S T A T E O F M I C H I G A N

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of **CONSUMERS ENERGY COMPANY** for authority to recover implementation costs, approval of a stranded cost true-up methodology, and other relief.	)	Case No. U-11955
In the matter of the application of **THE DETROIT EDISON COMPANY** for authority to recover retail access program implementation costs and approval of a true-up mechanism in connection with the recovery of stranded costs.	)	Case No. U-11956

At the October 24, 2000 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. John G. Strand, Chairman
Hon. David A. Svanda, Commissioner
Hon. Robert B. Nelson, Commissioner

OPINION AND ORDER

History of Proceedings

On March 31, 1999, Consumers Energy Company (Consumers) and The Detroit Edison Company (Detroit Edison) filed applications to commence their stranded cost true-up proceedings for 1998 in Cases Nos. U-11955 and U-11956, respectively, as required by the January 14 and February 11, 1998 and March 8, 1999 orders in Case No. U-11290 et al.

At a prehearing conference on May 11, 1999, Administrative Law Judge James N. Rigas (ALJ) granted leave to intervene to the Association of Businesses Advocating Tariff Equity (ABATE); Energy Michigan; the Michigan Independent Power Producers Association (MIPPA); the Michigan Petroleum Association and the Michigan Association of Convenience Stores (the MPA/MACS); the Michigan Power Limited Partnership, the Central Wayne Energy Recovery Limited Partnership, and Cadillac Renewable Energy, L.L.C., (collectively, the MPLP et al.); Attorney General Jennifer M. Granholm (Attorney General); National Energy Marketers Association; and the Michigan Community Action Agency Association (in Case No. U-11955 only). The Commission Staff (Staff) also participated.

The ALJ conducted evidentiary hearings on December 14 and 15, 1999. On January 28, 2000, ABATE, the Attorney General, Consumers, Detroit Edison, Energy Michigan, MIPPA, the MPA/MACS, and the Staff filed briefs. On February 11, 2000, ABATE, the Attorney General, Consumers, Energy Michigan, MIPPA, the Staff, Detroit Edison, and the MPLP et al. filed reply briefs. Because the Commission agreed to read the record, the ALJ did not prepare a proposal for decision or make provisions for exceptions and replies to exceptions.

<u>Description of the True-up Mechanism</u>

In the June 5, 1997 order in Case No. U-11290, the Commission adopted a framework for electric restructuring that included provisions for electric utilities to recover five categories of stranded costs: (1) capital costs of nuclear plants, (2) regulatory assets, (3) capacity costs arising from power purchase agreements, (4) employee retraining costs, and (5) costs related to the implementation of restructuring. Although prior Commission orders have generically referred to all five categories as stranded costs, the parties in these cases have largely distinguished between implementation costs, which encompass the last two categories, and transition costs, which make up the first three categories. Generally speaking, implementation costs are non-recurring costs that the utilities incur in addition to the operational costs that they already recover in their base rates and are necessary to accomplish the changes required by restructuring. In the same manner of speaking, transition costs are already being recovered from bundled retail customers in base rates and are likely to become uneconomic in a fully competitive setting.

The Commission recognized that quantifying stranded costs would be a complex undertaking and would be greatly dependent upon a number of assumptions regarding future events that are subject to change in light of actual occurrences. Consequently, the Commission determined that stranded cost recovery should be determined pursuant to a true-up mechanism that would make ongoing adjustments for changes in cost assumptions. June 5, 1997 order at 14.

More details of the true-up mechanism began to develop as the Commission considered various parties' suggestions in a series of electric restructuring proceedings. The Commission reviewed, modified, and approved true-up proposals for Consumers and Detroit Edison in the October 29, 1997 order in Case No. U-11454. In the January 14, 1998 order in Case No. U-11290 et al. at 18, the Commission further addressed the methodology it expected to use for true-up purposes. As summarized in the March 8, 1999 order in Case No. U-11290 et al., the Commission explained:

> Consumers and Detroit Edison are scheduled to file their true-up proposals for 1998 by March 31, 1999. At the time that this schedule was established, it was anticipated that open access would begin sometime in 1998. Although that has not occurred, the Commission concludes that a slightly modified proceeding for 1998 would be helpful for two reasons. First, in accordance with the [January 14, 1998] order [in Case No. U-11290 et al. at 18], the true-up proceeding is needed to review the prudence of any implementation costs incurred by the utilities. Second, because this will be the first true-up proceeding, there are significant

> policy decisions that need to be addressed. These could include: How quickly should billing and other direct access systems be phased-in?[16] Should billing and metering functions be limited to utilities or should other providers have the option? How should implementation costs be allocated among and recovered from customers? After these policy issues are resolved in the initial true-up proceeding, future true-up proceedings will be more limited to calculating the appropriate true-up amount in light of the Commission's prior policy determinations.

