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June 24, 2002

Ms. Dorothy Wideman
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

Re: Case No. U-13000

Dear Ms. Wideman:

Enclosed for filing in the above-referenced matter are an original and four copies of the **"Exceptions Of Consumers Energy Company"**. A Proof of Service is also enclosed. In addition, this document is being filed electronically with the Commission in the portable document format (PDF).

Sincerely,

Richard Chambers

H. Richard Chambers

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

f10602-1-80e

S T A T E O F M I C H I G A N

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of	)	
CONSUMERS ENERGY COMPANY	)	
To increase its rates for the distribution	)	Case No. U-13000
Of natural gas and for other relief	)	
______________________________________	)	

EXCEPTIONS OF CONSUMERS ENERGY COMPANY

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BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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EXCEPTIONS OF CONSUMERS ENERGY COMPANY

I. INTRODUCTION

A. Consumers Energy Requests That The Commission Expedite Its Final Order

The application in this case was filed approximately one year ago, on June 29, 2001. As amended during the course of the case, Consumers Energy is seeking an approximately $105 million annual rate increase. On December 20, 2001, the Commission granted a much-needed, but relatively modest, $15,380,000 interim rate increase. Evidentiary hearings were completed on January 31, 2002, and, by February 28, 2002, all briefs were submitted to the Administrative Law Judge ("ALJ"). Approximately 3 months later, on June 3, 2002, the ALJ issued his Proposal for Decision ("PFD"). The schedule established by the ALJ provides for exceptions to be filed by June 24, 2002, and for replies to exceptions to be filed by July 8, 2002. Thus, the earliest a final decision in this case can be issued will be over one year from the date the Company filed its application and supporting testimony and exhibits. Consumers Energy Company ("Consumers Energy") urges the Commission to act expeditiously in issuing a final order in this already seriously delayed case.

B. The Proposal For Decision Does Not Provide A Reasonable Basis For A Decision In This Case

In the PFD, the ALJ essentially adopted the positions set forth by the MPSC Staff on most ratemaking issues. Thus, with only a few exceptions, he accepted the Staff positions on test year, the appropriate manner of applying the "known and measurable" standard, the amount of 2001 and 2002 capital additions for determining 2002 rate base, the amount of Other Operation and Maintenance ("O&M") expense, capital structure and rate of return on equity ("ROE"). Where the ALJ accepted the Staff positions, he often did so in a summary fashion, without a detailed discussion of the arguments presented by Consumers Energy, and without offering any analysis of the strengths and weaknesses of the arguments presented. Because of this approach, Consumers Energy's Exceptions will, in large part, focus on the arguments that have previously been presented by the Staff in this case, and that were, explicitly or implicitly, adopted in the PFD.

It should first be noted that the calculation of the recommended revenue deficiency that is set forth on page 65 of the PFD appears to contain several ambiguities. These are summarized as follows:

-- The ALJ apparently intended to adopt the Staff final net operating income amount as his starting point for use in the ratemaking formula. As shown in the Staff brief at page 73, however, the Staff modified its position to adopt a revised uncollectibles expense amount. Had the ALJ used the Staff's final revised net operating income figure as his starting point, the level of O&M expense would have increased $1,400,000, and he would have therefore recommended an increase in the revenue deficiency of $1,400,000.

-- At page 54 of the PFD, the ALJ appears to adopt the Company's position with respect to an item of Other O&M expense referred to as "accounting for workload realignment." Notwithstanding his apparent conclusion, however, the revenue deficiency does not reflect the inclusion of that expense. Had it been included, the level of expense would have increased by $3,935,000, and the ALJ would have therefore recommended an increase in the revenue deficiency of $3,935,000.

-- Similarly, at page 57 of the PFD, the ALJ appears to have recommended adoption of employee benefits expense levels that had been accepted by the Staff. Notwithstanding this conclusion, however, the revenue deficiency does not reflect the inclusion of that level of expense. Had it been included, the level of expense would have increased by $6,236,000, and the ALJ would have recommended an increase in the revenue deficiency of $6,236,000.

-- There also appear to be a variety of other, more minor errors in the PFD's revenue deficiency calculation.

Attached to these Exceptions as Appendix A is a summary of the adjustments that appear to be necessary to the revenue deficiency recommended in the PFD in order to accurately reflect the apparent intent of the ALJ. This summary was developed in cooperation with the MPSC Staff. As shown on Appendix A, the actual revenue deficiency apparently recommended by the ALJ is $41,476,000.

C. <u>The ALJ's Reliance On The Staff Position Is Misplaced</u>

The primary differences between the Staff and Company positions in this case concern the determination of the appropriate level of capital investments for 2001 and 2002, and the appropriate level of other O&M expenses for 2002. Concerning these issues, the central argument made by the Staff and accepted by the ALJ was the allegation that Consumers Energy failed to present adequate evidence to support its proposed 2001 and 2002 capital expenditures and its proposed level of 2002 O&M expense. A review of the record evidence, which will be summarized below, demonstrates that the adequacy of the Company's evidence cannot be fairly criticized. Indeed, while the Staff approach merely applied inflation factors to an average of historical levels of capital expenditures and to the 2000 level of O&M expense to arrive at 2002 test year amounts, Consumers Energy presented detailed and comprehensive descriptions of programs and associated costs. The issue in this case is emphatically <u>not</u> which party presented the more complete and thorough analysis of the costs necessary to provide safe and reliable natural gas service. The Company's evidence easily wins any objective contest based on that standard. The real issue in this case is whether the regulatory philosophy of the MPSC Gas Division Staff will prevail. The Gas Division Staff obviously believes it is preferable to simply apply generic, across-the-board inflation adjustments to historical levels of capital investment and expense instead of conducting an analysis of the actual costs that are needed in order to provide safe and reliable service. The Company strongly contends that, at least in this case, the record demonstrates that the Staff approach results in a dramatic understatement of the true cost-of-service.

II. <u>TEST YEAR</u>

<u>The ALJ Erred In Adopting An Unduly Restrictive View of Known And Measurable Changes</u>

The Company presented detailed historical information based upon actual results for the year 2000. This formed the basis for Consumers Energy's interim rate relief request. For purposes of final relief, however, the Company presented a 2002 test year that is based upon Company management's analysis of what is <u>required to provide safe and reliable service</u>. This includes the projections of 2001 and 2002 capital expenditures and of 2002 O&M expenses. It is important that a 2002 test year be utilized since the rates that result from this case will go into effect sometime in 2002 and remain in effect thereafter. Basing rates on a historical test year would make it impossible for the Company to perform the work necessary to provide safe and reliable service and to earn a just and reasonable return.

As the evidence in this case makes clear, however, utilizing a projected 2002 test year requires more than just placing that label on a party's filing. The MPSC Staff states in testimony that, "Staff adopted Consumers' recommended test years. Consumers chose the 12 month ended December 31, 2000 as its historical test period and calendar year 2002 as its projected test year in this case." 11 TR 1798. Although it stated it was adopting the 2002 test year for final rate relief purposes, the Staff simply adjusted the 2000 historical results by estimated inflation to arrive at the 2002 test year. The Staff indicated that it was applying a policy of making adjustments for "known and measurable" changes; but Consumers Energy contends that the Staff approach followed in this case was so conservative that it completely failed to recognize the resources actually needed to provide safe and reliable service, and completely failed to recommend rates that will allow Consumers Energy a reasonable opportunity to earn a just and reasonable return in 2002 and thereafter. Consumers Energy's Executive Director of Rates and Electric Strategic Business Unit Planning, Mr. Ernst, addressed this aspect of the Staff presentation:

> "I believe that Staff has only presented a partial projected test year, having selectively chosen specific items that they wish to project in their analysis and rejecting or ignoring the majority of items." 12 TR 2234.

Mr. Ernst elaborated on this issue as follows:

> “Q Do the Commission’s gas standardized filing requirements allow for the Company’s interpretation of test year level of expenses and expenditures other than that presented by the Staff?
>
> “A Yes. The Commission’s gas standard filing requirements allow for the inclusion of known and measurable changes in establishing test year revenue requirements for gas. I believe that the Company has presented, through the testimony of several witnesses, many known and measurable projects and expense level increases that Staff has chosen to ignore.
>
> “Q What are the basic problems with Staff’s approach?
>
> “A The MPSC Gas Staff adopted a normalized historic test year with very limited known and measurable adjustments. Staff’s volumetric approach assumes that the cost of serving additional customers remains constant and locked-in at the adjusted historical levels. Sales forecasts are not utilized. The volumetric approach doesn’t account for reduced usage per customer or increasing expense levels.
>
> “The Gas Staff effectively requires that expenses be incurred in the historical period prior to allowing rate recovery. The [Staff] application of known and measurable adjustments simply does not work where there are demonstrated needs to spend at increasing levels to meet requirements that address system reliability, safety, security and customer expectations.
>
> * * *
>
> “Q What is the end result on the Company if Gas Staff’s approach is adopted?
>
> “A Failure to adopt a fully projected test year or a progressive approach to known and measurable adjustments in an increasing cost environment will result in rates that are inadequate to meet requirements. This, in turn, will require the Company to file and litigate ongoing rate cases, in a relatively short period of time, with the resulting regulatory lag. The company should be allowed a fair opportunity to earn its authorized rate of return at the time new rates are

placed in effect, rather than start out behind due to the use of a historical approach and the resulting regulatory lag.

"Q Is the methodology of developing the Other O&M expense used by the Staff for the test year level of expense appropriate?

"A No. The Company's presentation was significantly different than the methodology used by the Staff. The Staff's methodology produces an increase in expense over the historical period at essentially the rate of inflation for non-volumetric related O&M expense. Such an approach does not result in a reasonable level of Other O&M expense for the Company in this case.

"The Company's presentation utilized a more thorough methodology focusing on the significant growth in the identified programs. The testimony of Company witnesses PN Preketes, D DaPra, BC Sosinski, and RD Gladney addressed those specific programs. Mr. Torrey covered the non-specific program portion of Other O&M expense with a simple mathematical inflation adjustment.

"The difference between the two presentations is over $44 million ($286.0 vs. $241.6). These figures represent O&M levels for the combined Consumers and Michigan Gas Storage systems. This is an enormous variance that must be specifically addressed by the Commission.

"The Company has presented detailed evidence through several witnesses showing that the higher level of Other O&M expense is necessary to meet the near term needs of the gas transmission, storage, and distribution system. <u>The method of presenting the expense requirements that the Company made in this proceeding identified the specific programs and related actions underlying these needs.</u> The increase in expense requirements were categorized in programs to more easily identify those needs. <u>The Staff's presentation essentially declined to analyze that expense breakdown</u> and focused on a method that is not adequate to meet current known and measurable system needs. Thus, Staff has substantially understated revenue requirements associated with operation and maintenance." 12 TR 2235-2237. (Emphasis added.)

While both the Company and the Staff agreed on the use of a projected 2002 test year that includes known and measurable changes, only the Company's presentation actually accomplished this stated goal.

The following chart is a summary of the differences between the Staff and the Company for capital additions and O&M expense:[1]

Combined (CECo and MGS) Construction Expenditures

	2001	2002	Total
MPSC Staff [a]	$73,367,000	$75,050,000	$148,423,000
Consumers Energy [b]	$92,959,000	$133,011,000	$225,970,000

(a) Ex. S-121, Sched B-1-1, p 1 and 2 (CECo), and Ex. S-129, Sched B-2 (MGS).

(b) Company Brief, Appendix B, page 2.

Combined (CECo and MGS) O&M Expenses for 2002

	Other O&M	Company Use	Total
MPSC Staff	$236,353,000	$5,247,000	$241,600,000
Consumers Energy	$275,437,000	$7,729,000	$283,166,000

Company Brief, Appendix C, pages 1-3.

Staff, Ex. S-124 (CECo) and S-130 (MGS).

The reason for these differences is straightforward. For capital additions, the Staff, with only a few exceptions, simply took a five-year average of capital expenditures for the period 1996-2000, then escalated that average by 2.7% to obtain 2001 capital expenditures, and then by another 2.4% to obtain 2002 capital expenditures. 10 TR 1597. In contrast, Consumers

[1] These figures include Michigan Gas Storage Company. The Federal Energy Regulatory Commission ("FERC") issued its order approving exemption of MGS from FERC regulation under Section 1(c) of the Natural Gas Act upon its regulation by the MPSC in Michigan Gas Storage Company, Docket No. CP02-22-000, 98 FERC ¶ 61,223 (February 28, 2002).

Energy presented evidence describing specific capital projects and the associated costs that the Company would incur in 2001 and 2002. For O&M expenses, the Staff, again with a few exceptions, took the year 2000 level of expense and escalated it by 2.4% and 2.7 % (5.2% total) to arrive at their 2002 test year level of expense. In contrast, Consumers Energy presented evidence describing specific programs and associated expenses that are incremental to 2000 expense levels.

Thus, while the Company attempted to provide very specific supporting reasons for the rate increase it has sought in this case, the Staff declined to review those reasons and simply applied inflation factors to base historical amounts. No one can dispute that the Company's evidence is far more informative, and allows a more detailed understanding of the reasons for the rate increase being sought by the Company. It is difficult to understand why the Staff has taken the position that it is preferable to base rates upon across-the-board inflation adjustments, rather than upon detailed descriptions of programs and investments. The latter clearly provides a more meaningful basis for establishing rates.

The Staff's position ignored the fact that actual 2001 O&M expenses ($243 million; 13 TR 2340) exceed the Staff's recommended amount of O&M expense for the 2002 test year. The Staff's position ignored that the Company's actual earned return on equity declined throughout 2001, and had reached 4.67% for the 12 months ended November 2001.[2] See 11 TR 1819; Exhibit A-118. Most importantly, the Staff position ignored the fact that the programs identified by Consumers Energy and the associated costs are critical to providing safe and reliable service to customers.

[2] Although admittedly not a part of the evidentiary record, the return on equity reports filed by the Company with the Commission since the close of the record in this case continue to show low returns.

For many years, the Commission has consistently utilized projected test years to establish utility rates. The standard for determining the ingredients of a projected test year has also been fairly consistently stated, and is represented by the following excerpt from the Commission's June 29, 1990 Opinion and Order in Case No. U-9323:

> "A test year is a device employed to determine representative revenues, expenses, rate base, and capital structure for use in the rate-setting formula. A test year may employ historical, projected, or a combination of historical and projected data. A historical test year uses the latest known level of activity as a normal representation of future levels of activity, whereas a projected test year uses future expected levels of activity that incorporates normal changes in activity levels from one year to the next. However, both historical and projected test years use future expected price levels. Thus, so-called 'historical' test years and 'fully-projected' test years seek to set future rates by projecting future costs. <u>The difference between the two is that historical test years are based on the assumption that known business activity levels are representative of normal future business activity levels, while projected test years are based on attempts to project future changes in known business activity levels</u>." Opinion and Order, Case No. U-9323, p 7. (Emphasis added.)

Consumers Energy submits that, in this case, the Staff concluded, without doing the necessary investigation, that, if a modest inflation adjustment was made to year 2000 known business activity levels, the result would be representative of normal future business activity levels. This is clearly incorrect in light of the voluminous evidence Consumers Energy presented in this case, which has demonstrated beyond any reasonable doubt that the business activity levels (i.e., capital investment and O&M expense requirements) Consumers Energy needs to incur in 2001, 2002 and thereafter far exceed what the Staff approach yields.[3]

The ALJ apparently accepted the Staff allegation that the Company failed to provide details concerning the 2001/2002 capital expenditures and the 2002 O&M expense levels

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[3] As noted above, the Company's actual Other O&M expenses in 2001 were $243 million. 13 TR 2340.

it was proposing in this case that were adequate to demonstrate that these expenditures were "known and measurable." The fact is, however, that significant details were provided in testimony, exhibits, and workpapers.

An example of the information supplied in this case concerns the Operator Qualification program that was described by Mr. Preketes. This is a program that is designed to comply with new regulations required by the Pipeline Safety Reauthorization Acts of 1992 and 1996. As Mr. Preketes testified,

> "The intent of the regulation is to ensure a qualified workforce, and to reduce the probability and consequence of incidents caused by human error. The regulation requires pipeline operators to develop, maintain and execute a qualification program for individuals performing certain tasks on pipeline facilities. Full compliance with all provisions of the regulation is required by October 28, 2002." 6 TR 728.

The ALJ noted Staff's argument that the regulation has been in place for 3 years and that Consumers Energy's employees are already in compliance, thus implying that no increase in costs is warranted. As Mr. Preketes made clear, however, the regulation required an affected employer to have a compliance plan in effect by April 2001, and employees are to be qualified and certified under the plan by October 2002. The plan requires an extensive certification process that, contrary to the Staff's allegation, Consumers Energy employees did not meet prior to 2002. The additional costs are required to fully implement the compliance plan. The 2002 O&M expense associated with this program is $6,563,000, which represents a significant increase over the 2000 level of expense for this program of $2,468,000. See 6 TR 728; Exhibit A-66; Appendix C to initial Company Brief, page 2, line 8.

With respect to the "known" nature of the Operator Qualifications program, Mr. Preketes pointed out that the MPSC Gas Safety Staff has been directly involved in the

Company's planning efforts to achieve compliance. This included multiple briefings provided to the Gas Staff, inviting Gas Staff representatives to meetings of industry groups at which this issue was discussed, submitting the written program developed by Consumers Energy to achieve compliance with the Operator Qualification rules to the MPSC Staff, and undergoing a compliance inspection by MPSC Gas Safety Engineers on April 27, 2001. See more details at 13 TR 2316. Obviously, this is a "known" change. The MPSC Staff is fully aware of this program and the associated costs.

With respect to the "measurable" nature of the Operator Qualification program, Exhibit S-185 consists of many of Mr. Preketes workpapers originally filed in this case. The page marked "PNP wp-14" provides details concerning the development of this Operator Qualification ("OQ") expense. Of the $2,468,000 increase (i.e., 2002 over 2000), $981,000 is for training activities for gas operations, while $877,000 is for training activities for gas field operations. The components of the $981,000 and $877,000 increases are listed on that page as follows:[4]

"--	Inflation	$84
--	Add 1 Non-Ex in Engineering[5]	$20
--	Add 1 Exempt for IT training	$35
--	1/2 Headcount from FM for OQ	$43
--	1/2 Headcount from FM for OE	$43
--	Add 1 Exempt Team Ldr in Safety	$40
--	Trainers for OQ	$222
--	Training Evaluators for OQ	$458
--	Tx 1/2 Headcount to Supv/Admin	($15)
--	Building Modifications	$10
--	1 Headcount from FM for OQ	$5
--	Contractor Admin for OQ	$36"
	Total =	$981,000

[4] Numbers are in thousands.

[5] A "non-exempt" employee is an employee covered by the wage provisions of the Fair Labor Standards Act.

“--	Inflation	$145
--	OQ Formal Training	$444
--	Fuel Cost Increase	$18
--	Overtime due to OQ	$210
--	Increased Training for CPR/First Aid	$60”
	Total =	$877,000

The remainder of the $2,468,000 increase is similarly identified.

