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Q. IS THIS $34 MILLION THE TOTAL AMOUNT THAT MICHCON WOULD HAVE TO REFUND TO ITS CUSTOMERS TO COMPLETE THE RECONCILIATION CREDIT UNDER THE BASE CASE ASSUMPTIONS?

A. No, MichCon would have to refund a much larger amount. The reason is that MichCon is proposing to provide the reconciliation credit (or gross margin refund) to its GCC customers as well as its GCR sales customers, as indicated in the Company's response to question 1 in New Power's First Discovery Request, and $34 million is the amount that would be refunded only to the GCR sales customers. Application of the base case reconciliation refund rate of $0.91 per Mcf to all of the sales rate schedule volumes projected by MichCon for the period April through August 2002, including the projected 13 Bcf of GCC volumes during this period, would result in total refunds of $46 million.

<u>Evaluation of MichCon's Proposal</u>

Q. NOW THAT YOU HAVE EXPLORED IN MORE DETAIL THE WAY MICHCON'S PROPOSAL WOULD ACTUALLY OPERATE, WOULD YOU SUMMARIZE THE DEFECTS THAT YOU HAVE IDENTIFIED IN YOUR ANALYSIS OF THIS PROPOSAL?

A. I have identified two principal defects. First, if MichCon's proposal is adopted, then it is likely that customers will pay many millions of dollars more than the promised price of $2.95 per Mcf for gas purchased from MichCon in the last nine months of 2001. Customers will end up paying more than $2.95 because it is likely that the combination of

MichCon's proposed cash-out credits and the additional "reconciliation" refund of gross margins will together be less than the difference between the GCR rate for the last nine months of 2001 and the promised $2.95 price. I shall explain the basis for this conclusion in a separate section, later in my testimony.

The second defect in MichCon's proposal is the timing of the effective gas commodity rate changes that would result if it is implemented. There would be an immediate rate increase of $1.31 per Mcf in April 2001 under MichCon's own base case assumptions, and a larger increase with more realistic NYMEX prices. This immediate rate increase would provide an over-collection of much more than $100 million above the promised gas price of $2.95 for the last nine months of 2001. Then, in January 2002, the gas commodity price paid by MichCon's customers would decrease if – as appears likely – MichCon's gas supply costs are less in 2002 than for the last nine months of 2001. This lower rate would continue at least until the cash-out credits are exhausted in March 2002, and it would continue even longer if there is a "reconciliation" refund. If the reconciliation refund is large enough to achieve the promised gas price of $2.95 for the last nine months of 2001, then it would be likely to have to run through most of the summer of 2002 under MichCon's pricing plan. At that time, when the last of the refunds was completed, the effective gas commodity price would again increase.

Q. **WHY DO YOU OPPOSE THIS TIMING PATTERN?**

A. There is no justification for increasing MichCon's effective gas commodity price from $2.95 to $4.26 for the last nine months of 2001, when customers are still entitled to the

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benefit of the $2.95 price, merely to accumulate an over-collection so large that customers are charged a rate that is <u>less</u> than $4.26 for most of 2002, and less also than MichCon's 2002 gas costs. It may be helpful to some customers to cushion the "rate shock" that would otherwise occur in January 2002 if the $2.95 price ends at December 31, 2001 and prices immediately jump to the level of MichCon's gas costs for 2002. However, it is wrong to "solve" this problem by transferring the rate shock to April 2001. If the early termination proposal is to address the rate shock problem, it should involve a much smaller increase in April 2001, and then a further increase in January 2002, not a very large increase in April 2001 and then a <u>decrease</u> in January 2002.

Q. **WHAT IS THE BASIS FOR YOUR VIEW THAT MICHCON'S GAS SUPPLY COSTS FOR 2002 WILL BE LESS THAN THOSE FOR THE LAST NINE MONTHS OF 2001?**

A. For many months, the NYMEX futures prices for gas to be delivered in 2002 have been lower than the NYMEX futures prices for deliveries in the last nine months of 2001. This pattern has persisted as the entire NYMEX price structure has risen during the past several months. It indicates that gas buyers and sellers view the extreme tightness of the present market as a temporary exaggeration, with some price relief likely by early in 2002. As of early February, for example, the NYMEX strip for the 12 months of 2002 was approximately 75 cents per Dth less than the strip for the last nine months of 2001. This difference indicates that there may be a large gas cost decrease from 2001 to 2002,

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so it is premature to anticipate a large rate shock in January 2002 by imposing an excessive price increase on customers in April 2001.

Q. **HOW SHOULD THE TWO PRINCIPAL DEFECTS YOU HAVE IDENTIFIED IN MICHCON'S PROPOSAL BE ADDRESSED?**

A. The best way to address these defects is simply to deny MichCon's application for an early termination of its GCR suspension. That is the course of action which I recommend to the Commission. The problems that I have identified are caused by the defects in MichCon's proposal, and they disappear if the entire proposal is rejected. There is no need to try to solve these problems created by MichCon's proposed method for accomplishing an early termination, and no further action is required.