> [16]For example, it might not be appropriate to expend large sums for implementation of a program that can only be cost-justified if there are a million open access customers, when a less-costly option exists for a smaller number of participants.

Order at 28. These cases are Consumers' and Detroit Edison's initial true-up proceedings.

On June 5, 2000, after the record closed in these cases, the Customer Choice and Electricity Reliability Act, 2000 PA 141 (Act 141) and 2000 PA 142 (Act 142), became effective and codified in large part the Commission's prior open access orders. Among other things, Act 141 reduces Consumers' and Detroit Edison's retail electric rates by 5% immediately, § 10d, and provides for the recovery of net stranded costs through a true-up mechanism, §10a(9). The new legislation is dispositive of some issues addressed on the record in these true-up cases and affects how others will be resolved.

<u>Implementation Costs</u>

Prior to discussing the implementation costs actually incurred during and before 1998, the Commission would emphasize that simply incurring costs to implement Michigan's retail open access program is not a sufficient justification for their recovery. Expenditures associated with the implementation of the retail open access programs must produce results. Procedures, policies, methods, or electronic data interfaces that prove to be ineffective, inefficient, or unworkable may not entitle the company to recover the costs of those systems.

Because very little retail open access load is currently being served, it is difficult for the Commission to judge the effectiveness of Consumers' and Detroit Edison's implementation programs at this time. The Commission notes, however, that it expects Consumers and Detroit Edison to file information in their 2000 and 2001 true-up cases from which the Commission can determine the effectiveness of the implementation costs that the companies seek to recover.

For purposes of the present case, the Commission has reviewed the expenditures on the record and has granted deferred recovery as appropriate. However, it would caution the parties that these findings are conditional. If subsequent events reveal that costs were incurred for projects or systems that ultimately prove to be ineffective, inefficient, or unworkable or otherwise impede the progress to retail open access, the Commission reserves the right to undertake another review of those costs and may foreclose their recovery.

a. Summary of expenditures

Consumers reported that it incurred implementation costs of $19,905,000 during 1997 and 1998. Ex. ACE-33. Of the $19.9 million, $17.1 million related to changes to billing systems that are necessary to accommodate retail open access. Consumers' efforts to plan and prepare for customer education programs, to introduce a sample metering program associated with load profiling, and to participate in the formation of an independent transmission system organization accounted for much of the other costs. Consumers also incurred $849,000 related to transitional measures for its workforce. Consumers computed carrying costs at the 7% rate used by the Commission to develop previous estimates of stranded costs.

Consumers also provided a breakdown of the implementation costs by type of expenditure. According to this breakdown, \$3.8 million of the \$19.9 million represented labor expense attributed to Consumers employees (including allocated overheads), and \$12.1 million services provided by outside consultants and contractors. Consumers' primary contractor was Ernst & Young, LLP, which accounted for \$9.2 million of the expenditures. Ernst & Young provided much of the expertise for devising the retail billing system and integrating it with Consumers' existing systems. Tr. 492-94.

Detroit Edison reported implementation costs of \$7,534,389 in 1998, plus \$4,083,923 in the first quarter of 1999. Exs. ADE-45, ADE-46. Detroit Edison incurred those costs for tasks similar to Consumers', including customer education, business processes to handle transactions with open access customers and their suppliers, metering and billing, and upgrading information systems. As in Consumers' case, the work required to make information systems compatible with open access consumed the largest portion of Detroit Edison's expenditures, approximately \$4 million in 1998. Although Detroit Edison did not foreclose the possibility that it would incur employee retraining costs in the future, it did not report any for 1998. It computed carrying charges at its authorized pretax cost of capital of 10.01%. Tr. 784.

For each category of expenditure, Detroit Edison provided subcategories showing, by month, the amounts expended for its own employees' labor, contract labor and consulting services, and materials and equipment. Id. In 1998, Detroit Edison's total expenditures consisted of \$1.2 million for labor, \$4.2 million for contract and consultant services, \$1.1 million for materials and equipment, \$0.8 million for indirect charges (including allocated overhead), and \$0.3 million in carrying charges.

