

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of
THE DETROIT EDISON COMPANY
to increase rates, amend its rate schedules
governing the distribution and supply of electric
energy, implement power supply cost recovery plans,
factors and reconciliations in its rate schedules
for jurisdictional sales of electricity and for
miscellaneous accounting authority and regulatory
asset recovery.

Case No. **U-13808**
(e-file)

**MICHIGAN PUBLIC SERVICE COMMISSION STAFF'S
REPLY TO THE DETROIT EDISON COMPANY'S PETITION FOR REHEARING**

I. Reply to Detroit Edison with respect to the capital structure--The Commission was correct in adopting the 46% equity, 54% debt permanent capital structure for Detroit Edison recommended by the ALJ and Staff.

Detroit Edison requests a rehearing because, in part, based on the decision by the Commission to adopt the ALJ's and Staff's recommended capital structure of 54% debt and 46% equity, the Company was issued a credit rating downgrade by Standard and Poor's (S&P). S&P downgraded Detroit Edison's credit rating from BBB+ with a negative outlook to BBB with a stable outlook citing that Detroit Edison's credit metrics were more consistent with a 'BBB' corporate credit rating. Detroit Edison was BBB+ with a negative outlook since December 2003. In its petition, Detroit Edison cited a portion of Standard and Poor's comment on the Commission's rate order, stating "...in aggregate these actions are not sufficient to significantly bolster the utility's business profile and arrest the weak consolidated credit metrics before year end 2006 at the earliest." (Petition, page 2) Detroit Edison then goes on to restate many of its

previous arguments for a 50/50 capital structure that were vigorously rebutted in Staff's reply to exceptions, briefs and rebuttal testimony.

In Staff's reply to exceptions, Staff presented a clear picture of Detroit Edison's forecasted common equity and long-term debt profile, which took into account debt and equity recommendations from both Staff and Detroit Edison (Reply to Exceptions, pages 6-9). Staff's capital structure analysis used Detroit Edison's long-term debt profile developed by Detroit Edison in Exhibit S-229 (Reply to Exceptions, page 7). Staff then presented an appropriate common equity profile based on a 13 month common equity average and adjusted by equity modifications based on testimony provided by Detroit Edison's Treasurer (Reply to Exceptions, pages 7-8). Aggregating both debt and equity profiles together resulted in a capital structure of 54% debt, 46% equity. Detroit Edison has neither challenged nor rebutted any of the figures presented in Staff's Reply to Exceptions. Staff asserts that these figures are solid, reasonable and non-controversial. The Commission and the ALJ carefully weighed each of the party's arguments regarding an appropriate capital structure and came to the sound decision to adopt Staff's recommendation of a 46% equity, 54% debt capital structure. Thus, it appears that Detroit Edison's petition for a rehearing on the capital structure issue is based solely on the fact that S&P downgraded Detroit Edison's credit rating, with the implication that the approved capital structure played a role in the downgrade. Staff takes issue with this implication and refutes Detroit Edison's contention that the S&P downgrade was based in part on the Commission's capital structure recommendation.

Detroit Edison referenced S&P's comments regarding the Commission's November 23, 2004 rate order "...in aggregate these actions are not sufficient to significantly bolster the utility's business profile and arrest the weak consolidated credit metrics before year end 2006 at

the earliest.” (Petition, page 2) What the Company fails to do is to take the S&P comment in its full context. The comment was gleaned from a paragraph in S&P’s credit action report on DTE Energy. The paragraph was entitled “How did the MPSC’s recent rate order affect DTE Energy’s credit quality? The paragraph, in its entirety, reads:

The Nov. 23, 2004 MPSC rate order provides Detroit Edison with an increase in base rates of \$335.8 million, although about 40% of the increase will not become effective until 2006, when residential rate caps expire. However, the rate increase for Detroit Edison restores the utility’s revenue to \$3.95 billion by 2006, comparable with 2001 total. Furthermore, the MPSC has established the mechanism to recover deferred costs associated with stranded costs (\$241 million over five years), provided a surcharge for environmental cost recovery (about \$33 million per year from 2005 to 2009) and prescribed a regulatory proceeding to address the firm’s competitive position. However, in aggregate, these actions are not sufficient to significantly bolster the utility’s business profile and arrest DTE Energy’s weak consolidated credit metrics before year-end 2006 at the earliest.

