Consumers Energy

A CMS Energy Company

General Offices:
212 West Michigan Avenue Tel: (517) 788-0550
Jackson, MI 49201 Fax: (517) 788-0768

*Washington Office:
1016 – 16th Street, NW Tel: (202) 293-5795
Washington, DC 20036 Fax: (202) 293-5367

Writer's Direct Dial Number: (517) 788-1482
Writer's E-mail Address: hrchambers@cmsenergy.com

LEGAL DEPARTMENT
DAVID A MIKELONIS
Senior Vice President
And General Counsel

James E Brunner
William M Lange*
Jon R Robinson
Arunas T Udrys
Assistant General
Counsel

David E Barth
Francis X Berkemeier
H Richard Chambers
James W Dempsey
John P Dickey
Ann F Goodman
Deborah Ann Kile
Roger K Krakusin
Eric V Luoma
Wendy A McIntyre
Raymond E McQuillan
Deborah A Moss*
Mirče Michael Nestor
Robert M Neustifter
David A Pelt
Vincent P Provenzano
Susan L Rasmussen
Catherine M Reynolds
John C Shea
P Leni Staley
Charlotte A Walls
Kimberly C Wilson
Michael G Wilson
Attorney

July 8, 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 "**Consumers Energy Company's Replies to Exceptions**". 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

f10702-1-80c

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	)	
for authority to increase its rates for	)	Case No. U-13000
the distribution of natural gas and	)	
for other relief	)	
______________________________________	)	

CONSUMERS ENERGY COMPANY'S
REPLIES TO EXCEPTIONS

July 8, 2002

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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

CONSUMERS ENERGY COMPANY'S REPLIES TO EXCEPTIONS

Consumers Energy Company ("Consumers Energy" or the "Company") files the following replies to the exceptions filed in this proceeding by the MPSC Staff, the Attorney General, the Association of Businesses Advocating Tariff Equity ("ABATE"), Thomas C. DeWard, Metro Bureau Group Services, and the National Energy Marketers Association ("NEMA"). These replies are being filed in accordance with the schedule established by the Administrative Law Judge ("ALJ") in the Proposal for Decision ("PFD").

I. REPLY TO THE MPSC STAFF

A. Reply to Staff's Exception No. 1 – Accounting for Workload Realignment

The Company's Other O&M expense for the year 2002 includes $3,935,000 for Accounting for Workload Realignment. See Appendix C to the Company's Brief, page 2 of 4, line 11. Since this program arose after the year 2000, the Staff's method of inflating 2000 O&M expenses for inflation inappropriately ignores the 2002 O&M expense needed for this program. The ALJ correctly recommended adoption of the Company's proposal. PFD, p 54. The Staff's exception should be rejected.

Company witness Paul Preketes explained that, like all businesses, Consumers Energy uses an accounting system that attempts to properly classify expenditures as capital or expense. Mr. Preketes stated as follows:

> "Depending on the [accounting] Function used, all of a cost can be charged to Capital, all to O&M or a percent split to Capital with the remaining portion to O&M by using what is known as a Joint Expense Function code. Based on the type of work, these Joint Expense Functions have varying percentages of costs translating to O&M or Capital. A good example is the split of a supervisor's salary and expenses who has employees working on both Capital and O&M projects. <u>Because 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</u>." 6 TR 735. (Emphasis added)

Mr. Preketes explained how these capital/expense percentage splits are developed:

> "The most significant way that this shift in workload mix affects O&M costs is by periodic reviews of employee responsibilities and their use of the Joint Expense Functions for salaries, expenses, vehicles and equipment." Id.

It is important to realize that this issue only concerns the classification of expenditures as capital or expense. Mr. Preketes stated,

> "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." Id.

In his rebuttal testimony, Mr. Preketes stated as follows on this issue:

> "Since 1996-1997, when the Company-initiated reengineering programs were implemented, many jobs and associated processes were significantly changed. The Company took this filing opportunity to fully review and suggest a "true-up" of the accounting practices carried over from prior years that the Company's accountants believed were not fully supported by Generally Accepted Accounting Principles. Results of these reviews shifted nearly $4 million to O&M from Capital. No increases in total dollars to the Company were required." 13 TR 2322.

In a discovery response provided to the Staff (marked as Exhibit S-181, discovery answer 13000-ST-CE-718), the Company's chief accounting officer, Dennis DaPra, provided a further explanation of this issue:

> "The accounting changes referred to in Mr. Preketes testimony relates to changes in the Company's internal process, which resulted in different assignments for employees in the gas business unit. The associated charging of employees was subsequently reviewed to align the charging of time consistent with the duties being performed. This review was conducted internally and was not raised to the level of review by Arthur Andersen LLP."

Thus, the record indicates the following:

(1) There are periodic reviews of employee responsibilities to determine the nature of the projects to which employees are devoting their time, and to thereby determine the percentage of salaries and expenses that should be allocated between capital and expense.

(2) The "re-engineering" efforts the Company has pursued resulted in different assignments for employees, which affected the allocation of expenditures between capital and expense.

(3) The total dollars involved in this issue are the same—the only issue is the classification of those dollars as capital or expense.

