132

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 (efile)

MICHIGAN PUBLIC SERVICE COMMISSION

FEB 14 2001

FILED

TESTIMONY AND EXHIBITS

OF

RALPH E. MILLER

ON BEHALF OF THE MICHIGAN ATTORNEY GENERAL

February 14, 2001

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

A. My name is Ralph E. Miller. I am an independent consulting economist. My office is at 5502 Western Avenue, Chevy Chase, Maryland 20815.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL QUALIFICATIONS.

A. I am an economist specializing in the fields of utility regulation, industrial organization, and public policy towards business. I have more than thirty years of experience in public utility and related energy work, both as a consultant and in government. I am the author of several published reports and papers on public utility economics and energy matters, and I have testified in more than 30 different jurisdictions in a total of more than 250 public utility and other proceedings. I also have several additional years of experience in government and as a university teacher in antitrust, energy demand forecasting and supply analysis, and other areas of economics and energy.

Over the years, I have addressed almost all the aspects of gas and electric utility regulation, including rate of return, accounting and revenue requirements, rate design and cost of service, electric fuel and purchased gas cost recovery, industry structure and the role of competition, incentive ratemaking and other types of innovative rate designs, gas and electric supply planning and power plant licensing, productivity and efficiency, and the determination of marginal, incremental, and avoidable costs.

Q. **WHAT IS YOUR EMPLOYMENT EXPERIENCE?**

A. I have been an independent consultant for more than fifteen years. I also have ten years of experience as president or executive vice president of two different consulting firms specializing in public utility and energy matters. Before that, I spent three years in the federal government, where I was employed in positions at the Federal Power Commission, the Antitrust Division of the U.S. Department of Justice, and the Federal Energy Administration. I was on the faculty of the University of California for three years, where I taught economics courses at both the graduate and undergraduate levels.

Q. **PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

A. I did my undergraduate work at Harvard College, where I received the A.B. degree *summa cum laude* in mathematics in 1961, and I was elected to Phi Beta Kappa. I then went on to graduate work in economics at Harvard, where I received a Master's degree in 1963. I continued my graduate studies there until 1966, and I completed all of the course requirements for the Ph.D. degree, but not a doctoral dissertation.

Q. **WHAT IS YOUR EXPERIENCE IN THE SPECIFIC AREA OF GAS SUPPLY PLANNING AND GAS COST RECOVERY?**

A. Much of my work during the past 20 years has been in this area. I have reviewed the gas supply planning and/or gas cost recovery arrangements of more than 15 gas distribution companies (GDCs) in numerous regulatory proceedings in seven states, and I have extensive experience in gas pipeline cases at the FERC.

Beginning in 1981, I analyzed the way Southern Union Gas Company acquired gas supplies for its New Mexico distribution system, and I testified on aspects of this subject in U.S. District Court in 1982.

At the FERC, I reviewed requests by three interstate pipelines for recovery of take-or-pay buyout and contract reformation costs under Order No. 500. This work was done on behalf of customers of the pipelines or their representatives. It included detailed analysis of the gas purchase contracts and other materials obtained in the discovery process. I also testified in many pipeline rate proceedings and two pipeline gas inventory charge (GIC) proceedings, and I reviewed the gas supply restructuring plans proposed by two pipelines as part of their Order 636 compliance.

At the state level, I (along with one or more colleagues) have performed many management/performance audits of the gas purchasing practices and policies of the gas distribution companies in Ohio. These reports have audited three of the major LDCs in Ohio, as well as two smaller gas utilities that relied to a large extent on purchases of local production for their system gas supplies.

Here in Michigan, I have reviewed and testified on the gas supply plans and gas cost recovery (GCR) reconciliations of Michigan Consolidated Gas Company (MichCon) and Consumers Energy Company (Consumers) in each year from 1988 until the GCR clauses for these two gas utilities were suspended three years ago. In some years, I have also reviewed and testified on the gas supply plans and GCR reconciliations of Michigan Gas Utilities (MGU) and SEMCO Energy Gas Company.

