

A CMS Energy Company

August 6, 2004

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Michigan Public Service Commission
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Re: Case No. U-12999

Dear Ms. Kunkle:

Enclosed for filing in the above-referenced matter are an original and four copies of **“Consumers Energy Company’s Replies To Exceptions”**. I have also enclosed an original Proof of Service. In addition, the documents listed above are being filed electronically, in a PDF format, as part of the MPSC’s electronic filings program.

Sincerely,


Signature
Not Verified

Digitally signed
by H. Richard
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H. Richard Chambers

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

CONSUMERS ENERGY COMPANY'S
REPLIES TO EXCEPTIONS

August 6, 2004

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I. INTRODUCTION

On July 19, 2004 exceptions were filed by Consumers Energy Company (“Consumers Energy” or the “Company”), the Michigan Public Service Commission (“MPSC” or “Commission”) Staff, Attorney General Michael A. Cox (“Attorney General”), and the Association of Businesses Advocating Tariff Equity (“ABATE”). These replies are being filed pursuant to the schedule established by the presiding Administrative Law Judge (“ALJ”).

It is the position of Consumers Energy that the record evidence supports adopting the positions set forth by Consumers Energy in its exceptions and that, to the extent they are to the contrary, the exceptions of other parties should be rejected. If the Commission uses the traditional method in this case for determining gas depreciation rates and expense, as advocated by Consumers Energy, then the resulting annual depreciation expense would be \$101.0 million. Exhibit A-7, page 1, columns (6)-(7). If the Commission decides not to use the traditional method, then the record evidence establishes that use of the five-year average by function method is the superior alternative method. The resulting annual depreciation expense using the five-year average by function method would be \$86.1 million. Exhibit A-9, page 1R. Both methods use the traditional Average Life Group (“ALG”) procedure.

II. REPLY TO STAFF

A. Negative Net Salvage Value

1. Introduction

The differences between the depreciation expense resulting from the methodology proposed by the Staff in its exceptions and the depreciation expense resulting from the methodologies proposed by the Company in its exceptions result from the manner in which the net salvage percentage is determined. Consumers Energy agrees with Staff that the Staff methodology is more reasonable than the methods recommended by witnesses for the Attorney General and ABATE.¹ However, the Company disagrees that the Staff methodology is preferable to the methods supported by Consumers Energy in its exceptions.

The methodology that Staff uses for determining net salvage is a method that (i) has not previously been used for Consumers Energy's gas depreciation rates and (ii) has not, to the Company's knowledge, been adopted previously in a contested case in Michigan. If the Commission decides not to use the traditional methodology for determining Consumers Energy's gas depreciation rates (which results in an annual depreciation expense of \$101.0 million), then it should use the refinement of the Staff's five-year averaging approach discussed by Consumers Energy's witness Thomas L. Simonsen (which results in an annual depreciation expense of \$86.1 million).² Adoption of the Staff methodology in this case would not be appropriate.

¹ Consumers Energy also agrees with Staff that Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations, is not determinative of the appropriate depreciation rates in this case. See Consumers Energy's exceptions at page 20. While at some point in time a generic inquiry involving all utilities regarding the effects of SFAS 143 may have some value, Consumers Energy is not convinced that a generic inquiry should be initiated at this time. SFAS 143 does not apply to non-legal retirement obligations and does not address ratemaking accounting. *Id.* If a generic inquiry is initiated, it should involve all MPSC-jurisdictional gas and electric utilities, not just Consumers Energy, since SFAS 143 involves an industry-wide issue.

² These two methods are discussed in the Company's exceptions at pages 2-9. The annual depreciation expense amounts have been calculated based on plant balances at December 31, 2002.

2. Five Reasons Why Staff's Approach Is Not Appropriate for Consumers Energy in this Case

Mr. Simonsen testified that reasons why use of the Staff's net salvage methodology would not be appropriate in this case include the following:

“(1) Mr. Aldrich's approach is based on an oversimplification of the depreciation rate calculation process. This simplification results in invalid conclusions for Consumers Energy as a consequence of disregarding individual account and functional group relationships of net salvage to the assets retired.

(2) Mr. Aldrich's approach understates the appropriate cost of removal for Consumers Energy as a result of failing to adjust for unusual items that are known and in Form P-522, in particular the 2000 retirement of service risers.

(3) Mr. Aldrich incorrectly applied his approach to the net salvage data on Exhibit A-9 (TLS-2) that had already been adjusted instead of applying it to net salvage data on Exhibit A-5 (DSR-2R).

