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March 2, 2001

Ms. Dorothy Wideman
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

RE: Initial Brief of Michigan Consolidated Gas Company
MPSC Case Nos. U-12762 (e-file)

Dear Ms. Wideman:

Enclosed for filing in the referenced matter, please find the original and 5 copies of the Initial Brief of Michigan Consolidated Gas Company (MichCon).

Should you have any questions regarding this filing or require additional information, please do not hesitate to contact me. Your attention to this matter is appreciated.

Very truly yours,

David Champion

DCC

Enclosures

c: Counsel of Record

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of MICHIGAN CONSOLIDATED GAS COMPANY to terminate the suspension of its gas cost recovery clause and establish a cashout mechanism	)))))	Case No. U-12762 (e-file)

INITIAL BRIEF OF
MICHIGAN CONSOLIDATED GAS COMPANY

Michigan Consolidated Gas Company ("MichCon") submits this Initial Brief pursuant to Rule 339(2), R 460.339(2) of the Rules of Practice and Procedure Before the Michigan Public Service Commission ("Commission" or "MPSC") and the procedural schedule established by the presiding Administrative Law Judge ("ALJ") in this case.

I. Procedural History

On December 15, 2000 MichCon filed an application in which MichCon proposed to terminate the suspension of its gas cost recovery ("GCR") clause and establish a mechanism to cash-out and credit customers for the value of certain of the contracts in MichCon's gas supply portfolio. MichCon's application also proposed implementation of GCR factors for the last nine months of 2001. On January 11, 2001 MichCon filed the testimony and exhibits of Mr. Don M. Stanczak in support of its application. MichCon's application, testimony and exhibits were submitted in furtherance of MichCon's efforts to align various aspects its experimental gas customer choice ("GCC") program with the uniform terms and conditions for gas customer choice set forth in the Commission's decision in Case No. U-12550, Order dated October 13, 2000.

Pursuant to due notice a prehearing conference was held January 22, 2001 before ALJ Barbara A. Stump. At the prehearing conference, the Commission Staff entered its appearance and Intervenor status was granted to Attorney General Jennifer M. Granholm ("AG"), the Residential Ratepayer Consortium ("RRC"), the Association of Businesses Advocating Tariff Equity ("ABATE"), and New Power Company ("New Power"). At a motion hearing held February 12, 2001, Intervenor status was also granted to Energy America ("Energy America"). A request to dismiss a portion of MichCon's application was denied at a motion hearing held February 27, 2001.

At an evidentiary hearing held February 23, 2001 the testimony of MichCon witness Mr. Don M. Stanczak, AG witness Mr. Ralph Miller, RRC witness Mr. Frank Hollewa, Energy America witness Mr. Al McDonald and Staff witness Mr. William Aldrich was bound into the record and cross-examined. The record consists of 210 transcript and 10 exhibits admitted in evidence.

II. Gas Customer Choice Program Background

Approximately three years ago the Commission approved MichCon's request to implement an experimental GCC program intended to examine the benefits of extending retail gas transportation service to all residential customers in MichCon's service territory.[1] Two key features of the GCC program were the suspension of MichCon's GCR clause and the ability of participating customers to satisfy their natural gas needs by purchasing the commodity from an alternative supplier ("marketer") at a negotiated rate. Customers could also choose to retain MichCon as their natural gas supplier. Those that did choose MichCon paid a fixed natural gas commodity rate of $2.95 per Mcf.

[1] Case No. U-11682, Order dated April 28, 1998. (TR 42). Certain aspects of the GCC program approved in Case No. U-11682 were modified by the Commission in Case No. U-12050, Order dated August 17, 1999. (TR 42-43).

The initial response to MichCon's GCC program was favorable. Through the efforts of participating marketers, participation in the first year of the program reached the year one customer and volume limits established by the Commission.[2] (TR 45). During year two of the GCC program customer and marketer participation declined precipitously. That result was directly attributable to natural gas prices increasing to levels that prevented marketers from profitably offering customers a price competitive with MichCon's fixed $2.95 per Mcf price. Unable to profitably compete, participating marketers either solicited fewer GCC program customers or simply dropped out of the program altogether. (TR 45-46).

The prospects for year three of the program, scheduled to begin April 1, 2001, appear no better. Based on its GCC program experience to date, and in light of natural gas prices that today remain far in excess of MichCon's fixed $2.95 per Mcf commodity rate, MichCon projects a significant decline in GCC program participation by both customers and marketers. MichCon's recent experience confirms its expectations. In the four months since the year three solicitation period opened, MichCon has received no customer enrollments from marketers. (TR 46).