(4) If the Company failed to conduct these periodic reviews to properly allocate capital and expense, it would run the risk of being found not in compliance with Generally Accepted Accounting Principles ("GAAP") and the Commission's Uniform System of Accounts.

(5) Because of the shift in workload mix, a relatively greater amount of costs incurred in gas operations in 2002 and thereafter will be charged to expense functions.

Staff inconsistently states that the Company should account for its operations correctly, but then objects when the Company proposes an adjustment to do so. Consumers

Energy notes that the Staff failed to present any evidence on this issue. If Staff disputed that the Company was proposing to follow GAAP and the MPSC System of Accounts, Staff should have presented some evidence to support that contention. If it believed that the Company was not in compliance with GAAP in the past, and that this was somehow relevant to this case, it should have presented some evidence to support that contention. The accusations made by the Staff are baseless and, in the final analysis, irrelevant to a resolution of this issue.

In footnote 3 to its exceptions Staff specifically states that it is not taking the position that the accounting changes are inappropriate. Apparently Staff's sole basis for objecting in its exceptions is that the adjustment was not "reflected in the 2000 historical account balances." The timing of the adjustment is not a reason to ignore it for purposes of determining the year 2002 level of expenses. Contrary to Staff's claims, this is a known and measurable change.

The Company presented evidence indicating that, relative to what would have occurred in 2002 in the absence of the appropriate accounting change, capital investments would be decreased by $3,935,000 and O&M expenses would be increased by $3,935,000. See 6 TR 735; Exhibits A-66 and A-67 (see footnote). The evidence fully supports reflecting such expenses in the Company's rates.

B. <u>Reply to Staff's Exception No. 2 – Application of the Massachusetts Formula</u>

Staff recommended a disallowance of $253,000 based on the disagreement of its witness Mr. Mogis with how the "Massachusetts Formula" allocates certain parent costs to Consumers Energy. The Massachusetts Formula uses a consistent, straightforward approach for cost allocation. It has been accepted in the past by this Commission, as well as by the Federal Energy Regulatory Commission ("FERC"). In contrast, the methodology advocated by Staff is new, is subjective, and would introduce uncertainty into the allocations. The ALJ correctly found that there was not a sufficient basis to overturn the longstanding use of the Massachusetts Formula. PFD, pp 61-63. The Staff's exception should be rejected.

The Massachusetts Formula is used to allocate certain indirect costs among subsidiaries that cannot be readily identified with any individual subsidiary. These include such items as Board of Directors costs, internal audit costs, investor relations costs, employee/shareholder communications, etc. The Massachusetts Formula was originally conceived as a method for allocating state tax expense, and was subsequently adopted for allocating administrative and general expense in diversified corporations. Consumers Energy has used this formula since 1987. The MPSC Staff has reviewed the use of the Massachusetts Formula on several occasions, including the following: (i) in 1991, in connection with a compliance audit in Case No. U-9709, (ii) in 1993, in connection with electric rate Case No. U-10335, and (iii) in 1999, during the Intercompany Transactions Audit. The MPSC Staff has never previously challenged the use of the Massachusetts Formula. 13 TR 2345-2348.

Mr. Mogis expressed dissatisfaction with the results produced by the Massachusetts Formula, and claimed that his subjective conclusion that the CMS Energy Board of Directors deals with many other affiliates that are "probably very time consuming" and his subjective "page-by-page analysis of the 1999 Annual Report to Shareholders" provide a better basis upon which to make the necessary cost allocations. Mr. Mogis' subjective analysis results in fewer costs being allocated to Consumers Energy's gas operations, and therefore results in the $253,000 disallowance noted above. 10 TR 1685-1688.[1]

Consumers Energy witness Lynn Frederick presented rebuttal evidence on this issue. He pointed out that (i) Consumers Energy has used the Massachusetts Formula since 1987, (ii) as noted above, the MPSC Staff has reviewed its use on several occasions and has not challenged its use, (iii) FERC has approved the use of this formula, (iv) many other companies utilize this same formula for allocating similar costs, such as San Diego Gas & Electric, Duke Energy, Entergy Services, Inc., Questar Pipeline Company, and Williams Natural Gas Company. 13 TR 2346-2347.

The Massachusetts Formula is a cost allocation methodology that utilizes net plant (including net investments), revenues and wages as the allocation factors. The revenues and employee wages of non-consolidated operating companies in which the parent holding company may have an interest, however, are not included in the formula. Mr. Frederick explained why in his rebuttal testimony:

> "Q Do you agree with the MPSC Staff auditor's position that revenue and wages of a non-consolidated operating company (joint venture) should be included in the calculation of the Massachusetts Formula?
>
> "A No, for the following reasons:
>
> "1. The formula should be based only on consolidated financials of the parent and Consumers. Relying upon

[1] Staff in its exceptions attempts to support its position by citing to Case No. U-10150, a rate case involving Michigan Consolidated Gas Company, and Case No. U-10960, a rate case involving Michigan Gas Utilities. Staff attaches excerpts from the orders in those cases to its exceptions. The excerpts do not indicate that the Staff proposed use of Mr. Mogis' method in either of those cases. Further, the excerpts indicate that the facts and issues in the Michigan Consolidated Gas Company and Michigan Gas Utilities cases were different than in Case No. U-13000. In contrast to the situations in those cases, the evidence presented in the current proceeding by Consumers Energy shows that the method it is using is <u>consistent</u> with past practice, is <u>rational</u>, and is <u>reasonable</u>. The excerpts attached by Staff provide no support or basis for adopting Mr. Mogis' methodology in the instant case.

