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July 19, 2004

Ms. Mary Jo Kunkle
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

Re: Case No. U-12999

Dear Ms. Kunkle:

Enclosed for filing in the above-referenced matter are an original and four copies of the "Exceptions of Consumers Energy Company." This document is also being filed electronically, in PDF format, as part of the MPSC's electronic filings program. I have also enclosed a Proof of Service.

Sincerely,



Signature
Not Verified



Digitally signed
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CC: Hon. Daniel E. Nickerson, Jr.
Parties per Attachment 1
to Proof of Service

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the Matter of the Application of)
CONSUMERS ENERGY COMPANY)
for Accounting and Ratemaking Approval)
of Depreciation Rates for Gas Utility Plant)
_____)

Case No. U-12999

EXCEPTIONS
OF CONSUMERS ENERGY COMPANY

July 19, 2004

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I. INTRODUCTION

On June 28, 2004 Administrative Law Judge Daniel E. Nickerson, Jr. (“ALJ”) issued his Proposal for Decision (PFD”) in Case No. U-12999. Exceptions were initially due July 12. That date was subsequently extended by the ALJ to July 19. Consumers Energy Company (“Consumers Energy” or the “Company”) is filing the following exceptions pursuant to the schedule established by the ALJ.

II. USE OF THE EQUAL LIFE GROUP PROCEDURE VERSUS THE AVERAGE LIFE GROUP PROCEDURE

Gas depreciation rates in Michigan have traditionally been determined using the Average Life Group (“ALG”) procedure. 5 Tr 59. In this case, Consumers Energy recommended that the Michigan Public Service Commission (“MPSC” or “Commission”) switch to the Equal Life Group (“ELG”) procedure for purposes of determining Consumers Energy’s gas depreciation rates. Both procedures provide for full recovery of an investment. 5 Tr 70-71. The ALJ recommended that the Commission continue to use the ALG method in this gas depreciation case. While Consumers Energy believes that the ELG method would provide a

better matching of cause and effect,¹ the Company has decided not to contest this recommendation for purposes of Case No. U-12999. The Company is therefore withdrawing its request to switch to the ELG procedure.

III. THE ALJ ERRED IN NOT ADOPTING ONE OF THE AVERAGE LIFE GROUP ANALYSES PRESENTED BY CONSUMERS ENERGY

A. Overview of Company Position and Comparison of Proposals

The primary remaining issue in this case (given the Company's withdrawal of the request to switch to the ELG method) concerns how the net salvage costs should be determined. Consumers Energy's witness Donald S. Roff used the traditionally accepted depreciation methodology for determining net salvage. 5 Tr 92. He reviewed 10 years of actual historical data using a variety of analyses, taking into account trends and applicability of the data to the future. The Commission has approved use of this approach for Consumers Energy's gas depreciation rates in prior cases. This was the methodology which was used in establishing the depreciation rates approved in Case No. U-11509, the Company's last gas depreciation case. Consumers Energy requests that the Commission again use the traditional approach in determining net salvage.

If the Commission does not use the traditional approach, then it should determine net salvage using a five-year average of data on a functional basis. This is the methodology used in developing the depreciation expense level which is reflected in the interim gas rates approved by the Commission in its December 18, 2003 Order in Case No. U-13730. This alternate Consumers Energy ALG proposal is a refinement of the methodology previously used in

¹ The ALJ at one point in the PFD refers to the ELG method as an accelerated form of depreciation. This is not correct. See 5 Tr 105-106, Exhibit A-5, p. 9. However, given the withdrawal of this issue by Consumers Energy, this and other aspects of the discussion in the PFD related to the ELG need not be addressed.

settlements for two of the smaller Michigan gas utilities.² The methodology is set forth and supported in the testimony and exhibits of Consumers Energy's witness Thomas L. Simonsen. If the Commission rejects use of the traditional method, then it should adopt the Company's alternative proposal.

The ALJ erred in not recommending that net salvage costs be determined using one of the two Company ALG proposals (i.e., the traditional approach sponsored by Mr. Roff or the five-year average of data on a functional basis approach supported by Mr. Simonsen.). Each of these two Company proposals is superior to the approach recommended by the ALJ. The recommendation of the ALJ to use the approach for determining net salvage sponsored by the Attorney General's witness Charles King should be rejected.

The approach advocated by Mr. King, and recommended in the PFD, is: (i) contrary to, and a significant digression from, traditional gas depreciation practice in Michigan, (ii) contrary to the alternative methodology approved in settlements for two of the smaller Michigan gas utilities, (iii) contrary to the established principle that depreciation is a method of allocation not valuation, (iv) contrary to the principle that depreciation should allocate costs over the useful life of assets, (v) contrary to previous determinations of this Commission rejecting attempts to adjust historical data, (vi) contrary to principles of intergenerational equity, and (vii) contrary to the concept of gradualism. The record evidence requires rejection of the Attorney General's approach.

² The Staff proposal in Case No. U-12999 used the methodology that was used in the settlement agreements, which involved SEMCO Energy Gas Company and Aquila. See 5 Tr 109, 119. Various weaknesses in using this methodology for Consumers Energy are discussed at 5 Tr 90, 92-94, 96-97, 105-107 and 120-125. See also Consumers Energy's reply brief, pp. 13-20. The Company's alternative method uses the same basic approach, but at the functional level rather than at the total plant level, which among other things results in a better matching of cause and effect.

The annual depreciation expense resulting from the Company's two ALG proposals and the proposal of the Attorney General's witness Mr. King, and how they compare to expense levels resulting from the Case No. U-11509 depreciation rates, are summarized below. The expense resulting from the Staff proposal is included for comparison purposes.