The recent spike in natural gas prices and the behavior of marketers and customers in response to that event highlight a glaring defect in MichCon's GCC program. Simply put, fixed pricing stifles competition in periods of rising prices. The inability of marketers to compete for customers based on price frustrates customer choice and thus undermines a central objective of the GCC program.

The lack of competition in MichCon's GCC program also frustrates the Commission's stated goals. The Commission recently completed Case No. U-12550, a collaborative case

[2] The Commission established a first year residential cap of 75,000 customers and a commercial volumetric cap of 10 Bcf. The participation caps increased to 150,000 customers and 20 Bcf of non-residential load for the second year of the program. (TR 45).

process resulting in an order identifying uniform terms and conditions for the provision of gas customer choice to all customers in the State of Michigan. In response to that initiative MichCon filed its pending application in Case No. U-12761 to implement an enhanced and expanded GCC program in conformance with the Commission's decision in Case No. U-12550. MichCon's application in Case No. U-12761 discussed, among other things, MichCon's desire for early termination of its GCR clause suspension and return to the GCR process effective April 1, 2001. The application noted that reinstating MichCon's GCR clause effective April 1, 2001 would put MichCon's GCC program on the same timeline as the GCC program sponsored by Consumers Energy Company ("Consumers"). Returning to the GCR process would also eliminate MichCon's current fixed natural gas price of $2.95. From MichCon's experience it is evident that the fixed pricing component of MichCon's GCC program must be addressed concurrent with the GCC program changes MichCon proposes in Case No. U-12761 if those changes are to have any meaningful effect on gas customer choice in MichCon's service territory. (TR 42).

III. MichCon's GCC Program Pricing Proposal

MichCon proposes to remedy the defect in its GCC program by terminating the suspension of its GCR clause and implementing a GCR factor reflecting market prices during the nine-month period April 1, 2001 through December 31, 2001.[3] (TR 48).

The mechanics of MichCon's proposal are simple and straightforward. As MichCon witness Mr. Don Stanczak explained, MichCon has approximately 76.5 MMDth of gas under contract for delivery during the last nine months of 2001. (TR 47, Exh. A-2). The volumes MichCon contracted for were acquired on the assumption that participation in year three of the GCC program would be at or near the residential and commercial participation caps, and are

[3] MichCon has proposed a GCR factor of $5.17 per Mcf in its related GCR Plan filing, Case No. U-12766. The procedural schedule in that case has been held in abeyance pending the Commission's decision in this case.

priced significantly below current market prices. MichCon proposes to cash out these low-priced contracts (TR 48) and distribute the estimated $183 million[4] net gain on the transactions to all of its sales rate schedule customers, including customers participating in the GCC program, through a temporary volumetric credit currently estimated to be in effect from April 2001 through March 2002. (TR 49).[5]

MichCon's cash-out proposal is beneficial in several related respects. Removal of these fixed-price contracts from MichCon's 2001 gas supply portfolio will allow MichCon to implement a GCR factor approximating the current market price for natural gas. With a market-oriented GCR factor in place, marketers will be able to compete with MichCon for retail customers based on price. Further, MichCon's proposal to distribute proceeds from the cash-out to all its sales rate schedule customers – whether they buy their gas from MichCon or a GCC program marketer -- will eliminate any incentive for customers to remain with MichCon solely for the sake of receiving the cash-out credit. As a result, the universe of potential GCC program participants will not be artificially reduced by price-induced behavior. Moreover, distribution of the cash-out proceeds over a 12-month period will have a smoothing effect on natural gas prices between heating seasons. Applying the credit only during the last nine months of 2001 would most likely result in a significant natural gas price increase in January 2002, when customers' home heating bills are highest. Spreading the credit over a 12-month period will moderate potential natural gas price increases over the entire 2001-2002 heating season, a benefit unavailable to customers under the experimental GCC program. (TR 50-51).

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[4] The market value of the contracts is based on the NYMEX estimates shown in MichCon's 2001 GCR Plan, Case No. U-12766. (TR 49, Exh. A-2).

[5] The duration of the credit will depend on actual throughput. (TR 52).

