

STATE OF MICHIGAN
DEPARTMENT OF ATTORNEY GENERAL



MIKE COX
ATTORNEY GENERAL

P.O. Box 30755
LANSING, MICHIGAN 48909

August 6, 2004

Ms. Mary Jo Kunkle
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
Lansing, MI 48911

Dear Ms. Kunkle:

Re: MPSC Case No. U-12999

I am attaching for filing the Attorney General's Replies to Exceptions. I am also attaching a proof of service. This filing is being submitted electronically pursuant to the instructions in the Commission's notice of hearing.

Sincerely,

Donald E. Erickson

Digitally signed by Donald E. Erickson
DN: cn=Donald E. Erickson, o=State of Michigan, c=US

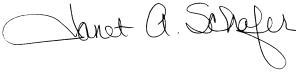


Donald E. Erickson
Assistant Attorney General

c All Parties

PROOF OF SERVICE - U-12999

The undersigned certifies that a copy of the Attorney General's Replies to Exceptions was served upon the parties listed below by mailing the same to them at their respective addresses with first class postage fully prepaid thereon on the 6th day of August 2004.


Digitally signed by Janet A. Schafer
cn=Janet A. Schafer, ou=Special Litigation Division, o=Michigan Attorney General's Office, c=US
Date: 2004.08.06 15:25:23 -0500
Reason: <none>

Janet A. Schafer

Administrative Law Judge:

Mr. Daniel E. Nickerson, Jr. (P36294)
Michigan Public Service Commission
6545 Mercantile Way
P. O. 30221
Lansing, MI 48909 **[ID Mail]**

MPSC Staff:

Mr. Steven D. Hughey (P32230)
Assistant Attorney General
Public Service Division
6545 Mercantile Way, Suite 15
Lansing, MI 48911 **[I.D. Mail]**

Consumers Energy Company:

Mr. Jon R. Robinson (P27953)
Mr. H. Richard Chambers (P34139)
Consumers Energy Company
212 West Michigan Avenue
Jackson, MI 49201

ABATE:

Mr. Robert A. W. Strong (P27724)
Clark Hill, P.L.C.
255 S. Old Woodward Ave., Third Floor
Birmingham, MI 48009

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

MPSC No. U-12999

Attorney General's Replies to Exceptions

Michael A. Cox
Attorney General

Paul F. Novak (P39524)
Assistant in Charge

Donald E. Erickson (P13212)
Assistant Attorney General

Special Litigation Division
Sixth Floor G. Mennen Williams Bldg.
525 W. Ottawa Street
P. O. Box 30755
Lansing, MI 48909

(517) 373-1123

August 6, 2004

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I. Introduction

The Administrative Law Judge (ALJ) issued a proposal for decision (PFD) and a notice of proposal for decision on June 28, 2004. That notice established July 12 as the deadline for filing exceptions and July 26 as the deadline for filing replies to exceptions. Consumers Energy Company (CECo or the Company) requested an extension of those deadlines to July 19 and August 6, respectively, and the ALJ granted those extensions.

The parties filed written exceptions on July 19, and the Attorney General is submitting these replies in response to the exceptions filed by the other parties.

II. Replies to the MPSC's Staff

Pages 17 and 22 in the PFD recommend adopting the proposal sponsored by the Attorney General's witness for calculating net salvage expense in this case. The Staff has requested the Commission to adopt the Staff's proposed methodology for addressing salvage values (Exceptions, p 2). The Staff has apparently had a change of heart.

The Staff's initial brief stated:

Staff continues to support its proposed depreciation rates as set forth in Exhibit S-27. However, Staff believes the witnesses for the AG and ABATE present persuasive arguments for their alternative positions regarding cost of removal expenses. The AG's inflation-adjusted cost of removal proposal and his proposal to recover removal costs following the procedures prescribed in SFAS 143 would reduce removal costs, and would help to eliminate the intergenerational inequities inherent in the traditional approach. An approach which ignores inflationary effects and overcharges customers today for a future inflated cost. The AG's and ABATE's proposal to recover only the current level of removal costs in utility rates is also a reasonable proposal if modified to recognize Consumers' asset retirement obligations as described at 5 Tr 114. This modified proposal would bring Consumers' accounting treatment in line with

SFAS 143, and with the pending Statement of Position (SOP) by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants on “Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment”.