<u>Program Design</u>

Q. **SUPPOSE THE COMMISSION DETERMINES THAT EARLY TERMINATION OF MICHCON'S GCR SUSPENSION IS APPROPRIATE. CAN MICHCON'S PROPOSAL BE MODIFIED IN WAYS THAT WOULD ADDRESS THE TWO PRINCIPAL DEFECTS YOU HAVE IDENTIFIED AND EXPLAINED?**

A. Yes, the first principal defect can and should be eliminated by one simple change. All that is necessary is to eliminate the cap that MichCon is proposing for the "Gross Margin Refund Mechanism" presented by Mr. Stanczak at page 12 of his testimony. If this cap is eliminated, then MichCon's customers will be assured that they will not have to pay more than the promised price of $2.95 per Mcf for their gas purchases in the last nine months of 2001.

Q. CAN YOU IDENTIFY MORE PRECISELY THE CAP THAT SHOULD BE REMOVED TO EFFECT THIS CHANGE?

A. Yes. At page 12 of his prepared testimony, Mr. Stanczak states that MichCon is proposing to refund:

> "an additional amount equal to the lesser of: 1) the aggregate amount of the increased costs, [above the $2.95 price] or 2) the gross margin MichCon realized during the period that the fixed $2.95 per Mcf rate was in effect."

Item "2)" in this description is the cap that should be removed. The additional refund would then be equal to the aggregate amount of increased costs above $2.95 paid by customers during the last nine months of 2001.

The cap that should be removed is also stated precisely in the last sentence of paragraph 9 of MichCon's application, which reads as follows:

> "This additional refund is limited to the actual gross margin MichCon realized during the 27-month period that the fixed natural gas commodity price of $2.95 per Mcf rate was in effect."

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Q. HAS MICHCON EXPLAINED WHY THIS CAP IS EITHER NECESSARY OR APPROPRIATE?

A. No, MichCon has not even attempted to explain why the cap is necessary or appropriate. Quite to the contrary, MichCon has instead devoted considerable effort to an attempt to demonstrate that the cap is unnecessary and will not have any effect at all. Specifically, Mr. Stanczak claims at page 13 of his prepared testimony that there is a high probability that customers will not pay more than the $2.95 per Mcf rate, after recognition of the proposed cash-out proceeds and the gross margin refund mechanism. This testimony is logically equivalent to a claim that there is a high probability that the cap will not have any effect at all.

Q. WHY IS MR. STANCZAK'S TESTIMONY ON PAGE 12 EQUIVALENT TO AN ASSERTION THAT THE CAP IS NOT LIKELY TO HAVE ANY EFFECT?

A. As Mr. Stanczak explains on page 12 of his prepared testimony, the amount of the gross margin refund proposed by MichCon is the lesser of: (1) the amount of increased costs above $2.95 paid by customers after recognition of the cash-out credits, or (2) the cap. If the amount of increased costs is less than the cap, which is what Mr. Stanczak claims is highly likely, then the cap is irrelevant because it has no effect. On the other hand, if the cap does become effective, then the amount of the gross margin refund will be less than the amount of increased costs above the $2.95 level, and in that situation the customers will end up paying more than the promised rate of $2.95 per Mcf.

Q. WHY SHOULD THE CAP BE REMOVED?

A. The cap should be removed because it would improperly and unfairly transfer the risk of high gas prices during the last nine months of 2001 from MichCon to its customers.

MichCon's position is that there is a high probability that the cap will have no effect. If MichCon is correct, then the cap should be removed because it is not needed. My position, in contrast, is that the cap is most likely to be reached and therefore limit the "reconciliation" refunds paid by MichCon to customers for the last nine months of 2001. If I am correct, then the cap will prevent customers from achieving the promised gas price of $2.95, and it should be removed because this risk transfer is inequitable.

Q. HOW WOULD THE PROPOSED CAP ACCOMPLISH THIS TRANSFER OF RISK?

A. The cap insulates MichCon from the risk of failing to recover any gas costs it may incur in excess of $2.95 per Mcf for the 36-month period from January 1999 through December 2001, taken as a whole. For the first 24 months of this period (*i.e.*, calendar years 1999 and 2000), MichCon's gas costs were approximately $70 million less than $2.95 per Mcf. But there is now a risk that MichCon's gas costs for 2001 may exceed $2.95 per Mcf by more than $70 million, because of the extremely high gas prices now being experienced. If the GCR suspension remains in effect until December 31, 2001, then MichCon would be responsible for these purchased gas costs, whatever they may

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turn out to be, and there would be a risk that the three-year total of MichCon's actual gas costs could exceed MichCon's gas cost recoveries at $2.95 per Mcf.