In New Jersey, I participated in the levelized gas adjustment clause (LGAC) proceedings as a consultant to the Ratepayer Advocate (or its predecessor, the Public Advocate) for ten years. During this period I reviewed the LGAC filings and gas supply planning of all four of the New Jersey LDCs. I also participated extensively in the consideration of gas cost recovery issues in the unbundling proceedings and base rate cases of the New Jersey LDCs.

In Maryland, I have for more than 20 years been reviewing the gas supply planning and gas purchases of several Maryland utilities, including Baltimore Gas and Electric Company ("BGE") and Washington Gas Light Company, in a variety of proceedings in which I have worked on behalf of Maryland People's Counsel. Other states in which I have done similar work include Pennsylvania, Nevada, and Utah.

Q. IS ANY OF YOUR EXPERIENCE IN CASES PERTAINING TO THE DESIGN OF PURCHASED GAS OR ELECTRIC FUEL ADJUSTMENT MECHANISMS?

A. Yes. In the late 1970s there was extensive interest in this topic, as the so-called "energy crisis" drove natural gas and electric fuel prices up rapidly. The activity in this area continued into the early 1980s in response to the federal Public Utility Regulatory

Policies Act (PURPA). During this period, I testified in four states in proceedings whose focus was the generic issue of how purchased gas charges or electric fuel rates should best be adjusted to reflect changing market conditions and provide utilities with a reasonable opportunity to recover their prudently incurred fuel or gas costs. My work in these generic proceedings was in addition to my testimony on the purchased gas or electric fuel costs of numerous individual utilities. I was also the principal author of a three-volume report on *Automatic and Discretionary Adjustment Procedures for Electric Utility Rates,* prepared under contract from and published in 1979 by the Experimental Technology Incentives Program of the U.S. Department of Commerce.

Q. **WHAT IS YOUR EXPERIENCE IN THE ANALYSIS OF COMPETITION AND MARKET STRUCTURE, ESPECIALLY AS IT RELATES TO THE GAS INDUSTRY AND THE UNBUNDLING OF GAS SUPPLY?**

A. As I stated in the summary of my professional qualifications, one of my areas of specialization in economics is industrial organization, and that field encompasses the analysis of competition and market structure. My work in this area has included a year in the Antitrust Division of the U.S. Department of Justice and extensive consulting experience in antitrust and related market structure cases. I have addressed the issues of gas supply competition and gas industry market structure in my work on gas rate design cases. Including collaboratives and roundtables as well as proceedings which were settled prior to hearing, I have worked on more than 30 gas rate design cases involving more than a dozen different LDCs in nine states. In recent years, all of these proceedings have involved unbundling issues and delivery or transportation service in addition to conventional gas sales. My experience in this area goes all the way back to the mid-1980s, when LDCs first began introducing gas transportation programs for their largest customers in response to FERC Order 436. More recently, I have participated in all phases of the comprehensive unbundling proceedings involving all four gas utilities in New Jersey from 1994, when they began, until 1999, and I submitted testimony there in 1999 in the unbundling proceedings under the New Jersey Electric Discount and Energy Competition Act. In Maryland, I have participated in the gas roundtables for Washington Gas and Baltimore Gas and Electric Company, as well as those for several smaller gas utilities. In Pennsylvania, I submitted testimony in 1999 and 2000 on behalf of the Office of Consumer Advocate in the restructuring proceedings of four of that state's gas utilities under Pennsylvania's Natural Gas Choice and Competition Act. I also testified as a witness for the Georgia PSC staff in Atlanta Gas Light Company's comprehensive unbundling case, and I was one of the principal consultants to the Delaware PSC staff in the 1995 gas service restructuring by Delmarva Power & Light Company (now Conectiv). In addition, I have extensive experience with unbundling and transportation issues at FERC, including participation in several of the pipeline unbundling proceedings pursuant to FERC Order 636. Here in Michigan, I participated in the collaborative activities in Case No. U-12550, and I have also testified on gas transportation issues in two base rate cases.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. I have been asked by the Michigan Department of Attorney General to make an independent analysis of the application by MichCon for an early termination of the suspension of its GCR clause, and also for a cash-out mechanism applicable to its remaining gas purchase contracts obtained in connection with that suspension.