This level of detail clearly provides an adequate basis to review the cost of the Operator Qualification program. Although the ALJ indicated at page 52 of the PFD that this degree of detail was inadequate, he failed to explain his conclusion. It is hard to imagine what additional information could be necessary. The evidence that the Company presented overwhelmingly justified both that the program was needed (indeed, required by federal law), and the total cost of the program. The evidence presented further identified the various sub-components of the total cost of the program. Given the detailed evidence on this issue, and the fact that the MPSC Staff is very familiar with the details of the program, it is completely unreasonable to refuse to reflect these costs in rates. A claim that this program is not “known and measurable” cannot reasonably be sustained.

Another example of the thorough evidence presented by Consumers Energy concerns the Pipeline Integrity Program. Mr. Preketes testified that there have been a series of pipeline ruptures that have occurred, which he identifies at 13 TR 2320. He stated as follows:

> “Remedial action from the analysis of the above pipeline ruptures indicate that there are problems that need to be addressed and the only way to verify the integrity of the transmission system is to implement a program that will analyze the condition of the pipelines so that they can be made safer as soon as possible. This program will be capital intensive in order to allow in-line inspection devices (‘smart pigs’) to be launched and received, retrofitting pipelines to make them smart pigable and remediating inferior sections of pipeline based on the analysis of smart pig data.

> "In 2000, Consumers identified 18 replacements of pipe on the 1300 line that required replacement based on the pipeline inspection device data after the March 7, 1999 rupture. In 2001, after reanalysis of this data, approximately one mile is being replaced and there have been additional anomalies identified. Currently, the pipeline is being operated at a reduced Maximum Allowable Operating Pressure ("MAOP") until additional work is completed.
>
> "Based on a pipeline inspection run in December 2000 of the 1700 line, 12 locations had to be cut out and replaced. The pipeline was operated at a reduced MAOP until repairs were made. This action was taken to avoid a potential rupture this winter which could have had a significant impact on serving the metro Detroit area. In many locations, this pipeline lies in the back yards of residential areas. Based on a close interval inspection survey in 2001 for the 600 line, exterior corrosion was found and approximately 80 feet of pipe was replaced. This was another potential pipeline rupture that was avoided through proactive inspection and repair actions.
>
> "<u>The MPSC Safety Staff has been aware of all of these issues.</u> The transmission system age and recent history indicates that additional resources and capital are required to maintain system integrity and safety. Continued safe and reliable operation of the gas transmission system depends on the financial ability of the Company to address these known and measurable pipeline integrity issues." 13 TR 2320-2321. (Emphasis added.)

The evidence is clear: this program is well- "known" to the MPSC Gas Safety Staff, and the associated costs are measurable based upon the history of dealing with these issues. More importantly, the program is clearly extremely important to assuring the safe and reliable operation of the Company's gas system. The PFD's omission of these facts does not change them.

Another example of the level of details supplied by the Company is provided by Exhibit S-69, which is a discovery response prepared by Mr. Preketes concerning the program Consumers Energy has underway to move customer meters located inside buildings to a location outside the buildings. In his testimony, Mr. Preketes described this aspect of this program as follows:

> "The Company has instituted a 10-year plan to move meters that are located inside customers' premises to outside locations. This plan will result in an increase in the volume of meters processed by the Meter Shop by approximately 10,000 to 12,000 per year for the next 10 years. The additional staff will be necessary to handle this increased volume." 6 TR 733.

In Exhibit S-69, Mr. Preketes provided significant details concerning this program and the associated costs. For example, he identified the number of meters that the Company has moved from inside to outside over the 1996-2001 period, he identified the average O&M cost and the average capital cost for each year for these relocations, he identified the number of meters remaining inside, he identified the estimated O&M expense and capital cost of the relocations for each year of the 2001-2005 period, and he identified the capital cost of purchasing approximately 11,000 meters per year. Important to this case, he also lists the <u>benefits</u> derived from this program, including that it will reduce the potential for inside gas leaks and will allow for a quicker detection of gas leaks. See Exhibit S-69, which also includes copies of letters between the MPSC Staff and the Company that document the details of the program.

In the face of this evidence, it is simply inaccurate to claim that there were insufficient details provided by the Company to allow an evaluation of the capital investments and O&M expense proposed by the Company in this case. Additional examples will be provided later in these Exceptions of the extensive record made in this case supporting the Company's position.

Perhaps recognizing the weakness of its argument that the Company failed to provide adequate details supporting its proposed level of capital investment and O&M expense, the Staff also made several other arguments. First, it contended that, "because of the limited time schedule provided in this rate proceeding, Staff was not able to review, understand and pass judgment on the management budget forecasts and adequately review and verify Consumers' actual historical cost of service at the same time." Staff Brief, p 21. In response, the Company does not mean to diminish the scale of the task that the Staff undertakes in connection with a general rate case. Yet, the evidence in this case establishes that, through their Gas Safety Section, the MPSC Staff was well aware of most of the capital and O&M programs on which the Company presented evidence <u>even prior to the commencement of this case</u>. It was not necessary for the Staff to start from scratch and attempt to understand the reasons for and the costs associated with most of these programs. <u>They already had that information</u>.[6] Further, MCL 460.6a establishes a statutory goal of completing general rate cases within nine months. The schedule that the Company initially agreed to in this case was approximately an 11 month schedule,[7] which should have been ample time to review the issues presented in this case.

The Staff also made the allegation that the Company "imposed additional obstacles" in this case by failing to respond to audit requests in a timely manner. Staff brief, p 22. That is untrue, and cannot serve as a justification for the Staff position in this case. Mr. Torrey responded to this allegation in his rebuttal testimony, and makes it clear that the Company fully cooperated with the Staff throughout the course of its audit. See 12 TR 2252-2253.

[6] See, e.g., 13 TR 2316 where Mr. Preketes describes the communications between the Company and Staff concerning the Operator Qualification program; 13 TR 2318 where he explains that the MPSC Staff reviewed and agreed to the Company's Damage Prevention plan; 13 TR 2318-2319 where he testifies that the Staff agreed to the Meter Move-out program; 13 TR 2321 where Mr. Preketes notes that the Staff has been kept aware of issues concerning the Pipeline Integrity program; 13 TR 2322 where he testifies that the Staff and Company have had discussions concerning increasing security measures.

[7] As noted earlier, schedule delays in this case now make it impossible for a final order to be issued prior to approximately 13 months from the filing of the application.

The fact is that the Staff simply declined to review in any detail the evidence presented by the Company concerning its 2001 and 2002 capital investments and O&M expenses, preferring to stick to a narrow review of the 2000 year data. That choice was not made due to lack of time, or due to lack of information. To the Company's great frustration, however, it was made in the face of overwhelming evidence that the Company needs to spend increasing amounts on its gas distribution and transmission systems to assure the continued supply of safe and reliable service to customers. Indeed, the Staff recommendation was made notwithstanding the Staff's admission that it did not know whether it was adequate or not. Its chief witness testified as follows:

> "Q Do you think Consumers Energy can adequately perform the work needed in 2002 to assure safe and reliable gas service that's in compliance with all state and federal rules and regulations if it only spends what the staff has recommended be used to set rates in this case?
>
> "A I don't know if they can or not." 11 TR 1836.

Further discussion of the evidence that the Staff refused to acknowledge is set forth below.

III. RATE BASE

The ALJ Erred By Understating Net Utility Plant In Developing Rate Base[8]

Consumers Energy presented evidence supporting an average net plant amount of $1,017,108,000 for Consumers Energy and $59,680,000 for Michigan Gas Storage Company ("MGS") (for a total of $1,076,788,000).[9] See Exhibit A-8, Schedule B-2. These amounts reflect year end 2000 figures, adjusted to reflect specific plant additions in 2001 and 2002.

[8] The manufactured gas plant component of rate base is also understated. Manufactured gas plant expenditures are discussed in Section VI of the Company's Exceptions.

[9] See Company initial Brief, page 10, footnote 1, for the explanation of a correction to the Company figure that increases net utility plant to $1,085,875,000.

Consumers Energy witnesses Mr. Preketes, Mr. DaPra, Mr. Sosinski and Mr. Gladney sponsored testimony and exhibits detailing those additions. See Appendix B for a more detailed discussion of the capital investments described by these witnesses.

The MPSC Staff presented evidence supporting a net plant amount of $971,443,000 for Consumers Energy (Exhibit S-121, Schedule B-1) and $66,334,000 for MGS (Exhibit S-129, Schedule B-2) for a total of $1,037,770,000. Thus, the Staff understates net plant by approximately $39 million ($1,076,788,000 - $1,037,770,000). The methodology used by the Staff started with year-end 2000 actuals. The Staff then calculated a five year average amount of capital expenditures for the 1996-2000 period, and escalated this average for two years worth of inflation (supposed to represent 2001 and 2002 inflation). See 10 TR 1596-1597.

Michael Torrey, Consumers Energy's Director of Revenue Requirements, Cost Analysis and Planning, testified that the Staff methodology is inadequate for two reasons. First, it fails to recognize the actual investments Consumers Energy must make in order to continue to provide safe and reliable gas service. The Staff should have reviewed (and then adopted) the actual capital investments that were identified by Company witnesses for 2001 and 2002. Second, the Staff's methodology is mechanically flawed in that Staff's five year averaging technique understates the impact of inflation over the seven year period relevant to this approach (1996-2002). This understatement occurs because the five year average amount of capital expenditures computed by the Staff effectively results in an amount stated in 1998 dollars (i.e., the average of 1996-2000 capital expenditures). When the Staff applies 2001 and 2002 inflation factors to this average, they only adjust the average to 2000 dollars (1998 escalated by two years of inflation), which leaves the 2002 test year for net plant understated. 12 TR 2248-2251.

Mr. Torrey presented rebuttal evidence that explained that the Commission should adopt the Company's net plant figures because they reflect actual investments planned by the Company's management for 2001 and 2002. If the Commission nevertheless determines to use the Staff approach, however, it must at least correct the mechanical flaws in the Staff's averaging technique. Mr. Torrey explained that this could be done by first escalating each year's capital expenditures in the five year period to state these amounts in year 2000 dollars, and then computing the five year average. This five year average would then be escalated for 2001 and 2002 inflation. Computing the capital additions in this way would increase Staff's net plant amount by $6,015,000. See 12 TR 2248-2251; Exhibit A-176. This would increase Staff's total net plant amount to $1,043,785,000, which would increase Staff's recommended revenue deficiency by $562,000. See Exhibit A-176. Because this increase in net plant would increase book depreciation and real and personal property taxes (i.e., there is more plant to depreciate and tax), the total impact of this correction to the Staff net plant methodology is an increase in revenue requirements of $948,000. See 12 TR 2248-2251; Exhibit A-176.[10] Consumers Energy is not advocating that the Commission use the Staff net plant figures, but if the Commission decides to do so, at least this adjustment should be made.

As noted above, Consumers Energy presented detailed evidence describing the capital investments that must be made in 2001 and 2002 in order to continue providing safe and reliable service. These investments are supported by the testimony of Mr. Preketes, Mr. DaPra, Mr. Gladney and Mr. Sosinski. Rather than use the artificial five year averaging technique described above, the Staff should have reviewed these 2001 and 2002 investments. Had it done so, it would have agreed that the Company's evidence was a far more accurate means of determining 2002 net plant. The Company's evidence in this area is summarized on Appendix B

[10] This adjustment is further discussed at pages 27-29 of the Company's Reply Brief in this case.

to these Exceptions. There is no evidence supporting a conclusion that these investments are unreasonable or imprudent. There is no evidence in this record supporting a conclusion that the amounts identified for these investments are overstated. There is only the Staff's and ALJ's refusal to analyze the evidence of Consumers Energy, in favor of a simple inflation adjustment to historical levels of investment.

As is evident from a review of the evidence summarized on Appendix B, the capital expenditures included in Consumers Energy's presentation in this case are based upon detailed, comprehensive plans. They do not constitute mere guesses or speculation. The projects are well-defined, for the most part have been reviewed by the MPSC Gas Safety Staff, and are needed in order to allow the Company to continue to provide safe and reliable service. The cost of those projects is based upon contracts and past experience. There is no valid reason to refuse to reflect these capital investments in the rates adopted in this case.

IV. O&M EXPENSES

The ALJ Erred By Recommending A Level Of O&M Expenditures That Is Unreasonably Low

The Company submitted its O&M evidence through multiple witnesses. As an aid in understanding the differences between the Company and Staff positions on O&M expense, the Company prepared an attachment to its Initial Brief, identified as Appendix C, pages 2, 3 and 4. This is attached to these Exceptions as part of Appendix C to these Exceptions. Page 2 compares Consumers Energy's O&M expenses for the year 2000 and the year 2002 with the Staff's recommendations. Column (f) identifies the difference between the Company's 2002 proposed O&M expenses and Staff's recommendations for 2002 O&M expenses. Page 3 provides the same information (in the same format) for MGS. Page 4 shows the development of certain of the expenses on pages 2 and 3.

The evidence offered by the Company concerning its 2002 level of O&M expense is summarized on Appendix C to these Exceptions. The Company urges the Commission to review all of this material to make its own evaluation of the adequacy of the Company's evidence and to provide itself assurance that the identified projects are indeed important to the continued provision of safe and reliable service. For purposes of emphasizing the need that exists, however, Consumers Energy will focus in these Exceptions on several important areas.

The Staff alleged, and the ALJ accepted the allegation, that the Company failed to provide adequate evidence supporting the claim that various programs discussed in Mr. Preketes rebuttal testimony are "known and measurable." This allegation cannot be sustained if the actual evidence presented by Mr. Preketes is reviewed:

> "The analytical methodology used to demonstrate that these expenditures were 'known and measurable' can be summarized as follows:
>
> "Known changes
>
> "a. The material condition of our facilities, pipes, valves, and other equipment is known from inspection, pigging, analysis, and other sound engineering methods.
>
> "b. The volume of that work is known from actual data or consistent trends.
>
> "c. The work has been reviewed with the Gas Safety Staff or other regulatory agencies or is the result of a known change in a rule or regulation.
>
> "d. The work is known if it has been agreed to be performed as the result of an MPSC Gas Safety Staff noncompliance resolution.
>
> "These known changes are certainly not budget forecasts that management can change at their discretion as the Staff's testimony claims.
>
> "Measurable Changes

> "The work is measurable from a cost and volume standpoint if one of the following occurred:
>
> "a. The work is a continuation of a previous year project and the unit costs are established, such as meter move costs.
>
> "b. The work has been performed in the past and the cost to do such work is known and easily measurable within the industry, such as pigging costs.
>
> "c. The costs are consistent with our historical unit costs." 13 TR 2313.

Mr. Preketes emphasized that the costs he presented were not mere "estimates":

> "Q Is it correct to described these costs as 'estimates'?
>
> "A No. It is important to understand that the projected expenditures that I am sponsoring are not estimates. They relate to known work with known costs. The expenditures are based on the condition of the Company's natural gas distribution and delivery system as constantly monitored by myself and the individuals who report to me. The cost of the activities that I have testified about is also known from our long experience with our system and through our previous work experience operating our system." Emphasis added. 13 TR 2314-2315.

In his rebuttal testimony, Mr. Preketes gave additional concrete examples of the known and measurable nature of these various programs. With respect to the Damage Prevention Program, Mr. Preketes testified that this program is designed to prevent excavation dig-ins to underground gas facilities. He explained that the Michigan Gas Safety Code requires Consumers Energy to have "a written program to prevent damage to pipelines from excavation activities." 6 TR 716. He further testified that the additional costs for this program included in this case are in part a result of three allegations of noncompliance received by the Company from the MPSC Gas Safety Staff which pertained to staking timeliness. 13 TR 2318. He explained that:

> "The MPSC Gas Safety Staff has reviewed Consumers' plan to resolve these issues and agreed to the final plan at a meeting on 11/7/01. The plan includes adding 25 additional employees, which is a known cost, to provide timely staking for major construction projects. Refer to Exhibit A-183 (PNP-4), lines 10-15, for the detailed known and measurable costs to support this program." 13 TR 2318.

Reference to Exhibit A-183 will reveal that the Company provided a detailed breakdown of the costs associated with the Damage Prevention program, separating the costs into categories of (i) wages and business expenses, (ii) supervisory and program management support, (iii) planning, scheduling and engineering services, (iv) advertising and promotional services, and (v) inflation on the base costs in 2000 for this program. It is clear that more than adequate information was supplied to the Staff for it to conduct a further review of these programs, if it had desired to do so. Indeed, as noted by Mr. Preketes, the Gas Safety Section Staff was already quite familiar with the Damage Prevention Program. 13 TR 2318. As shown in Appendix C, the adoption of the Staff level of O&M expense in the PFD understates these program costs by over $2 million.

With respect to the Meter Move Out Program, Mr. Preketes testified that it:

> "was implemented as a resolution to an MPSC Staff allegation of noncompliance dated 9/18/00. On November 20, 2000, the Company agreed to initiate a 'ten year plan to move all residential meters on its medium-pressure system from inside to outside.' * * * The Staff accepted the Company's proposal by letter dated August 15, 2001. The program was designed to start in 2001 and end in 2010. This program requires Consumers to move 10,000-12,000 residential meters annually from inside the building to outside. Annual progress updates are required by the staff. The known and measurable costs of this program are detailed in Exhibit A-183 (PNP-4), lines 16-19. <u>These costs are based on actual unit costs incurred during 2001</u>." 13 TR 2318-2319. (Emphasis added.)

Obviously, this program is both "known" (being done pursuant to an agreement between the Staff and the Company), and "measurable" (costs are based on the actual unit costs that the Company has actually incurred for these meter moves). See Exhibit S-69. Company is surprised that the Staff would argue to the contrary. As shown in Appendix C, the adoption of the Staff level of O&M expense understates these program expenses by $454,000.

The "known and measurable" nature of the Operator Qualifications program was discussed earlier in these Exceptions. As shown in Appendix C, the adoption of the Staff level of O&M expense understates the expenses associated with this program in 2002 by $2,255,000. To emphasize the point, this program is not optional and these are not optional expenses.

With respect to the Corrosion Control program, Mr. Preketes testified that this is also being done pursuant to an agreement with the MPSC Staff, and that the costs are well documented, since it has been underway for several years. In order to meet the terms of the agreement with the Staff, Consumers Energy must assign additional resources to the cathodic protection and atmospheric corrosion prevention work called for by the agreement. 13 TR 2319-2320. This program is clearly known and measurable.

While the Staff has never challenged the need for the programs described by the Company's witnesses, the Staff did file testimony complaining that the Company is not statutorily compelled to spend the O&M expense money it has projected will be spent in the 2002 test year. 11 TR 1802. Staff characterizes the O&M expenses for 2002 supported by Mr. Preketes as merely "budget requests," and, therefore not "known and measurable." *Id*. Elsewhere, Staff testified that "the Commission should only consider the rate impact of the decisions made by the management after those decisions are implemented operationally and recovery of the costs associated with those management decisions is sought in a rate proceeding." 11 TR 1801-1802. In other words, only <u>after</u> the money is spent is it appropriate to reflect it in rates.