Description	Composite Rate	Annual Expense	Variance from U-11509 Rates	Percentage Change from U-11509 Rates
Expense Using Case No. U-11509 Rates	4.48%	\$ 107,995,903 ¹		
Expense Using Traditional Method	4.19%	101,019,925 ²	\$ (6,975,978)	-6.46%
Expense Using 5-yr Average by Function	3.57%	86,071,594 ³	(21,924,309)	-20.30%
MPSC Staff Witness Proposal	2.93%	70,504,866 ¹	(37,491,037)	-34.72%
Attorney General's Witness Proposal	2.32%	55,937,897 ¹	(52,058,006)	-48.20%

Footnotes

Note - all expense figures are based on plant balances at year-end 2002.

¹ Exhibit A-6, page 1, columns (c) through (j), line 5.

² Exhibit A-7, page 1, columns (6) - (7).

³ Exhibit A-9, page 1R

Adopting the recommendation of the PFD to use the Attorney General's proposal would result in a significant understatement of depreciation expense and would be detrimental to customers in the long run. Current customers will not be paying their pro-rata share if the recommendation in the PFD is adopted.

B. One of the Company's ALG Net Salvage Calculations Should Be Adopted

1. Inclusion of an Appropriate Level of Net Salvage Is Critical in Establishing Depreciation Rates

The appropriateness of including net salvage in the calculation of depreciation expense has long been recognized. 5 Tr 75. Mr. Roff stated that the reason for including net salvage is discussed in the 1968 publication Public Utility Depreciation Practices, which states in part:

“Under presently accepted concepts, the amount of depreciation to be accrued over the life of an asset is its original cost less net salvage. Net salvage, as the name implies, is the difference between the gross salvage that will be obtained when the asset is disposed of and the cost of removing it. Positive net salvage occurs when gross salvage exceeds cost of removal, and negative net salvage occurs when cost of removal exceeds gross salvage. Thus the intent of the present concept is to allocate the net cost of an asset to annual accounting periods, making due allowance for the net salvage, positive or negative, that will be obtained when the asset is retired. This concept carries with it the thought that ownership of property entails the responsibility for its ultimate abandonment or removal. Hence if current users of the property benefit from its use, they should pay their pro rata share of the costs involved in the abandonment or removal of the property.” quoted at 5 Tr 75.

The appropriateness of recovering costs for net salvage does not appear to be in dispute. It is important that, in doing so, the historical relationship between net salvage at the time of retirement and original cost of property retired that resulted in the net salvage be maintained. The Company’s proposals do so. The method of the Attorney General’s witness Mr. King does not.

2. The Traditional Approach for Determining Salvage and Cost of Removal Should Be Used

The depreciation rates and expense that would result from using the traditional, long-standing methodology for establishing Consumers Energy’s gas depreciation rates were presented by Donald S. Roff, a Director in the firm of Deloitte & Touche LLP, one of the largest public accounting firms in the world. 5 Tr 67-68. Mr. Roff has participated in or directed depreciation studies for electric, gas, water and steam utilities, pipelines, railroads, and telecommunication companies in over 30 states and several Canadian provinces. 5 Tr 67.

For purposes of his study, Mr. Roff examined annual salvage and cost of removal experience for the ten-year period of 1993-2002. 5 Tr 75, 92, Exhibit A-5, p. 7. During his

analysis he examined annual amounts, rolling bands, and shrinking bands of retirement experience. Exhibit A-5, p. 7. An example is shown on Exhibit A-30. Based on his analyses, Mr. Roff determined that the salvage, cost of removal, and net salvage percentages shown on columns 10 through 12 of Exhibit A-5, Schedule 2 (p. 16) were appropriate. He testified that analyzing a longer period of years, as he did, helps to minimize timing mismatches and smooth results. 5 Tr 93. The depreciation rates and expense that result from using the traditional approach in combination with the ALG procedure are shown on Exhibit A-7.

All parties have proposed using remaining life depreciation rates. 5 Tr 95. The salvage properly allocable to customers is the net salvage at the time of the plant's retirement. 5 Tr 95. This allocates the cost that will be incurred among the generations of customers that will benefit from the property. 2 Tr 95.

Mr. Roff testified:

“For purposes of my calculations, I used selections based upon the actual net salvage experience. This reflects the historical cost changes that have occurred and what the cause and effect relationship would be if the plant were retired today.” 5 Tr 95. (Emphasis added).

Current net salvage percentages were not adjusted to reflect anticipated future inflation. 5 Tr 96. To the extent that the percentage changes in the future, such changes will be reflected in future depreciation studies. 5 Tr 96.

The traditional approach sponsored by Mr. Roff uses more representative data, provides a more precise analysis of cause and effect, and involves a detailed evaluation of historical data at the account level. See 5 Tr 92, 93, Exhibit A-5, p. 7. This approach should be used in determining depreciation rates in this case.

3. If the Commission Decides Not To Use the Traditional Approach in this Case Then It Should Use the Five-Year Average Approach Identified by Mr. Simonsen

If the Commission decides not to use the traditional method of determining net salvage costs, then a five-year average net salvage factor should be calculated by functional class of plant. 5 Tr 92-93, 111, 121-122. The depreciation rates and expense using the ALG procedure and the five-year average of net salvage by functional class of plant are shown on Exhibit A-9, p. 1R.