Q. IS YOUR TESTIMONY SUPPORTED BY EXHIBITS?

A. Yes. I have prepared Exhibits I-6 (REM-1) through I-8 (REM-3) to support this testimony.

Q. WOULD YOU SUMMARIZE THE CONCLUSIONS YOU HAVE REACHED AS A RESULT OF YOUR ANALYSIS OF MICHCON'S APPLICATION IN THIS PROCEEDING?

A. Yes. I have reached the following conclusions:

(1) MichCon's application for early termination of its GCR suspension should be denied.

(2) Early termination of the GCR suspension will not promote gas supply competition in Michigan. It will not lead to increased gas supply competition during the last nine months of 2001, except perhaps at the expense of MichCon's customers who would be forced to pay more than $2.95 per Mcf for their gas purchases during this period. Also, moving the termination date of the GCR suspension up from December 2001 to March 2001 will not provide any benefits for competition in 2002 and beyond.

(3) MichCon's witness Don M. Stanczak proposes a "Gross Margin Refund Mechanism" as part of its plan for early termination of the GCR suspension. This proposal includes a cap on the amount that could be refunded to customers under this mechanism. If the Commission approves MichCon's request for early termination, then this cap should be removed. Removal of the cap is needed to protect customers against the risk that they may have to pay more than the promised price of $2.95 per Mcf for the gas they purchase during the last nine months of 2001.

(4) Another aspect of MichCon's plan for early termination of the GCR suspension is to cash-out the Company's existing contracts to purchase 76.5 Bcf of gas during the last nine months of 2001 at fixed prices. MichCon is proposing to distribute the proceeds of this cash-out to its customers during the 12-month period from April 2001 through March 2002. If the Commission approves MichCon's request for early termination of its GCR suspension, then the cash-out proceeds should be returned to customers during the last nine months of 2001, which is the period from which the cash-out proceeds are derived.

(5) If the Commission approves MichCon's request for early termination of its GCR suspension, then the Commission should state clearly in its order that early termination will not constitute a basis for any change in MichCon's "annual LIFO" method of accounting for its gas storage activities. Any such change could enrich MichCon and its shareholders by as much as $120 million, at the expense of MichCon's customers, and it alone would be more than sufficient grounds for rejecting the entire proposal to terminate the GCR suspension nine months early.

141

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. I begin with a brief discussion of the criteria appropriate for evaluating MichCon's proposal for an early termination of the suspension of its GCR clause.

I then continue with a somewhat lengthy exploration of the way MichCon's proposals would actually operate, if approved by the Commission. This exploration is necessary because MichCon's application and the supporting testimony of Mr. Stanczak fail to address many of the important questions of what would actually happen if the proposal is adopted, and also because Mr. Stanczak's testimony and exhibits contain a major error which distorts his presentation of the issues he does address. The most important information missing from MichCon's filing is a presentation showing the rates that customers would pay under MichCon's proposal. My analysis shows that MichCon's proposal would result in a very large rate increase in April 2001 and – contrary to the view stated by Mr. Stanczak – it is likely that MichCon's proposal would cause customers to pay more than $2.95 for their gas purchases in 2001, even after all of the credits included by MichCon in its proposal.

After I have completed my discussion of the way MichCon's proposal would operate, I present my evaluation of this proposal. In my evaluation, I identify two principal problems with MichCon's proposal, and I explain that the best way to address these problems is simply to reject the proposal in its entirety. However, I also continue with a discussion of the possibilities for addressing these problems by changing the structure of MichCon's proposed program.