(4) Mr. Aldrich's approach understates the appropriate cost of removal for Consumers Energy as a result of failing to make adjustments for accounts 352.3 and 352.4, Well Construction and Well Equipment. Historical data for those accounts is not representative of expected future cost of removal.

(5) Mr. Aldrich's approach will result in large increases to rate base in the future for Consumers Energy as a result of understating cost of removal and deferral of cost recovery.”
5 Tr 120.

These reasons are discussed in more detail in subsection 3 below and in Mr. Simonsen's testimony at 5 Tr 120-125. Mr. Roff addresses various weaknesses in the Staff's position at 5 Tr 90, 92-94, 96-97, and 105-107.

The numerous weaknesses with use of Staff's averaging methodology for Consumers Energy require that it be rejected in favor of a more precise calculation. It is necessary to do so in this case in order for the results to satisfy the well-established prerequisite criterion that the method used be both systematic and rational. See 5 Tr 72.

3. Discussion of Weaknesses in the Staff Approach

a. Staff's Approach Over-Simplifies the Depreciation Rate Calculation Process, Resulting in Conclusions for Consumers Energy that Are Not Consistent With Actual Net Salvage During the Five-Year Period Evaluated

Total gas plant can be divided into four categories based upon function: (i) underground storage plant, (ii) transmission plant, (iii) distribution plant, and (iv) general plant. Each of these functional categories can, in turn, be divided into a number of accounts (12 for underground storage plant, seven for transmission plant, 15 for distribution plant, and 10 for general plant).

Staff's witness Mr. Aldrich gathered and analyzed historical net salvage data at the most general level, i.e., total gas plant. Mr. Simonsen gathered and analyzed historical net salvage data at the second level, i.e. by function. Mr. Roff gathered and analyzed historical net salvage data at the most detailed level, i.e., by account.

The Company presented evidence that shows the breakdown of the total plant that Mr. Aldrich used by functional categories and calculated the net salvage that results if the functional level of detail is used. See Exhibit A-8, pp. 4-5 and Exhibit A-10. Mr. Aldrich started with the total and then allocated backward to the pieces. Mr. Simonsen used the pieces on a functional basis as the starting point, thus preserving the historical functional relationships. A comparison of the results using the two approaches shows that Mr. Aldrich's method results in a significant understatement of net salvage expense as a result of not maintaining the actual, historical functional relationships for the five-year period reviewed. See Exhibit A-12, 5 Tr 122-123.

Mr. Simonsen testified:

“Mr. Aldrich calculates overall negative net salvage of approximately negative 69% and overall depreciation expense of approximately \$70.5 million. If the net salvage were calculated using a five-year average approach by function the overall negative net salvage would be approximately negative 92% and the overall depreciation expense would be approximately \$85.5 million. Making this correction alone results in an annual depreciation expense that is approximately \$15 million higher than calculated by Mr. Aldrich. I recommend that the Staff’s recommendation to use a simplified five-year average instead of the traditional approach be rejected. However, if the Commission chooses to use a five-year approach in determining depreciation rates, then at a minimum the data needs to be determined by function.” 5 Tr 121-122.

It is important to recognize that although Mr. Aldrich shows net salvages by account percentage on his exhibit, this is simply the result of a mathematical allocation of total dollars. 5 Tr 122. It is not based on an analysis of the actual cost of removal and actual salvage by either account or by function. Id.

Staff has argued that its approach is better because it results in a negative 69% net salvage. However, the goal is not to achieve a low negative net salvage percentage. The goal is to achieve a negative net salvage percentage 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. Reducing net salvage below the negative 92.40% historical five-year average that results if data is evaluated at the functional level would inappropriately ignore the reality that exists and would result in shifting costs that should be borne by current customers to later customers.