Early termination of the GCR suspension would greatly reduce or even eliminate this risk to MichCon, because customers would become responsible for MichCon's actual gas costs after March 31, 2001. Customers would thus bear the risk of gas costs higher than $2.95 per Mcf during the last nine months of 2001. MichCon is offering to mitigate part of this risk to customers through its proposed Gross Margin Refund Mechanism. However, MichCon is proposing to limit its own exposure under this mechanism, so that the "reconciliation" refunds for high gas costs experienced during the last nine months of 2001 cannot exceed the gross margins actually accumulated by MichCon from gas costs lower than $2.95 during the 27-month period of 1999, 2000, and the first three months of 2001.

Q. WHY IS THIS PROPOSED TRANSFER OF RISKS UNFAIR AND IMPROPER?

A. It is unfair for two reasons. First, it would force customers to bear the risk that gas costs for the entire 36-month period from 1999 through 2001 will exceed the fixed price of $2.95 per Mcf, but it does not give the customers any opportunity to share in the benefits if it turns out that gas costs for the entire 36-month period are less than $2.95 per Mcf. MichCon has already realized $70 million of margins from 1999 and 2000, because actual gas costs were less than $2.95 during these two years. If actual gas costs in 2001 exceed $2.95 per Mcf by less than $70 million, then MichCon will refund the excess. Customers will end up paying exactly $2.95 per Mcf in all three years, but MichCon will still have part of the $70 million from 1999 and 2000 as a gas supply profit for the 36-month period. On the other hand, if actual gas costs in 2001 exceed $2.95 per Mcf by more than $70 million, MichCon will refund only $70 million. Customers will end up paying $2.95 in 1999 and 2000, but they will pay more than $2.95 per Mcf in 2001. MichCon, however, will not have any gas supply losses for the three-year period as a whole, because its potential refund liability is limited by the risk transfer.

The second reason why the risk transfer is unfair and improper is that it flies in the face of the arrangements approved when the GCR suspension was instituted in Case No. U-11682. MichCon made the following statement in its application in that proceeding:

> 21. In proposing a fixed gas commodity rate of $2.95 per Mcf, MichCon recognizes that it will also assume significant risks. Portions of the Company's gas supply contract costs could be unrecoverable. . . . . MichCon will permit customers who initially chose third party suppliers to return to MichCon sales service at the proposed fixed gas commodity rate of $2.95 per Mcf plus existing non-gas rates irrespective of prevailing market prices. To the extent that MichCon does not have sufficient gas supplies to provide for the gas requirements of these returning customers, MichCon will assume the risk of purchasing gas supplies on the open market at rates in excess of the fixed $2.95 per Mcf gas commodity rate.

MichCon should be required to adhere to that promise, and to assure its customers that they will receive the benefit of the promised $2.95 gas commodity price for the full 36 months of the originally requested suspension period. The risk transfer is unwarranted and unjustified.

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Q. MR. STANCZAK CLAIMS THAT MICHCON'S CUSTOMERS HAVE SAVED ENORMOUS AMOUNTS OF MONEY BY PURCHASING GAS AT THE FIXED PRICE OF $2.95. IS THAT A VALID REASON FOR REQUIRING CUSTOMERS TO BEAR THE RISK THAT MICHCON'S ACTUAL GAS COSTS FOR THE PERIOD 1999 THROUGH 2001 MAY EXCEED $2.95 PER MCF?

A. No, it is not. Mr. Stanczak's Exhibit A-_/_(DMS-1) is a gross overstatement of the possible benefits from the $2.95 price. I do not agree that MichCon's customers obtained any benefit at all from this price in 1999 and 2000; instead, they paid $70 million more than they would have paid absent the GCR suspension. If the GCR had remained in effect in 1999 and 2000, the customers would have paid MichCon's actual gas costs for those two years, and those actual gas costs were $70 million less than the $2.95 per Mcf price actually paid by the customers.

Q. IS THERE AN ERROR OR SOME OTHER PROBLEM WITH EXHIBIT A-_/_(DMS-1), WHICH EXPLAINS HOW MR. STANCZAK COULD CLAIM THAT THE FIXED PRICE OF $2.95 PER MCF YIELDED $272 MILLION OF SAVINGS TO CUSTOMERS IN 2000, WHEN MICHCON'S ACTUAL GAS COSTS WERE LESS THAN $2.95 PER MCF?

A. Yes. Mr. Stanczak has assumed that MichCon's commodity gas costs would reflect only the NYMEX 3-day averages, and that MichCon's total gas costs would be these commodity costs plus 40 cents per Mcf. The first assumption is incorrect, and the second is doubtful and unsupported.

In MichCon's GCR plan for the last nine months of 2001, the projected average gas acquisition cost for 2002 is $4.94 per Mcf, and it is based on a projected average NYMEX price of $4.61 per Dth. These data suggest a differential of only 33 cents, not the 40 cents assumed by Mr. Stanczak. If the differential is reduced to 33 cents, this reduction would eliminate $14 million of the alleged cost savings identified by Mr. Stanczak in Exhibit A-1(DMS-1).