To further mitigate any potential adverse impact on customers currently paying MichCon's fixed $2.95 per Mcf rate, MichCon proposes to implement an additional refund, if necessary. More specifically, if GCR customers pay more than the current fixed $2.95 per Mcf rate during the last nine months of 2001, net of the cash-out credit, MichCon proposes to refund an additional amount equal to the lesser of the aggregate amount of the customers' increased costs or the gross natural gas sales margin MichCon realized during the 27-month period the fixed $2.95 rate was in effect. MichCon would effect distribution of this refund by continuing the volumetric cash-out credit on a month-to-month basis beyond April 2002 until the entire refund amount was distributed. (TR 52). Based on MichCon's estimates, the net effect of its cash-out and gross margin refund proposals will in all likelihood result in customers paying no more than the fixed $2.95 per Mcf rate during the period April through December 2001. (TR 52, Exh. A-3).

MichCon recognizes that gas prices and/or throughput could exceed its estimates for the last nine months of 2001. Because MichCon is committed to minimizing any adverse financial consequences to its customers that may flow from MichCon's early termination of its GCR clause suspension MichCon is prepared to protect its customers by taking an additional step to reduce its cost of gas through the end of this year. If natural gas prices and/or throughput increase to the point that the return of MichCon's gross sales margin fails to sufficiently mitigate 2001 gas costs, MichCon intends to rely on its relatively low-priced storage inventory to offset increased gas costs. MichCon's existing storage inventory is generally priced at rates less than $0.40 per Mcf.[6] Relying on a storage decrement in lieu of purchasing significantly more expensive gas at market prices allows MichCon to reduce its overall average cost of gas for 2001

[6] MichCon uses the last in, first out ("LIFO") methodology to account for gas in storage. (TR 54). MichCon does not propose any change to that methodology in this case.

and protect customers from the financial consequences of unanticipated gas cost or throughput increases in 2001.

The Commission has expressed its desire for more uniformity among and between the GCC programs sponsored by natural gas utilities in Michigan. MichCon's proposal in this case accommodates that objective. Approval of MichCon's application will put MichCon's GCC program on the same timeline as the GCC program sponsored by Consumers. Further, simultaneous implementation of the MichCon and Consumers GCC programs should be attractive to marketers. Terminating MichCon's $2.95 per Mcf fixed commodity rate will allow marketers to profitably compete for customers based on price. It will also eliminate the need for marketers to incur additional advertising, marketing, consumer education and customer service costs. (TR 79). Most importantly, customers will obtain the immediate advantage of lower prices resulting from increased competition. MichCon submits that the multiple benefits flowing from its GCC program pricing proposal amply justify approval of its application in this case.

III. Reaction to MichCon's Proposal

Reactions to MichCon's GCC program pricing proposal have been mixed. From the testimony of Energy America witness Al McDonald it appears that participating marketers support MichCon's proposal. (TR 77-80). On the other hand, the AG, the RRC and the Staff criticize MichCon's proposal and urge that it be modified or rejected.

RRC witness Mr. Frank Hollewa recommends rejection. Mr. Hollewa testified that if MichCon's proposal is adopted, MichCon's customers will pay more than MichCon's fixed $2.95 per Mcf commodity rate during the last nine months of 2001. (TR 112). Mr. Hollewa also testified that MichCon's proposal to decrement storage if such action is necessary to mitigate the financial consequence of rising prices would jeopardize the reliability of MichCon's natural gas delivery system under design day conditions. (TR 119).

AG witness Mr. Ralph Miller testified that early termination of MichCon's GCR suspension will not promote gas supply competition in 2001 or beyond and that, under MichCon's proposal, customers will likely pay more than $2.95 per Mcf during the last nine months of this year. (TR 146). According to Mr. Miller, customers have suffered at MichCon's expense due to the suspension of MichCon's GCR clause. (TR 144). To protect against the alleged risk that customers will suffer additional harm, Mr. Miller suggests two modifications to MichCon's proposal. Mr. Miller recommends that all proceeds from the contracts MichCon proposes to cash out be refunded to customers during the last nine months of 2001, the period from which the proceeds are derived. (TR 167). Mr. Miller also recommends that the gross margin refund cap proposed by MichCon be eliminated. In effect, Mr. Miller recommends that MichCon be required to guaranty that customers will pay no more than $2.95 per Mcf during 2001. (TR 159-160). Finally, Mr. Miller recommends that approval of MichCon's proposal include a condition that early termination of MichCon's GCR suspension will not constitute a basis for any change in MichCon's LIFO storage accounting methodology. (TR 140).