In a December 7, 1989 order in Case No. U-8678, the Commission expressed a standard that is far less restrictive than what is advocated by the Staff in this case. In that case, the Commission stated that "adjustments that are fairly easy to predict with a high degree of accuracy and are fairly certain to occur, should be taken into account if supported by the evidence." *Id.* (Emphasis added.) There is no question that the 2002 O&M expenses described by Company witnesses are "supported by the evidence," since they are described in detail and no party contradicted the programs, amounts or reasonableness of the O&M expenses. In addition, no one disputed that the expenditures were "fairly certain to occur" for the simple reason that the programs that Mr. Preketes testified about are already underway and dollars are already being spent on them:

> "Q Could you turn to your page 7 of your rebuttal testimony. On page 7 of your testimony in lines 8 through lines 19 you list a number of different programs which I believe you are suggesting that staff is recommending disallowances for funding of these programs. Is that correct?
>
> * * *
>
> "A Yes. . . .
>
> "On Operator Qualification Program, yes, that program started prior to 1999. **It is in full swing**.
>
> "It has to be. As my testimony says, we have to be in full compliance with the law in October of 2002, which requires about 48,000 evaluations, **which are well under way**.
>
> "Damage Prevention Program. We have geared that program up in discussions, as I have said in this rebuttal testimony. **That is well under way.**

"The Meter Move-out Program started in 2001, **it is well under way.**

"The Engineering Planning and Scheduling program is what has to be done. It is the mechanics that make all these work, so if these programs are done, that's done.

"The Corrosion Control Program started in 1994. It was a 10-year program with the Commission. It ends in 2004. **That is well under way.**

"Pipeline Integrity Program, the initial work that we did in that was in 1999. We did work in 2000, we did numerous work in 2001, and t**hat is well under way.**

"The Material Condition Program, which includes the Meter Move-out Program –

"JUDGE NICKERSON: Excuse me. It says excludes Meter Move-out.

"A Oh, excluding the Meter Move-out. The Material Condition Program, excluding the Meter Move-out, is **partially under way.**

"Pipeline Security Program, which deals with the events that the Office of Pipeline Safety, which is part of the Department of Transportation, asked us to perform, **is under way to** provide a baseline security as defined in the negotiations and discussions we've had with the Office of Pipeline Safety, Department of Transportation and Department of Energy, and that the American Gas Association has done in conjunction with the Interstate Natural Gas Association, and I'm actively involved in that as the Chair of the Operating Section of the American Gas Association.

"The Accounting Changes are all **in place for 2002.**

"The Civic Replacement has been **in place for years**. There was a significant known and measurable change that happened in 1998, when the state and federal government put additional money into the road program and that program jumped up. In fact, the number that I corrected earlier in my testimony of $32,300,000 was spent in 2001

> on that program. That's the highest amount we've ever spent on that program.
>
> "The Uncollectibles. Uncollectibles happen every year, as it says in my testimony. The bad debt loss ratio increased. It increased to .35 in the year 2000, and whether you look at the year 2000 or you look at the average that was asked for in discovery, it's .35. **So that's happening.**
>
> "And the Customer Contact Expense is happening because it was a **known postage increase**. There's a known additional number of customers and a known additional number of contacts." 13 TR 2327-2330. (Emphasis added.)

Mr. Preketes testified that the total O&M expense for Consumers Energy and Michigan Gas Storage for the year 2001 was $243,168,000. 13 TR 2340. This amount includes the initial stages of many of the O&M programs that Company witnesses have sponsored in this proceeding for the year 2002. Thus, there should be no question concerning the predictability of the O&M expenses projected by the Company in this proceeding: money is already being spent on these O&M programs – satisfying the requirement for predictability that the Commission spoke of in the U-8678 Order.

The Staff concern that the Company might not spend all of the O&M expense that is ultimately reflected in rates has resulted in the Staff taking an extraordinarily conservative position in this case. The O&M expenditures which the Company actually experienced in 2001 (13 TR 2340) are greater than the amount recommended by the Staff using their inflation method, thus giving further evidence of the inappropriateness of using that method in this case. The Company believes that, had the Staff been willing to take the approach of examining the evidence concerning the incremental work activity and incremental costs that Consumers Energy presented in this case, it would have been convinced that the Company's position was reasonable. Indeed, the Gas Safety Section had already reached that conclusion with respect to the various programs described by Mr. Preketes. This is not, as alleged by the Staff, putting Staff "in the position of making management decisions." 11 TR 1803. It does require the Staff to conduct an analysis that is different from the approach it actually used in this case—that of making a simplistic inflation adjustment to a historical level of expense. By accepting the Staff position in this case, the ALJ accepted a regulatory approach that took the easy way out, and that leaves Consumers Energy without the resources it needs to provide safe and reliable service to customers.

V. CAPITAL STRUCTURE AND RATE OF RETURN

A. Cost Of Common Equity

The ALJ Erred In Failing To Recommend That The Authorized Return On Common Equity Be Set At 12.25%

The ALJ recommended that the authorized return on common equity be set at 11.00%, the mid-point of Staff's recommended range of 10.75% to 11.25%. The evidence shows that the 11.00% mid-point is inappropriately low for the following reasons, among others:

(i) Making corrections that Staff's witness agreed to and accepted raises the average Discounted Cash Flow ("DCF") returns on equity for the Staff proxy groups to 11.30%;

(ii) The ALJ failed to adjust and increase the recommended return on equity upward for acknowledged gas industry risk;

(iii) As evidenced by Staff's own data, Staff's proxy groups have less risk than Consumers Energy's gas business;

(iv) The ALJ's premise that equity returns for proxy companies used by Consumers Energy would have decreased after the September 11 events is not supported by the evidence; and

(v) A return on equity of 11.00% is not sufficient to attract capital market investment.

If Staff's recommended range is used, the authorized return on equity should be set at 11.25%, which is the upper end of the Staff's range. Consumers Energy submits that the evidence, in fact, supports a return of 12.25% and such a return better reflects investor expectations. Consumers Energy addressed the issue of rate of return on common equity at length in it Brief at pages 30-44 and in its Reply Brief at pages 40-53 and 83-86. In this section of these Exceptions, Consumers Energy will primarily respond to issues specifically addressed by the ALJ. For a more complete discussion of the Company's position and evidence, reference should be made to the indicated pages in the Company's Brief and Reply Brief.

1. <u>The Recommended Return on Equity Needs to be Adjusted Upward to At Least 11.25% to (i) Correct for Calculation Errors, (ii) Reflect Increased Industry Risk, and (iii) Reflect the Risks of the Staff's Proxy Groups as Compared with Consumers Energy's Gas Business</u>

The ALJ accepted Staff's recommendation that the authorized return on equity be set at 11.00%. Assuming for purposes of argument that Staff's analysis is used as the starting point, the evidence nevertheless supports a higher return than 11.00%.

a. <u>The ALJ Erred in Failing to Adjust Staff's Recommendation Upward Due to Calculation Errors that Staff's Witness Agreed Should Be Corrected</u>

When Mr. Ballinger developed his initial range and his 11.00% recommendation, the results of his DCF analyses were 10.87% for his gas group and 11.22% for his combination group. In rebuttal testimony Mr. Vlisides identified several calculation errors in the dividend yield calculation. 11 TR 1964-1966. Mr. Ballinger, when he testified, <u>agreed</u> that the corrections identified by Mr. Vlisides should be made and increased the results of his DCF analyses to 11.01% and 11.38%.[11] 10 TR 1500. The average of the DCF results for Mr. Ballinger's two proxy groups increased from 11.05% to 11.20% as a result. 11 TR 1966.

Subsequently, during cross examination, Mr. Ballinger acknowledged that there was also an error in the calculation of the growth rate for Progress Energy, one of the proxy companies that he used. 10 TR 1573. Correcting this error increases the growth rate for the combination companies from 6.11% to 6.31%. Reply Brief, Appendix 2, page 1. Substituting 6.31% in place of 6.11% in the DCF calculation with the adjusted dividend yield of 5.27% shown on 10 TR 1500 results in an increase in the calculation of the DCF equity cost for the combination group from 11.38% to 11.58%. This in turn increases the average for Staff's DCF results for its two proxy groups from the original average of 11.05% to 11.30%, a result that is <u>above</u> the high end of Mr. Ballinger's 10.75% to 11.25% range. The ALJ erred in not adjusting the equity return upward to reflect the effects of the correction of the calculation errors.

Using the upper end of Staff's range rather than 11.00% is further supported by the uncontested evidence that the results from the DCF method should be given more weight than the results from use of the Capital Asset Pricing Model ("CAPM") due to problems and concerns with the CAPM theory and inputs (discussed in Consumers Energy's Brief at pages 39-41). Mr. Olson testified that investors in the real world do not use a CAPM approach. 5 TR 405. Mr. Vlisides testified that the academic community is increasingly rejecting the CAPM. 5 TR 503-504.

[11] This results from (i) an increase in the dividend yield to 4.77%, with a resulting increase in the adjusted dividend yield to 4.92% for the gas group, and (ii) an increase in the dividend yield to 5.11%, with a resulting increase in the adjusted dividend yield to 5.27% for the combination group. 10 TR 1500; 11 TR 1966. The adjusted dividend yield is mathematically calculated by multiplying the result of (one plus half the growth rate) times the dividend yield.

b. <u>The Recommended Return on Equity of 11.00% Should be Adjusted Upward to Reflect Increased Risks Being Faced by Consumers Energy's Gas Business</u>

The ALJ acknowledged at page 34 of the PFD that, from the perspective of an investor, Consumers Energy is facing increased risks in its gas operations. However, he erroneously failed to adjust the recommendation of 11.00% upward to reflect those risks.

While recognizing that there were increased risks, the ALJ incorrectly concluded:

> "There is no way for the ALJ to ascertain the appropriate level of risk to assign." PFD at p 35.

The ALJ's apparent conclusion that if the increased risk cannot be mathematically defined with precision it must be ignored is contrary to the evidence and the standards espoused by the United States Supreme Court in <u>Bluefield Water Works and Improvement Co</u> v <u>Public Service Commission of West Virginia</u>, 262 US 679; 43 S Ct 675; 67 L Ed 1176 (1923), and <u>Federal Power Commission</u> v <u>Hope Natural Gas Co</u>, 320 US 591; 64 S Ct 281; 88 L Ed 333 (1944).

It is a fundamental principle that the higher the investor perceived risk, the higher the required return. 5 TR 487. Regulatory commissions, including this Commission, have recognized that the presence of increased risk justifies increasing the authorized return on equity above the midpoint of a selected range. For example, in its February 5, 1996 Partial Final Opinion and Order in Case No. U-10685, the Commission held:

> "The Commission finds that the authorized return on common equity should be 12.25%, which is the upper end of Dr. Rao's range.... This return properly reflects the risks facing Consumers and the expected cost of equity." Order, p 28.

The absence of a precise quantification of the impact of risks does not preclude increasing the return to reflect those risks. Indeed, the evidence and the law require such an increase. Evidence regarding investors' perceptions of risk is discussed below.

c. <u>The Recommended Return on Equity Should be Adjusted Upward to Reflect that the Proxy Groups Used by Staff Have Less Risk than Consumers Energy's Gas Business</u>

After a proxy group is selected, that group needs to be evaluated for whether it is more, the same, or less risky overall than the company for which the return on equity is being determined. Companies with lower equity ratios have more risk. 5 TR 486. Likewise, companies with lower bond ratings have more risk. 5 TR 487-488.

Mr. Ballinger used two proxy groups, a combination gas/electric proxy group and a gas proxy group. Both of Mr. Ballinger's proxy groups, as a whole, are less risky than Consumers Energy's gas business as measured both by bond ratings and by equity ratios.

The range of investment grade bond ratings is shown at 5 TR 488. Consumers Energy has a Moody's Bond rating of Baa3 and a Standard and Poors' bond rating of BBB+, both of which are at the lower end of the range. Mr. Ballinger shows his combination proxy group as having a higher average Moody's rating of A3 (although he indicated during cross examination that it was quite possible it was higher yet at A2), and a higher Standard and Poors' rating of A-. Exhibit S-117, Schedule D-5, page 2, 10 TR 1569-1570. Consumers Energy has lower bond ratings and therefore has more risk than the proxy group. The average equity ratio for the proxy group of 43% is higher than the 39.8% Mr. Ballinger calculated for Consumers Energy, thus also indicating Consumers Energy has more risk than the combination proxy group. Exhibit S-117, Schedule D-5, p 2, 10 TR 1470.

Mr. Ballinger's gas proxy group is also less risky than Consumers Energy as shown by bond ratings (A3/A- for the proxy group compared to Baa3/BBB+ for Consumers Energy). His gas proxy group is also less risky as shown by equity ratios (44% for the proxy group compared with 39.8% for Consumers Energy). Exhibit S-117, Schedule D-5, page 1, 10 TR 1470).

Proxy companies that are less risky than Consumers Energy's gas business will produce a return that is lower than appropriate for Consumers Energy's gas business. 5 TR 491. These factors provide further support for the conclusion that the ALJ's recommended 11.00% return on equity is too low.

d. Earnings Growth Rates Should be Used as a Proxy for Growth in this Case

One of the inputs into a DCF analysis consists of the growth rates that investors anticipate. The ALJ did not directly address, in his PFD, the arguments of Consumers Energy that earnings growth rates should be used as a proxy for growth in this case.

Both Mr. Olson and Mr. Vlisides presented evidence that earnings growth rates should be used as a proxy for growth in this case. Mr. Olson testified that investors look at earnings expectations, not dividends. 5 TR 410. Mr. Vlisides indicated that that growth in dividends provides an incomplete picture and pointed out that there can be no growth in dividends without growth in earnings. 5 TR 494. Similarly, Mr. Olson explained that dividends are a function of earnings, and not vice versa. 5 TR 410.

The evidence presented by Mr. Vlisides and Mr. Olson support the conclusion that earnings growth rates provide the best proxy in this case for investor expectations of growth. Mr. Vlisides used earnings growth rates in his DCF analyses. In contrast, Mr. Ballinger used dividend growth rates and book value growth rates in addition to earnings growth rates. This skewed the results of Mr. Ballinger's calculations downward from where they would be if only earnings growth rates had been used.

The mathematical results of using Mr. Ballinger's data (as corrected during testimony) but using only earnings growth rates identified by Mr. Ballinger for his proxy companies are shown on Appendix 2, pages 2 and 3, to the Company's Reply Brief. The average growth for the gas companies increases from the 6.09% shown on Exhibit S-117, Schedule D-5, page 13 (as corrected at 10 TR 1470-1471), to 7.43%. (Reply Brief Appendix 2, p 2) The average growth for the combination companies increases from the 6.11% shown on Exhibit S-117, Schedule D-5, page 14, to 7.03%. (Reply Brief Appendix 2, p 3) Combining these growth rates with the adjusted dividend yields, corrected as discussed above, increases the return for the gas group to 12.35% and the return for the combination group to 12.30%.[12] <u>Using Mr. Ballinger's earnings growth rates for the growth rate component increases the results from the DCF analyses for both of his proxy groups above the 12.25% return requested by Consumers Energy in this case.</u>

2. <u>The Evidence Does Not Support the ALJ's Apparent Premise that an Update to Consumers Energy's Analyses Would Have Resulted in a Return on Equity Lower than Calculated by the Company; The Evidence Supports Rejection of such a Premise</u>

The need to increase the authorized return on equity above the 11.00% recommended by the ALJ is further supported by the analyses presented by Consumers Energy's witness Mr. Vlisides. Mr. Vlisides evaluated investor required return by applying the DCF methodology and CAPM methodology to two groups of proxy companies. 5 TR 483. The following chart provides a brief summary of results of Mr. Vlisides analyses:

[12] 4.92% + 7.43% = 12.35%; 5.27% + 7.03% = 12.30%.

Analysis	w/o Flotation Costs		With Flotation Costs	
	Average	Midpoint	Average	Midpoint
DCF Model – large proxy group	12.45%	12.42%	12.58%	12.57%
DCF Model – small proxy group	12.48%	12.83%	12.60%	12.93%
CAPM – large proxy group	11.71%	11.97%	11.87%	12.13%
CAPM – small proxy group	12.04%	12.36%	12.21%	12.53%
Average – all results	12.17%	12.40%	12.32%	12.54%

The large proxy group consisted of 20 publicly traded natural gas distribution companies, which Mr. Vlisides concluded was representative of the natural gas distribution industry as a whole. 5 TR 489. The second group, which is a subset of the first group, was selected to more closely mirror Consumers Energy's business risk and financial risk. 5 TR 489-490.

The focus of the ALJ's criticism of Mr. Vlisides analyses is that the data was not updated. The ALJ stated at page 30 of the PFD that while use of different proxy groups accounted for some difference in return on equity recommendations between the Company and the Staff, "the more significant difference between the two was the application of short-term interest rates." At page 35 the ALJ stated:

> "The ALJ finds it significantly detrimental to Consumers' case that it failed to update its testimony and analysis in light of numerous rate cuts, a slowing economy, and the contributing factor of the terrorist attack on September 11, 2001." PFD at p 35.

At page 36 he stated that the Company's analysis "cannot rise above the failure to update the data and analysis in light of the significant events following the filing of the original data and analysis." However, the evidence does not support the ALJ's apparent premise that updating data would have resulted in a decrease in the calculated investor-required return on equity. To the contrary, the evidence supports rejection of this premise.

Staff, without any basis whatsoever, made the totally unfounded and unsupported claim at page 52 of its brief that the reductions by the Federal Reserve in interest rates in 2001 "had a big effect on ...equity capital." Staff spuriously claimed at page 52 of its brief, without any basis whatsoever, that Mr. Vlisides did not update his DCF analysis because doing so would have resulted in a lower DCF cost of capital than was presented in his prefiled testimony. The ALJ incorrectly failed to reject these arguments.

Equity investment is considered a long-term investment, not a short-term investment. 5 TR 498. <u>Short-term interest rates do not drive required equity returns</u>.

The fallacy of Staff's hypothesis can be shown using record evidence in this case. The proxy groups selected by Mr. Ballinger and Mr. Vlisides are not identical. However, there is a substantial overlap in companies used, which allows Staff's speculation to be tested and rejected.

Nine of the 20 companies that Mr. Vlisides used in his larger proxy group of natural gas companies were also used by Mr. Ballinger. Seven of the ten companies that Mr. Vlisides used in his smaller proxy group of natural gas companies were also used by Mr. Ballinger. Mr. Vlisides used dividend yields calculated using recent three-month average stock prices, Value Line earnings growth rates and Zacks earnings growth rates. Exhibit 5 TR 494-495. Mr. Ballinger provides updated data for each of these inputs for the companies used by both the Staff and Consumers Energy.

The top half of Appendix 2, page 4, to the Company's Reply Brief[13] shows the returns on equity for the nine companies used by both Mr. Vlisides and Mr. Ballinger (i) using data utilized by Mr. Vlisides when he prepared his analysis and (ii) calculated in the same

[13] Pages 4 and 5 of Appendix 2 to the Company's Reply Brief are attached as Appendix D to these Exceptions.

manner using the updated data provided by Mr. Ballinger in his exhibits. The results show that both the dividend yield and growth rate for the group of nine companies increased, and that the calculated return on equity for this group increased from 12.11% to 12.18%, notwithstanding declines in the interest rates, the slowing economy, and the terrorist attacks.