The commodity price assumption is a much larger problem. In 1998, prior to the suspension of its GCR clause, MichCon had two types of fixed price gas purchase programs in effect, an "automatic" one and a "discretionary" one. Both programs involved the purchase of commodity gas supplies under fixed price contracts with 12-month or seasonal terms. Much of the gas purchased by MichCon in the months June through December 2000 would have been purchased under these fixed price contracts. The purchase prices would have been set earlier in 2000, when the fixed price contracts were negotiated, before the NYMEX price increases that occurred in May and June. MichCon would therefore have paid much less than the high NYMEX 3-day average prices shown in Exhibit A-1(DMS-1) for these purchases in the second half of 2000. It is impossible to determine how much gas MichCon would have purchased under its discretionary fixed price program if the GCR had remained in effect, but the "AutoFix" program would have yielded savings of $2.00 per Dth or more on purchases of 30 Bcf, and smaller savings on additional volumes. The GCR costs would therefore have been many tens of millions of dollars less than the amounts shown in Exhibit A-1(DMS-1), and in my judgment it is likely that they would have been much closer to $2.95 than to the inflated estimates presented in Exhibit A-1(DMS-1).

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Q. HAVE YOU FOUND A WAY TO MODIFY MICHCON'S PROPOSED PROGRAM DESIGN TO ADDRESS THE SECOND MAJOR DEFECT YOU IDENTIFIED, WHICH INVOLVES THE TIMING OF THE GAS RATE INCREASES THAT WOULD RESULT IF MICHCON'S PROPOSAL IS ADOPTED?

A. Yes. The timing of the rate changes could be improved if the cash-out proceeds are distributed to customers during the last nine months of 2001, which is the same period from which they are derived. Any gross margin refund required in addition to the distribution of the cash-out proceeds should begin in January 2002, and the rate for the gross margin refund should be calculated to spread that refund over the three months January through March 2002. If MichCon's request for early termination of its GCR suspension is approved, then these changes should be made in the program design.

Q. HOW WOULD THESE CHANGES IN PROGRAM DESIGN AFFECT THE NET GAS COMMODITY CHARGE RATES PAID BY CUSTOMERS?

A. The effect of these program changes is shown in my Exhibit I-___(REM-2). This example is based on the NYMEX prices and other assumptions in MichCon's GCR plan, and on the base case in Mr. Stanczak's Exhibit A-3(DMS-3).

MichCon's proposed program design is shown on the left-hand side of this exhibit. It reflects the cash-out credit rate of $0.91 per Mcf that I developed earlier in my testimony, when I explained how MichCon's proposal would operate. The only new information

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added to my presentation of MichCon's proposed program design in Exhibit I-7(REM-2) is the assumed GCR rate of $4.60 for 2002. This rate is consistent with my earlier explanation why it is reasonable to expect that MichCon's gas costs will be less in 2002 than in the last nine months of 2001, but here I have conservatively assumed that the decrease will be only 57 cents per Mcf, not the 75 cents indicated by the recent NYMEX prices for 2001 and 2002. With these assumptions, MichCon's proposed program design results in a net gas commodity rate of $4.26 for the last nine months of 2001, then a decrease to $3.69 per Mcf for the period from January through August 2002, followed by an increase to $4.60 for the last four months of 2002.

In the alternative program design that I recommend, the cash-out credit would be $1.81 per Mcf instead of the $0.91 under MichCon's program design. The reason is that my cash-out credit would be developed by spreading the $181 million of cash-out proceeds over the 100.3 Bcf of total sales rate schedule throughput projected for the last nine months of 2001, not the much larger volume projected for the 12 months from April 2001 through March 2002. This larger cash-out credit would yield a net gas commodity price of $3.36 for the last nine months of 2001. This rate is a much more modest increase of only 41 cents per Mcf over the current fixed price of $2.95, not the much larger increase of $1.31 that would result under MichCon's program design.

The net gas commodity price would increase to $4.13 for the first three months of 2002 under my alternative program design. This rate reflects the lower GCR rate of $4.60 that I expect for 2002. It also reflects a gross margin refund of 47 cents per Mcf. I derived this gross margin refund as the rate needed to refund $34 million to GCR sales customers during the first three months of 2002, when GCR sales are expected to be 73 Bcf under normal winter weather conditions. The $34 million amount of this refund is the amount that I derived in my correction of the base case in Mr. Stanczak's Exhibit A-___(DMS-3), as I explained in my discussion of the way MichCon's proposed program would actually operate. The gross margin refund rate of 47 cents per Mcf is less than the rate of 91 cents used by MichCon, because my proposal would make this gross margin refund during the winter months January through March, when MichCon's sales volumes are higher than during the summer months when MichCon is proposing to make the gross margin refund.

Q. **WHY IS YOUR ALTERNATIVE PROGRAM DESIGN SUPERIOR TO MICHCON'S PROPOSED PROGRAM DESIGN?**

A. It is better because it yields a gradual progression of rate increases, first in April 2001, then a further increase in January 2002, and a final increase in April 2002. MichCon's proposal, in contrast, has a very large increase in April 2001, followed by a decrease in January 2002, and then another very large increase in September 2002.