Like AG witness Mr. Miller, Staff witness Mr. William Aldrich recommends a price guaranty. In Mr. Aldrich's view, the only way to ensure that GCR customers and GCC program customers as a class will not be responsible for higher gas bills is to require MichCon to guaranty that customers will pay no more than $2.95 per Mcf for their April through December 2001 billed gas volumes, after credits received from April 2001 through March 2002 (TR 202).

IV. MichCon's Response To Criticisms Of Its Proposal

A. MichCon Should Not Be Penalized For Offering Customers A Choice

MichCon implemented its experimental GCC program to assist the Commission in determining whether the benefits of gas customer choice should be extended to all customers in MichCon's service territory. As MichCon witness Mr. Stanczak's testimony demonstrates, the results of the experiment are in. The most beneficial aspect of MichCon's GCC program is the significant customer savings it produced. MichCon's GCC program saved customers some $200 million in gas costs during the first two years of the program. MichCon estimates that gas cost savings in year three will be in the range of $400 to $500 million.[7]

A demonstrable defect in MichCon's GCC program is its fixed gas cost pricing component. Fixed pricing frustrates competition in periods of rising prices. This fact is confirmed in the testimony of Mr. Al McDonald, a witness for Energy America, a marketer participating in MichCon's GCC program. Mr. McDonald testified that the dramatic increase in gas prices since the inception of MichCon's GCC program prevented most marketers from competing with MichCon's fixed $2.95 per Mcf price. As a consequence, marketers either solicited fewer customers or simply declined to further participate in the GCC program. (TR 79). MichCon's proposal to promote price competition by terminating its GCR suspension represents an affirmative and timely response to this unfortunate circumstance.

Apparently dissatisfied with the significant customer savings achieved under MichCon's GCC program, and in complete disregard of the benefits of competitive pricing, the AG and the Staff ask the Commission to penalize MichCon. These parties recommend that MichCon's

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[7] Estimates offered by the Commission are consistent with those testified to by Mr. Stanczak. In a recent press release the Commission estimated savings associated with MichCon's fixed $2.95 per Mcf rate to be in excess of $600 million. (TR 44, 208).

proposal to lift the suspension of its GCR clause effective April 1, 2001 be adopted only if MichCon guarantees that sales rate customers, including GCC customers, will pay no more than $2.95 per Mcf during the last nine months of 2001. MichCon submits that the $2.95 per Mcf price guaranty recommended by the AG and Staff is patently unfair and wholly unjustified.

MichCon is committed to minimizing any negative financial impact on customers that may flow from an early return to the GCR process. As Mr. Stanczak testified, MichCon will implement a volumetric credit to provide all customers, including GCC customers, the benefit of the net gain on the sale of cashed-out contracts currently included in MichCon's 2001 gas supply portfolio. (TR 49-50). Further, and equally as important, MichCon will, if necessary, refund up to the gross margin earned on its gas sales while the $2.95 per Mcf rate was in effect.[8] (TR 51-52). The net effect of MichCon's cash-out and gross margin refund proposals, in conjunction with MichCon's plan to decrement storage in the event prices or throughput increase, will in all likelihood eliminate the prospect that customers will pay more than $2.95 per Mcf during the last nine months of 2001. (TR 52)

The suggestion that MichCon guaranty a $2.95 per Mcf price through December 2001 also ignores a salient feature of the GCC program, the income sharing mechanism. Under MichCon's GCC program the Company is required to share with customers a portion of its gas sales income above certain target levels. Though MichCon never achieved the income sharing target levels under the GCC program, MichCon is prepared to refund all of its gross margin from GCC program gas sales if necessary to mitigate any potential financial consequence that may flow from its proposal. These proposals demonstrate MichCon's commitment to its customers' financial well being. Imposition of a guaranty requirement as a condition of approving MichCon's application amounts to nothing more than a penalty for offering customers a choice.

B. MichCon's GCC Program Has Produced Significant Customer Savings

The significant customer savings achieved under MichCon's GCC program represent an equally compelling reason for rejecting the guaranty recommended by the AG and Staff. During the first two years in which MichCon charged its fixed $2.95 per Mcf rate, customers saved in excess of $200 million over the cost they would have paid had MichCon's GCR remained in effect.[9] (TR 43). For the period January through December 2001, MichCon estimates that customer savings under its GCC program will approach $500 million. (TR 44). MichCon's estimates are consistent with those offered by the Commission in its own analysis of customer savings under MichCon's GCC program. (TR 44, 208).