The functional class analysis was presented by Mr. Simonsen. Mr. Simonsen is a Corporate Tax Manager for Consumers Energy. 5 Tr 109. He has a bachelor's degree in engineering and an MBA degree with a major in accounting. 5 Tr 116. Throughout his career Mr. Simonsen has been involved in all aspects of book and tax depreciation. He is a member of the Society of Depreciation Professionals and has extensive background, knowledge and experience in the areas of book and tax depreciation. 5 Tr 116-117. Mr. Simonsen evaluated salvage and cost of removal data at the functional level for 1998-2002, the most recent five years of data that was available at the time of the study.

Consumers Energy reports annual net salvage information for retired gas plant on page 219 of its annual MPSC Form P-522 reports. Exhibit A-10 identifies the book cost of plant retired, cost of removal, and salvage, as reported in the Form P-522, for years 1998 through 2002.

The information in the P-522 report is reported on a total gas plant basis rather than on a functional basis or account basis. If the information is going to be used to determine net salvage for purposes of depreciation rates, some method of allocating the total costs must be used.

In addition to showing data as reported in the P-522 report, Exhibit A-10 shows the net salvage for each year from 1998 through 2002 by function, using the same four categories as appear on page 219 of the P-522 report. Mr. Simonsen testified that the functional data set forth on the exhibit was taken from the Company's books and records used in calculating the data that are summarized on page 219 of the Form P-522. 5 Tr 112. Thus, these breakdowns are input data used to develop the summary level numbers in the report, not the result of mathematical allocation of total dollars backwards.

The four functional categories used in the depreciation study for gas accounts are: (i) Underground Storage Plant, (ii) Transmission Plant, (iii) Distribution Plant, and (iv) General Plant. The calculation of the historical five-year average net salvage percentages for each of these categories based upon the functional data is shown on Exhibit A-8, p. 5. The use of the resulting five-year averages to determine net salvage percentages for the depreciation calculation is shown on Exhibit A-8, p. 4.³

Use of Mr. Simonsen's five-year averaging approach has numerous advantages over approaches proposed by witnesses for the other parties. These include: (i) the allocation by function is based on actual historical experience during the five-year period used, (ii) the allocation correctly maintains the historical relationships, (iii) data used for allocation is the input data used in developing the totals, (iv) while it does not eliminate the intergenerational inequity problem, it is more likely to minimize it as compared with using five-year data which have not been developed on a functional basis, (v) the results from using averages on a functional basis are more consistent with the concept of gradualism, (vi) it maintains the functional group relationships of net salvage to the assets retired, and (vii) it minimizes the rate base impact to

³ The resulting net salvage percentages are the same for both the ELG calculation shown on Exhibit A-8, pp. 1R-3R, and the ALG calculation shown on Exhibit A-9, pp. 1R-3R.

customers that occurs from use of the five-year approaches presented by witnesses for other parties. 5 Tr 110-111, 119-123, 125, Exhibit A-15.

4. Conclusion

The methodology used by Mr. Roff provides a broader historical base and greater level of analysis. The Company requests that the Commission use that traditional approach. Mr. Simonsen and Mr. Roff both testified that the traditional approach would be preferable and more accurate. See e.g., 5 Tr 89-90, 92-93, 113. If, however, the Commission chooses not to use the traditional approach, then the methodology set forth by Mr. Simonsen should be used.

C. The Recommendation of the ALJ To Adopt the Attorney General's Treatment of Net Salvage Should be Rejected

1. The Method that the PFD Recommends Be Adopted Requires Substantial Changes to the Long-Standing Methodology Used to Establish Consumers Energy's Gas Depreciation Rates

The Commission held in Case No. U-11509 that a party seeking substantial change in a long-standing depreciation methodology bears a heavy burden:

“The Commission disagrees, in significant part, with these parties’ requests. The HWI-based adjustments proposed by both Mr. Berquist and Mr. Peloquin represent substantial changes in the long-standing methodology used to establish depreciation rates for gas utilities. When faced with proposals like this, the Commission generally imposes upon the party or parties requesting such a change a heavy burden to demonstrate both the necessity and efficacy of the proposed change. [citations omitted]” December 7, 1998 Case No. U-11509 Order, p. 15. (Emphasis added)

As will be discussed in more detail below, the Commission should find that the Attorney General has not met that burden. He has not shown either the need to abandon the traditional methodology in this case or that his methodology accurately reflects appropriate net salvage and

depreciation expense. Concern that current net salvage may be high does not justify abandoning established principles of depreciation.

The proposal of the Attorney General's witness Mr. King that the PFD recommends be adopted has not previously been used in Michigan for gas depreciation. It abandons the historical relationship between net salvage and cost of plant being retired and substitutes what is, in essence, a present expense approach. Contrary to the statement at page 14 of the PFD, the testimony of the Attorney General's witness Mr. King is not clear, concise and credible. It is only with great difficulty that it is even possible to determine what forms the basis for Mr. King's final recommendation and how he split, adjusted, and then recombined data.⁴ The testimony and analysis would be better characterized as sophisticated sophistry.

The methodology used by Mr. King in his recommendation represents a substantial change in the methodology used to establish depreciation rates for gas utilities in Michigan.⁵ This is reflected in Mr. King's acknowledgment (see 5 Tr 179) that he has compared net removal cost experience with plant balances at the end of 2002 and that his removal cost allowances are not comparable to net salvage ratios, in addition to his splitting and then recombining of pieces. Mr. Roff testified that Mr. King's approach has no basis in depreciation theory. 5 Tr 90. This impropriety of Mr. King's approach is discussed throughout these exceptions.

