Membership%20Information/whoware.htm>, listing corporations with major Michigan operations as members of ELCON, including Ford Motor Company, General Motors, Delphi Automotive Systems and Daimler Chrysler.

<sup>102</sup> Bernard S. Black & Richard J. Pierce, Jr., *The Choice Between Markets and Central Planning in Regulating the U.S. Electricity Industry*, 33 COLUM. L. REV. 1341, 1353 (1993).

them – and they have power in their numbers. Commercial and industrial customers are equally unlikely to tolerate continued regulation and cross-subsidization – and they have the financial resources to lobby extensively. It follows, then, that Michigan *must* aggressively pursue a workable form of retail electric competition. And, it must be a form that promises to provide real choices to *all* electric customers, not just the “big fish.”

#### OPTIONS MORE LIKELY TO WORK

There is little argument that the road to an efficient market for residential electric service will be very slowly traveled. There is also little argument that customers will not tolerate a rocky road to that destination – the majority of them won’t even make the trip if they don’t have to. Assuming that universal service for residential customers is a goal of society, and assuming that politicians will be run out of office without it, it follows that default service of some sort, accompanied by an underlying obligation to serve, must be a significant part of any reasonable retail restructuring plan.

As noted, though, simply leaving the provision default service to the incumbent utility (as P.A. 141 does) is the easy way out, but anti-competitive. As several authors explained, the benefits of competition will not develop unless market entrants are forced to play by the same rules as incumbent utilities. In other words, all market participants must shoulder the responsibility for the provision of “default” or “last-resort” service. One way to do this would be to spread the expense of default service to all providers: “... if regulators insist on market intervention to achieve universal service objectives, they should create a common fund, with equitable contributions made by all competitors, to cover the cost of such service.”<sup>103</sup>

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<sup>103</sup> J. Gregory Sidak and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. ON REG. 117, 136 (1998).

This approach was recommended by the New York Public Service Commission when that state was considering possible approaches to electric deregulation: “[t]here is much to be said for dealing with [default service] needs by requiring all players in the market to provide the full gamut of consumer protections and be subject to an “obligation to serve.”<sup>104</sup> Administrative law judges Jeffrey E. Stockholm, Joel A. Linsider, and Michael Corso explain how this would work:

The "obligation to serve," under this POLR [(Provider of Last Resort)] approach, would also apply to all suppliers. [Market participants] would be permitted to specify the classes of customers and the geographic areas they intend to serve, and, within those bounds, ... would have to serve all customers without undue discrimination.... [T]he cost of POLR service would be spread over the entire customer base as is now the case; and there would be no need to designate an "interim POLR" that would provide service in the event a designated POLR defaults. In the end-state, we recommend that all [market participants] be required to provide all of the general consumer protections required of utilities under the Public Service Law and be required to serve without undue discrimination all customers in the customer classes and territories chosen ....<sup>105</sup>

While the above passage refers mainly to responsibility for “last-resort” service and allows market participants to choose to serve only certain customer classes and geographic territories, I would it a step further. Following the logic of the judges above, I propose that all market participants should be obligated to serve, both in a default service and provider of last resort capacity, a percentage of the residential and small business market equal to (or slightly in excess of) their share of the state-wide commercial and industrial load. This new “obligation to serve” would carry with it all of the responsibilities of the traditional regulatory compact – including assuring current and future demand is met – in exchange for the opportunity to serve

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<sup>104</sup> Proceeding on Motion of the Commission Regarding Provider of Last Resort Responsibilities, the Role of Utilities in Competitive Energy Markets and Fostering Development of Retail Competitive Opportunities, Case No. 00-M-0504 (New York Pub. Serv. Comm’n July 13, 2001).

<sup>105</sup> *Id.*

large, profitable customers. In this way, the potential “cherry-picking” problem is eliminated, and universal service is a viable option under competition.

In the absence of an obligation to serve for all market participants, however, the need for stand-by (or last resort) service cannot be completely eliminated if universal and uninterrupted service is to be had. And, as noted above, even where all participants operate under an obligation to serve, there needs to be a mechanism in place to deal with the situation where a competitor cannot provide its contracted load, or where the competitor suddenly leaves the system. This problem can be solved by a change to the typical tariff design. Dennis Weisman explains:

[T]he economically efficient pricing structure for the COLR [“Carrier of Last Resort”] option calls for a two-part tariff. The first part of the tariff is a flat rate charge based upon the level of option demand for standby or default capacity actually required by the customer. The second part of the tariff is usage sensitive and is designed to cover the variable costs associated with actual use of the standby facilities....