Q. **WOULD IT BE FEASIBLE FOR MICHCON TO BEGIN THE RECONCILIATION REFUND AS EARLY AS JANUARY 2002, AS YOU RECOMMEND, BEFORE IT HAS CLOSED ITS BOOKS ON 2001?**

A. Yes. The total dollar amount of the reconciliation refund is not affected by MichCon's actual gas costs for the last nine months of 2001. It depends only upon a comparison between the net gas commodity prices actually paid by customers and the $2.95 rate they

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were promised when the GCR was suspended. MichCon does not need any information about its actual gas costs to determine this rate difference, and the only other information it needs to calculate the total amount of the reconciliation refund is the customers' actual purchase volumes for the period April through December 2001. MichCon will have an excellent estimate of these actual volumes by the last week of December, so it will be able to develop its gross margin refund rate in time for January implementation.

Q. ARE THERE OTHER MATTERS RELATING TO THE REFUND TIMING?

A. Yes. If my alternative program design is not adopted, then MichCon will be accumulating a very large over-collection of its gas costs during the last nine months of 2001, because it will be reserving the refund of almost half of the cash-out credits until 2002. If MichCon is permitted to accumulate these large over-recoveries, then it should be required to accrue interest on them for the benefit of the customers who will be required to pay rates in advance of the costs to which those rates relate.

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Gas Supply Competition

Q. THE COMPANY IN ITS APPLICATION AND MR. STANCZAK IN HIS TESTIMONY BOTH CLAIM THAT AN EARLY TERMINATION OF THE GCR SUSPENSION IS NEEDED TO PROMOTE GAS SUPPLY COMPETITION IN MICHCON'S SERVICE TERRITORY. DO YOU AGREE?

A. No, I do not. The GCR suspension will end by its own terms at the end of this year, and early termination will do nothing to promote competition in 2002 and beyond.

Q. IS THERE ANY MERIT TO THE CLAIM THAT EARLY TERMINATION IS DESIRABLE TO PROMOTE GAS SUPPLY COMPETITION IN THE LAST NINE MONTHS OF 2001?

A. No, there is not. Competition does not benefit consumers unless it is expected to lead to lower prices or improved products and services. But MichCon's proposal for an early termination of the suspension would have exactly the opposite effect – it would force MichCon's GCR sales customers to pay prices higher than the $2.95 price established for the GCR suspension period. Additional competition during this limited nine-month period would not provide any economic benefits – just economic losses – if it is obtained only by making customers pay prices higher than those promised under the GCR suspension as originally proposed by MichCon and approved by this Commission; and that is the most likely result of an early termination of the suspension as now proposed by MichCon.

Gas supply competition has been hampered in many states during the past several months by the unsettled conditions in the natural gas market and the fly-up of gas prices. There is nothing that MichCon can do to make gas supply competition take off in these unsettled conditions, except perhaps to subsidize competition by charging prices that exceed its own cost of gas, and any such subsidy of sufficient size to promote extensive competition would be improper. It is much more appropriate to let the GCR suspension end normally at December 31, 2001 and let competition develop further as gas market conditions become more stable.

Q. **IS THERE ANY MERIT TO THE ARGUMENT THAT A WEAKENING OF COMPETITION DURING THE LAST NINE MONTHS OF 2001 WILL CARRY OVER INTO 2002?**

A. No, there is not. The development of programs for gas supply competition in Michigan is ahead of the programs in most other states. One reason is that the geographic situation of MichCon and Consumers Energy is very favorable for gas supply competition, because each has extensive company-owned underground storage connected to its gas distribution system. These storage facilities make it easy to divorce baseload gas supply responsibility from the storage and balancing activities needed to operate the MichCon and Consumers systems. It is therefore easier to introduce competition in gas supply on the MichCon and Consumers systems than elsewhere, because there is no need to address the complex problem of coordinating gas supply with storage management and daily load balancing requirements. With these advantages of having an advanced program development and a favorable geographic situation, there is no danger at all that competition in 2002 and thereafter will be impeded by a continuation of the fixed price of $2.95 per Mcf for the last nine months of 2001.

Q. SUPPOSE SOME MARKETERS SAY THEY WILL BE DRIVEN OUT OF MICHIGAN BY A FAILURE TO TERMINATE THE GCR SUSPENSION IN APRIL 2001, AS PROPOSED BY MICHCON, AND WOULD REMAIN AWAY EVEN AFTER THE SUSPENSION ENDS AT DECEMBER 31, 2001. WOULD THEIR ABSENCE CONTRADICT YOUR CONCLUSION THAT COMPETITION WILL NOT BE AFFECTED BY CONTINUATION OF THE GCR SUSPENSION FOR THE LAST NINE MONTHS OF 2001?

A. No, it would not. One of the major advantages of a competitive market is that its successful operation is not dependent upon the presence of any one or even a large number of potential competitors. If one or more gas marketers choose not to participate, then others will step in to take their place if the market situation in 2002 and thereafter is economically attractive to competition. Competition does not require that all of the potential competitors be attracted to Michigan, and many of those who would be attracted here may not even be apparent in the present proceeding.