⁴ Mr. King included multiple analyses in his testimony that he does not recommend be used. See e.g., 5 Tr 159, line 6. There are numerous fallacies with Mr. King's alternative analyses. His various age-based and present value adjustments diverge significantly from traditional net salvage methodology used to compute depreciation rates. See 5 Tr 89, 96-99. Mr. King's analyses do not support a conclusion that abandonment of a traditional depreciation methodology is required or appropriate. However, since Mr. King states that he is not recommending those alternative approaches be used, Consumers Energy will focus in these exceptions on the method which Mr. King did recommend, and which the PFD, in turn, recommended be used.

⁵ This would also be true of Mr. King's other methodologies.

2. Mr. King's Methodology Inappropriately Ignores Historical Relationships

The PFD incorrectly concludes at page 17 that “The AG’s approach is straightforward and based on historical salvage cost ratios rather than some estimate or projection.” The Attorney General’s approach is neither straightforward nor based on historical salvage cost ratios. It in fact disregards the actual historical net salvage cost ratios.

The goal is to achieve a net salvage that appropriately reflects costs that Consumers Energy will likely incur, and that this generation of customers should pay, based upon the best information that is currently available. Although analyses of Mr. Roff and Mr. Simonsen evaluate historical net salvage using two different methods (at the account level over 10 years versus at the functional level over five years), both are based on actual historical net salvage cost ratios. Mr. King’s approach is not. Reducing net salvage below the negative 92.40% historical five-year average that results if data are evaluated at the functional level⁶ would inappropriately ignore the reality that exists and would result in shifting costs that should be borne by current customers to later customers.

The invalidity of Mr. King’s approach can be illustrated by the following comparison of net salvage ratios that result from his method with the net salvage ratios actually experienced during the five-year period of 1998-2002 that Mr. King used in developing his recommendations. The chart below compares the net salvage ratios that actually occurred for plant retired in 1998-2002 for accounts 352.3, Well Construction, 352.4, Well Equipment, and 376.0, Distribution Plant Mains, with the net salvage ratios that result from Mr. King’s approach, the net salvage ratios recommended by Mr. Roff, and the net salvage ratios that result from the five-year average by function analysis addressed by Mr. Simonsen:

⁶ See Exhibit A-12, column (e).

Account	Net Salvage Ratios⁷			
	1998-2002 actual	King	Roff	Simonsen
352.3	-71%	-33%	-65%	-73%
352.4	-71%	-34%	-65%	-73%
376	-137%	-39%	-125%	-105%

While the recommendation of Mr. Roff for accounts 352.3 and 352.4 is similar to the five-year average, it was determined in a different manner. During the preparation of a depreciation study there can be instances in which actual account history is incomplete or does not represent the future. 5 Tr 124. Cost of removal and net salvage data vary considerably by year for Accounts 352.3 and 352.4, Well Construction and Well Equipment. See Exhibit A-14, pp. 2, 4. As a result, Mr. Roff in his analysis multiplied current cost of removal by the number of wells to determine the net salvage for these accounts.⁸ 5 Tr 124. This analysis provides further confirmation of the invalidity of the approach used by Mr. King.

As can be seen, Mr. King's method substantially understates the net salvage ratios for these accounts as compared to the recent historical experience. The net salvage ratios that Mr. King uses for accounts 352.3 and 352.4 understate actual experience for the most recent five-year period by over 50%. The net salvage ratio Mr. King uses for account 376 (which accounts for almost 38% of the plant balance as of December 31, 2002)⁹ understates actual experience by over 70%. Reference to Exhibit I-26 shows that the negative net salvage percentages calculated by Mr. King for the vast majority of other accounts are also substantially

⁷ Exhibit A-29 indicates that Mr. King relied upon the 1998-2002 shrinking band data on Mr. Roff's workpapers. The actual net salvage ratios for 1998-2002 shown on the table are the result of taking cost of removal less salvage for those years divided by retirements as shown on Mr. Roff's workpapers for those accounts. See Exhibit A-14 for 352.3 and 352.4 and Exhibit A-30 for 376. Net salvage ratios calculated by Mr. King, Mr. Roff and Simonsen for those accounts are shown on Exhibit I-26, columns H, I, and J.

⁸ In Case No. U-11509, Consumers Energy's last gas depreciation case, a dispute arose regarding the appropriateness of using this proxy method for determining net salvage ratios for Account 352.4. The Commission upheld the Company's methodology. December 7, 1998 Order, p. 6.

⁹ The balance for Account 376 is \$906.0 million. The balance for total gas plant is \$2,408.9 million. See Exhibit I-20.

less than the ratios calculated by Mr. Roff and Mr. Simonsen using the actual historical relationships. The traditional method used by Mr. Roff and the five-year by function method used by Mr. Simonsen provide much closer approximations to the actual historical experience than does the method Mr. King advocates.

There is no valid basis to ignore, as does Mr. King, the historical relationships if one concludes that the five-year historical average should be used as a proxy for net salvage in this case. Doing so would be arbitrary and unreasonable. The result of adopting Mr. King's approach would be to substantially understate the depreciation costs that should be recovered currently and shift those costs to future generations of customers, thus resulting in intergenerational inequity.

If, in fact, the Commission concludes that recent historical experience should be given greater weight in setting depreciation rates in this case, then the results from Mr. Simonsen's calculations should be used in establishing depreciation rates. Mr. King's method does not accomplish that goal.