There is no valid basis to ignore the historical functional relationships if the Commission concludes that a five-year historical average should be used as a proxy for net salvage in this case. Doing so would be arbitrary and unreasonable.

b. Staff's Method Understates Cost of Removal for Consumers Energy as a Result of Ignoring Unusual Items

In the year 2000, Consumers Energy determined that it had not been retiring risers installed on plastic services on its books. 5 Tr 123. In order to correct this, \$11.1 million of riser retirements were made in 2000. Id. Mr. Aldrich does not normalize the data. Mr. Simonsen testified that if Mr. Aldrich's analysis is corrected to show the proper year of retirement, without making any other adjustments, the negative 69% used by him would become a negative 75% and annual depreciation expense would increase by approximately \$4 million. Id. Exhibit A-13. (Exhibit A-13 shows the result of spreading the year 2000 riser retirements to the vintage year installed and individual retirement years. 5 Tr 123.) As noted previously, one of the benefits of using 10 years of data, as was done by Mr. Roff, is that it helps to minimize timing mismatches and smooth results. 5 Tr 93.

c. Staff's Approach Was Applied Incorrectly to Consumers Energy Data

In addition to other reasons that Staff's approach should not be used in this case, it should not be used because Staff's approach was applied to net salvage data that had already been adjusted. 5 Tr 120, 124.

d. Historical Data for Accounts 352.3 and 352.4 Is Not Representative of Expected Future Cost of Removal

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 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.

5 Tr 124. The resulting negative net salvage was 65%. 5 Tr 125. Staff's approach results in an assumed negative net salvage of only 50%.

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. Staff's approach understates the appropriate cost for these accounts. 5 Tr 124-125.

e. **Use of the Approach Advocated by Staff Will Result
In Large Future Increases to Rate Base For
Consumers Energy**

The approach advocated by Staff if adopted in this case for Consumers Energy will disadvantage future customers in multiple ways. First, it will defer recovery of depreciation expense that should be recovered from current customers to future customers. 5 Tr 125, Exhibit A-15. Second, it will result in large future increases in Consumers Energy's rate base compared to the result if actual depreciation expense were used. 5 Tr 125. 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.³ This shifting of costs to future customers occurs as a result of using an oversimplified approach. Id. In addition, it will have a long-term negative impact on income taxes. 5 Tr 97.

Consumers Energy agrees with the Staff that both the ABATE and Attorney General positions are contrary to the principle of intergenerational equity. However, the Staff proposal would also be contrary to that principle.

³ Staff approach would result in 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.

4. The Concept of Gradualism Supports Rejection of the Staff Recommendation

The Staff proposal would result in a 35% decrease in depreciation expense (or about \$37 million) below the levels that result from applying the rates approved in Case No. U-11509 to December 31, 2002 plant balances. This is a major reduction in expense levels. Given that periodic reviews occur, it would be appropriate in this case to moderate any decrease. This is particularly true given that the Staff approach is based on a simplified method that does not determine actual historical net salvage on either an account-specific basis (as does Mr. Roff) or a function-specific basis (as does Mr. Simonsen). Using the same data that Staff's witness Mr. Aldrich uses, but using the data on a functional level, results in a 20% decrease (or about \$22 million in expense). This is still a sizeable decrease, but it is both more moderate and more accurate than the result using the Staff method. The depreciation expense level of \$86.1 million that results from the approximately \$22 million expense decrease⁴ (See Exhibit A-9, p. 1) should be considered the absolute floor in any range of reasonableness for purposes of this case.

The concept of gradualism is discussed further in Consumers Energy's exceptions at pages 22-23. See also 5 Tr 97.

5. Staff's Approach Should Not Be Used in this Case

Consumers Energy is aware that the Commission has accepted use of simplified five-year average approaches for determining net salvage in settlements in gas depreciation cases involving SEMCO Energy Gas Company and Aquila. See 5 Tr 109, 119, Exhibit A-31. However, use in those cases of the simplified approach reflected agreements of all parties. Settlements by definition are compromises. The Commission was not presented with

⁴ The associated decrease in revenue requirements would be even greater. The approximately \$22 million voluntary reduction in depreciation expense that the Commission approved in its Case No. U-13730 December 18, 2003 Order for use in determining interim rate relief resulted in a \$34 million decrease in revenue requirements.

alternatives in those cases that might further refine use of a five-year approach. Further, such settlements cannot properly be relied upon as establishing a precedent, particularly for Consumers Energy, who was not a party to the cases.

The decision in this case must be based on the evidence in this case. In this particular case the Company has presented evidence that if a five-year approach is used, it would be appropriate to determine a five-year average of net salvage by function. The evidence in this case shows that using Staff's simplified methodology would result in inaccurate conclusions for Consumers Energy.

The Company advocates use of the traditional method. However, assuming for purposes of argument that a five-year average method is adopted, there is no valid reason to use in this case a five-year average for total gas plant net salvage, given its weaknesses, when the results that occur using the more precise five-year average net salvage by functional plant group are in the record.