The bottom half of Appendix 2, page 4, to the Company's Reply Brief shows the returns for the seven companies used by both that were in Mr. Vlisides smaller proxy group. The returns for the seven companies increased from 12.35% at the time Mr. Vlisides compiled his data to 12.49% using the updated data.

Mr. Ballinger adjusted the dividend yields in his DCF calculations to reflect the fact that dividends are paid quarterly. In its Brief the Company agreed that doing so is appropriate. Appendix 2, page 5, to the Company's Reply Brief shows that the updated average required equity return for the group of nine companies increases from 12.26% at the time of Mr. Vlisides original analysis to 12.34% if adjusted dividends yields are used. The updated average return for the group of seven companies that were included in Mr. Vlisides smaller proxy group increases from 12.50% at the time of Mr. Vlisides analysis to 12.66% if the adjusted dividend yield approach is used.

Appendix 2, pages 4 and 5, to the Company's Reply Brief not only shows the fallacy of the view that required equity returns declined during the year 2001, but also shows the inadequacy of the 11.00% return recommendation of ALJ in this case.

The proper focus is not when the analysis was done, but whether it is representative of investor expectations. The record evidence supports a conclusion that the 12.25% return on equity recommendation of Consumers Energy's witness Mr. Vlisides better reflects investor expectations than the 11.00% return recommended by the ALJ.

3. An 11.00% Return Is Not Sufficient To Assure Investor Confidence So As To Attract Capital

The record evidence indicates that investors perceive that there is increasing business risk in the gas utility industry. As acknowledged by the ALJ, Mr. Vlisides provided several examples. Mr. Vlisides testified, among other things:

> "In a November, 2000 study, A.G. Edwards points out that deregulation will continue to present a combination of new challenges and opportunities for local (gas) distribution (LDC's) companies. The study goes on to note that; 'In this increasingly competitive marketplace, traditional LDC's could be competing with independent gas marketers, electric utilities and distributors of alternative fuels.'" 5 TR 486-487.

Value Line, which is widely used by investors, has advised that conservative investors should stay with higher quality equities than local distribution companies. 5 TR 487, 490.

Mr. Olson, who has been involved with analyzing natural gas companies for over 30 years, identified numerous risks facing natural gas local distribution companies ("LDCs"). 5 TR 412-413. For example:

> "There has been growth in the number of customers. This growth in turn requires major investment to expand and upgrade the aging LDC infrastructure in order for the LDC to be able to provide reliable service to an enlarging customer base. There is additional risk due to the steady decline in average use per residential customer, which naturally decreases the profitability of this very important part of the business. In addition there are increased costs of regulatory mandates such as those related to pipeline integrity and safety concerns.... The growing cost of service pressures have been accompanied by actual and potential LDC unbundling, restructuring and commodity competition. Taken together, they represent an outright need for more capital and an increase in the business risk of the LDC." 5 TR 413.

He testified that it is not only what a regulator does that determines risk from an investor perspective, but what a regulator <u>might</u> do. 5 TR 415. Case No. U-13000 provides the MPSC with an opportunity to recognize these risk considerations. The evidence supports setting the return on equity higher than the midpoint of Staff's range.

The ALJ misconstrued the testimony of Mr. Olson as (i) relying upon the DCF and CAPM approaches (PFD, p 31) and (ii) recommending the return on equity be set at 17% to 22% in this case (PFD, p 36). Both of these conclusions are incorrect.

Mr. Olson used a comparable earnings analysis. 5 TR 404, 406. He testified that the output of models such as the DCF and CAPM "must and should be supplemented by a more market driven comparison standard." 5 TR 410.

Mr. Olson was aware that Consumers Energy is only requesting a return on equity of 12.25% in this proceeding. 5 TR 419. The thrust of his conclusion is summarized in the statement that:

> "[I]t would be completely inappropriate to set the return on equity below 12.25%." 5 TR 406.

Mr. Olson stated that Mr. Vlisides' recommendation of 12.25% (i) was supported by Mr. Olson's comparable earnings analysis and (ii) was conservative from an investor perspective. 5 TR 406.

Taking into consideration Mr. Olson's perspective is fully consistent with the mandates set forth in the <u>Bluefield</u> and <u>Hope Natural Gas</u> decisions. Mr. Olson has over 30 years of experience as a securities analyst and provides a perspective that is different from either of the other two expert return on equity witnesses. He is Senior Vice President and Director of Research at Sanders Morris Harris, an investment banking and securities firm. 5 TR 402. Prior to testifying in this case, neither Mr. Olson nor Sanders Morris Harris had been retained by CMS

Energy or Consumers Energy for any purpose.[14] 5 TR 405. Mr. Olson encouraged the Commission to think about the real world consequences of cost of capital decisions it will make in this case. 5 TR 403-420.

His testimony included the following statements:

> "I think the Commission should have, indeed deserves, the more complete picture that comes from a real world point of view. <u>Most investors, particularly institutional investors are looking for a steady increase in authorized ROEs by state ratemaking bodies in order to allow them to remain competitive in the race to attract capital</u> with Corporate America." 5 TR 404 (Emphasis added.)
>
> "Why should equity investors buy a 11%-12% ROE investment in an industry which has low growth, increasing risk, yet is still regulated, when they can buy a 17% ROE or higher investment in a non-regulated segment of Corporate America with similar risk characteristics to an LDC?" 5 TR 412.
>
> "When the authorized ROE for the LDC is stationary or falling, that just makes the alternatives all the more attractive." 5 TR 415.
>
> "*Wall Street investors have a tremendous number of choices for investments. They do not have to buy just regulated companies' equities when there are higher returns available from securities with similar business and financial risks.*" 5 TR 420.

The evidence presented by Mr. Olson reinforces the reasonableness of the 12.25% return requested by Consumers Energy and shows that from an investor perspective the 11% return recommended by Staff is not adequate. Mr. Olson's testimony is discussed further at pages 41-44 of the Company's Brief.

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[14] Mr. Olson received a flat fee for his testimony in this case. 5 TR 469. The ALJ stated at page 36 of his PFD that Mr. Olson had made two "strong buy" recommendations for CMS Energy stock during 2001, with the implication that this somehow impacts Mr. Olson's return on equity analysis for Consumers Energy's gas business. However, Mr. Olson made clear that the returns for CMS and Consumers Energy are separate. He testified that Consumers Energy's gas business only contributes about 12% of total CMS Energy earnings (5 TR457), that it would be inappropriate to use the analyses in Exhibits S-44 or S-45 to determine his views on CMS Energy at the time he testified (5 TR 458), and that it would be inappropriate to use CMS as a proxy for Consumers Energy's gas business (5 TR 459). His comparable earnings methodology in Case No. U-13000 used the Standard and Poors 400 Industrials Index as a proxy. 5 TR 406. To imply that his earlier buy recommendations for CMS Energy stock had any impact on his analysis in Case No. U-13000 is without foundation or merit.

4. <u>The ALJ Erred In Not Including Flotation Costs</u>

The ALJ erroneously concluded that inclusion of flotation costs is not appropriate. Failure to include flotation costs for common equity would result in an understatement of the required return. 5 TR 496. Issuance costs for debt are recovered through the net proceeds calculations. See e.g., 5 TR 509, 514. Flotation costs are embedded issuance costs that should be included in this case in calculating the authorized return on equity. The recoverability of such issuance costs in the return on equity was upheld in <u>Attorney General</u> v <u>Public Service Commission</u>, 136 Mich App 515, 521; 338 NW 2d 351 (1984). Mr. Vlisides presented testimony supporting use of a 3% flotation cost rate. 5 TR 495-496.

B. <u>Cost Of Long Term Debt And Short Term Debt</u>

<u>The ALJ Erred (i) In Not Recommending A Long Term Debt Cost Higher Than 6.42% And (ii) In Not Recommending A Short Term Debt Cost Above 3.11%</u>

The ALJ recommended adoption of long term debt cost and short term debt cost rates proposed by Staff. The Company believes that the ALJ's erred in not recommending higher cost rates. The primary difference between the Company and Staff regarding the cost rates relates to what time period should be used for variable cost rates. However, even if the Commission uses the Staff's time period as a proxy for variable cost rates, the long term debt cost calculated by Staff still must be increased from 6.42% to 6.51% to correct for calculation errors. Consumers Energy addressed the issue of cost of long term debt and short term debt in its Brief at pages 44-47 and in its Reply Brief at page 39.

1. Correcting Calculation Errors In Staff's Long Term Debt Calculation Increases Long Term Debt Cost To 6.51%

The Company identified four mathematical corrections that should be made to Staff's calculation of long term debt cost on its Exhibit S-117, Schedule D-2, if the Staff's assumptions are used regarding variable rate cost rates:

(i) Line 6. There was some confusion regarding whether the 1993 PCRB Series B 2010 issuance was at a fixed rate or variable rate. Exhibit A-119, page 4323 shows that the rate is fixed. The cost on a net proceeds basis is 6.18%. Exhibit A-4 (SBW-13, Revised), line 6, column i. If Schedule D-2 is used, 6.18% should be substituted for 3.67% on line 6, column 8.

(ii) Line 8. A note at the bottom of Schedule D-2 indicates that the Barclay debt rate is LIBOR plus 45 basis points. Mr. Ballinger has used a LIBOR rate of 2.37%. If Schedule D-2 is used, 2.82% should be substituted for 2.80% on line 8, column 8. This adjustment uses the LIBOR rate selected by Staff for use in its calculations.

(iii) Lines 13 and 14. The cost rates that are shown are equal to LIBOR plus zero points on line 13 of Schedule D-2 and LIBOR plus two basis points on line 14. The interest payments section on Exhibit A-119, page 4324, shows that the interest rates are LIBOR plus .60% and LIBOR plus .98%. The cost on line 13, column 8, should be increased to 2.97% and the cost on line 14, column 8, should be increased to 3.35%.

(iv) Line 20. The rate shown in column 8 should be 6.56% as shown on Exhibit A-55, line 6, and A-10, line 3, rather than 6.37%.

The Company has calculated that the mathematical result if these corrections are made, all other things being equal, is to increase the long term debt cost to 6.51%. (See Appendix F to the Company's Brief.)

The ALJ stated at page 38 of the PFD that he was unable to ascertain from Exhibit A-119, page 4323, whether the interest rate for the Michigan Strategic Fund 1993 PCRB Series B is variable or fixed. That document lists the interest rate (prior to calculation of net proceeds) as follows: "INTEREST RATE: 5.80%". This fixed interest rate can be contrasted with the wording for the 1993A series, which states it is an "Adjustable Rate Demand Limited

Obligation" and lists the interest rate as the "Initial Interest Rate". See Exhibit A-119, page 4322. It can also be contrasted with the cover page of the prospectus supplement for the floating rate senior notes that states that the notes "bear interest at a floating rate". Exhibit A-119, page 4323 provides confirmation that the 1993 Series B interest rate is fixed. Exhibit A-4 (SBW-13, Revised), line 6, column i, shows that the cost on a net proceeds basis is 6.18%.

2. <u>The Time Period Used By Staff In Its Selection Of Variable Rates Results In Rates Lower Than Appropriate For Purposes Of This Case</u>

Staff used October 2001 variable interest cost rates. The Company used May 2001 variable interest cost rates. The Company submits that the May 2001 cost rates used by the Company for variable rate long term debt issuances and short term debt are a better proxy to use in this case than the October 2001 rates used by Staff.

Mr. Ballinger testified in January 2002 that the economy had recovered somewhat from the substantial decline that occurred following the tragic events of September 11 events. 10 TR 1557-1558. The May 2001 variable interest cost rates reflect the initial effects of the recession that Mr. Ballinger testified began in March 2001, but do not reflect the effects of the tragic events of September 11, 2001.

Further, Staff's use of an October 2001 time period for variable rate debt does not take into consideration that some of the rates had hedges. 5 TR 528. Mr. Vlisides testified that it would not be correct to conclude that the cost of variable rate debt shown on Exhibit A-54 would all be lower than in May 2001. 5 TR 528-529.

C. **Other Interest Bearing Items**

The ALJ Erred In Excluding The Other Interest Bearing Items Category From The Capital Structure

At pages 40-41 of the PFD, the ALJ excluded the Other Interest Bearing Items category from the capital structure. The ALJ concluded that this category of costs should not be included in the capital structure in this case because it was not included in the capital structure in the Company's last gas rate case, Case No. U-10755. However, the ALJ acknowledged that the inclusion of this category in the capital structure was not an issue that was before the Commission in the last case. The exclusion of this category in the last case does not even rise to the level of dicta and provides no support for excluding this category of costs in the current case.

The Commission's gas case filing requirements list Other Interest Bearing Items as a category to be included in the capital structure. See Case No. U-10039, Order dated January 17, 1992.[15] Staff's witness Mr. Ballinger acknowledged that the Company incurs interest expense on the balances in the Other Interest Bearing Accounts. 10 TR 1564. Consumers Energy will be denied recovery of the interest expense it is incurring for this category of costs if Other Interest Bearing Items category is not included in the capital structure.

The evidence in the record indicates that while the components and amounts may vary, the existence of the category does not. For the reasons discussed above and at pages 28-29 of the Company's Brief, the Company's proposal to include $39,060,000 in the capital structure in this case for Other Interest Bearing Accounts at a cost rate of 9.83% is appropriate.

[15] See, in particular, General Instructions, Part I, and Schedule D-1.

VI. MANUFACTURED GAS PLANT EXPENDITURES

The ALJ Erred In Failing To Adopt Consumers Energy's Positions In The Areas Of Disagreement Between The Company And Staff Regarding Manufactured Gas Plant Remediation Cost Recovery

In its March 11, 1996 Order in Case No. U-10755 the Commission held that prudently incurred manufactured gas plant ("MGP") environmental response costs are recoverable from customers. Consumers Energy and the Staff are in agreement regarding the prudence and recovery of MGP costs for 1999 through October 2001. The Company and Staff do not agree, however, regarding whether costs incurred and insurance recovery received subsequent to October 2001 should be included in this case or deferred until a future case. The Company submits that the ALJ erred in not adopting Consumers Energy's positions with respect to these areas of disagreement. Consumers Energy addressed the issue of MGP recovery at pages 20 and 84-95 of its Brief and pages 64-70 of its Reply Brief.

The areas of disagreement essentially involve three timing issues. One deals with whether rate recognition of the November and December 2001 MGP costs should be approved in this case or deferred until a later rate case. A second is whether amortization of insurance proceeds received in late November 2001 can be included in rates in this case as an offset to amortization of MGP expenditures if rate recognition of November and December 2001 costs is not included in rates in this case. A third is whether rate recognition for amortization of 2002 MGP costs should be approved in this case or deferred until a later rate case. The effects of the different alternatives on the amortization amount in rates are summarized on Appendix 3 to the Company's Reply Brief.

A. **<u>Including The Amortization Of Insurance Proceeds Received In Late November 2001 In Rates Is Unreasonable If Amortization Of November And December 2001 MGP Remediation Costs Is Not Also Included In Rates</u>**

The ALJ has recommended including amortization of an insurance recovery received in late November 2001 in rates while at the same time excluding amortization of November and December 2001 remediation costs. The effect is to reduce amounts recovered in rates for MGP remediation costs. The Company submits that it is unreasonable to include amortization of insurance proceeds that were received in late November 2001 in rates if amortization of the November and December 2001 expenditures is not also included in rates.

In Case No. U-10755 the Commission, in discussing amortization of MGP costs, stated:

> "Recoveries from liability insurers and other third parties would also be recorded by vintage year and amortized in the same manner." March 11, 1996 Order, p 47, note 30.

The ALJ's recommendation does not amortize the insurance recovery in the same manner as the costs. If the cut-off date used in this case for rate recognition of MGP costs is October 31, 2001, then the same cut-off date should be used for rate recognition of insurance recoveries, which act as an offset to costs.

Staff tried to distinguish the insurance recovery situation by stating that the arbitrator's decision awarding insurance recovery was issued in July 2001. However the insurance recovery dollars were not received until around November 21. Exhibit S-177. Thus, cash was not received prior to the ALJ's October 31, 2001 cut-off date. For purposes of determining whether amounts should be included in rates in this case, the insurance recovery situation is not materially different than the situation in which a work plan for MGP remediation was in place prior to November, the costs that would be incurred had been determined and budgeted, projects and activities that would occur were known, commitments had been made, but the dollars, although known, were not actually spent until November or December. In both situations, the timing and amount of dollars was known prior to October 31, 2001 but an exchange of dollars (through receipt or payment) had not yet occurred. In both situations, the Company knew how much it was going to receive or spend prior to November 2001.

It is a general principle that if the Commission considers anticipated reductions in costs, then anticipated increases in costs for the corresponding period must also be considered. Michigan Consolidated Gas Company v Public Service Commission, 389 Mich 624; 640; 209 NW 2d 210 (1973), General Telephone Company v Public Service Commission, 78 Mich App 528, 539-540; 260 NW 2d 874 (1977). Given the amortization methodology adopted by the Commission, Consumers Energy will never be able to recover MGP costs for November and December 2001 that are amortized on its books prior to being included in rates. Using an October 2001 cutoff in this case for recovery of MGP remediation costs, but not for recovery of offsetting MGP insurance proceeds, would be confiscatory.

Either both the November 2001 MGP-related insurance payment and the November and December 2001 MGP-related costs should be included in rates in this case or neither should be included in rates in this case. It would be unreasonable and unlawful to include the MGP amortization of 2001 insurance proceeds that reduce rates in this case without also including the MGP amortization of 2001 costs that increase rates.

B. The Commission Should Allow Recovery Of November And December 2001 MGP Remediation Costs In This Case

The Company submits that the ALJ is mistaken in his view that the Case No. U-10755 Order precludes recovery of the November and December 2001 MGP remediation costs in this case. It disagrees with his conclusion that MGP remediation costs for November and

December 2001 could not be audited or reviewed for prudence. Those costs were incurred prior to the test year, were incurred prior to the close of the record, and were subject to a prudence review in Case No. U-13000.

The approach that the Commission adopted in its March 11, 1996 Order in Case No. U-10755 provided for the following:

> "(1) environmental cleanup costs will be recorded in a deferred account for each vintage year and amortized over ten years, (2) amortization of each vintage year's deferred balance will begin in the next calendar year, (3) rate recognition of amortization expense will not occur until after a prudence review in the next rate case, (4) carrying costs will be earned on balances included in rate base (at the authorized pre-tax rate of return) after the prudence review (i.e., no carrying costs can be earned prior to a rate case), and (5) tax effects will be recorded by using deferred accounting."
> March 11, 1996 Order, p 47. (Footnotes omitted)

There has been a prudence review in this case.

The Company's witness Mr. Kelterborn testified as to the prudence of MGP costs, including the November and December 2001 costs. 5 TR 628-639. The Staff's witness Mr. Pettiford did not include the November and December 2001 amounts in his recommendation because of the timing of Staff's filing in the case. However, Mr. Pettiford and Dr. Nwabueze did review 2001 activities, records and the prudence of the underlying work plans, and found them to be prudent. 10 TR 1665-1666. Mr. Kelterborn pointed out that:

> "The need for environmental investigation and remediation and the parameters for clean-up are mandated and defined by the state and federal government. . . . The costs incurred were costs for activities that are necessary under current environmental regulations."
> 5 TR 629.