3. Further Illustration that Mr. King's Methodology Ignores Historical Relationships

The accounts with the largest negative net salvage are Accounts 376, Distribution Plant Mains, and 380, Distribution Plant Services. The mains and services have to be purged and capped even if left in the ground, so there is cost involved. Moreover, the historical cost of removal used by Mr. Roff reflects actual experience and would therefore only reflect the costs that are incurred, not costs that are not incurred. 5 Tr 80, 103.

Exhibit A-30 illustrates that over the 10-year period from 1993 through 2002 the net salvage for Account 376, on an annual basis, when matched with cost of property removed from service has ranged from a low of negative 72% to a high of negative 184%, with an average

of negative 121%. As noted above, Mr. Roff's recommendation is to use negative 125% net salvage, while Mr. Simonsen's five-year method results in negative 105% net salvage. Exhibit A-8, p. 4. Both are within the range of historical experience. Furthermore, both are much more in line with experience than the negative 39% recommended by the Attorney General's witness Mr. King. (See Exhibit I-26, column H). This is about half of the lowest historical year and less than one-fourth of the highest year. Using such a low rate is based on a faulty matching of cause and effect and would be a recipe for disaster.

Mr. Roff testified with regard to Account 380 that consistent with prior trends the Company continues to incur considerable removal costs for retiring services, although the percentage net salvage has become less negative. 5 Tr 80. Mr. Roff relied upon the full historical experience and recent trends in developing his net salvage recommendation. Id.

4. Mr. King's Methodology Ignores Established Depreciation Principles

It is well established that the recoverable cost of removal is the cost at the time the plant is retired while the recoverable cost of the asset itself is at original cost. As noted above, the 1968 National Association of Regulatory Utility Commissioners ("NARUC") publication Public Utility Depreciation Practices states:

"Under presently accepted concepts, the amount of depreciation to be accrued over the life of an asset is its original cost less net salvage. Net salvage as the name implies, is the difference between the gross salvage that will be obtained when the asset is disposed of and the cost of removing it." p. 24 as quoted at 5 Tr 75. (Emphasis added).

Thus the recoverable cost for the plant is the original cost, while the recoverable cost for the net salvage¹⁰ is the gross salvage less cost of removal at the time of the asset's disposition.

The MPSC Uniform System of Accounts states in instruction B of account 403, Depreciation Expense, that:

“The utility shall keep such records of property and property retirements as will reflect the service life of property which has been retired and aid in estimating probable service life by mortality, turnover, or other appropriate methods; and also such records as will reflect the dollars and percentage of salvage and cost of removal for property retired from each account, or subdivision thereof, for depreciable utility plant.” (Emphasis added)

See 5 Tr 121. Mr. Simonsen testified that, as can be seen by this instruction, it is the intent that depreciation rate factors be evaluated on an individual account basis and it has been the historical practice of the Commission to issue depreciation orders on that basis. 5 Tr 121. Moreover, the percentage of salvage and cost of removal for the property retired is the appropriate focus. The property retired would be retired at its original cost.

Contrary to established principles, the Attorney General takes a five-year average of the cost of removal and salvage and compares it not to corresponding retirements for the period being evaluated but to the entire remaining plant balances. He then takes this percentage and uses it to come up with a cost of removal allowance which is in turn used to come up with a net salvage ratio that has no relationship to actual net salvage ratios during the five year historical period. The end result is that current customers do not pay depreciation based on the

¹⁰ It is well established, and has been recognized by NARUC both in 1968 and 1996 publications that the salvage which is recoverable through depreciation rates is net salvage, which would include cost of removal, that current customers should pay their pro rata share of the cost of removal, and that this treatment is in harmony with generally accepted accounting practices. See 5 Tr 75-76, 98. The net salvage required for the calculation is the future net salvage at the time of plant retirement. 5 Tr 95.

current embedded relationship, but rather based upon a hypothetical relationship. Mr. King's approach has no basis in established depreciation theory. 5 Tr 89-90, 91, 92, 95.

5. Proposals to Change From An Accrual Accounting Method to an Expense Method Are Inconsistent with Fundamental Principles of Depreciation

Proposals of Mr. King seek to develop a level of depreciation expense for net salvage equal to cash outlays for salvage and cost of removal. This is accomplished by developing an annual average of recent dollar experience. Mr. Roff referred to this as a cash accounting approach. 5 Tr 91. He testified that cash accounting for net salvage has not been used for Consumers Energy's gas depreciation rates in the past and should not be used in this case:

"Prior and current practice has been to use accrual accounting. Accrual accounting reflects the fundamental accounting principle of matching. The matching principle requires the proper determination of costs in each accounting period. This includes accrual for investment costs and net salvage costs. Accrual accounting recognizes the cause and effect relationship between retirements and net salvage. Cash accounting is inconsistent with the accrual accounting provisions of the Uniform System of Accounts, is inconsistent with traditional depreciation accounting and past practices approved by this Commission for Consumers Energy's gas business, and is unfair to customers as only the last generation of customers associated with an asset pays for related net disposal costs." 5 Tr 91.

Use of cash accounting approaches should be rejected.

The PFD properly concludes, at page 13, that the proposal of ABATE's witness Mr. Selecky to expense \$8 million of cost of removal was inconsistent with the principle of intergenerational equity and should be rejected. While the Attorney General's witness Mr. King is less direct than ABATE's witness Mr. Selecky, his proposal also involves what is effectively expensing of the same cost of removal. See e.g., 5 Tr 183, line 31, Exhibit I-26, column C.

The PFD (page 15) refers to the assertion by Mr. King that failure to use the method he advocates results in a permanent and growing loan. That assertion is incorrect.