In the next section of my testimony, I demonstrate that there is no merit to the Company's claim that early termination of the GCR suspension is needed to promote gas supply competition. The last section of my testimony is my analysis of MichCon's projected gas costs for 2001, in which I show that MichCon's proposal is likely to force customers to pay more than $2.95 per Mcf for gas purchased in 2001 unless the proposal is rejected or modified as I recommend.

Criteria for Evaluating MichCon's Proposals

Q. **WHAT CRITERIA SHOULD BE USED IN EVALUATING MICHCON'S APPLICATION FOR EARLY TERMINATION OF THE GCR SUSPENSION?**

A. The most important criterion, by far, is whether early termination will permit MichCon's gas sales customers to receive the full benefit of the gas price of $2.95 per Mcf that was promised to them for three years when the GCR suspension was approved in Case No. U-11682.

Q. **HAS MICHCON IDENTIFIED OTHER CRITERIA THAT IT CONSIDERS RELEVANT TO THIS EVALUATION?**

A. Yes. MichCon's application and the prepared testimony of its only witness in this proceeding, Don M. Stanczak, together identify three other factors that they claim are relevant to this evaluation. One is the promotion of gas supply competition. The second is cushioning the rate shock that MichCon claims will occur in January 2002 if the suspension is not terminated early. The third is the achievement of greater uniformity between the Customer Choice programs of MichCon and Consumers Energy.

Q. **DO YOU AGREE WITH THE COMPANY'S VIEW THAT THESE CRITERIA ARE IMPORTANT?**

A. No. I agree that the first two of the Company's three criteria are relevant to an evaluation of the application for early termination, but they are much less important than assuring gas sales customers the full benefit of the $2.95 price they were promised. The third criterion is not even relevant to this application because early termination of the GCR suspension has no bearing on the uniformity set forth in the Commission's order in Case No. U-12550, where the structure of the Customer Choice programs was addressed.

Q. **WHY IS IT OF PARAMOUNT IMPORTANCE THAT MICHCON'S CUSTOMERS RECEIVE THE BENEFIT OF MICHCON'S $2.95 GAS PRICE FOR THE FULL 36 MONTHS IT WAS PROMISED TO THEM?**

A. MichCon's GCR clause was in effect for fifteen years until it was suspended at the end of 1998, pursuant to MichCon's application approved by the Commission in Case No. U-11682. Under the GCR clause, MichCon's gas supply rates to its gas sales customers were cost-based. They recovered MichCon's reasonably and prudently incurred actual gas costs, but no more.

In contrast, the fixed gas supply price of $2.95 per Mcf established in Case No. U-11682 is not and never was a cost-based rate. MichCon's application in Case No. U-11682 did not even claim that the proposed rate of $2.95 was based on MichCon's expected gas costs for the period 1999-2001, when the rate was to be in effect. The $2.95 rate was designed instead to provide MichCon with an assured profit of many millions of dollars from its gas supply activities. It exceeded MichCon's own projections of its gas costs for the years 1999-2001 by $0.35 per Mcf, which translates into a margin of approximately $70 million per year. And MichCon was able to lock in a large fraction of this planned gas supply profit margin by entering into fixed price gas purchase contracts for the approved three-year period of the GCR suspension.

MichCon was able to institute this $2.95 rate in excess of its projected gas costs because it sought and received a suspension of its GCR clause at a time when natural gas prices were declining. The regulatory justification for this $2.95 rate was that it was not a rate increase, and it did not have to be cost-based because it was not higher than the rate then in effect. By obtaining a suspension of its GCR clause at a time when gas prices were declining, MichCon could keep the resultant gas cost savings for itself and its shareholders, instead of passing them on to its customers in the form of lower rates under the cost-based GCR procedure.