Company witness Mr. Torrey presented testimony that the actual costs for November and December 2001 were consistent with the budgeted costs of $1.4 million. 12 TR 2251-2252.

The November and December 2001 costs are historical costs, have been spent, and therefore are actual expenditures. Staff witness Mr. Pettiford agreed that it was possible to determine the actual level of these expenditures and that the costs were measurable. 10 TR 1670.

While the actual expenditures for November and December 2001 had not yet occurred at the time of the Staff review, planned expenses for November and December 2001 and the underlying work plans did exist and could be reviewed. 12 TR 2251. The Staff audit did not identify any imprudence in work plans or costs. The Company submits that Staff's review in conjunction with the evidence presented by Mr. Kelterborn and Mr. Torrey provides a sufficient basis to begin recovery in rates for the November and December 2001 costs.

The costs for November and December 2001 are known and measurable. The activities that led to those costs are also known. There has been opportunity for a prudence review in this case, a prudence review was undertaken, and the evidence supports a conclusion that the November and December 2001 costs are prudent. Deferring recovery until after a later rate case is not reasonable under the circumstances.

As noted above, the November and December 2001 remediation costs, which are based on earlier work plans and commitments, are not materially different than the insurance proceeds in which an arbitration decision was issued in July with performance occurring in November. Including the November and December 2001 costs would increase the level of MGP expenditures for 2001 approved for recovery in this case by $1.4 million (which would be amortized over 10 years) above the level if an October 2001 cutoff is used. 12 TR 2252.

C. <u>Recovery Of 2002 MGP Remediation Costs</u>

The Company presented evidence calculating MGP remediation costs of $9.29 million in 2002. Exhibit A-64, p 6, 5 TR 626, 639. Costs identified for 2002 were based on the specific activities that will be undertaken. 5 TR 625, 5 TR 639. These costs are shown by type of activity and site on Exhibits A-64 and A-65. Mr. Kelterborn stated that the need to undertake these activities is known and can be measured with reasonable certainty. 5 TR 626.

The Company recognizes that inclusion of the amortization of 2002 expenditures will require a modification from the approach used previously. In its Brief, the Company requested that, given the magnitude of the 2002 costs, the Case No. U-10755 method be modified to allow $929,000 be included in rates in this case for amortization of the 2002 costs, with the unamortized balance included in rate base.

In Case No. U-10755 the Commission included $853,000 for cleanup expenses in the test year injuries and damages allowance as an offset against future MGP expenses. See Case No. U-10755 Order, March 11, 1996, pp 44, 48. This was in addition to allowing for deferral and amortization of expenditures. March 11 Order, pp 45-46. An alternative to including amortization of 2002 expenditures would be to use a similar approach in this case to partially offset future expenditures,[16] with deferral and amortization of expenditures in excess of the offset amount. As noted in the Company's Reply Brief, if the Commission defers rate recovery for 2002 expenses, the Company requests the Commission include an allowance in this case as an offset against future MGP remediation expenses similar to the approach used in Case No. U-10755.

[16] The average annual expenditure during the five year period following 2002 is anticipated to be in excess of $5 million per year. 5 TR 626.

VIII. COST OF SERVICE AND RATE DESIGN

A. Company Use And Lost And Unaccounted For Gas

The Commission Should Adopt The ALJ's Second Recommendation Regarding Company Use And Lost And Unaccounted For Gas

The ALJ made two different and conflicting recommendations concerning Company use and lost and unaccounted for gas. At pages 63-64, the ALJ identifies the two different positions taken by the Staff and Consumers Energy, and recommends that the Commission adopt the Staff position because it is "more consistent" with how the Commission has handled this issue in the past. At pages 86-87, however, the ALJ actually discusses the evidence presented by Consumers Energy outlining how relatively recent changes in the manner of operation of the Company's storage fields have resulted in a change in lost and unaccounted for gas that is not fully reflected in the Staff's five year average approach. The ALJ indicates at that point in the PFD that Consumers Energy presented "convincing evidence" and recommends adoption of the Company position with respect to transportation customers. The Commission should adopt the ALJ's second recommendation. When he focused on the evidence that was presented, he clearly was persuaded that the Staff's five year average approach did not adequately reflect current conditions.

For a further discussion of this issue, see pages 82-83 and 110 of the Company's Brief, and pages 54-55 of the Company's Reply Brief.

B. Residential Monthly Customer Charge

The ALJ Erred In Not Increasing The Residential Monthly Customer Charge To $8.00

The Company proposed an increase in the residential monthly customer charge from $6.50 to $8.00. Staff suggested a monthly customer charge of $7.50, although Staff actually calculated a monthly customer cost of $7.74. Exhibit S-147 (WGA-5), Page 3 of 16. The ALJ recommended adoption of the Staff position. The primary difference between the Company and Staff positions concern the treatment of labor overheads in the calculation of customer-related costs. Staff excluded such costs, basing its approach on an interpretation of a statement in Case No. U-4331, dating back to November 9, 1973. Actually, the citation within that order does not exclude labor overheads from the calculation of customer costs. It says that "costs that are directly incurred as the result of a customer's connection to the gas system" should be included. If there were no functions such as customer accounting, services and billing, there would be no labor overheads associated with them. These costs are "associated directly with supplying service" as the result of a customer's connection to the gas system.

The Staff-developed formula follows a narrow interpretation of customer-related costs. It does not include any of the labor overheads, such as pensions and benefits and payroll taxes allocated to customer accounting and customer service functions, or supervision and engineering O&M expenses included in the calculation of customer-related costs. It has been a tradition to base the customer charge for residential customers on customer costs calculated based on the class cost-of-service study. The labor overheads Consumers includes are associated with customer billing. Consumers Energy calculated, using Staff's approach, that the residential customer-related cost would be $8.40 per month, by including customer-related labor overheads (and excluding the customer-related portion of O&M supervision and engineering expenses). See, Exhibit A-159.

Consumers' position included substantial evidence supporting the Company's proposed customer-related costs. In Case No. U-10755, the Company's last general rate case, Staff witness acknowledged that a case might be made for including labor overheads in the formula for calculating customer-related costs. See, e.g., Discovery Response No. 13000-CE-ST-7 (Exhibit A-149), in which Mr. Aldrich conceded that labor overheads could be classified as customer-related "depending on the way labor is allocated." Thus, contrary to the ALJ's assertion, the Company's proposal is supported by the controlling legal authority and substantial evidence in the testimony of Mr. Brockett and Mr. Belknap, and by interpretation of Staff's position in Case No. U-10755.

Staff's approach is inconsistent. For purposes of Staff's overall cost of service study, Mr. Aldrich allocated employee pensions and benefits and payroll taxes (labor overheads) to such functions as customer accounting and customer service. See page 1 of 16 of Exhibit S-147. The costs associated with these functions are classified as customer-related and are included in Staff's formula for calculation of customer-related costs allocated to various rate classes. Therefore, the portion of labor overheads allocated to these functions should be classified as customer-related and included in the calculation of customer-related costs. Staff's use of labor overheads in Exhibit A-147 supplements the previous Commission directives regarding labor overheads and customer charges. A residential monthly customer charge of at least $7.74 is reasonable and $8.00 should be adopted as requested.

C. <u>Minimum Daily Supply Requirement</u>

<u>The ALJ Failed To Address An Important Language Addition To The Company's Rules</u>

Consumers Energy proposed to include the following language in its transportation rate schedules:

> "In the months of January, February and March the customer's daily gas supply to the Company shall be not less than that customer's gas consumption in that same month in the prior year reduced by 3% of that customer's ACQ, then divided by the number of days in that month. Failure to supply this minimum

> daily quantity will result in the application of the Unauthorized Gas Usage Charge to any daily supply shortfall." See Exhibit A-108, pages 34, 39, 44 and 49.
>
> In testimony, the Company explained the basis for this proposal:
>
> "Over the last fifteen years, the annual volume of transportation service has tripled and the business of gas supply has emerged as a commodity business for the suppliers who use sophisticated methods to arbitrage gas supply. Greater fluctuations in daily supplied gas volumes have the potential to put undue burden on the Company's storage withdrawal capabilities during the peak winter months. The minimum daily supply requirement proposed in this case is a simple method of reducing the risks of excess storage withdrawals without imposing a daily balancing requirement on all end-users. Daily balancing could be very expensive to implement for the Company and would put pressure on the end-users to precisely anticipate their daily gas supply requirements. This concept is also consistent with rules regarding daily delivery obligations for the Gas Customer Choice program." 8 TR 1300.

The Staff supported this change. The ALJ failed to address it. The Commission is requested to prove it.

VII. CONCLUSION

Consumers Energy requests that the Commission issue its final order consistent with the foregoing Exceptions, find that Consumers Energy's rates should be revised to produce additional annual revenues of approximately $105 million (including partial and immediate rate relief), and grant other relief set forth herein.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

Dated: June 24, 2002

By: Richard Chambers

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APPENDIX A

Case No. U-13000 CECo General Gas Rate Case

Revision of the Proposal for Decision (PFD) Revenue Deficiency to Reflect
Revenue Requirement Adjustments - As Discussed in Section I.B. (000)

Line No.	Description (a)	PFD Results (b)	Revised Results (c)
1	Rate Base	$ 1,378,295 [1]	$ 1,378,295 [1]
2	Required Rate of Return	7.25% [1]	7.25% [1]
3	Income Required	$ 99,926	$ 99,926
4	Adjusted Net Operating Income	79,758 [2]	79,862 [3]
5	Income Deficiency	$ 20,168	$ 20,064
6	Revenue Conversion Factor	1.5683	1.5683
7	Revenue Deficiency - per PFD	$ 31,629 [1]	$ 31,466
	Adjustments to the PFD Result:		
8	MPSC Staff Initial Brief - Uncollectible Expense Revision		1,400 [4]
9	Massachusetts Formula		253 [5]
10	Sales and Use Taxes		4 [6]
11	Accounting Workload Realignment		3,935 [7]
12	Health Care & Employee Benefits		6,236 [8]
13	Life Insurance Refund		(1,667) [9]
14	Michigan Single Business Tax		(151) [10]
15	**Total Adjusted Revenue Deficiency**		$ 41,476

Footnotes

[1] U-13000 PFD, page 65.

[2] Ties to PFD page 65 - detail:

MPSC Staff NOI	$ 80,270	Exhibit S-123, line 4, column (f).
Add. Disallowances	(512)	Exhibit S-124, line 11, column (m).
Adjusted NOI	$ 79,758	

[3] Revise the MPSC Staff adjusted NOI to consider only the impact of interest synchronization caused by the equity infusion of $150.0 million into the Capital Structure.

MPSC Staff NOI	$ 80,270	Exhibit S-123, line 4, column (f) (Footnote #2).
After tax of Int. Synch	(408)	See below.
Revised NOI for PFD	$ 79,862	

U-13000 PFD Adjusted NOI with interest synchronization included for the equity infusion.

PFD Rate Base	$ 1,378,295	
Change in Wtd Cost Debt	-0.000846	(3.32% - 3.40%) (PFD versus Staff)
Change in Interest	$ (1,166)	
FIT Rate	35%	
FIT Expense Change	$ 408	

[4] MPSC Staff additional revenue requirement recognized in its Initial Brief position of $29.9 million (versus $28.5 million filed position).

[5] U-13000 PFD, page 62.

[6] U-13000 PFD, page 94 ($5,694 less $2,000).

[7] U-13000 PFD, page 54 - Accounting for Workload Realignment, page 54 of the PFD.

[8] U-13000 PFD page 57 (Health Care & Employee Benefits detail from CECo Initial Brief, Appendix C, pages 2 and 3).

[9] CECo Initial Brief, Appendix C, page 3 of 4, line 37, column (e) increased by Staff's inflation factor ($1,585 * 1.052 = $1,667).

[10] U-13000 PFD, page 94 ($691,000 less $842,000).

APPENDIX B

APPENDIX B TO EXCEPTIONS

SUMMARY OF EVIDENCE DESCRIBING CAPITAL INVESTMENTS FOR 2001 AND 2002

A. Mr. Preketes (6 TR 705-742, 13 TR 2309-2326)

Material condition program - This program represents capital expenditures of $22,175,000 in 2001 and $28,091,000 in 2002. Exhibits A-67 and A-68. Mr. Preketes explained that these expenditures are based upon a Decision Analysis Model that is designed to explicitly manage risk associated with the operation of gas pipelines, regulator stations and metering facilities. He explained that these investments were for (i) the replacement of deteriorated steel pipe to meet the requirements for a remedial plan agreed upon by Consumers Energy with the MPSC Gas Safety Staff to achieve code compliance for corrosion control, (ii) an increased emphasis on the replacement of cast iron pipe and acetylene-welded steel pipe, (iii) the replacement of thin wall steel gas main, (iv) the relocation of gas mains in certain mobile home parks, (v) the acceleration of the relocation of meters from inside to outside buildings as agreed to with the MPSC Gas Safety Section, and (vi) enhancing capacity at new regulator stations and customer metering facilities and other general system enhancement measures. See 6 TR 710-711. Mr. Preketes testified that it "is important to the safety and reliability of our gas system that we update and replace these facilities." 6 TR 710. More details are supplied at 6 TR 709-711; 13 TR 2331.

Pipeline Integrity program - This program represents capital investments of $1,300,000 in 2001 and $5,412,000 in 2002 for Consumers Energy, and $878,000 in 2001 and $5,100,000 in 2002 for MGS. Exhibits A-67 and A-68. Mr. Preketes explained that these amounts are needed to implement a program that will analyze the condition of pipelines to identify any problems that might exist. Mr. Preketes noted two catastrophic pipeline incidents in the States of Washington and New Mexico that prompted increased federal attention to the issue of pipeline safety from the United States Congress and the Department of Transportation's Office of Pipeline Safety. 6 TR 711-712. He also noted several pipeline ruptures on Consumers Energy's system that occurred in 1997 and 1999. 13 TR 2320. Mr. Preketes testified that

> ". . .the only way to verify the integrity of the transmission system is to implement a program that will analyze the condition of the pipelines so that they can be made safer as soon as possible. This program will be capital intensive in order to allow in-line inspection devices ("smart pigs") to be launched and received, retrofitting pipelines to make them smart pigable and remediating inferior sections of pipeline based on the analysis of smart pig data." 13 TR 2320.

Mr. Preketes noted that the MPSC Gas Safety Staff is aware of all of these issues. 13 TR 2321. He further stated that

> "The transmission system age and recent history indicates that additional resources and capital are required to maintain system integrity and safety. Continued safe and reliable operation of the gas transmission system depends on the financial ability of the Company to address these known and measurable pipeline integrity issues." 13 TR 2321.

More details are provided at 6 TR 711-713, 740-742 and 13 TR 2320-2321.

<u>Corrosion control</u> - This program represents capital investments of $1,255,000 in 2001 and $1,555,000 in 2002. Exhibit A-67. Mr. Preketes testified that this is a program designed to prevent the loss of metal from pipelines and is necessary for both underground (typically accomplished through "cathodic protection") and above ground (typically accomplished through wrapping or painting of the pipeline) facilities. Mr. Preketes explained that the Company is in the middle of a ten year remediation program agreed to with the MPSC

Gas Safety Staff to repair or replace all non-compliant underground and above ground pipe. More details are supplied at 6 TR 714-715 and 13 TR 2319-2320.

Engineering/Planning/Scheduling - This is a group of activities and investments that will require capital expenditures of $7,581,000 in 2001 and $9,037,000 in 2002. Exhibit A-67. These investments are necessary in three broad categories: (1) computer applications, (2) acquisition of land and right-of-way, and (3) acquisition of tools. The computer applications category consists of a group of systems, including (i) customer internet access (to allow customers the ability to request, schedule and pay for company services such as new gas installations over the internet), (ii) order management and routing ("OMAR") system that will increase employee productivity by accomplishing the planning and scheduling of employee work through a consolidated computer system, (iii) the replacement of obsolete handheld computers and related equipment used by gas employees for workload management purposes, and (iv) the geographic information system ("GIS") which converts paper maps of gas pipelines to computer based graphic maps, and then adds inspection and maintenance schedules and historical data to allow a more efficient analysis and prioritization of various projects. 6 TR 722-728.

The acquisition of land and right-of-way expenditures relate to right-of-way associated with new or relocated gas facilities. The tools category relates to a wide variety of tools needed by the Company's gas field employees, as well as certain capitalized office equipment. Id. More details on these investments are supplied at 6 TR 722-728 and 13 TR 2319.

Meter technology and management system program - This program represents capital investments of $2,556,000 in 2001 and $5,261,000 in 2002. Exhibit A-67. The dollars represent the cost of new meters purchased to replace meters that have been removed from service due to malfunction, to comply with the MPSC's meter exchange requirements, and in connection with the meter relocation program (inside to outside). More details are provided at 6 TR 733-734.

Civic Improvement - This category represents capital investments of $26,923,000 in 2001 and $27,506,000 in 2002. Exhibit A-67. Mr. Preketes explained that this relates to activity initiated by local, state and federal governmental bodies associated with the construction of new or improved roads and bridges, the installation of sewer systems, road widening, etc. These projects often require the relocation, lowering, abandonment or removal of gas pipe. This work has expanded dramatically because the state has recently significantly increased the funding of infrastructure projects, from $500 million in 1998, to $1.2 billion for each year of a five year period. The increased civic improvement infrastructure work results in increased gas utility expenditures. 6 TR 737-738. More details are found at 6 TR 736-738.

Small Technology Applications - This category represents capital investments of $234,000 in 2001 and $79,000 in 2002. This category consists of computer applications designed and installed to meet specific needs. For example, this includes computer applications that allow customers to directly access information concerning Company services via the Company's website, as well as electronically communicate with the Company. This also includes the customer Online Billing Information application that allows customers to electronically view current and historical account information and to pay their bill using on-line options. Another example is the Real Estate Work Center application which provides statewide support for the management of real estate operations. This includes facility maintenance scheduling, work order tracking and emergency response and follow-up. More details are provided at 8 TR 1146-1147.

Technology Infrastructure, Software - This category represents capital investments of $490,000 in 2001 and $840,000 in 2002. These investments are largely designed to reflect the periodic updating to computer systems necessary to improve efficiency and enhance the usefulness of equipment that was installed several years ago. These changes are cost-effective by extending the useful life of existing equipment and adding new or expanded functions. More details are stated at 8 TR 1147.

Technology Infrastructure, Equipment - This category represents capital investments of $7,280,000 in 2001 and $6,840,000 in 2002. This is equipment needed to update technology in the areas of desktop publishing, printing, tape handling equipment, voice and radio communications and related technology support. Mr. Preketes explained that this type of equipment is replaced or upgraded on a managed basis, based on installed life, capacity limits, maintenance history, and technical obsolescence. Some computer units are replaced on a pre-planned schedule to maintain technically viable computer systems and to levelize the replacement process. More recently, many of the equipment purchases have been focused outside of Company offices, as remote monitors of information and in mobile vehicles for the dispatch of customer-related services. More details are provided at 8 TR 1148.