Mr. Roff testified:

“From the standpoint of current depreciation expense, the customer is only paying his pro rata share of the total cost of an asset over its life. Further, as accumulated depreciation is increased, this results in a declining rate base and a declining revenue requirement for that property. The fact that the depreciable rate base is growing is irrelevant, because the depreciation expense and return component of revenue requirement are fixed. Mr. King’s approach undercollects costs that should be paid currently, shifting those costs to future generations of customers. Despite Mr. King’s response to the question at page 26, line 1 of his testimony, his approach is nothing more than the expensing of cost of removal as incurred. Under Mr. King’s approach, rate base will be higher in future years than it would otherwise be causing increased costs to customers in the future.” 5 Tr 99-100.

Mr. King’s approach does not accurately reflect depreciation expense.

6. The PFD Incorrectly Concludes that the Order In Case No. U-11509 Supports Rejection of the Traditional Approach in Favor of Mr. King’s Approach

The PFD incorrectly concludes at page 16 that the Commission’s decision in Case No. U-11509, Consumers Energy’s last gas depreciation case, somehow supports use of Mr. King’s methodology. However, the Commission in that case adopted rates determined using the traditional methodology over objections that adjustments needed to be made to reduce net salvage. The approach used by Mr. Roff in his analysis in this case has traditionally been used in Consumers Energy gas depreciation cases to determine net salvage.

By way of illustration, the appropriate net salvage percentages for Accounts 376 and 380 were the subject of controversy in Case No. U-11509. The Commission concluded in its December 7, 1998 Order in that case that it should rely on the traditional methodology and that net salvage values should be revised to negative 100% and negative 220% for Accounts 376 and

380 respectively. Mr. Roff concluded in the current case that updated information supported revising the net salvage ratios to negative 125% and negative 200%. Exhibit A-5, Schedule 2 (p. 16). Mr. Simonsen's analysis of five years of data at the functional level results in negative 105% and negative 168%. The record evidence supports continuation of the traditional methodology in this case and rejection of the net salvage percentages of negative 39% and negative 89% advocated by the Attorney General.

In his current study, Mr. Roff updated data through December 31, 2002, the last full calendar year prior to the study. The cost of removal used in developing the relationship appropriately includes inflationary effects that occurred while the property being retired was in use. 5 Tr 93-94, 95. To the extent the relationships change in the future, this will be reflected in future depreciation studies. The remaining life technique compensates for any over- or under-accruals of depreciation and plant and reserve transactions different than those used in calculating previous rates. 5 Tr 76-77. Arbitrarily assuming a different relationship, as advocated by the Attorney General would be unreasonable. Mr. Roff's net salvage calculations use the best information that was available at the time of the study and should be adopted. If those are not used, then the alternative approach presented by Mr. Simonsen should be used.

7. Mr. King's Methodology Improperly Introduces An Element of Valuation Based On Speculation By Ignoring the Existing Cause and Effect Relationship

In order to maintain the appropriate matching and the cause and effect relationship, the net salvage percentages must be determined by matching the cost of removal for property with the cost of the corresponding property that has been retired. Mr. Roff and Mr. Simonsen do so in their analyses. See Exhibit A-8, p. 5, Exhibit A-30. This approach maintains the embedded relationship between the original cost of the asset and the net salvage

when the asset is disposed. From a cost allocation standpoint, the traditional method provides the appropriate process for recognizing net salvage in depreciation rate calculations. 5 Tr 98.

The Attorney General advocates use of a cash basis approach instead of an accrual basis approach. 5 Tr 91. This is contrary to the basic tenets of depreciation accounting, which require that depreciation expense should be allocated over the life of the asset and that costs should be borne by the customers that cause them and not by some earlier or later generation. See 5 Tr 72-73. In addition, the approach advocated by the Attorney General is contrary to the well-established principle that depreciation should allocate costs without making valuation adjustments. Depreciation accounting by definition is a process of allocation, not valuation. 5 Tr 72, 90. The Attorney General's approach understates the net salvage percentages because it compares the wrong numbers. As noted above, Mr. King's proposal has the effect of substituting a present expense approach in place of a depreciation expense approach. 5 Tr 89.

Continued use of an accrual accounting approach is consistent with past practice and principles applicable to regulatory depreciation.

8. The PFD Incorrectly Concludes that FERC Order 631 is Applicable to This Case

One of the underlying rationales Mr. King offered in support of abandonment of traditional depreciation principles in favor of his approach is that the Federal Energy Regulatory Commission ("FERC") Order No. 631 "requires utilities to separate depreciation from recovery of removal costs." 5 Tr 158. Consumers Energy presented evidence that Mr. King has misconstrued FERC Order No. 631 and that FERC Order No. 631 is not, in fact, applicable. The PFD at page 17 rejects Consumers Energy's arguments that Order No. 631 is not applicable. The conclusion in the PFD is in error.

Neither FERC Order No. 631, *Accounting, Financial Reporting and Ratemaking Requirements for Asset Retirement Obligations* Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (“SFAS No. 143”), also referenced by Mr. King, supports the conclusion that Mr. King reached. SFAS 143 is a financial reporting requirement that deals with identification, measurement and recording of legal liabilities and offsetting costs associated with asset retirement. 5 Tr 101. Order No. 631 addresses accounting requirements of SFAS 143 for FERC jurisdictional utilities.

First of all, it should be noted that neither document mandates any accounting for assets for which there is no legal asset retirement obligation (“ARO”).¹¹ 2 Tr 101-102. Mr. Roff testified with respect to SFAS 143:

“SFAS 143 has no applicability to non-legal retirement obligations. Further, use of the SFAS 143 methodology for depreciation accounting is not appropriate or required. SFAS 143 does not deal with regulatory accounting. There is an enormous difference between financial reporting requirements and regulatory accounting requirements.” 5 Tr 102.