The Staff’s initial brief (pp 8-9) went on to state:

The propriety of the positions of Staff, the AG, and ABATE with regard to cost of removal expenses should be determined by referring to SFAS 143 (“Accounting for Asset Retirement Obligations”) and the pending Statement of Position (SOP) by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants on “Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment”. By focusing on accruing removal costs at present value (AG) (5 Tr 114, 5 Tr 175-178), or recording removal costs to expense as incurred (AG and ABATE) (5 Tr 114, 5 Tr 179, 5 Tr 130), the intervenors’ proposals are consistent with the recent accounting pronouncements. Staff’s proposed treatment of cost of removal, while not strictly in compliance with the recent accounting pronouncements is, if approved by the Commission, allowable under SFAS 71, the accounting standard that allows utility accounting to track with ratemaking treatment.

As Staff’s initial brief indicated, Staff’s approach represents a minimum correction to CEC’s proposed handling of costs of removal. But, the Attorney General urges the Commission to go beyond that minimum correction and adopt the ALJ’s recommendation in the PFD. The Commission should at least remove CEC’s implied inflation and should incorporate present values consistent with SFAS 143. Ultimately, the Commission should use the most accurate, available information regarding CEC’s costs of removal and adopt a cost of removal more appropriately related to actual expense for the last 5 years.

The MPSC must base its decision in this case on the record. MCL 24.285. The record supports, and previously the Staff previously supported, what the ALJ has recommended. Whether the Commission wishes to entertain a generic accounting case should not become the basis for determining the outcome in this case as the Staff’s exception suggests. The Staff’s exception says that its methodology is most appropriate, but Staff’s exception fails to offer any

specific reason why its methodology for addressing salvage values is more appropriate than the ALJ's recommendation.

III. Replies to CECo

A. ALG versus ELG

CECo argues that the Commission should adopt one of its ALG net salvage calculations (Exceptions, pp 4-9). Thus, CECo apparently accepts the ALJ's recommendation (PFD, pp 4-10) to continue ALG depreciation instead of ELG depreciation as originally proposed by CECo witness Roff.

B. Cost of Removal/Net Salvage

CECo argues that the Commission should reject the ALJ's recommendation to adopt the method proposed by the Attorney General's witness to calculate costs of removal (net salvage) (Exceptions, pp 9-23).

First, the CECo argues that the Attorney General has not satisfied the burden of proof required to support a change in method (Exceptions, pp 9-10). That argument is specious at best. As page 14 in the PFD states, "The ALJ finds the testimony and exhibits sponsored by Charles W. King, the witness for the AG, clear, concise, and credible." Mr. King's testimony and exhibits as well as the testimony and exhibits presented by the Staff and ABATE show that the current method supported by CECo result in a total that vastly exceeds CECo's booked depreciation year-in-and-year-out. In addition, CECo's method relies upon historical ratios that assume future inflation will equal historical inflation despite evidence that such an assumption conflicts with current expectations of future inflation.

CECo argues that Mr. King's methodology inappropriately ignores historical relationships and established depreciation principles (Exceptions, pp 11-15). The premise of CECo's arguments beg the question. History may be a basis for predicting future outcomes, but history should not be used when current facts belie use of history. In this case, CECo's recent removal cost experience as well as declining inflation since the 70s and 80s provide an evidentiary basis for the ALJ's conclusion (PFD, pp 14-17) that history is not a valid basis for projecting future costs of removal. CECo argument (Exceptions, pp 14-15) that Mr. King's method ignore established depreciation principles is erroneous. The NARUC quotation offered by CECo says that net salvage is the difference between the gross salvage that will be obtained when the asset is disposed of and the cost of removing it. This definition focuses on projecting future gross salvage and future costs of removing assets. The point of Mr. King's testimony is that CECo's method for projecting those future values is no longer accurate because CECo's method is based upon applying historical relationships which are not reasonably consistent with future expectations. Instruction B from USOA Account 403 does not define how dollars and percentages should be calculated; it merely provides that the resulting amount will be booked in that account.

There are three fundamental errors inherent in CECo's proposals. First, CECo's proposals incorporate previous levels of inflation over many years and assume that inflation from the present will continue at the historical difference for many years in the future. The Commission should eliminate these inappropriate assumptions (5 T 158). Second, the recovery of removal costs precedes the actual incurrence of removal costs, so recovery has a much higher present value than the present value of the incurred costs. As the Financial Accounting Standards Board has recently concluded with regard to asset retirement obligations (AROs),

removal costs should be booked only at their present value (5 T 159). Third, the level of CECo's actual removal costs is well below CECo's estimates of its projected costs, so for ratemaking purposes the MPSC should adopt a calculation that is consistent with actual experience (5 T 159). Using the ratio between actual retirement costs and 2002 year-end plant balances develops a more reasonable estimate of removal cost dollars (5 T 179 and Exhibit I-25). Mr. Simonsen's alternative fails to correct CECo's removal cost calculation to fully remove inflation, to fully reflect the present value of recovery and cost dollars, and to more correctly match annual revenues and expenses.