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Q. **MICHCON'S APPLICATION ALSO CLAIMS THAT EARLY TERMINATION OF THE GCR SUSPENSION IS NEEDED TO ASSIST IN ACHIEVING THE GOAL OF GREATER PROGRAM UNIFORMITY SET FORTH IN THE COMMISSION'S OCTOBER 13, 2000 "CONSENSUS ORDER" IN CASE NO. U-12550. DO YOU AGREE?**

A. No, I do not. Program uniformity is a bogus issue in this proceeding, because it is completely unrelated to the question of gas pricing. Uniformity was found in the U-12550 collaborative to be desirable for matters such as operational features, program rules, and an Authorized Gas Supplier Agreement. The buy/sell arrangements used by Consumers are one of the principal specific operational features on which there was a consensual desire for uniformity. Program rules address matters such as customer recruitment and sign-up. Any actions required by MichCon to establish uniformity in all of these areas were presumably addressed by MichCon's application in Case No. U-12761, and in any event they are irrelevant to the gas pricing at issue in the present proceeding because there is no mandate in the U-12550 order for MichCon and Consumers to have uniform gas pricing practices.

Q. WOULD EARLY TERMINATION THE GCR SUSPENSION, AS PROPOSED BY MICHCON, ACHIEVE UNIFORMITY IN THE GAS PRICING PRACTICES OF MICHCON AND CONSUMERS ENERGY?

A. No, it would not. Consumers' annual GCR periods run from April through March, whereas MichCon's are on a calendar year basis. Consumers has applied for a GCR factor of $5.69 for the 12 months beginning April 2001, including a "volatility component" of $1.00 per Mcf. MichCon, in contrast, has applied for a GCR factor of $5.17 per Mcf for the last nine months of 2001, with quarterly adjustments based on changes in NYMEX prices. MichCon and Consumers are proposing different gas purchasing strategies, and they use very different methods of accounting for their storage operations. All of these differences have important implications for gas pricing, and they will all persist even after the Consumers and the MichCon GCR suspensions have both ended, so there will be no gas pricing uniformity even if the MichCon suspension is terminated early.

If MichCon believes that some uniformity in gas pricing practices between it and Consumers is desirable, then it should address these major differences in gas procurement, storage accounting, and GCR factor design. MichCon's focus on the nine-month timing difference between its own GCR suspension and that of Consumers is a transparent excuse for seeking an early termination of the $2.95 gas price obligation that is now threatening to overwhelm the gas supply profits which MichCon accumulated in the first two years of its GCR suspension.

Customers Are Likely to Pay More than $2.95 for Purchases in 2001

Q. **DO YOU CONSIDER IT LIKELY THAT MICHCON'S CUSTOMERS WOULD PAY ONLY $2.95 PER MCF FOR THE GAS THEY PURCHASE IN THE LAST NINE MONTHS OF 2001?**

A. No, it is likely that customers would end up paying much more than the promised rate of $2.95 per Mcf, even after recognition of the full amount of the cash-out credits and any reconciliation credit they may receive in 2002.

Q. **AT PAGE 13 OF HIS PREPARED TESTIMONY, MR. STANCZAK CLAIMS THAT "*THERE IS A HIGH PROBABILITY THAT CUSTOMERS WILL NOT PAY MORE THAN THE $2.95 PER Mcf RATE.*" WHY DO YOU DISAGREE WITH HIS CLAIM?**

A. Mr. Stanczak supports his claim by reference to his Exhibit A-3 (DMS-3), but there are three fundamental problems with this exhibit, and with Mr. Stanczak's testimony relating to it. First, as I have already explained, there is a major analytical error in the development of this exhibit, because it attributes the entire amount of the cash-out proceeds ($181 million under Mr. Stanczak's assumptions) to the GCR sales customers, whereas the MichCon proposal in this proceeding would actually distribute these proceeds among all sales rate schedule customers, including Gas Customer Choice (GCC) customers as well as GCR sales customers. Because of this error, the "Base Case" in column (A) of Exhibit A-3(DMS-3) is simply incorrect, and it should be ignored

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completely. As I shall explain, it turns out that Mr. Stanczak's "Sensitivity 2" is actually very close to the situation that would occur under Mr. Stanczak's Base Case assumptions, but with a correct analysis of the way MichCon's proposal would work in this situation. It therefore follows that customers will not achieve the $2.95 rate unless there is a "reconciliation" refund of $45 million, even under Mr. Stanczak's Base Case assumptions.

The second fundamental problem with Mr. Stanczak's analysis is that the NYMEX futures prices for the last nine months of 2001 have already risen far above the levels he assumes for his Base Case. With a more realistic set of NYMEX prices, the reconciliation refund required to achieve the $2.95 rate would be $55 million or $65 million, not the $45 million discussed by Mr. Stanczak, as I shall also explain.