While FERC Order No. 631 requires certain subsidiary records, the fundamental accounting for cost of removal in depreciation rates and expense is unchanged. 5 Tr 102. The FERC specifically concluded in Order No. 631 that there was no need to fundamentally change accounting concepts. Id. Furthermore, the FERC has no accounting jurisdiction over Consumers Energy’s gas operations. Id.

¹¹ Consumers Energy presented testimony that it had identified two legal asset retirement obligations related to its gas business. 5 Tr 114.

9. Adoption of the Attorney General's Methodology Would Be Detrimental to Customers In the Long Run and Create Intergenerational Inequity

Adopting the net salvage proposal advocated by Mr. King would have a benefit to customers in the short term, but would be detrimental to customers in the long run. The long-term harm of understating depreciation expense is reflected in the following statement from the NARUC publication Public Utility Depreciation Practices, 1968:

“The regulatory body prescribing depreciation rates is thus confronted with a decision which affects both the short-run and the long-run interest of the customer who pays rates for utility service. If the commission consistently prescribes (depreciation) rates below the lower limit of the zone of reasonableness, this results immediately in lower revenue requirements. But in the long run the requirements for income taxes and return more than offset the apparent savings in depreciation expense, so the rates for service must be higher than if depreciation rates had been more adequate.”
Page 33 as quoted at 5 Tr 96-97.

The record evidence indicates that proposals of the other parties would result in a significant decrease in depreciation expense from both current levels and levels determined using traditional depreciation methodology. This would be detrimental to the Company in the short run and detrimental to the customers in the long run.

The approach advocated by Mr. King will disadvantage future customers in multiple ways. First, it will shift recovery of depreciation expense that should be recovered from current customers to future customers. Second, it will result in large future increases in Consumers Energy's rate base compared to the result if actual depreciation expense were used. Depreciation reserves reduce rate base and benefit customers. The Company's revenue requirement will, as a result, increase due to the higher net plant in rate base, costing future

customers more.¹² The effects of adopting the Staff's proposal are discussed at 5 Tr 125 and shown on Exhibit A-15. While the impact of adopting the Attorney General's approach was not calculated, the impact would be greater by virtue of the even lower depreciation expense levels that result.

10. The Recommendation in the PFD Is Contrary to the Concept of Gradualism

The Attorney General in this case has objected to use of the recognized concept of gradualism, arguing that the Commission rejected gradualism at page 60 of its November 7, 2002 Order in Case No. U-13000. What the Commission rejected at page 60 of that order was the Attorney General's argument that the concept of gradualism precluded elimination of interclass subsidies, not the concept itself. The overall increase was approximately 12% while the increase in residential rates that the Attorney General objected to was approximately 16%, only slightly higher than an equal percentage increase would have been. Case No. U-13000 Order, Exhibit A, Summary of Rates and Tariff Sheets. That decision is hardly an abdication of the concept of gradualism.

The Staff, Attorney General and ABATE proposed major decreases in depreciation expense, ranging from a decrease of approximately 35% for the Staff to approximately 67% for ABATE. Adoption of the recommendation in the PFD would result in a 48% reduction in depreciation expense below levels resulting from using depreciation rates approved in Case No. U-11509. Mr. Roff testified:

“Mr. Aldrich's proposal would reduce depreciation expense by over 1/3. Proposals of Mr. Selecky and Mr. King would reduce depreciation expense by larger amounts. I urge the judge and the

¹² Mr. Aldrich is proposing a \$37 million depreciation expense reduction. 5 Tr 125. Mr. Simonsen calculated that if the \$37 million depreciation expense reduction that Staff is proposing had been in effect from 1993-2002, Consumers Energy's net plant would be \$300 million higher as a result of the depreciation expense reduction. 5 Tr 125, Exhibit A-15.

Commission to carefully consider the absolute magnitude of the differences in annual depreciation expense between not only my recommendation and those of the other parties, but also the relative magnitude of the existing annual depreciation expense contrasted with the proposals of the other parties. If the Commission concludes some adjustment should be made to cost of removal, it should be more modest than proposed by the other parties. While the purpose of depreciation is cost allocation, one purpose of capital recovery in the ratemaking process is to help insure financial integrity. And while depreciation is not a cash expense, it does have an impact on cash flow. The reduction in depreciation expense proposed by the other parties would have a detrimental effect on Consumer's [sic] cash flow, making it difficult to internally fund infrastructures, improvements and replacements." 5 Tr 97.

Adoption of Mr. Roff's recommendation would result in a reduction of about 6% below the expense using the Case No. U-11509 rates. Mr. Simonsen's calculation of the five-year average net salvage on a functional basis would result in a decrease in depreciation rates of approximately 20%, still a sizeable reduction, from the expense resulting from Case No. U-11509 depreciation rates. If the Commission concludes that it will not use the traditional approach for determining net salvage in this case, this is the largest decrease that should be adopted.

IV. THE ALJ ERRED IN RECOMMENDING THAT THE COMMISSION REQUIRE A STUDY OF NET SALVAGE

Staff's proposal (Staff brief, p. 4) that the Commission require the Company to undertake a study "to discover why its [net salvage] costs appear to be so excessive when compared to other gas companies" uses a "guilty until proven innocent" logic. Staff has not shown that the negative 117% net salvage resulting from the traditional analysis (see Exhibit A-12) is in fact excessive. The ALJ's recommendation to adopt the Staff proposal to require a study should be rejected.