MichCon's customers have already suffered once, because MichCon was permitted to suspend its GCR clause and fix its gas supply price at $2.95 per Mcf at a time when its actual gas costs were declining from that level. It would be double jeopardy for the customers now to be facing an increase in their gas costs, even before the three-year term of the original GCR clause suspension has been completed, because gas costs have now risen above the promised gas supply price of $2.95. MichCon should not be permitted to increase its gas charges to reflect higher costs at times when costs are increasing, but also to refrain from decreasing its gas charges to reflect lower costs at times when costs are decreasing.

How MichCon's Proposal Would Operate

Q. **DOES MICHCON'S PROPOSAL FOR THE EARLY TERMINATION OF ITS GCR SUSPENSION ASSURE CUSTOMERS THAT WILL RECEIVE THE BENEFIT OF THE PROMISED $2.95 PRICE FOR THE ENTIRE PERIOD THROUGH DECEMBER 2001?**

A. No, it does not. MichCon's proposal is structured so that "heads, the Company wins; and tails, the customers lose."

MichCon's actual gas costs during 1999 and 2000 were far less than the fixed gas commodity rate of $2.95, and MichCon realized $70 million of profit from its gas supply activities during these two years. (*The $70 million includes an amount for 2000 that was provided by MichCon in response to a discovery request. The discovery response includes a note that the amount for 2000 is confidential and unaudited financial information. It also states that unauthorized use or disclosure of this information may violate federal securities laws. However, the response was provided by MichCon without a formal request for confidential treatment.*) Under MichCon's proposal, if gas costs in

2001 remain sufficiently favorable, then customers will continue to pay the fixed gas commodity charge of $2.95 per Mcf, as they were promised, and MichCon will retain all or much of the $70 million it obtained by charging an above-cost rate in 1999 and 2000. This scenario is the "heads, MichCon wins" aspect of the Company's proposal.

If gas costs in 2001 turn out to be less favorable, then MichCon will have to return some of the $70 million profit from 1999 and 2000 to its customers in 2001, to keep the net costs to customers at the $2.95 level. But if gas costs in 2001 are so high that the entire $70 million of gas supply profits accumulated by MichCon in 1999 and 2000 is not sufficient to keep the costs for customers at $2.95 per Mcf, then it is the customers and not MichCon who would be at risk under MichCon's proposal. This scenario is the "tails, the customers lose" aspect of the Company's proposal.

In short, under MichCon's proposal, customers cannot end up paying less than $2.95 for their gas commodity purchases in 2001, but they can end up paying more.

Q. **SUPPOSE MICHCON'S PROPOSAL IS ACCEPTED. WHAT GAS SUPPLY PRICE WOULD CUSTOMERS PAY DURING THE LAST NINE MONTHS OF 2001?**

A. They would pay the GCR rate for the "stub" period April through December 2001, less a credit to distribute the proceeds from MichCon's proposed cash-out of its fixed price contracts for this period. Both of these rates depend upon gas prices. If MichCon's fixed price gas purchase contracts are cashed out at the NYMEX prices used by MichCon in developing its GCR plan for the stub period, then the gas price charged during the last nine months of 2001 would be $4.26 per Mcf. This gas price is the GCR rate of $5.17 per Mcf proposed by MichCon in its GCR plan for the stub period, Case No. U-12766, less a cash-out credit of $0.91 per Mcf.

Q. HOW DID YOU DETERMINE THE RATE FOR THE CASH-OUT CREDIT?

A. I accepted the testimony of Mr. Stanczak that the aggregate market value of the cash-outs is $181 million at the NYMEX prices used in MichCon's GCR plan for the stub period, as shown in his Exhibit A-2(DMS-2). I divided this amount by 198.1 Bcf of rate schedule sales to obtain the unit rate of $0.91 per Mcf.