S&P goes on to explain the basis for its downgrade. In particular, S&P stated, “Detroit Edison’s competitive position and cash flow have eroded throughout 2004 with the introduction of deregulation in Michigan.” What is significant is that S&P does express in the above caption that the MPSC Order addresses some of the competitive positioning and deregulation issues the Company has been dealing with, but that the bulk of the recovery won’t take place until the 2006-2007 time frame. Based on this fact, the Company’s current credit metrics, according to S&P’s calculations, place it in the ‘BBB’ ratings range. Throughout the entirety of the S&P ratings report, the commentary neither explicitly nor implicitly referred to the Commission’s decision to grant Detroit Edison a 54% debt, 46% equity capital structure as a factor in its decision to downgrade the Company’s credit rating. As a matter of fact, S&P’s credit report did state:

Going forward, Standard and Poor’s expects the company’s consolidated financial profile to garner credit protection measures appropriate for the rating over a sustained period. Specifically, adjusted FFO interest coverage is expected to be

above 4x, adjusted FFO to total debt to be about 25% and **adjusted debt leverage to be migrating to 55% or below** (Emphasis added.)

Therefore, despite Detroit Edison's argument that the rate order's 54% debt, 46% equity capital structure approval played a role in the Company's credit rating downgrade, it appears that S&P was unfettered or neutral on the Company's approved capital structure.

Based on S&P's rationale for its downgrade, it appears that even if the Company were granted a 50/50 capital structure, the downgrade would have most likely still occurred. It appears that the time frame involved with Detroit Edison's financial recovery spurred the ratings action downgrade from S&P and not Detroit Edison's recommended capital structure. It is also interesting to review S&P's historical rating of Detroit Edison's debt. S&P had not changed their bond rating for Detroit Edison since 1990, when they raised the Company's rating to BBB+ from BBB. Detroit Edison had some very good years since 1990, but S&P did not adjust their bond rating. For Detroit Edison to now focus on the S&P downgrade because of the capital structure approved by the Commission in its order is unreasonable. S&P would have downgraded Detroit Edison's bonds even if a 50% debt to equity capital structure had been allowed in this case.

In its petition, Detroit Edison failed to take into account the reactions of the other major rating agencies, Moody's and Fitch. Fitch released a statement after reviewing the Commission's Order, stating: "The final order issued by Michigan Public Service Commission in the Detroit Edison Co. rate case is consistent with Fitch's expectations and is generally supportive of Detroit Edison's credit quality." Fitch maintained Detroit Edison's credit rating at BBB+ with a stable outlook. Moody's has not changed Detroit Edison's Baa1 rating at this time and it placed the Company's outlook negative back in January 2004, before the Commission's final order. Moody's has not formally announced any credit ratings action based upon the

Commission's order. Therefore, it appears that Detroit Edison is basing its rehearing petition solely on the rating actions of one rating agency, S&P, despite the supportive ratings position of Fitch and the neutral position of Moody's. Staff has established a clear rationale as to why it appears S&P downgraded Detroit Edison's credit quality. The rating agency comments indicate that the ratings downgrade was not based on Detroit Edison's capital structure but instead on the delayed time frame that Detroit Edison could expect to reap the majority of the financial benefits that were embedded in the Commission's rate order.

It was correct for the Commission to properly balance both the interests of the ratepayers and that of Detroit Edison's shareholders in its decision to grant Detroit Edison a 54% debt, 46% equity capital structure (Case No. U-13808, Opinion and Order, p 31). The Commission was correct when it opined:

The Commission finds that the Staff's proposed 46% equity ratio represents a significant improvement over the 40% equity ratio approved in Detroit Edison's last electric rate case and is consistent with the Company's present needs. A capital structure with a common equity ratio of 46% is reasonable for setting rates in this case because it strikes a proper balance between the interests of ratepayers and the Company's shareholders. *Id.*

Detroit Edison states that the equity ratio granted by the Commission in this case is really lower than what was granted in its 1994 order. This conclusion is incorrect and not supported by the evidence. A layer of preferred stock may be viewed as equity by the rating agencies depending on the type of preferred stock. Preferred stock does not have the same type of discretionary dividends as common stock for a public utility. To assume that the preferred stock that was included in Detroit Edison's 1994 capital structure is equivalent to common equity is unreasonable. Therefore, the common equity in the capital structure granted by the Commission in this case is not less than the total common equity granted in the 1994 case.