For periods after 1998, both Consumers and Detroit Edison projected in some detail the costs that they expected to incur in order to be in a position to offer open access to all retail customers by 2002. Consumers' projection of 1999-2002 implementation costs was $198.3 million. Ex. ACE-34. Detroit Edison projected that it would incur $101.3 million, which excludes any cost projection for the year 2002. Ex. ADE-37. Both Consumers and Detroit Edison explained that the timing of the planned expenditures has been coordinated with the expected rate of customer participation in the open access program. Consumers requests that the Commission concur "that the cost categories and cost levels are appropriate and consistent with the Commission's intent" and either confirm that the "expenditures to put in place systems to ensure all 1.6 million customers can elect retail open access by January 1, 2002 are appropriate" or provide a contrary indication so that it may "postpone development of systems and reduce expenditures." Consumers' initial brief at 23. Similarly, Detroit Edison seeks Commission "approval of the level and areas of expenditures for the continued implementation of Customer Choice." Detroit Edison's initial brief at 6.

b. <u>Implementation cost review</u>

In addition to implementation costs incurred during the 1998 true-up period, Detroit Edison also seeks recovery of costs incurred during the first quarter of 1999. The Staff objected on the ground that those costs should be addressed in the 1999 true-up proceeding. The Commission agrees. The Commission established the true-up mechanism on an annual basis. Costs incurred in 1999 are not within the scope of this case.

The Staff proposes to disallow labor expenses incurred by both Consumers and Detroit Edison for their own employees who were reassigned to work on implementation tasks. The disallowances amount to $3,760,000, or all of Consumers' labor cost, and $860,353, or 45% of

Detroit Edison's 1998 direct labor cost (based on the results of an internal study). Exs. S-47, S-48. In the Staff's view, the compensation paid to existing company employees who perform implementation work is not necessarily an incremental cost attributable to electric restructuring, but instead it may be classified as other operation and maintenance (O&M) expense, which the utilities recover through their base rates. In Consumers' case, Staff witness Gerald F. Geml supported the non-incremental nature of the labor costs by noting that Consumers' actual other O&M expense and actual employee headcount in 1998 were less than the amounts used in the 1996 test year to set Consumers' current base rates in Case No. U-10685 and that the difference is more than enough to absorb the implementation labor costs. Tr. 831-32.

The Attorney General agrees with the Staff's proposed disallowances. The Attorney General argues that the Commission's orders set forth two conditions for the recovery of implementation costs: that the costs are prudent and that they would have been avoided but for the inception of direct access. ABATE argues that none of the implementation costs should be recovered until the Staff conducts a full-scale audit of the costs.

Consumers argues that it is entitled to full recovery of its implementation costs because the costs were prudently incurred, which none of the parties disputed. Consumers relies on the Commission's prior statement: "[I]f the costs are prudently incurred, it would also be inappropriate to disallow recovery by the utility." June 5, 1997 order, Case No. U-11290, at 13.

Consumers further argues that the costs are incremental, relate directly to open access, and would not have been incurred but for the implementation of open access. Consumers explains that, in some cases, it met the work demands of implementation-related activities by reassigning existing employees to those efforts and using new hires, contract labor, or overtime to backfill their previous responsibilities. Consumers says that it also used chargeback labor more extensively, which means that the internal units responsible for implementation tasks absorbed greater cost allocations of the other units that support a variety of company operations. In effect, Consumers says, chargeback labor is not different from using personnel provided by an outside contractor. It explains that the duration and complexity of restructuring efforts may have obscured how it replaces the tasks and functions previously performed by an employee that it reassigns to implementation activities. However, it asserts, the workload related to implementation is incremental in that it exceeded Consumers' preexisting human resources. Consumers argues that those costs are not recovered in base rates and that the Staff's reliance on cost levels assumed for setting rates in the 1996 test year to demonstrate otherwise would be retroactive ratemaking.

Detroit Edison also opposes the Staff disallowance of its implementation costs. Detroit Edison says that the fact that the employees are now working on implementation-related activities is dispositive, regardless of the duties they were assigned prior to restructuring. It says that a disallowance would require assumptions regarding whether it replaced the persons transferred to implementation functions, which are not supported by the record.

In response to ABATE's request for a complete Staff audit, Consumers and Detroit Edison say that the Staff has already conducted an appropriate audit.