Technology Infrastructure, General Office - This category was added in Mr. Preketes revised testimony, 8 TR 1151-1152, and represents $1,867,000 of capital investment in 2002. This investment is a result of the determination that it is not feasible to relocate existing core telephone and data communications equipment in the new office building that is under construction in Jackson. See discussion of Mr. Gladney's testimony below. Investing in new communications technology at the outset will allow the equipment to remain functional further into the future, reduce the probability that additional investments will be needed in the near term to replace older units transferred from exiting facilities, eliminate the risk of communications outages during the course of the move to the new facility, and reduce the total cost of installation by accomplishing the work during the construction period. More details are supplied at 8 TR 1152.

B. Mr. Gladney (7 TR 1015-1022; 13 TR 2356-2359)

General Office Facility - This represents capital investments of $1,998,000 in 2001 and $10,260,000 in 2002. Exhibit A-83. Mr. Gladney, who is the Manager of Business Services for Consumers Energy, testified that the General Office Facility Project will combine Jackson offices from several locations around the city in a new office building, and will consolidate certain computer operations, gas systems control and gas commodity management activities at an existing office building. He explained that the buildings being vacated were under lease that was scheduled to expire, and that the Company fully evaluated what would be necessary to renovate those facilities and update them for current technology requirements. Mr. Gladney stated that the results of this analysis revealed that "it was not cost effective to rehabilitate the existing facilities to meet these basic office needs." More details are supplied at 7 TR 1020.

Statewide Realignment - This represents capital investments of $3,539,000 in 2001 and $7,035,000 in 2002. Exhibit A-83. Mr. Gladney explained that this project is similar to the General Office project, except that it relates to outstate facilities. He testified that many of the mechanical and structural systems at these facilities were constructed in the 1950's and 1960's and are thus nearing the end of their useful life. In addition, the need to adapt the workspaces to new and expanded technology support was going to require major investment in any event. Through prioritization determined based upon current and future use, the age and condition of facilities, and benefits to customers, a multi-year program was designed to accomplish the needed facility improvements. More details are supplied at 7 TR 1020-1021.

Fleet Equipment - This represents capital investments of $646,000 in 2001 and $492,000 in 2002. Exhibit A-83. These investments are for a variety of gas utility field equipment, such as (i) trailer units that carry trenchers, backhoes, or pipe boring devices, and (ii) work tools and analytical units used in the maintenance and repair of fleet and motorized equipment. Investment levels for such equipment are scheduled based upon physical inspections and compliance with State highway codes, and are maintained at fairly stable levels. More details are found at 7 TR 1021.

Services Infrastructure - This represents capital investments of $98,000 in 2001 and $110,000 in 2002. Exhibit A-83. These investments cover a variety of items, including property assessments from local governmental units for various civic improvements, mail processing equipment, material reclamation equipment. More details are provided at 7 TR 1022.

C. Mr. DaPra (5 TR 537-562; 13 TR 2275-2282)

Mr. DaPra is Senior Vice-President of Accounting and Regulatory Affairs for Consumers Energy and sponsored a group of capital investments that totaled $1,814,000 in 2001 and $5,364,000 in 2002. Exhibit A-57. These investments are for computer systems and office equipment, including the following: (i) The current corporate accounting computer system is over 20 years old, utilizes outdated data base technology, and is becoming increasingly expensive to maintain. The new system architecture will allow for the integration of all financial subsystems that will provide common data collection, information access and financial reporting. (ii) Upgrades to several accounting and billing systems are necessary and will provide greater efficiencies in the customer billing process, and will allow for closer monitoring of operating costs. (iii) A new data management system is needed and will allow for the more effective management of electronic records, and will also address paper storage concerns that will be intensified when the Company's current headquarters relocates to the new building currently under construction. (iv) A new set of business systems is required and will streamline the employee recruiting process, allow employees to directly update certain personnel records, and develop electronic training methods to replace in-classroom training. (v) Certain expenditures are needed to replace worn out office equipment and to improve computer systems to allow for more streamlined accounts payable processing. More details are supplied at 5 TR 553-556.

D. Mr. Sosinski (6 TR 841-875; 12 TR 2192-2197)

Mr. Sosinski is the Manager of Gas Transmission & Storage for Consumers Energy, and the General Manager of Michigan Gas Storage Company ("MGS"). As General Manager of MGS, he is responsible for gas transmission and storage operations. 6 TR 841.

CECo-Compression - This represents capital investments of $1,421,000 in 2001 and $5,129,000 in 2002. Mr. Sosinski explained that this category of projects includes work at compressor stations, which provide the pressure needed to move gas through pipelines and in/out of storage fields. The specific type of projects include engine emission controls, replacement of field heaters and station valve operators, installation of additional gas separator capacity. Considerably greater details are provided at 6 TR 845-849.

CECo-Measurement, Regulation and Pipeline - This category represents capital investments of $7,676,000 in 2001 and $6,393,000 in 2002. These investments are for the Company's transmission system and measurement facilities and regulator stations to assure safe and reliable delivery of gas. Examples of these projects are new city gate stations, remote terminal unit replacements, condemnation payments in connection with the installation of new pipelines, relocation of pipelines. More details are supplied at 6 TR 849-855.

CECo-Storage - This category represents capital investments of $1,913,000 for 2001 and $3,048,000 for 2002. These are investments made to the Company's storage systems to support, maintain and increase cyclic capacity and deliverability of the storage fields. Specific examples of these projects are drilling of horizontal well extensions (which increases the deliverability of the storage field), the conversion of a depleted gas reservoir to a new storage field, and the replacement of master meter tubes (which increase the accuracy and the flow range of the measurement). More details are provided at 6 TR 855-857.

MGS-Compression - This category of capital investments represents $531,000 in 2001 and $2,756,000 in 2002. These are similar to the same type of projects as described above for Consumers Energy. In addition, there is a significant project scheduled for 2002 that will consolidate two headquarters offices for MGS at the Muskegon River site. Renovations of that site will be necessary to accommodate the additional employees and associated vehicles. Over time this consolidation will result in greater operational and cost efficiencies. More details are provided at 6 TR 864-866.

MGS-Measurement, Regulation and Pipeline - This group represents capital investments of $829,000 in 2001 and $513,000 in 2002. These investments are essentially for the same type of projects as described above for Consumers Energy. More details are supplied at 6 TR 866-867.

MGS-Storage - This category represents capital investments of $1,822,000 for 2001 and $2,666,000 for 2002. The projects in this group are similar to the Consumers Energy storage projects described above. More details are supplied at 6 TR 867-868.

APPENDIX C

APPENDIX C TO EXCEPTIONS

SUMMARY OF EVIDENCE
CONCERNING O&M EXPENSES FOR 2002

Attached to the Company's initial Brief in this case was Appendix C, pages 2-4. That Appendix provided a comparison of the Company and Staff positions on Other O&M expense in this case on a project-by-project basis. Because it offers a convenient means of identifying the differences between the company and Staff positions, it is attached at the end of this Appendix, and is referred to throughout this Appendix.

A. Testimony of Paul N. Preketes

Mr. Preketes provided detailed information concerning O&M programs that the Company needs to perform in order to continue to serve its customers safely and reliably. Mr. Preketes' exhibits A-66, A-68 and A-183 and his workpapers, Exhibit S-185, provide detailed descriptions and explanations of these programs and expenses.

The evidentiary record reveals that Mr. Preketes provided great detail concerning all of these programs in his direct, supplemental and rebuttal testimony (see 6 TR 704-742, 8 TR 1097-1100, 1137-1152, 13 TR 2293-2300, 2308-2336), during cross-examination (see 6 TR 743-813, 8 TR 1102-1136, 13 TR 2327-2341) and through exhibits. (See Exhibits A-66 through A-68, A-93 through A-100, A-183, A-184, S-185, S-186.) Mr. Preketes testified as follows concerning these programs:

> "Q. Please generally describe the types of programs you are supporting.
>
> "A. The Company is requesting in this proceeding that the increased cost of the programs I describe in this testimony be recognized in rates. I am supporting the changes to the following major programs: Material Condition, Pipeline Integrity, Corrosion Control, Damage Prevention, Succession Planning, Appliance Service Plan, Engineering, Operator

> Qualification, Uncollectibles, Meter Technology, Accounting Changes, and Civic Improvement. These programs are integral to the gas operations of both Consumers and MGS, and are designed to provide safe and reliable service to customers and meet new regulatory requirements. My testimony addresses increases in these programs from the historical year 2000 into the test year 2002.
>
> "Q. Do you have any general comments about the level of spending for these programs?
>
> "A. Yes. In evaluating the level of O&M and capital expenditures included in this proceeding, I believe that it is important to understand the past efforts made by the Company to contain costs. Consumers Energy has not had a general gas distribution rate increase for over 17 years. During this time, the Company has employed aggressive but prudent management of O&M expenses and capital expenditures to increase productivity and operational efficiencies, and to avoid incurring unnecessary costs. To be frank, the negative revenue impacts arising from warmer than normal weather and the rate freeze imposed pursuant to the three-year experimental customer choice program have required the Company to intensify its already aggressive pursuit of operational efficiencies and cost savings. Our success in these efforts has enabled us to continue to provide safe and reliable service while deferring as long as possible a request for an increase in customer rate levels." 6 TR 707-8.

He went on to say that the Company had reached the point where resources, without rate relief, are no longer adequate to provide safe and reliable service to customers and meet all the requirements imposed by regulations. Mr. Preketes provided a detailed explanation of each of the programs that form the basis for the Company's O&M request in his testimony and exhibits. These programs are summarized below.

<u>Material Condition Program</u>

The Company's O&M requirement for the year 2002 for the Material Condition Program is $12,382,000. Appendix C to the Company's Brief, page 2 of 4, line 1. Mr. Preketes explained the purpose of the Material Condition Program as follows:

> "The material condition program is in place to address the replacement of pipelines, regulation, metering facilities and additions to gas facilities due to obsolescence, and deterioration and the addition of new facilities to upgrade equipment and instrumentation. It is important to the safety and reliability of our gas system that we update and replace these facilities." 6 TR 709-710.

Mr. Preketes described the methodology and goals of the program: the replacement of "deteriorated steel pipe to meet the requirements for the last years of the ten-year remedial plan agreed upon with the MPSC Gas Safety Staff"; replacement of cast iron pipe and acetylene-welded steel pipe, 6 TR 710-711; capacity enhancements, *e.g.*, replacement or upgrading of regulator stations and customer metering program, 6 TR 711; 6 TR 800, and system enhancement "to assure meeting customer demands," 6 TR 711, which results from an annual analysis of the Company's system by looking at system pressures and other indicia, 6 TR 805, resulting in a "firm" amount prepared for work for this year. 6 TR 806. This analysis is the most current step in an annual analysis that has been going on for years. *Id*. This program rests on a decision analysis methodology that analyzes the long-term needs of the system for the purpose of replacing obsolete buried pipelines that show no sign of corrosion or wear until they fail: "[M]anagement . . . analyzes its [pipeline] system for performance – wear, leak history, weld failures – and based on that analysis makes decisions on what are things regarding safe operation, safe long-term operation, and also efficient operation." 6 TR 789.[1]

<u>Pipeline Integrity Program</u>

The Company's anticipated O&M expenses for the Pipeline Integrity Program for the year 2002 are $2,536,000. Appendix C to the Company's Brief, page 2, line 2. The Pipeline Integrity Program was established by Consumers Energy to respond to various federal safety

[1] *See also* 13 TR 2321, 13 TR 2328. *See also* Exhibit S-185 [Mr. Preketes' workpapers, in particular, WP-01, -02, -20, -21, -23, -24,-48].

initiatives. The United States Congress, in response to pipeline explosions in Bellingham, Washington and Carlsbad, New Mexico, 6 TR 711, as well as other pipeline ruptures, 13 TR 2320, including one on Consumers Energy's Line 1300 on March 7, 1999. *id.*, is considering legislation that will affect 1,754 miles of pipeline on Consumers Energy's system, requiring retrofits that will cost $68,000,000. 6 TR 711-712. Mr. Preketes testified that rules being promulgated by the U.S. Department of Transportation's Office of Pipeline Safety, expected to be effective by May of 2002, 6 T 740, will require Consumers Energy (and all other gas utilities) "to install internal inspection devices and receivers, [and] make provisions to minimize service interruption, as well as perform the required testing." 6 TR 712. Consumers Energy has developed a five-year plan to deal with these federal requirements.

Additionally, in 2000, Consumers Energy "identified 18 sections of pipe on the 1300 line that required replacement." 13 TR 2320. Based on a pipeline inspection of the 1700 line in December 2000, 12 locations had to be cut out and replaced. 13 TR 2321. The MPSC Gas Safety Staff has been aware of all of these issues. *Id.*[2]

Despite the previous knowledge and involvement of the Gas Safety Division, the Staff did not recommend any increases in O&M on account of this program because this program, for the reasons discussed, was not part of the Company's 2000 O&M expenses. Thus, as shown on Appendix C to the Company's Brief, p. 2, by merely escalating the 2000 O&M expenses for inflation as the Staff has done, Staff has provided no revenues whatsoever for this program.

[2] *See also* 6 TR 711-713 [describing the specifics of the program]; 6 TR 746; 6 TR 767-775; 6 TR 809; 13 TR 2320; 13 TR 2328; Exhibit A-66, Exhibit A-67, Exhibit A-68; Exhibit- A-183 and Exhibit S-185 (WP-03-04)

Corrosion Control Program

The O&M expenses for the Corrosion Control Program in 2002 are $6,528,000. Appendix C to the Company's Brief, page 2 of 4, line 3. The Corrosion Control Program is designed to "preven[t] the loss of metal from a pipeline . . . above and below ground." 6 TR 714. This program was also instituted under the supervision of the MPSC Gas Safety Division, *id*., and Consumers is in the seventh year of a ten-year remediation plan, *id*., "to repair or replace all non-compliant underground and above ground pipe as part of an agreement with the MPSC Gas Safety Division." *Id*. Annual updates are provided to the Staff concerning these remedial programs. 13 TR 2319. *See also* Exhibit A-66; Exhibit A-183; Exhibit S-185 (WP 05-06).

The Staff, employing the inflation adjustment of 5.2% to the year 2000 O&M expenses for this program, recommends $3,369,000 for this program, roughly one half of what the Company is requesting. The Staff recommendation vastly understates the level of expense needed to adequately fund this program.

Damage Prevention Program

The O&M expenses for the Damage Prevention Program in 2002 are $7,558,000. Appendix C to the Company's Brief, page 2 of 4, line 4. The Damage Prevention Program "is a process for preventing excavation dig-ins to underground facilities." 6 TR 715. This program provides an important safety service, assuring the "accurate location and marking of underground facilities, adherence to safe digging practices, proper placements of facilities and strong public education and awareness." *Id*. According to the Michigan Gas Safety Code (Rule 614) Consumers Energy is required to have "a written program to prevent damage to pipelines from excavation activities." 6 TR 716. This program provides the method through which

Consumers Energy complies with this Commission regulation. In 2002, Consumers Energy's damage prevention plan focuses on:

1. Increasing public understanding of damage prevention issues;

2. Improving the forecasting, screening and scheduling of excavator request for staking;

3. Achieving excavator compliance with safe digging practices; and

4. Improving the timeliness of the staking of our gas facilities.

4 TR 716. The goals of this program are to reduce the number of "dig-in" damages compared to the total number of MISS DIG requests staked in the field. Fewer damages will result in reduced hazard to our customers, employees and the general public and increased reliability of service and customer satisfaction." 6 TR 719.[3]

Notwithstanding the fact that the program was created to fulfill the Company's obligations imposed by Commission rule, Staff merely escalates the 2000 O&M expense for this program by its inflation factor. The Staff's recommendation is $5,379,000, or $2,179,000 less than what the Company shows the program is actually needed in 2002.

Succession Planning Program

Facing the inevitable fact that its workforce is aging, the Company has established a Succession Planning Program, designed to organize and analyze current and future personnel needs. The 2002 O&M expenses for this program are set forth on Appendix C to the Company's Brief, page 2 of 4, line 5 in the amount of $2,250,000. Staff's recommendation, on the other hand, based on the 5.2% inflation escalator used by Staff, is $337,000.

Mr. Preketes described the 2002 year needs for this program:

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[3] 6 TR 750-753; 13 TR 2318; 13 TR 2328; Exhibit A-66; Exhibit A-183; Exhibit S-185 (WP-07).

"Currently, the average age of retirement at Consumers' gas utility is 59 (PHP-W/P-11), and the earliest retirement age is 55. In 2002, 40% of exempt, 25% of nonexempt, and 18% of union employees will be age 55 or older. On average, 53% of those eligible to retire do so. The number of employees retiring will significantly increase in 2002 because of the high percentage of employees turning 55 or older. The number of employees eligible to retire will continue to increase for the next several years. Each retiring employee takes with him an average of 30 years of Company service . . . . Therefore, we must begin hiring not only to fill vacancies, but also to begin transferring knowledge from those for whom retirement is imminent." 6 TR 720.[4]

Staff's recommendation substantially understates the level of expense for this item that should be used in setting rates.

Appliance Repair Plan/Appliance Repair

The O&M expenses for the Appliance Repair Plan/Appliance Repair Programs sponsored by Mr. Preketes $17,414,000. Appendix C to the Company's Brief, page 2 of 4, line 6. Mr. Preketes described these plans as follows:

"The Appliance Service Plan Program (ASP) is a service contract offering for our customers who wish to protect themselves from unexpected and high repair costs when their Heating, Cooling and Ventilation (HVAC) equipment and major household appliances break down. Various combinations of this protection option are packaged together in several different plans. When a covered appliance breaks down, all covered repairs are made at no additional charge for service calls, parts, or labor. Furnace and central air conditioner tune-ups are also available for an additional fee. Consumers gas utility employees perform approximately half of the repair service generated by Appliance Service Plans, with the remainder provided by outside contractors. Customer charges for this program are designed to at least cover its costs.

* * *

"[The] Appliance Repair is a service provided to customers who need repairs on their furnaces, air conditioners, water heaters, ranges, and clothes dryers. Unlike ASP, there is no service contract, and customers only pay for this service after repair work

[4] *See also* 6 TR 752-754; Exhibit A-66; Exhibit S-185 (WP 08-11).

> is completed. Consumers gas utility employees perform all of the repair service generated by the Appliance Repair program. Customer charges for this program are designed to at least cover its costs." 6 TR 721.

As Mr. Preketes testified, if the revenue earned by these programs which is used to lower gas rates, is eliminated because the Company is prohibited from engaging in these activities as a result of the recent Code of Conduct established by the Commission, the Company's revenue requirement would need to be increased by approximately $10.5 million.[5]

The Staff recommended $15,224,000 for this program, based on its inflation adjustment. The Staff's recommendations for this program are inconsistent. The Staff recommends that <u>all</u> of the revenues be considered (which reduces the Company's revenue requirement) but only recommends that part of the expenses (which increases the revenue requirement) be considered. Either the revenues and expenses should both be included or both excluded. Staff's recommendation, which is $2,190,000 less than the Company's, should be rejected and the Company's recommendation accepted.