The provider serving as the COLR would optimally require each standby user to report peak-period demand requirements. This reporting requirement would serve both efficiency and equity ends. First, it would allow the carrier to deploy plant and equipment in the most cost-effective manner consistent with the level of expected demand. Second, there is a self-policing dimension to this requirement in that the customer would assume the risk if demand forecasts were either too high or too low.<sup>106</sup>

Another, but still not perfect, way to structure the provision of default service (to encourage the development of a competitive market for this service) would be to make residential customers more attractive to serve. This can be done by automatically aggregating these customers into bargaining pools, according to their geographic location or some other criteria. In Ohio, for example, municipalities may adopt an ordinance that aggregates all customers within municipal boundaries. Under the Ohio method, municipalities can choose, in

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<sup>106</sup> Dennis L. Weisman, *Competitive Markets and Carriers of Last Resort*, 124 NO. 1 PUB. UTIL. FORT. 17, 6 (July 6, 1989).

adopting their ordinances, to set up “opt-in” (under which a customer must make an affirmative decision to participate in the aggregated group) or “opt-out” systems (where all customers are automatically included unless they indicate their choice not to be included).<sup>107</sup> Once aggregated, the municipality would then seek bids from suppliers for the right to serve the now significantly more attractive load, and enter into 2-3 year contracts for electricity generation.

The opt-out method is particularly attractive in light of one major issue facing residential retail competition: the tendency of customers to do nothing. In other words, an opt-out method would solve the problem of consumer inertia in the face of competition. Like systems that simply relegate the default service function to the incumbent utility automatically, “opt-out” aggregation would allow individual customers the option of not choosing, but would allow the municipality, as a whole, to enter the competitive retail market in search of the lowest price.

Texas also encouraged aggregation in its restructuring design, but left much more flexibility for those interested in filling this role. Under the Texas plan, an aggregator is defined as “a person or organization that helps create an electricity-buying group.”<sup>108</sup> While aggregators must register with the Public Utility Commission, anyone with a desire to serve as an aggregator may contract with customers to combine electric loads and attempt to get volume discounts or other benefits for the combined group.<sup>109</sup> In fact, the Texas Public Utility Commission touts this system as an emerging business opportunity for entrepreneurs.

Finally, as an alternative to (or in addition to) formal aggregation, and following Mr. Weisman’s tariff design change recommendation (above), there is no reason why default service provision couldn’t be offered to the market for bid. Since the potential load is known to the

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<sup>107</sup> B. Alexander, *Default Service: Can Residential and Low Income Customers be Protected when the Experiment Goes Awry?* 40 (April 2002) at <http://www.ncat.org/liheap/dereg.htm>.

<sup>108</sup> Texas Public Utility Commission, *Questions – Aggregation* (2003) at [http://www.powertochoose.org/yourrights/q\\_aggregation.asp](http://www.powertochoose.org/yourrights/q_aggregation.asp).

<sup>109</sup> *Id.*

provider, and since the customer, or in the case of aggregation, the customer pool, assumes the risk of paying for it, there should eventually be providers willing to provide this service. In any event, though, the incumbent utility would be able to, and undoubtedly would, bid, as well – for the option of providing both regular and stand-by service, especially to aggregated loads. And, in the unlikely event that no provider bids to provide default service, where an obligation to serve is imposed on all competitors, the Public Utility Commission could assign the responsibility for a particular group of customers to any provider.

#### CONCLUSION

Public Act 141 will not result in retail competition for all consumers of electricity in Michigan. In fact, it is unlikely to result in retail choice for anyone other than large commercial and industrial consumers who are inexpensive to serve relative to the revenue they generate for the electric provider. As such, and given that competition will be demanded by the politically powerful commercial and industrial sector, it is imperative that the Michigan legislature consider the options for reform provided above. Any of these options, combined with limited and non-interfering oversight by the Michigan Public Service Commission, will lead to choice in the residential sector, and the benefits of competition originally promised by former Governor Engler. Inaction, on the other hand, will most certainly lead to an unhappy public when residential rate freezes are lifted in 2006, and residential customers are left to bear the entire burden of the utility's remaining "obligation to serve."