B. Study of Negative Net Salvage Costs

At page 3 of its exceptions, Staff indicates its support for the ALJ's recommendation regarding a study of why Consumers Energy's net salvage costs are higher than other gas companies. Consumers Energy addresses that issue at pages 23-26 of its exceptions.

III. REPLY TO THE ATTORNEY GENERAL

A. Deferred Accounting Approval

Consumers Energy has requested that the Commission approve deferred accounting for any timing differences that result from implementation of SFAS 143 or the Statement of Position related to Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment. 5 Tr 113-114. The ALJ agreed with Consumers Energy that there is no

valid reason not to grant the request. The Attorney General in his exceptions opposes these requests.⁵ The Attorney General's exception on this issue should be rejected and the recommendation of the ALJ adopted.

The request for regulatory asset/regulatory liability treatment for any timing differences related to SFAS 143 has also been requested in Case No. U-13730. Consumers Energy anticipates that the requested authority will be granted in that case. However, the Company notes that the Attorney General at page 9 of his March 29, 2004 replies to exceptions in that case took the position the MPSC should defer a decision to Case No. U-12999. Now in his exceptions in Case No. U-12999 the Attorney General objects as well. There appears to be no dispute that SFAS 143 is effective and that for Consumers Energy at least two legal liabilities exist. See 5 Tr 114. Various additional information was provided in Case No. U-13730. The request is not premature. If the Commission has not granted such authority prior to the time it issues an order in this case, then the Company requests such authority be granted in this case. 5 Tr 114.

The regulatory asset/liability treatment related to SFAS 143 is only requested for accounting timing differences between required SFAS 143 reporting versus the regulatory recovery model. The Company is not requesting any additional recovery, only that the Commission provide for recovery through normal depreciation rates rather than a separate, specific charge. There is no valid basis not to grant the requested authority. See generally 5 Tr 100-102. The specific accounting would be governed by the Uniform System of Accounts.

With regard to the Statement of Position, the Company requested authority to set up regulatory assets and regulatory liabilities to account for any timing differences which result

⁵ Although the Attorney General only discusses the request insofar as it relates to the Statement of Position, he refers to 5 Tr 113-114, which address both requests. The Company is therefore responding with regard to both.

if the Financial Accounting Standards Board approves the Statement of Position. 5 Tr 113. Obviously the authority would be conditioned on the Statement being approved, and indeed would not be necessary if it was not. Granting the authority in this case will help conserve the resources of the Commission and the parties and avoids the need for a separate case.

The case cited by the Attorney General in his exceptions does not preclude the deferred accounting approvals requested. That case, Consumers Power Co v Public Service Commission, 78 Mich App 581 at 585-586, 261 NW2d 10 (1977), merely provides that the Commission must make adequate findings of fact. It can do so based on the record in this case.

B. Synchronization With Revenue Requirements

Depreciation rates established in this case should become effective concurrently with the effective date of an order that reflects any changes to depreciation expense in the calculation of revenue requirements.

IV. REPLY TO ABATE

ABATE takes exception to the recommendation of the ALJ to reject the proposals of its witness Mr. Selecky. The ALJ properly rejected ABATE's arguments.

There are fundamental problems with the proposal of ABATE which require its rejection. The approach advocated by ABATE's witness Mr. Selecky, like the approach advocated by the Attorney General's witness Mr. King, is: (i) contrary to, and a significant digression from, traditional gas depreciation practice in Michigan, (ii) contrary to the approaches approved in settlements for two of the smaller Michigan gas utilities, which are referenced in Section II.A.5, (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. It disregards existing relationships and creates hypothetical, non-existent relationships. Problems with ABATE's approach include the following:

A. Net Salvage

1. Failure to Appropriately Evaluate the Applicability of the Data

The starting point for the net salvage calculations of ABATE's witness Mr. Selecky is the total gas plant data. His proposal is based on an oversimplification which results in invalid conclusions as a result of ignoring individual account and functional group relationships of net salvage to the assets retired. Further, his proposal fails to adjust for unusual items, fails to reflect that data for accounts 352.3 and 352.4 are not representative of future cost, and will result in large increases in rate base in the future.

2. ABATE's Proposal to Change From An Accrual Accounting Method to an Expense Method Is Inconsistent with Fundamental Principles of Depreciation

The proposal of Mr. Selecky seeks 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.

The proposal of Mr. Selecky to use cash accounting approaches should be rejected.