While Consumers Energy does not believe that a study should be ordered, Consumers Energy is, nevertheless, willing to examine the issue internally on a voluntary basis and willing to work with the Commission Staff to cooperatively address the issue. Consumers Energy will advise the Staff of the results of its internal review. Regardless of how the Commission rules on this issue, however, it is important that any study not delay the final resolution of this depreciation case, which was originally filed in 2001. Case No. U-12999 can, and should, be decided based upon the record evidence. At a minimum, the depreciation expense reflected in the interim order in Case No. U-13730 should be maintained.

Mr. Roff testified with regard to net salvage:

“The 1996 National Association of Regulatory Utility Commissioners (“NARUC”) publication Public Utility Depreciation Practices addresses this issue at page 19:

‘In an increasing number of instances, the average net salvage is estimated to be a large number when expressed as a percentage of original cost, sometimes in excess of 100%. This may look unrealistic but is appropriate and necessary so that the required cost allocation occurs.’

The negative net salvage is not an indication that the level is too high.” 5 Tr 94

The fact that it is over negative 100% does not establish it is excessive.

Staff seeks to support its position that a study should be required by indicating that Consumers Energy has not explained why its negative net salvage is higher than negative net salvage of SEMCO, Aquila, and MichCon. Mr. Roff explained that such comparisons are likely to be misleading:

“Over the course of my thirty-one year career I have found that asset information and related depreciation parameters are impacted by a wide variety of factors and forces, making comparisons precariously specious. As such, direct comparisons of individual

utilities or select account parameters are misleading at best.”
5 Tr 94.

Further, depreciation rates for two of the utilities relied upon by Staff for support were established pursuant to settlement agreements (Exhibit A-31), and may include considerations that are a result of the settlement process.

Furthermore, Staff has proposed that the Company be required to undertake an analysis that would require information that the Company does not have and realistically cannot obtain. There is an assumption made that if Consumers Energy’s net salvage is higher than that of other gas utilities, Consumers Energy’s net salvage must be too high. However, it is possible that the net salvage of other utilities understate the most appropriate levels (thus deferring costs), that the other utilities recovered more than they needed to at an earlier point in time, that the property being retired is in different amounts or has a different age than property for Consumers Energy, that different geographical or metropolitan conditions affect original cost or net salvage, that the net salvage for the other utilities was not calculated based upon a complete analysis, that net salvage for other utilities was calculated in a different (possibly less accurate) manner, or that any number of other distinctions result in different net salvage percentages. Other considerations could include whether salvage and cost of removal were booked in the same year or different years and whether the results for other utilities on a functional and account specific basis are consistent with the percentages used. To do a comparison with other utilities, information would be needed regarding the books, records, and practices of other utilities that is not likely to be readily available. Further gas depreciation studies are time consuming and costly.

The ALJ acknowledges that there are a wide variety of factors that could explain the disparity with other utilities. He also acknowledges the concern of the Company regarding the availability of the data. However, he responds that the focus of the study sought by Staff is

into Consumers Energy's own books, records, and practices. It is not clear, however, that the reasons for the differences between Consumers Energy and other utilities can be determined from the Company's books, records, and practices.

Any party to the next depreciation case can undertake reviews of net salvage that they deem appropriate and propose rates based on the methodology of their choice. In the present case, parties agreed in December 2001 to suspend proceedings in order to allow parties time to review possible cost of removal issues. 3 Tr 41. Parties have had an opportunity to review these issues in this case. While parties offered several alternative approaches, none presented evidence establishing that the Company's historical net salvage ratios are not representative of net salvage experience. Indeed, each relies upon the historical experience in some fashion. The recommendation in the PFD to require the Company to undertake a study of net salvage should be rejected.

V. CONCLUSION

Depreciation rates and expense should be established based on the use of the traditional net salvage analysis sponsored by Mr. Roff. If the Commission concludes that that review should focus on the most recent five-year historical period for determining net salvage, then the five-year average net salvage by function rates and expense calculated by Mr. Simonsen should be used. The recommendation in the PFD to use a methodology presented by the

Attorney General's witness Mr. King should be rejected, as should the recommendation to require a study of net salvage.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

Dated: July 19, 2004

By:



Signature
Not Verified

H. Richard Chambers

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STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the Matter of the Application of)
CONSUMERS ENERGY COMPANY)
for Accounting and Ratemaking Approval)
of Depreciation Rates for Gas Utility Plant)
_____)

Case No. U-12999

PROOF OF SERVICE

STATE OF MICHIGAN)
) SS
COUNTY OF JACKSON)

Margaret Hillman, being first duly sworn, deposes and says that she is employed in the Legal Department of Consumers Energy Company; that on July 19, 2004 she served an electronic copy of the "Exceptions of Consumers Energy Company" upon the persons listed in Attachment 1 hereto, at the e-mail addresses listed therein. She further states that she also served a hard copy of the same document to the addresses listed in Attachment 1 by depositing the same in the United States mail in the City of Jackson, Michigan with first-class postage thereon fully paid.

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Signature
Not Verified

Margaret Hillman

Digitally signed
by Margaret
Hillman
Date:
2004.07.19
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Margaret Hillman

Subscribed and sworn to before me this 19th day of July, 2004.

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Signature
Not Verified

Sammie B Dalton

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by Sammie B.
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State of Michigan, County of Jackson
My Commission Expires: 01/04/08
Acting in the County of Jackson

ATTACHMENT 1 -- TO CASE NO. U-12999

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