The Commission finds that the Staff's proposed disallowances of non-incremental labor expenses should be adopted. Neither Consumers nor Detroit Edison provided an adequate showing that those costs were in addition to the employee-related costs typically incurred by a utility operation in providing electric service in a reasonable, efficient manner. The redeployment of members of an existing workforce is not necessarily an unusual occurrence in large organizations. A reassignment can be short-term, temporary, or routine in nature. It may reflect efficiencies attained in preexisting work functions or the elimination of redundant positions. Unless the cost would not have been incurred, and represents a task or activity that would not have been performed, but for restructuring, it is more properly classified as the type of expense assigned to base rates.[1] The record does not establish that the labor costs subject to the proposed disallowances are incremental. In future true-up proceedings, Consumers and Detroit Edison should demonstrate the extent, if any, to which employee reassignments represent incremental costs. One approach would be to identify the vacated positions or responsibilities that the company was, or will be, required to fill by hiring additional employees or acquiring replacement services.

The Staff also proposed to disallow $652,000 of implementation costs that Consumers incurred for workforce transition. Consumers incurred the costs as severance expense in reducing its workforce at the Karn, Weadock, and Campbell plants. The Staff argues that the expenses incurred to reduce the workforce are normal improvements in efficiency and are unrelated to restructuring. The Staff points out that some of the costs were incurred prior to the Commission's June 5, 1997 order in Case No. U-11290 that commenced restructuring.

Consumers argues that it incurred the severance expense to improve the efficiency of its generating units in preparation for a competitive environment. It argues that this type of cost is covered by the Commission orders defining employee retraining costs as stranded costs.

The Commission finds that the Staff's proposed disallowance of severance expense that Consumers incurred in reducing its generation workforce is appropriate. As the Staff argues, the Commission sets rates to recover the reasonable cost of service, and a utility is obligated to strive for efficiency in order to keep its rates down. Thus, Consumers had an ongoing responsibility to

[1]This is true regardless of whether the costs were prudently incurred. The costs recovered in base rates are also set on the basis of reasonableness.

its ratepayers to implement efficiency measures to reduce its cost of service prior to restructuring, and the advent of restructuring does not discharge the company of this responsibility. Consumers does not explain any connection between its efforts to reduce its employee count and the Commission's initiation of restructuring proceedings. Absent a showing that restructuring caused the costs to be incurred, a utility could use restructuring as an opportunity to recoup out-of-pocket costs for efficiency measures that it would have undertaken in any event.

The Staff objects to Detroit Edison's use of a 10.01% interest rate for calculating carrying charges and recommends that the Commission adopt the 7% rate that Consumers used. The Staff argues that a 7% rate would be consistent with the 7% discount rate used in earlier orders computing stranded costs. The Staff also argues that 7% is more representative of a short-term borrowing rate, which is consistent with the timeframe between Detroit Edison's cost expenditures and their recovery.

Detroit Edison responds that its authorized rate is a pretax rate, which is appropriate to reflect that it will be required to pay taxes on the revenues it collects to recover implementation costs.

The Commission finds that both Consumers and Detroit Edison should use 7% to compute carrying charges. The Commission agrees with the Staff that a true-up proceeding is intended to focus on the period between the incurrence and recovery of costs and that a borrowing rate is a more reasonable means of compensating Detroit Edison for the time value of its funds during that period. Unlike Consumers, Detroit Edison's proposed carrying charge is based on its authorized weighted average cost of capital, which reflects the cost of capital associated with its entire capital structure at the time that its base rates were set.[2] Moreover, the 7% rate was used in prior orders

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[2]Detroit Edison's insistence on a pretax rate of return, in contrast to Consumers' position, attempts to obscure the issue. If a short-term borrowing rate is appropriate to reflect carrying

and is consistent with the discount rate applied to revenues received from transition charges to recover stranded costs.

After adopting the disallowances proposed by the Staff, the Commission finds that 1998 true-up implementation costs (before post-1998 carrying charges) of $15,376,000 for Consumers and $6,921,040 for Detroit Edison should be approved, as computed in Exhibits S-47 and S-48.

c. Cost recovery mechanism

Although the parties proposed surcharges to recover the approved implementation costs, their proposals do not take into account the changes required by Acts 141 and 142. At the same time, there are pending cases that may affect the stranded cost recovery mechanisms. (For example, in another order issued today in Case No. U-12639, the Commission commences a proceeding to implement Section 10a(10) of the Customer Choice and Electricity Reliability Act.) Instead of deciding how to effect the recovery of the 1998 implementation costs in this order, the Commission will defer the means of recovery until pending questions regarding the stranded cost recovery mechanism are resolved. As noted, recovery is subject to the conditions stated in this order.