ABATE readily admitted in its brief (as did its witness Mr. Selecky in testimony—see 5 Tr 136-137) that it seeks to have the Commission change from an accrual accounting approach to a yearly expensing of net salvage. ABATE argues that if the Commission adopts its approach net salvage will be reduced from \$58 million per year to \$8 million. However, the proper question is not whether the amount recovered decreases if ABATE's approach is used but whether the amount recovered is consistent with established depreciation theory and practice. The amount recovered under ABATE's proposal is not.

Mr. Roff testified that use of ABATE's approach would be contrary to fundamental principles of depreciation accounting as well as being inconsistent with MPSC accounting requirements. 5 Tr 103. Contrary to assertions in ABATE's exceptions, the 1996 NARUC publication Public Utility Depreciation Practices does not endorse excluding net salvage from depreciation rates. Mr. Roff testified:

"Q. At page 9 of his testimony Mr. Selecky sets out a quote from Public Utility Depreciation Practices which he argues supports his position. Do you agree?

"A. The quotation indicates that some commissions have moved to current period accounting for gross salvage and/or cost of removal. However, it does not indicate an endorsement of that approach. The paragraph immediately before the paragraphs quoted by Mr. Selecky states:

‘Historically, most regulatory commissions have required that both gross salvage and cost of removal be reflected in depreciation rates. The theory behind this requirement is that, since most physical plant placed in service will have some residual value at the time of retirement, the original cost recovered through depreciation should be reduced by that amount. Closely associated with this reasoning are the accounting principle that revenues be matched with costs and the regulatory principle that utility customers who benefit from consumption of plant pay for the cost of that plant, no more, no less. The application of that principle also requires that the cost of removal be recovered over its life.’

Use of the historical approach for Consumers Energy’s gas depreciation rates should be continued.” 5 Tr 104 (Emphasis added).

As discussed above, the net salvage which is to be recovered is the cost at the time property is retired. The matching concept and cause and effect principle require this cost to be recovered over the life of the asset so that customers that benefit pay the cost.

ABATE’s approach does not allocate cost of removal over the life of the plant. It would inappropriately shift net salvage costs for property currently in use which should be paid by current customers to future customers. The best proxy for costs is to use the historical relationship between net salvage and original cost rather than absolute dollars of costs. Net salvage costs for property currently in use will be higher at the time the assets are retired than they are currently because they will include future cost escalation. If historical relationships continue, ABATE’s approach will shift approximately \$50 million of costs per year that should be recovered currently to future customers.

Furthermore, the approach ABATE advocates fails to take into consideration that there can be large variations in net salvage from year to year. 5 Tr 103. Mr. Roff testified:

“Under the remaining life methodology, the rates are self-correcting at each review period if net salvage assumptions used were too high or too low since rates reflect actual retirement experience in determining amounts that need to be collected over the remaining life of plant in service. This benefit would be lost if net salvage costs were treated as an operational expense. Net salvage should continue to be recovered as part of depreciation expense.” 5 Tr 103.

Use of the traditional approach of addressing net salvage as part of depreciation expense based on historical relationships should be continued for Consumers Energy’s gas depreciation rates in this case. Mr. Selecky’s proposal to change this method should be rejected.

3. Proposed Age Based and Present Value Adjustments Are Inappropriate

Mr. Selecky argues that the traditional approach to determining net salvage is faulty as a result of not taking into consideration the present value of costs and makes various age based (inflation-related) adjustments in support of his position that the Company’s approach overstates net salvage. His adjustments diverge significantly from the traditional net salvage methodology used to compute depreciation rates. See 5 Tr 89, 96-99.

Adoption of proposals for age based or present value adjustments would introduce an element of valuation into the depreciation process. This would be improper because depreciation is a cost allocation process, not an asset valuation process. Furthermore, ABATE’s proposal would have the effect of inappropriately lowering the assumed net salvage costs with the result of keeping depreciation rates artificially low.⁶

⁶ ABATE’s witness admitted that his method even understated the net salvage on a cash basis for three of the five years he reviewed. See 5 Tr 139.

The proposal advocated by ABATE represents a substantial change in long-standing methodology used to establish depreciation rates for gas utilities. ABATE has not established either the necessity or efficacy of its proposed adjustments and methodology. Its proposals are based on speculation and arbitrary assumptions.

ABATE's witness inappropriately disregards historical relationships in his recommendation. There is inadequate record support for the adjustment proposal made by the ABATE witness.