Third, Exhibit A-3(DMS-3) indicates on line 10 that MichCon has $45 million of gross margins from the period January 1999 through March 2001, and that this amount is available to make a reconciliation refund if needed to achieve the $2.95 price. But $45 million is not the amount actually available for the reconciliation refund, nor is it even a reasonable or supported estimate of the amount that will be available. Instead, it is simply the actual gross margin from calendar year 1999 only, as Mr. Stanczak himself explains in his testimony, with no recognition of the gross margins from 2000 or the first three months of 2001. If reasonable estimates are included for 2000 and the first three months of 2001, as I shall explain, it turns out that the total gross margin for the period from January 1999 through March 2001 is likely to be much less than the $45 million shown by Mr. Stanczak.

If Exhibit A-3 (DMS-3) is modified to correct these three errors, it becomes clear that customers are likely to require a reconciliation refund of approximately $60 million to achieve the $2.95 price under a more realistic set of base case assumptions, but that the gross margin amount available for that reconciliation refund under MichCon's proposal is likely to be much less than the $45 million indicated by Mr. Stanczak. Customers will therefore be left with net gas commodity charges that exceed the $2.95 price by more than $15 million.

Q. **HOW DID YOU DETERMINE THAT A GROSS MARGIN REFUND OF MORE THAN $40 MILLION WOULD BE REQUIRED TO ACHIEVE A PRICE OF $2.95 PER MCF FOR THE LAST NINE MONTHS OF 2001, EVEN UNDER MR. STANCZAK'S BASE CASE ASSUMPTIONS?**

A. The calculations in support of this analysis are shown in columns (A)-(C) of my Exhibit I-8 (REM-3). The first six lines of column (A) are the same as the corresponding lines in the Base Case column of Mr. Stanczak's Exhibit A-3(DMS-3). The first difference occurs on line 7, where I have allocated the $181 million of cash-out credits between GCR sales and GCC volumes, correcting Mr. Stanczak's erroneous assumption that the entire $181 million would be available for GCR sales.

With this correction, it turns out that a gross margin "reconciliation" refund of $34 million is needed for the GCR sales customers, as shown at line 8 of my exhibit, not the $1 million on line 9 of Mr. Stanczak's exhibit. However, one further correction is also required, because the GCC customers would receive the same gross margin refund as

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the GCR sales customers under MichCon's proposal. I calculated the GCC gross margin refund by assuming that it is proportional to the GCR sales refund, based on throughput during the last nine months of 2001. This GCC refund requirement is $7 million, so the total gross margin refund requirement is $41 million.

Q. WHY IS THIS CORRECTED BASE CASE CLOSE TO THE "SENSITIVITY 2" CASE IN MR. STANCZAK'S EXHIBIT A-3 (DMS-3)?

A. An alternative way to calculate the gross margin refund requirement correctly is to treat the GCC volumes as though they were GCR sales volumes. This approach is shown in columns (D) and (E) of my Exhibit I-8 (REM-3). I begin by calculating the difference between the GCR rate charged to customers and the fixed gas price of $2.95. The first five lines of column (D) show this calculation, and they are the same column (A). However, to calculate the gas cost increase I then apply this difference of $2.22 to the entire throughput of 100 Bcf, not just to the GCR sales volumes. The result of this calculation is a gas cost increase of $222 million for GCR sales and GCC customers combined.

To calculate the gross margin refund requirement, I then subtract the total amount of cash-out proceeds, which remains $181 million in this example. There is no need to allocate these credits between GCR sales and GCC customers, because the gas cost increase amount already includes the GCC customers. The difference between these two amounts is a gross margin refund requirement of $41 million, the same as in the corrected base case.

This approach is essentially the same as Mr. Stanczak's "Sensitivity 2" because both approaches apply the rate difference of $2.22 per Mcf to a volume larger than the base case projection of GCR sales. Mr. Stanczak has chosen a volume of 102 Bcf as an illustrative example, but it happens to be very close to MichCon's projection of total throughput for the last nine months of 2001, which is the quantity appropriate for the corrected base case.

Q. IS THERE ANY LOGIC IN APPLYING THE PRICE DIFFERENCE FOR GCR SALES CUSTOMERS TO THE TOTAL THROUGHPUT VOLUME, WHICH ALSO INCLUDES GCC CUSTOMERS?

A. Yes. The GCC customers will be purchasing their gas from marketers, not from MichCon, but the price will presumably be competitive with MichCon's GCR rate. The GCC customers will also experience a differential between the price they pay to marketers and the fixed price of $2.95 per Mcf. I do not claim that this differential will necessarily be the same as the one experienced by the GCR sales customers, because the marketers' prices are not likely to be exactly the same as MichCon's GCR rate. However, it is reasonable to treat the GCC customers as experiencing the same differential as the GCR customers for the purpose of calculating the gross margin refund requirement, because MichCon is proposing to provide the GCC customers with the same cash-out credits and gross margin refunds that it provides to GCR sales customers. The price difference actually experienced by the GCC customers is irrelevant to this calculation because the gross margin refund rate for the GCC customers will be the same as the rate

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for the GCR sales customers, and it will therefore depend instead on the price difference faced by the GCR sales customers.