Q. WHY DID YOU SPREAD THE $181 MILLION OF CASH-OUT VALUE OVER 198.1 BCF OF RATE SCHEDULE SALES?

A. According to the testimony of Mr. Stanczak, MichCon proposes to distribute the cash-out proceeds to all of its sales rate schedule customers by means of a volumetric credit during the 12-month period April 2001 through March 2002. In its GCR plan for the stub period, MichCon is projecting 198.1 Bcf of total rate schedule sales for this 12-month period, as shown in Exhibit A-___(DRK-8) of the U-12766 filing. The 198.1 Bcf total consists of 100,254 MMCF for the last nine months of 2001, plus 97,879 MMCF for the first three months of 2002. These quantities are MichCon's own projection of the sales volumes over which the proposed cash-out credit would be returned to customers.

Q. ARE THE NYMEX PRICES USED BY MICHCON TO DEVELOP ITS GCR PLAN FOR THE LAST NINE MONTHS OF 2001 A REALISTIC ESTIMATE OF THE GAS COSTS MICHCON WILL ACTUALLY INCUR DURING THAT PERIOD?

A. No, they are not realistic in relation to the current NYMEX gas futures market. The NYMEX prices used by MichCon for its GCR plan are $4.70 per Dth for the months April through October 2001, and $4.55 per Mcf for November and December, as shown by Mr. Stanczak in his Exhibit A-2 (DMS-2). However, for the entire period from January 1 through February 9, 2001 (the latest data available for the preparation of this testimony), the NYMEX prices for the summer months April through October have remained at or above $5.25, except for one day (January 31) when they fell briefly to near $5.10. On some days during this period, these NYMEX prices have been as high as $6.00 per Dth. During this same period, the NYMEX prices for November and December 2001 have been even higher. Current NYMEX prices for the last nine months of 2001 are therefore at least 60 cents per Dth higher than those used by MichCon in its GCR plan, and the average NYMEX level for the past six weeks has been approximately $1.00 per Dth higher than the GCR plan prices.

Q. HOW WOULD THE PRICES TO BE PAID BY CUSTOMERS UNDER MICHCON'S EARLY TERMINATION PROPOSAL BE AFFECTED BY NYMEX PRICES 60 CENTS OR $1.00 PER DTH HIGHER THAN IN MICHCONS GCR PLAN?

A. The prices paid by customers would also be higher. If the gas prices in the GCR forecast and those used to cash-out the fixed price contracts both rise by 60 cents per Dth, the net gas commodity price paid by customers would be $4.63 per Mcf, or 37 cents higher than the rate of $4.26 based on the NYMEX prices in MichCon's GCR plan as filed. If NYMEX gas prices are $1.00 higher than those in the GCR plan as filed, the net gas commodity charge rate paid by customers would be $4.87, or 51 cents higher than one based on the NYMEX prices in the GCR plan as filed. Exhibit I-_6_(REM-1) summarizes these results.

Q. HOW DID YOU CALCULATE THESE PRICE DIFFERENCES?

A. MichCon's GCR plan includes a quarterly contingent factor, like the one approved by the Commission in MichCon's 1998 GCR plan, Case No. U-11455. With this contingent factor, MichCon will review the NYMEX prices in late March, prior to implementing its GCR factor for April. If the NYMEX prices for the last nine months of 2001 are 60 cents higher in late March than the NYMEX prices used to develop the GCR plan, the authorized GCR factor would increase by 60 cents per Mcf, to $5.77 per Mcf. If the NYMEX prices are $1.00 per Dth higher than those used in the GCR plan, the authorized

150

GCR factor would increase by $1.00 per Mcf, to $6.17 per Mcf. This changes are shown in the first column of Exhibit I-6 (REM-1).

Q. WOULD THE CASH-OUT CREDITS ALSO INCREASE?

A. If the cash-outs are made at these higher NYMEX prices, then the cash-out credits would also increase, but the increase in the cash-out credits would be much less than the increase in the GCR factor. If the NYMEX prices are 60 cents per Dth higher than in MichCon's GCR plan, the cash-out credit would increase by only 23 cents, to $1.14 per Mcf. If the NYMEX prices are $1.00 higher than those in MichCon's GCR plan, the cash-out credit would increase by only 39 cents, to $1.30 per Mcf.