In Case No. U-11509, as here, witnesses for various parties argued that future levels of inflation were not likely to match historical levels inherent in the cost rates used to calculate net salvage ratios and depreciation rates and proposed that various inflation-related adjustments be made. The Commission rejected those arguments and proposals. It should do so in the current case also.

The periodic reviews of depreciation rates allow an opportunity to update the rates to reflect more recent experience. Consumers Energy has done so in its analysis in the present case. Consumers Energy presented a depreciation study by an expert consultant who prepared it in accordance with a methodology he found to be reasonable and consistent with generally accepted accounting practices. The results support the proposals of Consumers Energy.

Based upon the record evidence in this case, the Commission should continue to rely upon the traditional methodology used by Consumers Energy's witness Mr. Roff when computing net salvage percentages. If, however, the Commission concludes in this case that the review should focus on the most recent five years of data for the net salvage calculation, instead of ten years of data, then the Commission should use the five-year average by function approach presented by Mr. Simonsen, an expert witness with almost 30 years of depreciation expertise.

4. ABATE Fails to Distinguish Between Financial Accounting and Regulatory Accounting

ABATE in its exceptions seeks to support its position by reference to a draft Statement of Position (“SOP”) by the Accounting Standards Executive Committee of the America Institute of Certified Public Accountants on Accounting for Certain Costs and Activities related to Property, Plant, and Equipment. However, its conclusion does not follow.

ABATE has misconstrued the nature and impact of the proposed SOP. First, it should be noted that the SOP is a proposal only and has not been adopted. 5 Tr 113. Second, if adopted the SOP would affect financial accounting for depreciation, not regulatory accounting. Id. If the Financial Accounting Standards Board approves the SOP then the Company will need to set up regulatory asset and regulatory liabilities to account for the timing differences related to the SOP. The Company has requested that the Commission grant such authority in this case. Id. Third, there is no evidence that the basis for expense would be the approach ABATE advocates even if it were adopted. There are considerable differences between financial reporting, which deals with the preparation of GAAP-based financial statements as mandated by the Securities and Exchange Commission for public companies, and regulatory accounting, which is reflective of applicable regulatory rules and reporting requirements. 5 Tr 100.

B. ABATE’s Proposal Is Contrary to the Principle of Intergenerational Equity

The ALJ correctly concluded at page 13 of his Proposal for Decision that ABATE’s proposal is contrary to the principle of intergenerational equity. As discussed in subsection A, it would substitute an expense method for an accrual method, fail to spread the net salvage costs over the life of the plant while it was in service, and would fail to recognize that there can be large variations in an individual year and that there may be instances in which plant

retirements and cost of removal are not recorded in the same year. Further, ABATE's approach would have a detrimental impact on customers in the long run. See 5 Tr 96-97. Its proposal would significantly reduce the amount of depreciation expense recovered in the near term, resulting in significant intergenerational inequities.

C. ABATE's Proposal Is Contrary to the Concept of Gradualism

ABATE has proposed a decrease in depreciation expense of over 67%. See Exhibit A-6. The decrease in depreciation expense resulting from ABATE's position is even larger than the decrease resulting from the Attorney General's position. *Id.* As noted in the Company's exceptions, Mr. Roff testified:

"I urge the judge and the 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.

Concern that net salvage percentages may be too high does not justify adopting a methodology that results in net salvages that are too low. ABATE's proposed decrease is contrary to the concept of gradualism and should be rejected for this reason in addition to other reasons discussed.

V. **CONCLUSION**

Consumers Energy respectfully requests that the Commission issue a final order consistent with the positions expressed above and in the Company's exceptions.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

Dated: August 6, 2004

By:



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)

Sammie B. Dalton, being first duly sworn, deposes and says that she is employed in the Legal Department of Consumers Energy Company; that on August 6, 2004 she served an electronic copy of “**Consumers Energy Company’s Replies To Exceptions**” 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.



Sammie B Dalton

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by Sammie B.
Dalton
Date: 2004.08.06
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Sammie B. Dalton

Subscribed and sworn to before me this 6th day of August, 2004.



Mary K. Polack

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by Mary K.
Polack
Date: 2004.08.06
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Mary K. Polack, Notary Public
State of Michigan, County of Jackson
My Commission Expires: 09/09/06
Acting in the County of Jackson

ATTACHMENT 1 -- TO CASE NO. U-12999

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