

**May 2006 - To the Customers of Edison Sault Electric (ESE) Company:**

As you are probably aware, the price you pay for electricity has increased substantially over the last several years and even more so since 2004. The major reason for this is that the cost for purchases we make from other suppliers outside of our own hydro generation have increased dramatically. These outside purchased power costs are based primarily on producing electricity by coal and natural gas. The costs for coal and natural gas have gone up over 100% and 50% respectively since 2004 for those two fuel types.

We must purchase 60% of the electricity from outside suppliers as our hydro base is limited in its production capabilities. The long term purchased power contracts we have in place with our two outside suppliers (We Energies and Consumers Energy) were reviewed and approved either by the Michigan Public Service Commission (MPSC) or the Federal Energy Regulatory Commission (FERC).

In September of each year, we file with the MPSC a projection of our Power Supply Cost Recovery (PSCR) costs for the following year. The costs for these outside purchases are reviewed/audited/modified annually and then approved by the Michigan Public Service Commission. In March of the following year, we file a reconciliation of PSCR costs from the previous year comparing actual costs to the estimate previously approved. Any PSCR costs over-recovered by us are refunded to the customers with interest; any PSCR costs which are under-recovered are then added to the next year's PSCR. By statute, the only item included in the recovery of PSCR costs is the cost of power supply. We do not collect for any other costs such as profits, wages, benefits, poles, wires or any other operational or maintenance items through the PSCR. This process has been in place for over twenty years and the only difference in this year's PSCR is the magnitude of the increase. This charge appears as "PSCR CHARGE (\$0.000/KWH)" as a line item on most customer bills.

Further, the introduction by the Federal Energy Regulatory Commission of mandated Regional Transmission Organizations to help spur competition has impacted how these transmission costs are spread as they are also part of the PSCR costs. Finally, here in Michigan we lack sufficient generation in order to have a robust competitive market which limits our options for purchasing power outside of our own hydro generation. Basic and elementary economics are at work here - lack of enough of a product (electricity) at the wholesale level to sustain competition along with increased prices for items which create that product (coal, natural gas) or act as alternatives to that product.

We are distressed as are many of our customers in discussing the issue of increasing electricity prices. We believe that we have always acted in the best interest of our customers and we will continue to do so. However, the new environment in which we currently find ourselves is not just a local or regional condition but is also being played out throughout the rest of the country as well. Until certain things are put into place such as additional generation or increased access to other outside purchased power sources through transmission upgrades (which will take at least several years), we will continue to see higher energy costs.

Importantly, even with these price increases, our rates are still 10% - 25% below the state average depending upon which rate categories one compares.

Several of our customers have exercised their rights to contest our current PSCR applications before the Michigan Public Service Commission for recovery of our PSCR costs. This is a serious set of events which we take notice of and to which we testify that we have used our best efforts to secure reasonably priced sources of electric supply going into the future. We believe that we have followed good industry practice and have indeed secured reliable power sources at reasonable cost. Our own internal observation on this subject is that our customers exercising the contested issue are not asking the right question. Instead of asking "Why are costs going up?" everyone should be asking (given the current conditions in Michigan) "Are we going to have reliable sources of electricity in three to five years from now?" It is my belief that because of the actions we have taken over the last decade, the customers of both Edison Sault and Cloverland Electric will have reliable sources of electricity going into the future. That may not be the case in all areas of the country.

The time has come for us to bring the above message to our customers and we intend to do just that over the next several months. We look forward to being able to help our customers understand this important issue.

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Critics of deregulation, including industrial customers who initially supported efforts to restructure the retail electric markets, have blamed rising electricity costs on deregulated markets and now clamor for a return to the “good old days” when rates were lower. They claim that deregulation of electricity markets has resulted in higher power prices pointing to the “fact” that power is now cheaper in regulated states than deregulated states. While appealing on the surface and apparently linear in their argumentation to the uninitiated, such claims are unsubstantiated by the evidence when the complexities of electricity markets are considered.

Political pressure has been building lately on state commissions with deregulated retail electric markets. For instance, **in Maryland where residential rates may increase as much as 72% for customers** who elect not to seek a competitive power supplier, there have been calls for the resignation of the Chairman of the Maryland Public Utility Commission.

In truth, **electricity prices are increasing around the nation in both regulated and deregulated electricity markets**. For instance, Southern Company, the only investor owned utility in Georgia, which has not restructured its retail electric market, recently requested a near double-digit rate increase. Old Dominion Power Company, a regulated electric provider in Virginia, also requested a substantial rate hike. Other utilities in regulated areas of the country will likely follow suit.

Simply put, deregulation has not caused power prices to increase. Rather, restructured retail electric markets simply are more efficient at translating changes in underlying fuel costs to the ultimate consumer than regulated markets.

An analogy underscores this point. On your way home from work, you realize that you need milk. You can either stop at the corner store at the end of your street where milk is \$2.00 per gallon or you can go to the grocery store a mile away where milk is \$1.50 per gallon. It is the same with electricity in restructured markets. Consumers can either stay on standard offer service (the corner store) or they can shop the market place (the grocery store) for a better power deal. In states that have not restructured their retail electric markets, customers are forced to go to the corner store since there is no grocery store. The promise and benefit of properly restructured retail electric markets is not that prices will always be lower than previous periods, but rather that because customers will have choice over their energy supplier and **where there is effective competition prices** paid will be lower than they would have been had those costs determined through expensive and cumbersome rate cases.

Why electricity costs are rising—increasing input costs

If deregulation is not to blame for rising electricity costs, the natural question to ask is why electricity costs are increasing. The answer is relatively simple—**the cost of fuels used to generate electricity is increasing**. Electricity is generated by four main fuel sources—hydro, nuclear, coal and natural gas—with the last 2 accounting for approximately two-thirds of all electricity generated in the U.S. during 2005 according to the EIA. According to industry source Platt's, delivered coal prices increased almost 113 percent, from \$54.95/standard ton in 2004 to \$117/standard ton in 2005, while the Energy Information Administration reported that natural gas prices jumped approximately 68 percent around the country over the same time period. With such substantial increases in fuel costs, it should surprise no one that electricity prices are increasing as well.

Given that the underlying cause of the electricity price increases has no connection to whether a state has restructured its retail electricity market, an interesting comparison is whether retail customers in restructured states have fared better than consumers in states with regulated retail electricity markets. While this issue has not been extensively studied, at least one state utility commission has concluded that restructuring the retail market has provided substantial benefits to all customer classes, including residential consumers. The Texas Public Utility Commission concluded that residential customers in Houston would have saved almost \$1500 per year versus regulated prices while customers in the Dallas area would have saved \$800 per year compared with what regulated prices would have been.

Conclusion

Those who blame deregulation for rising electricity costs commit the classic logical fallacy of assuming a causal link because one event occurred after the other. While such an approach has an intuitive appeal, it is unsubstantiated by the evidence. Unfortunately, **higher electricity costs are not the result of a single event, such as deregulation, but rather reflect changes in underlying economic conditions that are likely to persist for quite some time**. While restructuring has caused some hiccups in the electricity industry around the nation, it should not bear the blame for rising electricity costs.

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