<u>Engineering/Planning/Scheduling</u>

The O&M expense for Engineering/Planning/Scheduling for the year 2002 is $13,735,000. Appendix C to the Company's Brief, page 2 of 4, line 7. The major elements of this program are "(1) computer application support and enhancement ($2,460,000); (2) computer storage capacity additions ($452,000); and (3) realignment and addition of employees to reflect reductions in certain capital programs and concurrent increases in O&M programs which support system reliability, regulatory compliance and customer satisfaction ($645,000)." 6 TR 723. The computer enhancement element consists of development and operation costs for new computer system or enhancements that "directly support our programs for system reliability, regulatory

[5] *See also* 6 TR 754-758; Exhibit A-66; Exhibit S-185 (WP-12).

compliance or customer satisfaction." *Id*. The specific enhancements are Customer Internet Access (designed to permit customer scheduling and bill payment), Order Management and Routing (designed to manage distribution, service, regulatory compliance and other work types under one management system) hardware replacement of obsolete computer equipment, both in-field handheld and centralized host processors and a Global Information System consisting of software and database for intensive gas infrastructure information. 6 TR 725-726. Additionally, in conjunction with the introduction of the new management systems described above, employees will be realigned to be more responsively organized. 6 TR 726.[6]

Staff's recommendation for this program is $10,704,000, which is $3,031,000 less than the Company's.

Operator Qualification

The 2002 O&M expense for the Operator Qualification program is $6,563,000. Appendix C to the Company's Brief, page 2, line 8. This program, as Mr. Preketes described at 6 TR 728, was established by Consumers Energy in response to a federal mandate:

> "This program is designed to comply with a new regulation mandated by Congress in the Pipeline Safety Reauthorization Acts of 1992 and 1996. The new regulation created a new Subpart N in Title 49 of the Code of Federal Regulation Part 192 – TRANSPORTATION OF NATURAL AND OTHER GAS BY PIPELINE: MINIMUM FEDERAL SAFETY STANDARDS. The intent of the regulation is to ensure a qualified workforce, and to reduce the probability and consequence of incidents caused by human error. The regulation requires pipeline operators to develop, maintain and execute a qualification program for individuals performing certain tasks on pipeline facilities." *Id*.[7]

Mr. Preketes estimated that the Company will be required to conduct approximately 48,000 evaluations for the Company's field employees pursuant to this federal

[6] *See also* 13 TR 2319; 13 TR 2328; Exhibit A-66; Exhibit A-183; Exhibit S-185 (WP-13)
[7] *See also* 6 TR 809; 13 TR 2315-2318; 13 TR 2327-2328 Exhibit A-66; S-185 (WP-14).

mandate. 6 TR 729. The Gas Safety Staff is aware of this program and has reviewed the Company's compliance. The Staff's recommendation for this program ($4,308,000 based on Staff's historical expenses escalated by 5.2% inflation) results in a $2,255,000 shortfall in the resources necessary for the Company to comply with this governmentally mandated program.[8]

Uncollectibles/Customer Billing

The Company's Uncollectible O&M expense is "caused by customers who, for any number of reasons, have not or cannot pay their utility bill." 6 TR 729. After a period of time these debts are written off as bad debts. *Id*. The O&M expense for 2002 for the Company's uncollectible/customer billing expense is $11,531,000. Appendix C to the Company's Brief, page 2 of 4, line 9. The Company calculated its Bad Debt Expenses based on gas prices that are higher than the frozen GCR during the recent rate freeze, 6 TR 730, and on an analysis of the higher uncollectibles immediately after the rate freeze was lifted, the number of bankruptcies during the same period, research regarding the experience of neighboring gas utilities, and an examination of the low-income assistance programs sponsored by governments in Michigan. 6 TR 730-731. The MPSC Staff has been involved in addressing the problems facing low-income customers, conducting forums and seeking recommendations for dealing with this problem. 6 TR 731-732. The higher incidence of bad debt expense will necessitate O&M expense increases due to increased staffing and higher costs associated with outside and professional services accompanied by more reminder notices, reminder telephone calls and ultimately more field visits for bill collection. Specifically the Company will add 6 additional employees to meet the increased workload requirements.[9]

[8]The O&M expense for the Operator Qualification Program takes into account Mr. Preketes' supplemental testimony which adjusted the timing of this program.

[9] 6 TR 732, 6 TR 759-761; 13 TR 2323-2325; 13 TR 2329-2330; Exhibit A-66; Exhibit A-183(page 4 of 4); Exhibit S-185 (WP-15-17).

The Staff recommendation for this O&M expense for the year 2002 is $9,191,000, or $2,340,000 short of the Company's O&M needs for the year 2002.

Metering Technology & Management Systems Program

Mr. Preketes described this program in his testimony: "This program includes the procurement, processing, inspection, repair and recycling of meters used by Consumers to measure gas usage. It also includes the computer systems which track meter inventory, accuracy testing and inspection schedules." 6 TR 733. This program is needed "to cover two items: (1) increased staffing requirements in the Meter Shop ($420,000) and (2) increased costs associated with computer systems for regulatory compliance." 6 TR 733.[10] The Company's 2002 O&M expense for this program is $2,327,000, as set forth in Appendix C to the Company's Brief, page 2 of 4, line 10. The Staff, employing its inflation adjustment, recommends $1,873,000. This understates the appropriate level of expense.

Accounting for Workload Realignment

The Company's O&M expense for this program for the year 2002 is $3,935,000. Appendix C to the Company's Brief, page 2 of 4, line 11. Mr. Preketes explained that this shift is not a net increase in cost, but rather, "[b]ecause of a shift in workload mix, a relatively greater amount of costs incurred in Gas Operations in 2002 and thereafter will be charged to expense functions, and a relatively lesser amount charged to capital functions." 6 TR 735. Mr. Preketes continued:

> "I need to stress here that these changes are really just a shift of dollars from the overheads that are normally charged to Capital to a direct expense activity in O&M. It is the effect of changes in our Business Plans with the goal of gaining more efficiencies in Gas Operations. As shown on Exhibits A-66 (PNP-1) (Line 11) and A-67 (PNP-2) (Line 12), changes in the use of the Joint Expense

[10] *See also* Exhibit A-66; Exhibit S-185 (WP-18).

> functions by Consumers gas utility employees will result in an O&M increase of $3.935,000 and a corresponding reduction of $3,935,000 in Capital expenditures in 2002.
>
> * * *
>
> "These accounting changes occur periodically and the support cost allocation procedures for supervision and other overheads follow Generally Accepted Accounting Procedures (GAAP) and are approved by the Consumers gas utility Accounting Department." 6 TR 735-736.[11]

Purchasing/Technology/Customer Contact Services

In addition to the testimony discussed above, Mr. Preketes also sponsored testimony concerning Other O&M expense originally sponsored by Mr. Kenneth C. Emery.[12] In this testimony, Mr. Preketes supported O&M expenses for 2002 relating to Purchasing Services, $255,000, Technology Services, $6,800,000, and Customer Contact Services, $13,662,000. These amounts are set forth on Appendix C to the Company's Brief, page 2, lines 18-20. "Purchasing Services" cover the procurement of materials and services to support Company operations and customers distribution facilities. "Technology Services" cover the needs of electronically moving additional information to field workers dispatched to remote site locations and maintaining the voice and data networks which connect all field and office workers on a "24 x 7" basis as well as emergency coverage for the safety of the general public and employees. 8 TR 1141. "Customer Contact Services" include monthly mail preparation and mailing of approximately 1.6 million gas billings monthly, over 2 million telephone calls annually as well as letters and e-mail messages. 8 TR 1142. The O&M requests that the Company has made on account of these activities result from "increases in customer telephone volume and billing

[11] *See also* 13 TR 2322-2323; 13 TR 2329; Exhibit A-66; Exhibit- A-183; Exhibit S-185 (WP-19).
[12] Mr. Emery left the Company after filing his testimony but before cross examination was scheduled.

expenses, . . . [increased] wages, telephone costs and postage rate increase in January . . . scheduled for July 2001." *Id.*[13]

The Staff's recommendation for these programs is $198,000 (Purchasing Services), $4,969,000 (Technology Services) and $13,380,000 (Customer Contact Services). This understates the level that should be used for this case.

B. Testimony of Benedict Sosinski

Mr. Sosinski also provided testimony concerning the Company's 2002 O&M related to compression, gas transmission, storage and fuel gas.[14] For compression, these expenses are $8,505,000; for gas transmission, $5,357,000; for storage, $3,416,000, as set forth in Appendix C to the Company's Brief, page 2 of 4, lines 13-15. Mr. Sosinski explained: "This increased level of expenditures is necessary in order to continue to provide safe and reliable service in the most efficient manner possible." *Id.* Further in his testimony, Mr. Sosinski expanded on the reason why the Company is requesting increased O&M for these programs:

> "However, the Company has reached the point at which our resources are no longer adequate to meet all applicable operational requirements and the needs of customers without significant new investments and expenditures. Current rate levels will not support these additional expenditures, and in order to continue to provide service at the current levels of safety, reliability, and customer service, additional investment must be made in the new and existing programs that I describe below." 6 TR 844-845.

The O&M expenses for compression, *i.e.*, "upgrades, repairs and overhauls at the compressor stations," 6 TR 857, reflect the change in operation of the Consumers Energy/MGS transmission system over the last fifteen years. As a result of the change in the customer mix

[13] *See also* 8 TR 1129; 8 TR 1135; 8 TR 1142-1144; 13 TR 2330; Exhibits A-93 and 99; Exhibit A-183; workpaper KCE 3.

[14] Fuel gas is addressed elsewhere in the Exceptions.

now served by Consumers Energy, the Company has scheduling control over only approximately 50% of the gas entering the transmission system. Additionally, use of the Company's storage fields has increased dramatically. These new uses have made performance of the compressors "a critical part of meeting customer requirements." 6 TR 858. The Company's response has been to implement "(i) a preventive/predictive maintenance program, (ii) engine/compressor foundation regrouts, (iii) pipeline foundation repairs, (iv) sulfa scrub chemical, (v) glycol cleanup and arsenic removal, and (vi) facilities maintenance," 6 TR 858 –860.

The transmission-related O&M expenses sponsored by Mr. Sosinski are "(i) right-of-way clearing and maintenance, (designed to provide an enhanced margin of safety by clearing encroaching brush); (ii) heater burner/flame arrestors (replacing indirect heater at compressor and city gate stations to enhance safety and reliability); and (iii) buildings, asphalt, and station maintenance," (designed to accomplish maintenance that has been deferred for several years). 6 TR 860-861.

The storage-related O&M expenses are for (i) well location maintenance,(ii) well remediation, (iii) free gas user buyout program, and (iv) buildings and asphalt repairs. 6 TR 861.

Mr. Sosinski supported O&M expenses for Michigan Gas Storage as well. Those O&M expenses, similar in nature to those for Consumers Energy, are compression-related, *i.e.*, "upgrades, repairs and overhauls the compressor stations," 6 TR 769; transmission-related, *i.e.*, "right-of-way clearing and spraying . . .heater burner/flame arrestors . . . and buildings/asphalt and city gate maintenance; and storage-related, *i.e.*, "well location maintenance . . . , well remediation . . . , free gas user buyout . . . , and building and asphalt repairs." 6 TR 870. The O&M expenses for MGS are set forth on Appendix C to the Company's Brief, page 3.

Using the Staff inflation adjustment of 5.2%, Staff recommends $6,627,000 for Consumers' compression-related O&M expense in the year 2002, $5,049,000 for transmission-related O&M expense in the year 2002 and $2,741,000 for storage-related O&M expense in the year 2002. Similarly, for MGS, Staff recommends $1,978,000 for compression -related O&M for the year 2002, 4,910,000 for transmission-related O&M expenses for the year 2002 and $911,000 for storage-related O&M expenses for the year 2002.

C. <u>Testimony of Rufus Gladney</u>

Mr. Gladney also testified concerning O&M expenses required by the Company in 2002 relating to the construction of new headquarters for the Company. Mr. Gladney described the reason for the change of headquarters and the increased O&M expense that will be required:

> "The reasons for making this move is we are experiencing more frequent and more severe failures of significant building systems to the extent that we had a couple choices. We could either make decisions to invest and substantially replace and renovate the existing facilities, which would result in either significant investments in the existing facilities that we're in or responding when failures occur, which would drive our O&M up.
>
> "To move to a new facility will allow us to really keep those O&M expenses somewhat relatively flat." 7 TR 1025.

The O&M expenses supported by Mr. Gladney for the year 2002 are set forth in Appendix C to the Company's Brief, page 2 of 4, lines 22 and 23. These O&M expenses fall into two categories: General Office Facilities, $7,719,000, and Field Facilities, $4,311,000. O&M expenses for General Office Facilities recognize the O&M expenses to "relocate various Jackson-based operations into a new facility in downtown Jackson or in the Parnall East center." 7 TR 1017. Mr. Gladney explained these expenses:

> "For 2002, the increase shown represents the operation and maintenance expense to move '24 x 7' operations (computer operations center and communications equipment) from the main Parnall office building to the expanded Parnall East operations center. To accomplish this relocation, extensive design and analysis are required to maintain operational integrity and reliability of the equipment. Due to the age of the facilities, hazardous materials (asbestos) abatement procedures will be a significant portion of the expense. From an overall perspective, expense increases have been minimized through a combination of renegotiation of materials and service contracts and a redesigned approach to performing service work." 7 TR 1017-1018.

For the 2002 O&M increases associated with Field Facilities Operations, Mr. Gladney testified:

> "The expenses incurred in 2000 cover the basic needs for day-to-day housekeeping and minor maintenance needs at 27 locations across the State. Techniques to reduce expense through renegotiation of outside support services and continued work redesign have resulted in increases well below industry experience. The increase shown on line 2 is associated with a major maintenance program that will be coordinated with capital investment to repair, upgrade or replace facility structural and mechanical assets. The increase in O&M expenditures is required to ensure the facilities can continue to accommodate the current workforce. This multi-year project, Statewide Realignment, will be further detailed in a discussion of capital projects." 7 TR 1018.

Staff's recommendation, using the 5.2% inflation factor, for the 2002 O&M expenses relating to these programs, is $7,253,000 (General Office Facility Services) and $3,286,000 (Field Facilities Operations). This understates the levels that should be used in this case for these categories by $1,490,000.

D. <u>Testimony of Dennis DaPra</u>

Mr. DaPra also testified concerning certain known and measurable O&M expenses for the 2002 test year relating to "increases in employee benefit costs, customers uncollectibles, and the amortization of manufactured gas plant costs."[15] 5 TR 541. The Company's Other O&M expenses sponsored by Mr. DaPra are detailed on Exhibits A-56, A-58 and A-126. The Company's O&M expenses relating to these items for 2002 are summarized on Appendix C to the Company's Brief, page 2, lines 25-32 and page 3, lines 9-13. The development of the Company's position on these issues is further explained on Appendix C to the Company's Brief, page 4.

Mr. DaPra provided detailed testimony concerning the manner in which costs common to the combined utility are allocated to the gas portion of the business. Mr. DaPra explained that costs common to the combined utility are allocated based either on the relationship of employee labor dollars charged to gas operations compared to the total labor dollars charged to both electric and gas operations or the relationship of employees in gas operations to the total number of employees in both electric and gas operations. For 2002, those employee benefit costs allocated on labor (Pension, Employee Savings Plan and Supplemental Executive Retirement Plan costs) are allocated 29% to gas, 71% to electric. Those employee benefits allocated for 2002 on employee count (Health Care and Life Insurance-for Post Retirement as well as for Active) are allocated 31% to gas, 69% to electric.

Mr. DaPra further testified in great detail concerning the employee pension plan and the postretirement health care plan, 5 TR 542-548, the Company expense relating to contributions to the employee savings plan, 5 TR 548, and the Supplemental Executive Retirement Plan. *Id.* Mr. DaPra also provided detailed testimony concerning the customer uncollectible expense reserve. 5 TR 548-549.[16]

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[15]Manufactured Gas Plant costs are discussed elsewhere in the Exceptions.
[16]Mr. DaPra submitted Supplemental Direct Testimony, 5 TR 557-562 which described the change to the Company's health care plan. These changes are incorporated in Exhibit A-56.

Mr. DaPra testified that national health care costs are skyrocketing. 13 TR 2278. The Company has amended its health care plan to require significant employee contributions to health care to help defray double digit increases in costs. 5 TR 560. While Company cost increases are below national trends, they are still significant. 13 TR 2279. Mr. DaPra submitted rebuttal testimony, 13 TR 2274-2282, rebutting the Staff position concerning Staff's use of 2.4% and 2.7% escalation rates for 2001 and 2002 health care costs. Mr. DaPra provided detailed information in Exhibit A-180 concerning the national trends in health care costs. The Company's health care cost levels are reasonable, known and measurable. 13 TR 2279.

Mr. DaPra also testified that the Company calculated its pension and postretirement health care expense in accordance with Generally Accepted Accounting Principles ("GAAP"). 5 TR 543. The annual calculations required by the accounting standards are performed by the Company's actuary, Hewitt Associates, using methodologies and assumptions required under the provisions of GAAP. 5 TR 542. In addition, actuarial assumptions are reviewed annually to insure consistency with GAAP by the Company's auditors, Arthur Andersen. *Id.* The Company is required to record these higher level of costs in accordance with Statement of Financial Accounting Standard 106. 13 TR 2280.

In calculating the cost of its pension and postretirement health care and life insurance expense, in accordance with these accounting standards, the Company is required to take into account the four components of expense: (i) service cost of the programs, (ii) interest cost, (iii) expected earnings on plan assets, and (iv) amortization of gains or losses, together with prior service costs and any transitional amounts. 5 TR 543. Significant components of the increase in Company costs are (i) plan changes resulting from a change in the Company's negotiated union contract, (ii) declining investment earnings, (iii) changes in economic conditions that have adversely affected the discount rate used to measure the amount owed to employees and to retirees, (iv) expiration of a transition amount for FAS 87 and (v) other experience. 5 TR 544-546. As a result of these changes, for the year 2002, Employee Pension expense will be $5,460,000 and Health Care and Life Insurance –Postretirement will be $21,731,000. Appendix C to the Company's Brief, page 4, column (h), lines 1 and 2.

As a result of the January 1, 2002 changes to the active employee health program detailed in Mr. DaPra's supplemental testimony, 5 TR 560, for the year 2002, Health Care and Life Insurance – Active Employees will be $11,974,000. Appendix C to the Company's Brief, page 4, column (h), line 3. This amount reflects a $1,545,766 reduction from the Company's initial request as a result of cost containment measures that require significant employee contributions to health care costs. Without implementing these changes in health care coverage for active employees, the Company's health care costs for active employees would have increased by 13%. 5 TR 560-561, 13 TR 2278-2281.

The Company contributions to the Employee Savings Plan will be $5,964,000 for 2002. Appendix C to the Company's Brief, page 4, column (h), line 4. The increase primarily reflects higher corporate matching amounts due to increased salaries. 5 TR 548. The Supplemental Executive Retirement O&M expense, determined by the company's actuary, 5 TR 548, for 2002 is $658,000. Appendix C to the Company's Brief, page 4, column (h), line 5.