Stranded Cost True-up Methodology

As noted, the March 8, 1999 order in Case No. U-11290 et al. indicated that neither Consumers nor Detroit Edison had begun to provide open access service or incur transition costs (as opposed to implementation costs) prior to or during 1998. The order indicated that the 1998 true-up cases would address the remaining issues regarding the stranded cost true-up methodology and related policy questions. Although several parties developed proposals for computing and truing

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charges, the tax consequences of debt have much less effect on the pretax return than the substantial proportion of equity capital assumed in Detroit Edison's position.

up stranded costs, the record closed prior to the enactment of the recent restructuring legislation and, consequently, the record does not reflect the changes to the process that are required by the legislation. Because the Commission today commences Case No. U-12639 to implement Section 10a(10) of Act 141, those issues are properly relegated to that docket.

Metering

In response to the March 8, 1999 order in Case No. U-11290 et al., the parties addressed issues related to competitive metering and access to meter data. Both Consumers and Detroit Edison opposed the concept of permitting other suppliers to provide metering and billing services in competition with those provided by the incumbent utility. On the present record, it is not necessary to address the metering and billing issues raised in the March 8, 1999 order in light of the following provisions of Section 10q of Act 141:

> (4) Only investor-owned, cooperative, or municipal electric utilities shall own, construct, or operate electric distribution facilities or electric meter equipment used in the distribution of electricity in this state. . . .
>
> (5) The commission shall not prohibit an electric utility from metering and billing its customers for services provided by the electric utility.

MCL 460.10q; MSA 22.13(10q). If there are other issues related to metering, billing, or access to meter data that cannot be resolved with reference to Section 10q or that have arisen since its enactment, those issues should be brought to the Commission by application or complaint, as appropriate.

On March 2, 2000, Energy Michigan filed a motion requesting an immediate decision on the metering issues in these cases. The motion is moot in light of the provisions of Section 10q.

The Commission FINDS that:

a. Jurisdiction is pursuant to 1909 PA 106, as amended, MCL 460.551 et seq.; MSA 22.151 et seq.; 1919 PA 419, as amended, MCL 460.51 et seq.; MSA 22.1 et seq.; 1939 PA 3, as amended, MCL 460.1 et seq.; MSA 22.13(1) et seq.; 1969 PA 306, as amended, MCL 24.201 et seq.; MSA 3.560(101) et seq.; and the Commission's Rules of Practice and Procedure, as amended, 1992 AACS, R 460.17101 et seq.

b. Implementation costs of $15,376,000 incurred by Consumers during or prior to 1998 should be approved for deferred recovery, subject to the conditions stated in this order.

c. Implementation costs of $6,921,040 incurred by Detroit Edison during or prior to 1998 should be approved for deferred recovery, subject to the conditions stated in this order.

THEREFORE, IT IS ORDERED that

A. Implementation costs of $15,376,000 incurred by Consumers Energy Company during or prior to 1998 are approved for deferred recovery, subject to the conditions stated in this order.

B. Implementation costs of $6,921,040 incurred by The Detroit Edison Company during or prior to 1998 are approved for deferred recovery, subject to the conditions stated in this order.

The Commission reserves jurisdiction and may issue further orders as necessary.

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, pursuant to MCL 462.26; MSA 22.45.

MICHIGAN PUBLIC SERVICE COMMISSION

/s/ John G. Strand
Chairman

(S E A L)

/s/ David A. Svanda
Commissioner

/s/ Robert B. Nelson
Commissioner

By its action of October 24, 2000.

/s/ Dorothy Wideman
Its Executive Secretary

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, pursuant to MCL 462.26; MSA 22.45.

MICHIGAN PUBLIC SERVICE COMMISSION

Chairman

Commissioner

Commissioner

By its action of October 24, 2000.

Its Executive Secretary

In the matter of the application of **CONSUMERS ENERGY COMPANY** for authority to recover implementation costs, approval of a stranded cost true-up methodology, and other relief.	)))))	Case No. U-11955
In the matter of the application of **THE DETROIT EDISON COMPANY** for authority to recover retail access program implementation costs and approval of a true-up mechanism in connection with the recovery of stranded costs.	)))))))	Case No. U-11956

Suggested Minute:

> "Adopt and issue order dated October 24, 2000 approving retail access program implementation costs incurred during or prior to 1998 by Consumers Energy Company and The Detroit Edison Company, as set forth in the order."