> other financial data would introduce greater subjectivity and uncertainty into the formula.
>
> "2. CMS Energy has only a partial investment in a joint venture, which relates to a portion of the assets, revenues and wages. Other partners own the balance. Including all of the assets, revenues and wages in the formula would not accurately reflect reality.
>
> "3. A joint venture has its own workforce, which includes costs that are duplicative to some of the costs being allocated.
>
> "4. The focus of the CMS Board of Directors and CMS Senior Management is on the investment, which is a component of the Massachusetts Formula." 13 TR 2347.

Mr. Frederick further testified that the whole point of the Massachusetts Formula is that it allows the use of a consistent approach from year to year that avoids the need for extremely subjective and potentially controversial judgments regarding these indirect costs. In his words, the use of the formula "represent[s] a balance between conceptual correctness on one hand and practicality on the other hand to provide a consistent and equitable allocation result over the long term." 13 TR 2346. Mr. Frederick expressed concern over the problems that would be created if, instead of the application of a straightforward formula on a consistent basis, it was necessary to engage in a highly subjective analysis of these costs. Mr. Frederick stated that such a subjective method would "obviously produce very different results from year to year, thus making it inappropriate to use for ratemaking purposes." 13 TR 2348. Avoiding such subjective standards is why the Massachusetts Formula was devised in the first place.

Staff states at page 4 of its exceptions that "Staff is <u>not</u> advocating that Consumers abandon its use of the Massachusetts Formula to allocate parent company costs for book accounting purposes." (Emphasis added) Staff reiterates at page 6 of its exceptions "Staff notes that it is <u>not</u> asking the Commission to order Consumers to adopt [Mr. Mogis'] methodology for accounting purposes." (Emphasis added) Remarkably, however, Staff argues that, even if the Massachusetts Formula is deemed to produce accurate results for accounting purposes, the Commission need not rely upon the results of the formula for ratemaking purposes in this case. This inconsistent position is effectively an invitation to the Commission to engage in arbitrary ratemaking practices. It is grossly unfair for Staff to argue that the Commission should abandon use of the Massachusetts Formula for ratemaking purposes while encouraging its continued use for accounting purposes.

Further, Staff states at pages 6-7 of its exceptions with regard to Mr. Mogis' method that "Staff is <u>not</u> recommending its use in the long term." (Emphasis added) Apparently Staff does not have confidence that the method it advocates be used in this case for ratemaking should be used for any other purpose or any other case. The Massachusetts Formula is a consistent and logical allocation method. The Staff position on this issue should be rejected.

C. <u>Reply to Staff's Exception No. 3 – Allowance for Company Use and Loss and Unaccounted For Gas</u>

Staff argues in its exceptions that the percentage allowance for Company use and loss and unaccounted for gas that is included in tariffs for transportation service should be 0.82% rather than 1.72%. The ALJ discussed this subject twice in his PFD. The first time is at pages 63-64. The second time is at pages 86-87. The first discussion is a more general discussion in which he concluded that the percentage proposed by Staff is more consistent with past practice. However, at pages 86-87, the ALJ, after undertaking a more detailed analysis of the evidence, concluded:

> "The ALJ finds that Consumers has presented convincing evidence in support of its proposed allowance...The ALJ finds that based on the changing operations of Consumers the calculations performed on the most recent cycle are more indicative of the present and future loss and unaccounted for gas." PFD, p 87.

As set forth by the Company at page 51 of its Exceptions, the Commission should adopt the ALJ's second recommendation.

Consumers Energy recovers from transportation customers for the Company's use and loss and unaccounted for gas on its system through retaining a percentage of gas received. In the Company's transportation tariffs this is referred to as "Allowance for Use and Loss". See Rule F4.1.D at page F-4.00 in the Company's gas tariffs.

Mr. Aldrich calculated the percentages for Consumers Energy and for Michigan Gas Storage ("MGS") based on historical five-year data. 11 TR 1897-1898, Exhibits S-143 and S-145. As a result, Mr. Aldrich's data does not reflect recent changes in Company operations. 12 TR 2194. The percentage of 1.72% that Consumers Energy is proposing be used for transportation customers is based on actual volumes for the 12-month period ended April 2001. 12 TR 2192.

Company witness Benedict Sosinski testified with respect to the 1.72%:

> "<u>This percentage reflects company use and loss and unaccounted for volumes that are representative of how the Company has operated and will operate in the future</u>. In addition, the period covered in the Company's calculation contains a complete storage injection and withdrawal cycle, rather than a complete injection cycle and partial withdrawal cycles from two different years, such as that contained in the calendar year data utilized by Mr. Aldrich." 12 TR 2193. (Emphasis added)

Mr. Sosinski indicated that the higher loss and unaccounted for volumes are the result of changing operations and these conditions will continue to exist in the future. 12 TR 2193. Use of 1.72% is appropriate for transportation service.