The customer uncollectible reserve, established in accordance with sound accounting practices to "recognize that as gas service is provided, a percentage will ultimately become uncollectible" is $3,743,000 for 2002. Appendix C to the Company's Brief, page 4, column (h), line 6.

Manufactured gas plant amortization is discussed in Section VI of the Company's Exceptions.

E. Testimony of Ronn J Rasmussen

Mr. Rasmussen sponsored O&M expenses related to the Gas Customer Choice Program. These O&M expenses relate to "enhancements to the Company's billings systems, customer education efforts, customer call center activities, postage and mailings, and customer research." 7 TR 1062. At 7 TR 1070-1073, Mr. Rasmussen described the elements that went into these O&M expenses. In addition, Mr. Rasmussen explained these O&M expenses on Exhibit A-89, reproduced in pertinent part here:

Exhibit A-89

Development of Changes in Gas
Customer Choice Program Expense for 2002 versus 2000
($000)

		2002	2000	Change
1	Direct Program Expenses	$505	$197	$308
2	Customer Education Expenses	$495	$1	$494
3	**Total**	**$1,000**	**$198**	**$802**

Source: RJR WP-2

Source: MPSC Case No. U-13000, Exhibit A-89.

Staff adopted Mr. Rasmussen's adjustment.

F. Michigan Gas Storage Company

Mr. Preketes, Mr. DaPra and Mr. Sosinski all testified concerning the O&M expenses for Michigan Gas Storage Company in addition to those of Consumers Energy. Since MGS is fully integrated into the operations of Consumers Energy, the arguments made on behalf of Consumers Energy also support MGS' O&M expenses. The O&M expenses for MGS, which are additional to the O&M expenses for Consumers Energy discussed *supra* can be found on Appendix C to the Company's Brief, page 3.

<u>Attachment To Appendix C Of Consumers Energy Company's Exceptions</u>

<u>PAGES 2-4 OF APPENDIX C TO CONSUMERS ENERGY COMPANY'S BRIEF</u>

CONSUMERS ENERGY COMPANY
Comparison of the Other O&M Expense between
the Company and the MPSC Staff for **Consumers Energy Company only** - 2002 (000)
(Case No. U-13000)

Line No.	Description	2000 Historical (Normalized)	Staff Inflation Factor [4]	2002 Staff ((b) x (c))	2002 Company	Difference ((d) - (e))
	(a)	(b)	(c)	(d)	(e)	(f)
	PNPreketes (Ex. A-66 and A-68)					
1	Material Condition	$ 11,565	1.052	$ 12,162	$ 12,382	$ (220)
2	Pipeline Integrity	-	1.052	-	2,536	(2,536)
3	Corrosion Control	3,204	1.052	3,369	6,528	(3,159)
4	Damage Prevention	5,115	1.052	5,379	7,558	(2,179)
5	Succession Planning	320	1.052	337	2,250	(1,913)
6	Appliance Service Plan	14,476	1.052	15,224	17,414	(2,190)
7	Engineering, Planning and Scheduling	10,178	1.052	10,704	13,735	(3,031)
8	Operator Qualification	4,096	1.052	4,308	6,563	(2,255)
9	Uncollectibles/Customer Billing	8,740	1.052	9,191	11,531	(2,340)
10	Metering Technology and Mgt System	1,781	1.052	1,873	2,327	(454)
11	Accounting for Workload Relignment	-	1.052	-	3,935	(3,935)
12	Sub-total	$ 59,475		$ 62,547	$ 86,759	$ (24,212)
	BCSosinski (Ex. A-72)					
13	Compression	$ 6,302	1.052	$ 6,627	$ 8,505	$ (1,878)
14	Transmission	4,801	1.052	5,049	5,357	(308)
15	Storage	2,606	1.052	2,741	3,416	(675)
17	Sub-total	$ 13,709		$ 14,417	$ 17,278	$ (2,861)
	PNPreketes (Emery) (Ex. A-93 and A-99)					
18	Purchasing	$ 188	1.052	$ 198	$ 255	$ (57)
19	Technology Services Costs	4,725	1.052	4,969	6,800	(1,831)
20	Customer Contact Services	12,723	1.052	13,380	13,662	(282)
21	Sub-total	$ 17,636		$ 18,547	$ 20,717	$ (2,170)
	RDGladney (Ex. A-82)					
22	General Office Facility Services	$ 6,897	1.052	$ 7,253	$ 7,719	$ (466)
23	Field Facilities Operations	3,125	1.052	3,286	4,311	(1,025)
24	Sub-total	$ 10,022		$ 10,540	$ 12,030	$ (1,490)
	DDaPra (Ex. A-126) (Col. (e), App. C, p. 4)					
25	Employee Pension	$ 2,539	-	$ 5,088 [5]	$ 5,327	$ (239)
26	H/C and Life Insurance - Post Retirement	16,590	-	17,465 [6]	21,072	(3,607)
27	H/C and Life Insurance - Active Employee	9,203	1.052	9,678	11,401	(1,723)
28	Employee Savings Plan	4,775	1.052	5,022	5,609	(587)
29	Supplemental Executive Retirement Plan	486	1.052	511	658	(147)
30	Customer Uncollectible Reserve	3,155	-	3,420 [7]	3,743	(323)
31	Manufactured Gas Plant Amortization	853	-	(483) [8]	587	(1,070)
32	Sub-total	$ 37,601		$ 40,701	$ 48,397	$ (7,696)
	RJRasmussen (Ex. A-89)					
33	Gas Customer Choice	$ 198	-	$ 1,000 [9]	$ 1,000	$ -
34	Individual Program Total	$ 138,641		$ 147,752	$ 186,181	$ (38,429)
35	Other - includes MATorrey	74,783	-	77,092	78,788	(1,696)
36	Sub-total	$ 213,424 [1]		$ 224,844	$ 264,969	$ (40,125)
37	Less: Life Insurance Refund	-	-	-	1,585 [11]	(1,585)
38	EICP True-up	372 [2]	-	-	372 [1]	(372)
39	Save and Share True-up	104 [2]	-	-	104 [2]	(104)
40	Other Issues	413 [3]	-	-	803 [12]	(803)
41	Grand Total	$ 212,535 [3]		$ 224,844 [10]	$ 262,105	$ (37,261)

Footnotes

[1] Ties to Ex. A-20 (MAT-6 Rev), column (g), line-19.
[2] Ties to Ex. A-21 (MAT-7), column (c), lines-16 and 17.
[3] Ties to Ex. S-31 (SCD-1), Interim Rate Filing. (P & I Order, dated 12-20-01, based on this level of expense.
(Other Issues is Executive Bonuses)
[4] Ex. A-125 (Staff Inflation Factors for 2001 & 2002 2.4% and 2.7%).
[5] Col. (b) L-25 plus Staff adjust on Ex. S-124 (WCJ-2), col. (g), L-14.
[6] Col. (b) L-26 plus Staff adjust on Ex. S-124 (WCJ-2), col. (g), L-15.
[7] Col. (b) L-30 plus Staff adjust on Ex. S-124 (WCJ-2), col. (g), L-16.
[8] Col. (b) L-31 plus Staff adjust on Ex. S-124 (WCJ-2), col. (g), L-18.
[9] Col. (b) L-33 plus Staff adjust on Ex. S-124 (WCJ-2), col. (g), L-17.
[10] Ties to Ex. S-124 (WCJ-2), column (g), line-26.
[11] Ex. S-177 (DR 13000-ST-CE-788).
[12] Other Issues are (Disallowances $65, Exec Bonuses $413, Econ Development $199, NGS $66 and Y-2K $60)

CONSUMERS ENERGY COMPANY
Comparison of the Other O&M Expense between
the Company and the MPSC Staff for **Michigan Gas Storage Company only** - 2002 (000)
(Case No. U-13000)

Line	Description	2000 Actual	Staff Inflation [2]	2002 Staff ((b) x (c))	2002 MGS	Difference ((d) - (e))
	(a)	(b)	(c)	(d)	(e)	(f)
	PNPreketes (Ex. A-66 and A-68)					
1	Material Condition	$ 82	1.052	$ 86	$ 86	$ 0
2	Pipeline Integrity	-	1.052	-	500	(500)
3	Corrosion	48	1.052	50	651	(601)
4	Succession Planning	-	1.052	-	60	(60)
	Sub-total	$ 130		$ 137	$ 1,297	$ (1,160)
	BCSosinski (Ex. A-74)					
5	Compression	$ 1,881	1.052	$ 1,978	$ 2,687	$ (709)
6	Transmission	1,816	1.052	1,910	2,620	(710)
7	Storage	866	1.052	911	1,112	(201)
8	Sub-total	$ 4,563		$ 4,799	$ 6,419	$ (1,620)
	DDaPra (Ex. A-126) (Col. (e), App. C, p. 4)					
9	Pension	$ 69	-	$ 78 [3]	$ 133	$ (55)
10	Savings Plan	300	1.052	315	355	(40)
11	Active Health Care	504	1.052	530	573	(43)
12	Retirees Health Care	635	-	717 [4]	659	58
13	Sub-total	$ 1,507		$ 1,639	$ 1,720	$ (81)
14	Individual Program Total	$ 6,200		$ 6,575	$ 9,436	$ (2,862)
15	Other - includes MATorrey	4,525	-	4,934 [5]	3,896	1,039
16	**Grand Total**	**$ 10,725** [1]		**$ 11,509** [6]	**$ 13,332** [7]	**$ (1,823)**

Footnotes

[1] Ties to Ex. A-9 (MAT-16, Rev), page 2 of 2.

[2] Ex. A-131 (Staff CPI Inflation Factors for 2001 and 2002 2.4% and 2.7%).

[3] Column (b) line-9 plus Staff adjustment on Ex. S-130, line 12 allocated between Pension and OPEB.

[4] Column (b) line-12 plus Staff adjustment on Ex. S-130, line 12 allocated between Pension and OPEB.

[5] Determination Column (d), line-15:

Historical Other Portion of MATorrey (Line-15)	$ 4,525
Less:	
FERC Assessment & Expenses	835 [2]
Y2K Expenses	21 [2]
Net Amount for Inflation Growth	$ 3,669
Staff Compounded CPI Multiplier	1.052
Staff Amount for 2002	$ 3,858
Historical Period Fuel Credit Amounts	1,076
Grand Total	$ 4,934

[6] Ties to Ex. S-130 (RCM-2)

[7] Ties to Ex. A-9 (MAT-16, Rev), page 2.

CONSUMERS ENERGY COMPANY
Development of the Other O&M Expenses
for Employee Benefits, etc. Shown on
Lines 25-31 of Appendix C-2 and Lines
9-12 of Appendix C-3 (000)
(Case No. U-13000)

Line	Description	2000 Actual [1]	Adjustments [2]	Less: Portion Alloc to MGS	2002 Total ((b) + (e))	2002 MGS Amount (Lines 9-12)	Combined Total (CECo & MGS)
	(a)	(b)	(c)	(d)	(f)	(g)	(h)
	Consumers Energy						
1	Employee Pension	$ 2,539	$ 2,852	$ (64)	$ 5,327	$ 133	$ 5,460
2	H/C & Life Insurance - Post Ret.	16,590	4,507	(24)	21,072	659	21,731
3	H/C & Life Insurance - Active	9,203 [3]	2,267	(69)	11,401	573	11,974
4	Employee Savings Plan	4,775	889	(55)	5,609	355	5,964
5	Supp Exec Retirement Plan	486	172	-	658	-	658
6	Customer Uncollectible Reserve	3,155	588	-	3,743	-	3,743
7	MGP Amortization	853	(266)	-	587	-	587
8	Total CECo Amount	$ 37,602	$ 11,009	$ (214)	$ 48,397	$ 1,720	$ 50,117
	Michigan Gas Storage						
9	Pension	$ 69	$ 64		$ 133		
10	Savings Plan	300	55		355		
11	Active Health Care	504	69		573		
12	Retirees Health Care	635	24		659		
13	Total MGS Amount	$ 1,507	$ 214		$ 1,720		

Footnotes
[1] Exhibit A-126.
[2] Exhibits A-56 (DD-1) and A-58 (DD-3).
[3] Exhibit A-126, adjusted to exclude the $1.6 million in footnote (1).

APPENDIX D

Consumers Energy Company
Comparison of Original and Upated DCF Return On Equity
Using Zacks and Value Line Earnings Growth Rates
For Proxy Companies Used By Both MPSC Staff and Consumers Energy

Gas Proxy Companies Used By Both MPSC Staff and Consumers Energy That Were Included In Mr. Vlisides Large Proxy Group

		NA Vlisides Data			BL Ballinger Data		
Line	Company	Dividend Yield (a)	Growth Rate (b)	ROE (c)	Dividend Yield (d)	Growth Rate (e)	ROE (f)
1	AGL	5.13%	5.95%	11.08%	5.08%	8.18%	13.26%
2	ATMOS	4.86%	8.42%	13.28%	5.43%	8.91%	14.34%
3	NJ RESOURCES	4.50%	6.92%	11.42%	3.86%	7.07%	10.93%
4	NW NATURAL GAS	5.05%	6.63%	11.68%	5.11%	7.13%	12.24%
5	NUI	3.50%	10.67%	14.17%	4.46%	9.84%	14.30%
6	PIEDMONT	4.56%	7.50%	12.06%	4.74%	7.42%	12.16%
7	SOUTHERN UNION		12.75%	12.75%		10.25%	10.25%
8	SW GAS	3.90%	4.75%	8.65%	3.76%	4.22%	7.98%
9	UGI	6.42%	7.50%	13.92%	5.69%	8.50%	14.19%
10	Average	4.74%	7.90%	12.11%	4.77%	7.94%	12.18%

Gas Proxy Companies Used By Both MPSC Staff and Consumers Energy That Were Included In Mr. Vlisides Small Proxy Group

		NA Vlisides Data			BL Ballinger Data		
Line	Company	Dividend Yield (a)	Growth Rate (b)	ROE (c)	Dividend Yield (d)	Growth Rate (e)	ROE (f)
11	AGL	5.13%	5.95%	11.08%	5.08%	8.18%	13.26%
12	ATMOS	4.86%	8.42%	13.28%	5.43%	8.91%	14.34%
13	NJ RESOURCES	4.50%	6.92%	11.42%	3.86%	7.07%	10.93%
14	NW NATURAL GAS	5.05%	6.63%	11.68%	5.11%	7.13%	12.24%
15	NUI	3.50%	10.67%	14.17%	4.46%	9.84%	14.30%
16	PIEDMONT	4.56%	7.50%	12.06%	4.74%	7.42%	12.16%
17	SOUTHERN UNION		12.75%	12.75%		10.25%	10.25%
18	Average	4.60%	8.41%	12.35%	4.78%	8.40%	12.49%

Columns (a), (b), and (c) use data utilized by Mr. Vlisides when he prepared his analysis and are from Exhibit A-49.
Columns (d), (e), and (f) are calculated in the same manner as the first three columns using updated data provided by Mr. Ballinger.
Column (d) is from Exhibit S-117, Schedule D-5, page 9 revised.
Column (e): The calculation of the growth rate is shown on page 2, column (e) of this Appendix 2.

Consumers Energy Company
Comparison of Original and Upated DCF Return On Equity
Using Zacks and Value Line Earnings Growth Rates
For Proxy Companies Used By Both MPSC Staff and Consumers Energy
Adjusted For Quarterly Dividends

Gas Proxy Companies Used By Both MPSC Staff and Consumers Energy
That Were Included In Mr. Vlisides Large Proxy Group

		NA Vlisides Data				BL Ballinger Data			
Line	Company	Dividend Yield (a)	Adj Div Yield (b)	Growth Rate (c)	ROE (d)	Dividend Yield (e)	Adj Div Yield (f)	Growth Rate (g)	ROE (h)
1	AGL	5.13%	5.28%	5.95%	11.23%	5.08%	5.29%	8.18%	13.46%
2	ATMOS	4.86%	5.06%	8.42%	13.48%	5.43%	5.67%	8.91%	14.58%
3	NJ RESOURCES	4.50%	4.66%	6.92%	11.58%	3.86%	4.00%	7.07%	11.07%
4	NW NATURAL GAS	5.05%	5.22%	6.63%	11.85%	5.11%	5.29%	7.13%	12.42%
5	NUI	3.50%	3.69%	10.67%	14.36%	4.46%	4.68%	9.84%	14.51%
6	PIEDMONT	4.56%	4.73%	7.50%	12.23%	4.74%	4.92%	7.42%	12.33%
7	SOUTHERN UNION			12.75%	12.75%			10.25%	10.25%
8	SW GAS	3.90%	3.99%	4.75%	8.74%	3.76%	3.84%	4.22%	8.05%
9	UGI	6.42%	6.66%	7.50%	14.16%	5.69%	5.93%	8.50%	14.43%
10	Average	4.74%	4.91%	7.90%	12.26%	4.77%	4.95%	7.94%	12.34%

Gas Proxy Companies Used By Both MPSC Staff and Consumers Energy
That Were Included In Mr. Vlisides Small Proxy Group

		NA Vlisides Data				BL Ballinger Data			
Line	Company	Dividend Yield (a)	Adj Div Yield (b)	Growth Rate (c)	ROE (d)	Dividend Yield (e)	Adj Div Yield (f)	Growth Rate (g)	ROE (h)
11	AGL	5.13%	5.28%	5.95%	11.23%	5.08%	5.29%	8.18%	13.46%
12	ATMOS	4.86%	5.06%	8.42%	13.48%	5.43%	5.67%	8.91%	14.58%
13	NJ RESOURCES	4.50%	4.66%	6.92%	11.58%	3.86%	4.00%	7.07%	11.07%
14	NW NATURAL GAS	5.05%	5.22%	6.63%	11.85%	5.11%	5.29%	7.13%	12.42%
15	NUI	3.50%	3.69%	10.67%	14.36%	4.46%	4.68%	9.84%	14.51%
16	PIEDMONT	4.56%	4.73%	7.50%	12.23%	4.74%	4.92%	7.42%	12.33%
17	SOUTHERN UNION			12.75%	12.75%			10.25%	10.25%
18	Average	4.60%	4.77%	8.41%	12.50%	4.78%	4.97%	8.40%	12.66%

Columns (a), (c), (e), and (g) are the same as page 4
Columns (b) and (f) calculate the adjusted dividend yield using the formula (1+.5g)xY

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of CONSUMERS ENERGY COMPANY for authority to increase its rates for the distribution of natural gas and for other relief	))))))	Case No. U-13000

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 June 24, 2002 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 served a hard copy of the same document to the addresses listed in Attachment 1, by depositing the same on June 24, 2002, in the United States mail in the City of Jackson, Michigan with first-class postage thereon fully paid.

Sammie B. Dalton

Sammie B. Dalton

Subscribed and sworn to before me this 24th day of June, 2002.

Kelly Fisher

Kelly Fisher
Notary Public, Jackson County, Michigan
My Commission Expires: 01/18/06

ps0602-1-80e

ATTACHMENT 1 -- TO CASE NO. U-13000

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