Q. WHY IS THE INCREASE IN THE CASH-OUT CREDIT SO MUCH LESS THAN ANY INCREASE IN THE NYMEX PRICES?

A. The cash-out credit is derived from MichCon's existing contracts to purchase 76.5 million Dth at fixed prices, but MichCon is proposing to spread the total dollar amount of that credit across 198.1 Bcf of sales volumes. A $1.00 per Dth increase in the cash-out prices provides $76.5 million of aggregate cash-out credits, but the amount is only 39 cents per Mcf because that $76.5 million is spread over a sales volume that is almost three times as large as the 76.5 million Dth MichCon has under fixed price contracts.

Q. WHERE WILL MICHCON'S CUSTOMERS STAND AT THE END OF 2001, IF MICHCON'S PROPOSAL IS ADOPTED?

A. In the base case, which reflects the NYMEX prices in MichCon's GCR plan as filed, customers will be paying a net gas commodity price of $4.26 per Mcf during the last nine months of 2001, or $1.31 per Mcf more than the $2.95 price promised under the GCR suspension. If GCR sales during this period match MichCon's forecast of 82 Bcf, which Mr. Stanczak identifies at line 2 of his Exhibit A-3(DMS-3), then the GCR sales customers will have paid $107 million more than the promised rate of $2.95. If the NYMEX gas prices are higher than those in MichCon's GCR plan, then the net gas commodity rates paid by MichCon's customers will be more $1.31 per Mcf above the promised price of $2.95, and the excess payments by GCR sales customers will exceed the base case amount of $107 million.

Q. HOW DID YOU CALCULATE THIS PAYMENT OF $107 MILLION MORE THAN THE PROMISED RATE OF $2.95 PER MCF?

A. MichCon's filed GCR rate of $5.17 per Mcf will have collected $2.22 per Mcf more than the promised $2.95, or a total of $182 million as shown at line 7 in the Base Case column of Mr. Stanczak's Exhibit A-3(DMS-3). The GCR sales customers will also have received cash-out credits of $75 million at the cash-out credit rate of $0.91 that I have explained. The net of these two amounts is a cost of $107 million over the $2.95 rate.

Q. WHY IS THIS CREDIT OF $75 MILLION IN YOUR ANALYSIS SO MUCH LESS THAN THE $181 MILLION SHOWN BY MR. STANCZAK AT LINE 8 OF EXHIBIT A-___(DMS-3)?

A. There are two reasons. First, Mr. Stanczak has made a major analytical error in developing his Exhibit A-_3_(DMS-3). There he attributes the entire $181 million of cash-out credits from his Exhibit A-_3_(DMS-2) to the 82 Bcf of GCR sales that MichCon is projecting for the last nine months of 2001. However, MichCon's own proposal – which Mr. Stanczak himself discusses at pages 10-11 of his prepared testimony – is to distribute the cash-out credits to all of MichCon's sales rate schedule customers, including those in the GCC program as well as those actually purchasing GCR sales gas. Some of the $181 million of base case cash-out credits will therefore be diverted to GCC customers, leaving less for the GCR sales customers and their 82 Bcf of base case projected purchases.

Q. HAVE YOU DETERMINED HOW MUCH OF THE $181 MILLION OF BASE CASE CASH-OUT CREDITS WOULD GO TO GCC CUSTOMERS?

A. Yes. Under MichCon's proposal, the cash-out credit will be distributed volumetrically to all sales rate schedule customers. In its GCR plan, which is the basis for Mr. Stanczak's own base case analysis, MichCon is projecting GCC volumes of 18 Bcf during the last nine months of 2001. The combination of this 18 Bcf of GCC volumes with the 82 Bcf of GCR sales yields total sales rate schedule throughput of 100 Bcf during this period. The GCC volume of 18 Bcf is 18% of the total throughput, and it will therefore receive

18% of the $181 million of base case cash-out credits, or $$33 million. In consequence, only $148 million of the cash-out proceeds will be available for the 82 Bcf of GCR sales.