Establishing a level for transportation customers that reflects the more recent information is particularly important given that the transportation customers provide gas for

Company use and loss as gas in kind. While an argument could be made for use of the higher percentage for both sales and transportation customers, the Company has accepted Mr. Aldrich's loss and unaccounted for gas percentage for purposes of sales service.[2] However, the Company does not agree that use of this percentage is appropriate for transportation service.

D. Reply to Staff's Exception No. 4 – Adjustment to Transportation Loads to Reflect Known Changes

Consumers Energy presented evidence supporting an adjustment to transportation customers' loads to reflect known and measurable changes occurring after the historical year 2000 period. The ALJ accepted the adjustment. Staff takes the position that the adjustment should not be accepted. However, Staff admits in its exceptions that it did not determine if it was valid.

The adjustment in question is really a group of adjustments to specific transportation customers' loads to reflect known changes occurring after the historical 2000 period. These are consumption changes due to plant closings or to new customers or other similar events. See 9 TR 1411. The Staff declined to accept them because they were, in total, allegedly "immaterial." 11 TR 1897. Although this adjustment may not be as significant as some others, making the adjustment is consistent with the Company's position that known and measurable changes to 2002 O&M and 2001 and 2002 capital expenditures should be made in this case.

Staff admits at page 8 of its exceptions that it did not give consideration to this adjustment. Staff states: "Staff did not waste time in attempting to determine if ...[the

[2]

	Company	Staff
Sales Customers	0.82%	0.82%
Transportation Customers	1.72%	0.82%

transportation volume] change was valid." That is Staff's prerogative. However, Staff's decision not to review the adjustment does not provide a valid basis to reject the adjustment.

E. Reply to Staff's Exception No. 5 – Employee Benefit Levels

Consumers Energy presented evidence supporting the following year 2002 Other O&M levels for employee pension and health care/life insurance:

Description	2002 Amount
Employee Pension	$5,460,000
Health Care/Life Insurance - Post Retirement	$21,731,000
Health Care/Life Insurance – Active Employee	$11,974,000

The year 2000 levels and the development of the year 2002 amounts are summarized on Appendix C to the Company's Brief, page 2, lines 25-27, page 3, lines 9, 11 and 12, and page 4, lines 1-3.[3] The ALJ accepted the indicated levels of expenditures. PFD, p 57. Staff takes the position in its exceptions that the total for these expenses should be reduced by approximately $4 million. Staff's position should be rejected. Contrary to the Staff's assertions, Consumers Energy presented detailed evidence supporting the appropriateness of using the employee benefit levels calculated by the Company.

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) are allocated 29% to gas, 71% to electric.

[3] Pages 2-4 of Appendix C to the Company's Brief are included as part of Appendix C to the Company's Exceptions.

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 detail concerning the employee pension plan, the postretirement health care plan and the active employee health care plan costs. 5 TR 542-548, 558-560, 13 TR 2275-2281. The Staff's approach of using inflation projections with only minimal additional adjustments results in a significant understatement of the appropriate level of expenses for these categories.

Mr. DaPra 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. Significant components of the increase in pension expense and postretirement health care and life insurance expense 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.

The Company relied upon the determination of its actuary (Hewitt Associates) for the proper level of 2002 expense. As the Company's chief accounting officer, Mr. DaPra testified:

> "Under the provisions of GAAP, Financial Accounting Standards (FAS) 87 and 106 describe the methodologies and assumptions to calculate and account for pension and postretirement health care. The calculations required by these two accounting standards are performed annually by Consumers Energy's actuary (Hewitt Associates). In addition, the actuarial assumptions are reviewed by

> the Company's auditors (Arthur Andersen) to insure consistency with GAAP.
>
> * * *
>
> "Q Did the calculations of fiscal year 2000 and 2002 expense for the pension plans and post retirement health care plans follow the described methodologies of FAS 87 and 106?
>
> "A Yes. The amounts for both years were based on FAS 87 and 106 and calculated based on information specific to the Company." 5 TR 542-544.

Staff did not use the prescribed actuarial process described above.

In its calculation of pension expense the Staff utilized a 2001 figure, made one adjustment to reflect the Pension Transition Obligation amortization (see 5 TR 546), and then simply adjusted the resulting amount by one year of inflation. This inflation methodology is not consistent with the requirements of FAS 87, and would not reflect actual pension expense. The Company's figure for pension expense should be used in this case. The Company is required to record these higher levels of costs in accordance with Statement of Financial Accounting Standard 106. 13 TR 2280.

Similar to its treatment of pension expense, Staff for post retirement health care and life insurance apparently started with a 2001 figure and escalated that by one year of inflation (2.4%) to arrive at its recommended 2002 level of expense. This approach is inadequate for several reasons.