It is patently clear from MichCon's and the Commission's independent analyses that customers have not "suffered" under the GCC program. To the contrary, they have saved significant sums. Conversely, if MichCon returns its gross sales margin to customers, MichCon will be in the same no profit, no loss position it would have occupied had its GCR clause remained in effect. Comparing the relative economic positions of MichCon and customers, it is the customers who are financially advantaged. The recommendation that MichCon be penalized for helping achieve that result is simply unwarranted and the recommendation should be rejected.

C. Competitive Pricing Should Be Promoted, Not Precluded, In This Case

A Commission order directing MichCon to continue its fixed $2.95 per Mcf price for the last nine months of 2001 will have a detrimental effect on competition. Energy America witness Mr. McDonald testified that in such circumstances marketers will be unable to compete with MichCon based on price and will either suspend further marketing efforts in MichCon's service territory or simply abandon the GCC program altogether. (TR 79-80). Moreover, if MichCon's

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[8] The potential refund amount is currently estimated to be approximately $70 million. (TR 145).

cash-out credit and gross margin refund are made to MichCon's sales customers only, that circumstance may prompt GCC program participants to seek any means at their disposal to return to MichCon's sales service solely for the sake of the guaranty. (TR 61). Neither result furthers the Commission's efforts to extend the benefits of gas customer choice to Michigan consumers.

Under ideal circumstances, the cash-out credit proposed by MichCon would be made available only to MichCon's sales customers. However, as Mr. Stanczak testified, precluding GCC program customers from obtaining the credit would likely prevent customers from enrolling in the GCC program or induce existing GCC customers to leave the program. (TR 61). MichCon is, of course, open to other approaches. But to date, no party has offered an acceptable alternative.

D. Customers Will Be Reliably Served Under MichCon's Proposal

RRC witness Mr. Hollewa was highly critical of MichCon's proposal to decrement storage if such action was necessary to offset increases in gas prices and/or throughput. Mr. Hollewa claimed that it was impossible to decrement storage without jeopardizing system integrity for design day purposes. (TR 119). Cross-examination of Mr. Hollewa revealed that his claim was unfounded. Mr. Hollewa admitted that his assertion about a threat to system integrity under design day conditions was based upon a number of assumed operating conditions reflected in past and current MichCon GCR plan case filings. (TR 126, Exh. A-5). When asked about the physical realities of decrementing storage Mr. Hollewa acknowledged that a storage decrement would have no operational consequence if, for example, MichCon increased flowing supplies to offset storage withdrawals. (TR 127). MichCon has a number of available options

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[9] AG witness Mr. Miller claims this figure is a "gross overstatement". Yet when asked to substantiate his claim Mr. Miller admitted that he had no support for it. (TR 187-188, Exh. A-9).

for ensuring reliable service to its customers. (TR 128). The suggestion that the exercise of one such option would jeopardize reliability is simply unfounded, and should be ignored.

V. Conclusion

A stated goal of the Commission's gas customer choice efforts to date has been to extend the benefits of choice to all residents in the State of Michigan. That goal will never be achieved if the Commission adopts recommendations that incent Michigan consumers to remain gas sales customers of their incumbent utility. The Commission can only achieve its stated goal by taking affirmative action to promote competitive pricing of the gas sales commodity. MichCon's proposal in this case accomplishes that result. The relevant evidence in this case demonstrates that terminating MichCon's $2.95 per Mcf rate should attract marketers to Michigan, thereby stimulating competition for customers in MichCon's GCC program. (TR 79-80). The evidence also shows that customers will benefit if MichCon's application is approved. There will be less customer confusion, more competition based on price, and a smoother transition from fixed to competitive pricing than would otherwise occur in January 2002. (TR 78-79). Conversely, denial of MichCon's application will have an adverse effect on competition and the success of gas customer choice, thereby frustrating the Commission's goal of extending choice to all consumers in the State of Michigan. MichCon urges the Commission to promote competition, not preclude it. The Commission can ensure that result by granting MichCon's application in this case.

Respectfully submitted,

MICHIGAN CONSOLIDATED GAS COMPANY

By: ______________________

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Its Attorney

Dated: March 2, 2001

STATE OF MICHIGAN

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In the matter of the application of MICHIGAN CONSOLIDATED GAS COMPANY to terminate the suspension of its gas cost recovery clause and establish a cashout mechanism	)))))	Case No. U-12762 (e-file)

CERTIFICATE OF SERVICE

I hereby certify that I have caused copies of the Initial Brief of Michigan Consolidated Gas Company to be served upon all counsel of record in this case by electronic mail.

David C. Champion

Dated: March 2, 2001