Q. WHAT IS THE SECOND REASON FOR THE DIFFERENCE BETWEEN THE $75 MILLION OF BASE CASE CASH-OUT CREDITS IN YOUR ANALYSIS AND THE MUCH LARGER AMOUNT SHOWN BY MR. STANCZAK IN EXHIBIT A-3 (DMS-3)?

A. The second difference is that Mr. Stanczak's Exhibit A-3 (DMS-3) is designed to reflect the total amount of base case cash-out credits that GCR sales customers would eventually receive, whereas the $75 million in my analysis is the amount of base case cash-out credits that GCR sales customers would actually receive in the last nine months of 2001 under MichCon's proposal. The GCR customers would eventually receive $148 million of base case cash-out credits, as I have just explained, but MichCon's proposal is to spread these credits out over the 12 months April 2001 through March 2002. Because almost half of MichCon's annual throughput occurs in the first three months of each calendar year, GCR customers would receive only slightly more than half of the $148 million in the last nine months of 2001, which I have calculated more precisely as $75 million.

15-4

Q. WHAT WOULD HAPPEN TO MICHCON'S GAS COMMODITY CHARGE RATES IN 2002 UNDER MICHCON'S PROPOSAL, AND SPECIFICALLY UNDER THE ASSUMPTIONS IN MICHCON'S BASE CASE?

A. The GCR rate would be subject to change, because January 2002 would be the beginning of a new GCR year. However, the cash-out credit would continue unchanged for the first three months of 2002 under MichCon's proposal, and in the base case it would remain at a rate of $0.91 per Mcf. While it remained in effect, the cash-out credit would enable customers to continue paying a net gas commodity charge rate less than MichCon's current year gas supply costs. Under MichCon's proposed program design, the credit would last through March 2002, at which time it would have returned the full amount of cash-out proceeds obtained by MichCon. Under MichCon's base case assumptions, the credit would return a further $73 million during these three months to the GCR sales customers whose base case net gas costs in 2001 exceeded the fixed price of $2.95 by $107 million. When the cash-out credit expired at the end of March 2002, these customers would then still have paid $34 million more than the promised rate of $2.95 per Mcf for their gas purchases in 2001.

Q. DOES MICHCON'S PROPOSAL INCLUDE ANY FURTHER ARRANGEMENTS TO ENABLE CUSTOMERS TO ACHIEVE THE PROMISED COST LEVEL OF $2.95?

A. Yes. MichCon is also proposing to refund additional amounts that may be required to achieve the promised cost level of $2.95 per Mcf, but only to the extent of the gas supply

155

profits it has recorded during 1999, 2000, and the first three months of 2001 when the $2.95 rate was in effect. To accomplish this additional refund, MichCon would provide a volumetric credit at a rate equal to the cash-out credit rate ($0.91 per Mcf in the base case), beginning immediately upon the termination of the cash-out credit. For convenience in exposition, I shall refer to this further refund as the "reconciliation credit."

Q. HOW LONG WOULD THIS RECONCILIATION CREDIT HAVE TO RUN IN THE BASE CASE, TO REFUND THE REMAINING $34 MILLION OF NET GAS CHARGES TO THE GCR SALES CUSTOMERS ABOVE THE PROMISED RATE OF $2.95?

A. Under MichCon's base case assumptions, it would have to run through August 2002 and into part of September.

Q. HOW DID YOU DETERMINE THE TIME PERIOD THAT THE RECONCILIATION CREDIT WOULD HAVE TO RUN?

A. MichCon's proposal is to use a reconciliation credit at the same rate as the cash-out credit, which is $0.91 per Mcf in the base case. To refund $34 million at this rate, the credit would have to be applied to a volume of 37 Bcf. According to the five-year forecast included in MichCon's GCR plan for the last nine months of 2001, if the credit to GCR sales customers began in April 2002, it would have to run through August and part of September to achieve the volume of 37 Bcf.