First, the use of a 2.4% inflation adjustment is a dramatic understatement of the actual rate of increase being experienced for these costs. Mr. DaPra explained this in his rebuttal testimony:

> "<u>The MPSC Staff position has completely disregarded the fact that health care costs are increasing at a significantly higher rate than inflation. National health care costs are skyrocketing.</u> Double digit increases in health care costs are occurring throughout this

> country. Increases in the Company's most recently completed years of census and demographic data for our retiree group shows an annual increase of 11.3%. Daily newspapers have been full of articles on these escalating health care cost increases. I have included several in Exhibit A-180 (DD-4). * * * Exhibit A-180 (DD-4) also includes an analysis by Hewitt Associates (the Company's Actuary) on expected double digit increases in health care and prescription drug cost. The most recent Hewitt analysis shown on page 1 of 8 of the Exhibit projects 2002 health care cost increases of 13% to 16% over the 2001 level." 13 TR 2278-2279. (Emphasis added)

Second, the Staff inflation factor approach ignores the fact that, like pension expense, the Company must follow FAS 87 and 106 in calculating and booking annual post retirement health care costs. Mr. DaPra filed supplemental testimony in this case in which he explained the situation with respect to these expenses:

> "Amounts collected in customer rates for post-retirement health care are placed in a trust and invested in various equity funds <u>and valued periodically as required under Financial Accounting Standard 106</u>. Since the filing of my direct testimony the market value of those assets placed in the trust have further declined, as has the equity market for other nationwide investments, and have not earned the projected return. At the time of my direct testimony, it was assumed that assets would earn 3% over the 2001 period. The employee census data used was based on information as of January 1, 2000 as post-retirement health care actuarial analysis is performed generally around August of each year. Actuarial analysis of employee census data as of January 1, 2001 was completed in August and is reflected in this supplemental testimony. The impact of this updated census data reflects significant changes in both the expected return on plan assets as well as additional costs for retiree health claim expense. The Company now estimates the market value of the trust assets, which reflects market losses since the beginning of the year, will remain at this reduced level and will not experience any additional growth through year-end. This decline in the expected return on plan assets coupled with the overall decline of the market value of the assets accounts for 75% of the $2,116,614 increase in post-retirement health care and life insurance costs that I am updating. The remaining 25% of this increase reflects the escalating health care costs for our retiree group that includes higher than anticipated increases from the 2000 level. Over 50% of the health

> care claims from our retiree group is for prescription drugs. Retirees use two to three times the prescription drugs as active employees. The 18% increase in prescription drug costs coupled with the higher usage for retirees has resulted in an increase in retiree health care claim expense." 5 TR 559-560. (Emphasis added)

Because of the requirement that the Company follow FAS accounting standards, these increases cannot be ignored:

> "Q Does the Company have discretion as to whether it reflects the post-retirement costs developed by its Actuary or ignores recording these higher costs in its financial records?
>
> "A No. The Company is required to record these higher level of costs in accordance with Statement of Financial Accounting Standard 106." 13 TR 2280.

Thus, the figures supplied by Consumers Energy for post-retirement health care costs are far more accurate than the simplistic inflation factor applied by the Staff.[4] The Staff methodology is inconsistent with the accounting standards that must be followed by the Company with respect to this item, as well as simply ignoring national trends for health care costs.

As noted above, Mr. DaPra testified that national health care costs are increasing at a significantly higher rate than inflation. 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 cost increases are below national trends, they are still significant. 13 TR 2279. In his rebuttal testimony, 13 TR 2274-2282, Mr. DaPra rebutted the Staff position concerning Staff's use of 2.4% and 2.7% escalation rates for 2001 and 2002 active employee health care costs. Mr. DaPra provided detailed information in Exhibit A-180

[4] In its exceptions, Staff makes reference to its brief on this issue. Staff made the assertion at pages 72-73 of its brief that in the last general rate case the Commission included an amount for post-retirement health care costs that turned out to be in excess of what the Company incurred. As discussed at pages 62-63 of the Company's Reply Brief, the Staff allegation is not correct.

concerning the national trends in health care costs. The Company's health care cost levels are reasonable, known and measurable. 13 TR 2279.

F. **Reply to Staff's Exception No. 6 – The ALJ's Rejection of Staff's Request to Take Official Notice of Non-Record Documents**

Staff in its reply brief requested that the ALJ and Commission take official notice of two attachments to its reply brief. One is a press release dated February 4, 2002. The other is a study conducted by Regulatory Research Associates dated January 24, 2002. The ALJ denied the request to take official notice, correctly concluding at pages 95-98 of the PFD that official notice was not appropriate. Staff's exception challenging that ruling should be denied.

Consumers Energy discussed in detail reasons why taking of official notice is not proper in the "Objection of Consumers Energy to Staff's Request that the Commission take Official Notice of Two Documents" filed on March 8, 2002. The Company incorporates that response by reference. For the convenience of the Commission, a copy is attached to these Replies to Exceptions as Appendix 1.

G. **Reply to Staff's Exception No. 7 – Recognition of the January 2002 Equity Infusion in Capital Structure**

On January 3, 2002 CMS Energy infused $150 million into Consumers Energy's capital structure. 11 TR 1967. At page 29 of the PFD the ALJ ruled:

> "The infusion has, in fact, occurred. The ALJ finds it must necessarily be included in the capital structure to provide shareholders an opportunity to earn a fair return on their investment. This is true regardless of whether that investor is, in this case CMS Energy, or a private individual investor."

As found by the ALJ, there is no valid reason not to include the 2002 equity infusion in developing the capital structure. Staff in its exceptions seeks two forms of relief. First, it argues that the $150 million equity infusion should not be included in the capital structure notwithstanding the fact that it has actually occurred. In the alternative it states that if it is included there should be a written commitment that it will remain at Consumers Energy and that the historical dividend policy will not be changed. Consumers Energy will address the two forms of relief requested by Staff seriatim.