Based on the Commission's own clear, concise and reasonable determination of Detroit Edison's capital structure in this rate case, the Commission should deny the Company's petition to adjust its capital structure to 50% equity, 50% debt. The petition is based on a ratings downgrade by only one rating agency, S&P, and does not take into account the opinions of the other major rating agencies. Fitch was supportive of the Commission's Order and held Detroit Edison's credit quality steady. Moody's, despite having Detroit Edison on a negative outlook for about a year, has not taken any action with regards to the Company's credit quality. The S&P credit downgrade does not justify a capital structure increase, especially since the rating agency's action were not based on Detroit Edison's capital structure as Detroit Edison would lead the Commission to believe. The Commission was correct in its capital structure determination and should deny Detroit Edison's unsubstantiated and unwarranted petition to adjust its capital structure.

II. Reply to Detroit Edison's Petition with respect to its request for an additional year of inflation

Detroit Edison has argued that another year of inflation should be added to its revenue requirement because of the amount of time it has taken to litigate this rate. Staff urges the Commission to reject this request. It would be bad policy to adjust the rates issued in this case for one factor alone, i.e., for inflation. Numerous factors are involved in setting rates. Some changes will result in possibly higher rates; some will possibly result in lower rates.

Further, in order to grant Edison's request the record would have to be reopened. Reopening the record would open the door for further issues to be raised, such as the possibility of increased sales due to increased use by individuals and companies of more electricity.

In sum, Staff urges the Commission to reject Detroit Edison's request.

III. Reply to Detroit Edison's Petition with respect to LIEEF

Detroit Edison urges the Commission to reconsider its decision regarding LIEEF and asserts that these funds should only be used for customers in its territory. The Commission considered this argument in its Opinion and rejected. Detroit Edison's Petition raises no new arguments in support of the Commission granting its Petition. For that reason, it is not properly raised in a Petition for Rehearing.

Moreover, Detroit Edison's position ignores the fact that the Commission may reach a similar result in Consumers Energy's pending rate case. Thus, funding from the state's two largest electric companies will be available to continue this state-wide program authorized by Act 141.

Therefore, Staff urges the Commission to reject the Petition for Rehearing in this regard.

IV. Reply to Detroit Edison's Petition with respect to the PSCR factors

Detroit Edison has argued in its Petition for Rehearing that the Commission has rejected Edison's PSCR proposal, the Commission lacks authority to modify Edison's proposal, and if the Commission did not reject Edison's PSC proposal without modification, the Commission should adopt it as requested in Edison's application. While Detroit Edison is correct that the Commission rejected its proposal to reinstate the PSCR mechanism for 2004 coincident with approval of the company's request for a mitigation adjustment to operate in tandem with the PSCR mechanism. Detroit Edison is incorrect in asserting that the Commission lacks authority to modify Edison's proposal. The Commission has statutory authority to provide money in rates for Edison's power costs by including the costs in base rates or by including the costs in a PSCR factor. See 1939 PA 3; MCL 460.6a *et seq.* The Commission is not bound to pick one method

over another if the Commission in its legislative discretion determines that circumstances warrant it. See *Attorney General v PSC*, 231 Mich App 76 (1998) and *Attorney General v PSC*, 249 Mich App 424 (2002).

Although Staff disagrees with Detroit Edison's claim that the Commission lacks authority to modify its PSCR proposal, Staff does agree with Detroit Edison's statement on page 24 of its Petition that Edison is free to pursue the 2005 PSCR plan in a separate MCL 460.6j(3)(7) proceedings. Staff agrees with Detroit Edison on this point for the reasons recently articulated by Staff in its Response to the Attorney General's Motion for Summary Disposition filed in U-14275 on January 6, 2005. The Administrative Law Judge agreed with Staff's position in that case.

Detroit Edison also continues to argue in favor of its mitigation proposal to act in tandem with its PSCR factor. Staff supports the Commission's decision with regard to this issue for the reasons stated in Staff's testimony and briefs and in the Commission order.

Respectfully submitted,

**MICHIGAN PUBLIC SERVICE
COMMISSION STAFF**

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Subscribed and sworn to before me
this 18th day of January, 2005.

Pamela A. Walters, Notary Public
State of Michigan, County of Ionia
Acting in the County of Ingham
My Commission Expires: 02/04/2007