Q. **HOW DID YOU DETERMINE THAT THE GROSS MARGIN REFUND REQUIREMENT WOULD BE $55 MILLION OR $64 MILLION USING NYMEX PRICES MORE CURRENT THAN THOSE IN MICHCON'S BASE CASE?**

A. As I have already explained in connection with my Exhibit I-6 (REM-1), the recent NYMEX prices for the last nine months of 2001 have been at least 60 cents per Dth higher than those in Mr. Stanczak's base case, and the average NYMEX price level for the past six weeks has been approximately $1.00 per Dth higher than the base case NYMEX prices. Sensitivity Case B, which is shown in column (F) of my Exhibit I-8 (REM-3), is a calculation of the gross margin refund requirement on the assumption that NYMEX prices for the last nine months of 2001 are $1.00 per Dth higher than those in MichCon's base case.

This calculation uses the same method as my Modified Base Case in columns (D) and (E) of the exhibit, except that I have collapsed the two columns into one. The $1.00 per Dth increase in the NYMEX prices yields a GCR rate that is $1.00 per Mcf higher than MichCon's base case. The resulting gas cost increase for the 100 Bcf of total throughput is therefore $100 million more than the $222 million in the base case. However, the higher NYMEX prices yield an increase of only $77 million in the cash-out proceeds, so the gross margin refund requirement is $23 million higher than in the base case. A similar calculation using a 60-cent increase in the NYMEX prices, which I have not shown in my exhibit, indicates an increase of $14 million above the base case gross margin refund requirement, to a total of $55 million.

Q. **HOW DID YOU DETERMINE THAT THE GROSS MARGINS AVAILABLE FOR REFUNDING ARE LIKELY TO BE MUCH LESS THAN THE $45 MILLION SHOWN BY MR. STANCZAK, IF THEY ARE LIMITED BY THE REFUND CAP PROPOSED BY MichCon?**

A. As I have previously explained, the actual gross margins for 1999 and 2000 were $70 million, with the qualification that the amount for 2000 is unaudited and may be subject to change. However, MichCon is also expecting that its gas costs for the first three months of 2001 will be much higher than the fixed price of $2.95 per Mcf. MichCon's GCR plan filing includes sufficient data to calculate this negative margin. It contains a work paper of the Company's accounting witness, Jennifer C. Schmidt, identified as WP-JCS-2. It shows a projected cost of $152 million for 93 Bcf of projected gas purchases in these three months. It also shows a projected cost of $158 million for 48 Bcf of storage withdrawals, including 14 Bcf priced at 37 cents per Mcf as the estimated annual storage decrement under MichCon's annual LIFO method for storage accounting. The projected total city gate sendout for GCR sales is therefore 93 Bcf, and the projected total cost for this sendout is $310 Bcf, or $3.32 per Mcf. This cost is $35 million more than the fixed price of $2.95, which is a negative margin of $35 million under MichCon's base case assumptions.

The negative margin for the first three months of 2001 becomes much larger if the higher NYMEX prices experienced in the past six weeks are used in developing it. If the NYMEX prices for the last nine months of 2001 are $1.00 higher than those in MichCon's base case, the cost recovery deficit for the first three months of the year increases by $25 million, and the gross margin for these three months becomes a negative $60 million. This projected negative margin of $60 million is the most realistic current estimate for the first three months of 2001. If it is combined with the gross margins of $70 million realized by MichCon in 1999 and 2000, the net amount available for the gross margin refund under MichCon's proposed cap is only $10 million. That amount is far too small to enable MichCon's customers to achieve a gas price of $2.95 per Mcf for the last nine months of 2001.

Q. **WHY DOES AN INCREASE IN THE NYMEX PRICES FOR THE LAST NINE MONTHS OF 2001 AFFECT THE GROSS MARGIN REALIZED DURING THE FIRST THREE MONTHS OF THE YEAR?**

A. The reason is MichCon's annual LIFO method for storage accounting. The projected storage withdrawals during the first three months are priced at the annual average cost of gas purchased by MichCon during the entire calendar year 2001. Increases in the gas costs during the last nine months of the year therefore increase the book cost of storage withdrawals made during the first three months.

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Q. IS THERE ANY OFFSET FOR THE LARGER CASH-OUT PROCEEDS THAT WOULD RESULT FROM THE HIGHER NYMEX PRICES?

A. No, there is not. MichCon's proposal is to remove the cash-out proceeds from its gas cost calculations, and instead to credit the entire amount to GCR sales and GCC customers taking gas during the last nine months of 2001. None of these cash-out proceeds have any effect on the annual gas purchase cost used to develop the storage withdrawal cost rate under MichCon's annual LIFO accounting method.

Q. DOES THIS CONCLUDE YOUR PREPARED DIRECT TESTIMONY?

A. Yes, it does.