CECo argues that ALJ's recommendation of Mr. King's method amount expenses costs of removal (Exceptions, pp 16-17). A reasonable examination of Exhibits I-25 and I-26 demonstrates that Mr. King has recommended cost of removal percentages and net salvage ratios, which is what CECo and the Staff did also. CECo simply disagrees with the Mr. King's conclusions regarding the fallacies resulting from CECo's method and Mr. King's revision of numbers to avoid those fallacies. Mr. King proposed applying a different ratio to plant balances to determine depreciation expense; Mr. King did not propose substituting a fixed amount of expense for the effects of gross salvage and costs of removal upon depreciation expense.

CECo has essentially repeated its arguments that the MPSC should use Mr. Roff's "traditional" method (Exceptions, pp 9-10 and 17-18). When the inputs to a traditional method are not reasonably predictive of future results, then the Commission should abandon the traditional method.

CECo argues that Mr. King's method improperly places depreciation on a cash basis (Exceptions, p 19). That argument is a red herring. All witnesses' numbers reflect accruals by CECo; CECo does not book its expenses or revenues on a cash basis.

CECo argues that FERC Order 631 and SFAS 143 do not apply to CECo and, therefore, that Mr. King erroneously relied upon FERC Order 631 and SFAS No. 143 (Exceptions, pp 19-20). Mr. King recommended adopting a method that is consistent with FERC Order 631 and SFAS 143 (5 T 177-182), but he recommended the SFAS 143 method to correct fallacies in CECo's method (5 T 174-176).

CECo argues that the PFD's recommendation will be detrimental to customers in the long run (Exceptions, pp 21-22). This argument begs the question. CECo's argument assumes that historical inflation ratios reflecting historical inflation far in excess of expected future inflation represent an adequate basis for predicting future net salvage/costs of removal. Contrary to the conclusions drawn by Mr. King, Mr. Aldrich, Mr. Selecky, and the ALJ, assuming that CECo's method accurately predicts future costs of removal—despite the huge mismatch between historical removal expense and projected removal expense, then Mr. King's method would understate current depreciation expense. But, CECo's claim is belied by experience and current expectations of future removal costs. CECo's method is simply a mechanical one that reaches a result the Company desires. If CECo's method is erroneous, the current customers pay too much and future customers will pay too little. Intergenerational inequity will only occur if cost projections are too high or too low. The record supports the ALJ's conclusion that Mr. King's method and results are the correct ones.

CECo argues that the Attorney General's position and the ALJ's recommendation in the case violate the principle of gradualism, which the Attorney General has supported in past cases. The most recent occurrence of that argument was in CECo's gas rate case U-13000. Page 60 in the Commission's November 7, 2002 order in U-13000 brushed the gradualism argument aside with barely any comment. The Commission should not reject gradualism in a rate case involving

CECo's recovery of increased costs, and then give the Company the benefit of gradualism in the face of clear evidence demonstrating that CECO's proposed depreciation rates and expense are too high.

IV. Replies to ABATE

The exceptions filed by ABATE address its alternative to fix removal costs as an operations and maintenance expense and leave removal costs out of the calculation of depreciation expense. The Attorney General offers no replies to that argument.

V. Relief Requested

For the reasons stated above, Attorney General Michael A. Cox requests the Michigan Public Service Commission to issue a final order modifying the method used to calculate removal costs (net salvage cost) in calculating depreciation rates and expense and rejecting the ELG depreciation procedure. The Attorney General supports the ALJ's recommendations except as stated in his earlier exceptions.

Respectfully submitted,

Michael A. Cox
Attorney General

Paul F. Novak (P39524)
Assistant in Charge

Donald E. Erickson

Digitally signed by Donald E. Erickson
DN: cn=Donald E. Erickson, o=Michigan
State, email=DERICKSON@MICHIGAN.GOV,
c=US



Donald E. Erickson (P13212)
Assistant Attorney General

Special Litigation Division
Sixth Floor G. Mennen Williams Bldg.
525 W. Ottawa Street
P. O. Box 30755
Lansing, MI 48909

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