1. **The January 2002 Equity Infusion Should Be Included in the Capital Structure**

The Company presented testimony in November 2001 that an equity infusion would occur in 2002. 5 TR 513. The Company presented testimony in January 2002 that the equity infusion had occurred. 11 TR 1967. Staff does not dispute that the equity infusion did, in fact, occur. The $150 million equity infusion in January 2002 is a known and measurable event. Staff correctly admits that any uncertainty about whether it would occur no longer exists.

It has been the Commission's consistent and unswerving policy in the last three Consumers Energy rate cases to recognize verified equity infusions in the capital structure. See March 11, 1996 Order, Case No. U-10755, pages 14-15. Regardless of whether the Commission chooses to use a 13-month average or Staff's point-in-time balance as the starting point, an adjustment to increase the common equity balance by $150 million to reflect the January 2002 known and measurable change must be made.[5]

Staff provides no valid basis to digress from that consistent practice and policy. Failure to reflect the equity infusion that occurred in January 2002 in the capital structure would mean that rates would not be set on a level of common equity that would provide shareholders an opportunity to earn a fair return on their investment. The January 2002 equity infusion cannot legally be ignored in setting rates.

[5] The Company's equity balance of $2,200,389,000 includes the January 2002 $150 million equity infusion. Exhibit A-10. The Staff's balance of $2,006,237,000 does not. 10 TR 1481. Adjusting the Staff balance to include the $150 million infusion increases it to $2,156,237,000.

a. <u>The January 2002 Equity Infusion Is a Verified, Known and Measurable Event</u>

Staff's witness Mr. Ballinger recognized in his testimony that it is appropriate "to capture known changes in arriving at a capital structure that is representative of the 2002 projected test year." 10 TR 1479. In support of his position regarding the 2002 equity infusion, Mr. Ballinger took the position that there was "uncertainty on the infusion of equity into Consumers." 10 TR 1481.

Staff admitted at page 42 of its brief that CMS Energy's equity infusion of $150 million into Consumers Energy's common equity on January 3, 2002 "<u>eliminated the uncertainty of the infusion</u>." (Emphasis added). This, by itself, should be sufficient to resolve the issue in favor of recognition of the equity infusion, consistent with past practice. It is both known and measurable. However, in case there is any residual doubt, the Company will address various assertions that are made by Staff to further demonstrate that there is no valid basis to exclude the verified equity infusion in setting rates in this case.

b. <u>CMS Enterprises Stock Revaluation</u>

Staff's discussion of the situation regarding the CMS Enterprises Stock and its effect on capital structure misconstrues the facts and evidence in this case. In 1987, as part of a corporate reorganization, ownership of NOMECO, a non-regulated oil and gas exploration company, was transferred from Consumers Energy to CMS Enterprises, a non-regulated subsidiary of CMS Energy. Consumers Energy received CMS Enterprises stock in payment for NOMECO. Staff's witness Mr. Ballinger summarized this general background as follows:

> "The CMS Enterprises preferred stock was issued to Consumers for NOMECO as part of a corporate reorganization in 1987. The issue originally consisted of ten shares with a value of $150 million and was to be redeemed in five annual installments, beginning in 1991. In 1991, the terms of the stock were amended

> so that the annual redemptions were deferred until 1997 and the dividend was increased. To record the 1991 amendments on its books, Consumers revalued the stock and increased its paid in capital (common equity) by $100 million." 10 TR 1481-1482.

There was an issue in the last three rate cases with regard to whether the $100 million increase in value resulting from the revaluation should be recognized in the Company's capital structure for ratemaking purposes.

In its May 10, 1994 Order in Case No. U-10335, pages 31-33, the Commission concluded that recognition of the $100 million increase in common equity resulting from the revaluation of the CMS Enterprises stock was "not reasonable or appropriate for ratemaking purposes." The Commission reached the same conclusion in its February 5, 1996 Partial Final Opinion and Order in Case No. U-10685, pages 10-12, and in its March 11, 1996 Order in Case No. U-10755, pages 11-12.

After three attempts, Consumers Energy concluded that the Commission was not going to recognize the additional $100 million that resulted from the revaluation for ratemaking purposes. Exhibit S-157 summarizes the above history and describes what occurred next:

> "In the mid 1990's, Consumers Energy had 3 rate cases in which $100 million of its Book Equity balance was in dispute. The $100 million issue was due to a 1991 increase in Consumers Energy's book equity resulting from a revaluation of CMS Enterprises Preferred Stock. . . which the Company held.
>
> "In case U-10755, Alan M. Wright testified that he would reduce Consumers Energy's book equity to correspond to the Commission's regulatory equity balance if the Commission did not recognize the full equity balance. The Commission chose not to include the $100 million for ratemaking purposes.
>
> "Accordingly, the $50 million return of stockholder's contribution in 1997 and in 1998 for a total return of stockholder's contribution of $100 million was done in order to align Consumers Energy's book equity balance with the MPSC's approved regulatory equity balance."

In rebuttal testimony Mr. Vlisides emphasized that the return of the $100 million was a return of CMS Enterprises stock, not a return of CMS Energy equity infusions. 11 TR 1967.

Staff has incorrectly interpreted Exhibits S-80 and S-81 as indicating that Consumers Energy returned equity infusions back to CMS Energy. In his rebuttal testimony Mr. Vlisides clarified:

> "Mr. Ballinger's assertion is unfounded. As shown on Exhibits S-80 and S-81, Consumers total common shareholder's equity has increased from $1.598 billion in 1995 to $2.026 billion in 2000. That is an increase of over $400 million over the five-year period. The return of stockholder's contribution shown on Exhibit S-81 for 1997 and on Exhibit S-80 for 1998 is a return of the CMS Enterprises preferred stock, not a return of CMS Energy equity infusions." 11 TR 1967

The adjustments on Exhibits S-80 and S-81 aligned the book equity balance with the MPSC's approved regulatory equity balance. They did not represent the return of a common equity infusion.

The Company essentially reversed the revaluation to match the value of equity that the Staff recommended and the Commission recognized in those prior cases. The action of the Company in decreasing paid in capital by $100 million through the 1997/1998 adjustments was fully consistent with the Commission's prior orders and the recommendations of Mr. Ballinger in the last case. It is disingenuous for the Staff to criticize the Company for acting in accordance with the position that Staff in the earlier cases advocated.

Contrary to the suggestions of Staff at pages 15 and 16 of its exceptions, there is absolutely no evidence whatsoever that the equity infusion that was included by the Commission in the capital structure in its Case No. U-10755 Order was ever returned to CMS Energy. The $100 million CMS Enterprises stock revaluation amount was a separate and distinct amount.

This separate and distinct $100 million revaluation amount <u>was never included in the capital structure for ratemaking.</u> Further, the evidentiary record in this case indicates that the Company told the Commission in Case No. U-10755 what action it planned on taking with respect to the $100 million revaluation amount if the revaluation amount was not included for ratemaking. Exhibit S-157. Staff's attempt to manufacture a credibility issue relies on an incomplete, inaccurate, and strained analysis that cannot hold up under scrutiny.[6]

The ALJ correctly rejected the attempt of Staff to equate the issue regarding the CMS Enterprises Stock with an equity infusion and then the return of the infusion. He stated:

> "The ALJ is convinced, by Consumers' presentation, that the return of the $100 million during 1997 and 1998 was consistent with Consumers stated intent as a result of the Commission order in MPSC Case No. U-10755, supra. It is separate and distinct from any other capital amounts. In fact, Alan M. Wright, alerted the Commission in MPSC Case No. U-10755, supra, that in the event the Commission did not decide to include the $100 million in common equity that it would be returned to CMS Energy. Exhibit S-157. The Commission did not include the $100 million as common equity in MPSC Case No. U-10755, supra. Consumers simply followed through as it had stated and returned the $100 million." PFD p 29.

Rather than create a mismatch between the ratemaking equity balance and the book equity balance, the adjustment put the two in harmony with each other with regard to the treatment of this amount. The $100 million amount had <u>never</u> been recognized in the equity balance for ratemaking purposes.

[6] Staff's assertion that the reversal of the effects of the revaluation of the CMS Enterprises stock is inconsistent with the view that dollars cannot be traced is mixing two separate and distinct concepts. The general principle that dollars used for a particular purpose cannot be traced to the source of those dollars because they are fungible is a valid and accepted concept. However, this does not mean that the value of a particular investment held by the Company cannot be revalued. One involves the value of an asset for purposes of ratemaking. The other involves the use of funds for operations.

The issues involving the CMS Enterprises stock were unique and directly related to the Company's stated intent of matching the value of the CMS Enterprises stock included in equity on its books to the value of the CMS Enterprises stock that the Commission held was appropriate for ratemaking. It involved a question of what value should be placed on certain assets held by Consumers Energy. The issue is not pertinent to the question of whether a known and measurable change resulting from an equity infusion should be recognized. Ignoring a known and measurable change resulting from an equity infusion that has actually happened, based on unsubstantiated speculation, would be unreasonable and unlawful.

c. <u>Staff's Reference to Other Events</u>

In its exceptions, Staff takes the position that the 2002 equity infusion should not be included in the capital structure because the effects of certain other events have not been included. Any impact on the capital structure of the other events referenced by Staff either (i) cannot legally be included for purposes of this rate case due to statutory prohibitions and prior Commission determinations or (ii) is speculative and therefore cannot be included for this reason. The potential existence of future events in no way supports ignoring the actual, verified, historical January 2002 equity infusion.

Staff is correct that the Company did not make an adjustment to the capital structure for electric securitization bonds. However, neither did Staff's witness Mr. Ballinger. The reason for this is simple. The securitization proceeds are not relevant due to a statutory mandate that any savings that result from securitization be used only for electric customers and rates. 11 TR 1976-1977. See MCL 460.10d(4). Further, making such an adjustment would be inconsistent with prior Commission determinations.

Staff is also correct that the Company did not include any adjustment for a potential sale of electric transmission facilities. However, neither did Mr. Ballinger. It was not a known and measurable event. 11 TR 1977. Further, there is no basis to conclude that there would be any change in the capital structure ratios. It is the ratios, not the dollar balances per se, that are utilized in developing the overall required rate of return. The most reasonable assumption to use for purposes of Case No. U-13000 is that the capital structure ratios would not be affected.

Staff is also correct that the Company did not include issuances of new debt. Again, neither did Mr. Ballinger. Staff misconstrues statements in the record that new debt would be issued in 2002. Mr. Vlisides clarified that the need for a debt issuance was a reference to the issuance of replacement debt to replace existing debt as it matures, not the issuance of additional debt. 11 TR 1973, 1974. Consequently, this would not result in a change in the capital structure. 11 TR 1973.

When all is said and done, the fact remains that the January 2002 equity infusion is a known and measurable event. It is not an uncertainty. None of the issues raised by Staff justify ignoring this event in developing the capital structure in this case.

d. The January 2002 Equity Infusion Is Consistent With the Need to Maintain and Improve Consumers Energy's Equity Ratio

Mr. Vlisides testified that in order to maintain and improve Consumers Energy's financial ratings, all other things being equal, it is necessary to maintain or increase the Company's common equity ratio. 5 TR 509. The January 2002 equity infusion is fully consistent with this goal. Mr. Ballinger's Exhibit S-117, Schedule D-5, p 1, as corrected, shows that Consumers Energy's equity ratio is lower than those of gas companies in his proxy group.

Mr. Vlisides noted that the Company has an equity ratio below the gas industry in general. 5 TR 507. Even with the equity infusion, the equity ratio for Consumers Energy would remain low. See Exhibit A-52, page 1, line 17.

The issuance of trust preferred securities ($125 million), senior notes ($350 million) and the MCV write-off ($80 million) that are reflected in the capital structures recommended by the Company and the Staff have the effect of diluting the common equity ratio. See Exhibit A-10. The January 2002 equity infusion helps offset the dilution resulting from these events. Ignoring the January 2002 equity infusion would be counter to the goal of assuring financial soundness of Consumers Energy and would not be reasonable or appropriate.

2. <u>Response to Staff's Request for Assurances that the January 2002 Equity Infusion Will Remain In the Consumers Energy Capital Structure</u>

Staff expresses concern regarding whether the January 2002 equity infusion will be allowed to remain in the capital structure. Staff cites to recent events regarding CMS Energy's financial condition as reinforcing its concerns.[7] Consumers Energy understands that the Staff may have concerns and understands what the Staff is trying to accomplish in asking for assurances that the historical dividend policy will be maintained.

The record in this case shows that Consumers Energy has consistently adhered to an 80% dividend payout ratio[8] policy, calculated on estimated net income available to common shareholders. CMS Energy has orally made a commitment to Consumers Energy not to pull cash

[7] Staff attached press releases by Moody's Investor Services, Fitch Ratings, and Standard and Poor's to its exceptions as support for its concerns. As anticipated by Staff in its exceptions, Consumers Energy objects to consideration of these documents as evidence in this case. The press releases are not relevant to the issue of whether the 2002 equity infusion should be reflected in Consumers Energy's capital structure. There is no indication that the agencies believed a change had occurred in the historical 80% payout ratio policy. Further, insofar as Consumers Energy is concerned, the statements at most reflect opinions, not facts.

[8] A dividend payout ratio refers to the percentage of net income available to common shareholders that is paid to the shareholders in the form of dividends. Exhibit S-158. Any payout ratio of less than 100% indicates that the payment was from net income.

out of the utility beyond the normal amounts. Consumers Energy has been operating with an understanding, and continues to operate with the understanding, that the Commission expects it to adhere to the 80% dividend payout ratio policy. The Company believes that these commitments should be sufficient.

Staff makes reference to Exhibit S-158 in its exceptions. Exhibit S-158 shows the common dividends paid, net income available to common shareholder, and dividend payout ratio for 1995 through 2000. An equity infusion can occur through suspension of dividends, a cash infusion, or a combination of the two. 5 TR 509. In 1995 an increase in common equity was accomplished by a temporary suspension of the 80% dividend policy in conjunction with a cash infusion. See the Commission's March 11, 1996 Order in Case No. U-10755, pp 14-15 and footnote 15 on p 15. Thus, 1995 should be excluded in reviewing historical averages.

Exhibit S-158 indicates that, consistent with the 80% payout policy, the average dividend payout ratio for the five-year period of 1996 through 2000 was 81.36%. Due to the use of estimated net income in determining the dividends and the timing of payments, the dividend payout ratio for any given year will most likely not equal 80%. However, as reflected on Exhibit S-158, over time the dividend payout ratio will be approximately 80%.

H. <u>Reply to Staff's Exception No. 8 – Term and Form of Transportation Contract</u>

The Company has previously indicated that the Staff proposal is acceptable.

II. <u>REPLY TO THE ATTORNEY GENERAL</u>

The initial sections of the Attorney General's exceptions include what she labels as an outline of the evidence. In discussing the Attorney General's evidence, the Attorney General makes various assertions regarding positions that she believes the Commission should adopt. The Company assumes that the issues for which she intends to take exception are the three issues identified in the section labeled "Exceptions" and will therefore focus its response on those issues. The Company's positions on other issues have been set forth in the Company's Brief, Reply Brief, Exceptions and other sections of these Replies to Exceptions. In particular, the Company responds to the Attorney General's arguments at pages 99-105 of its Reply Brief.

A. Reply to the Attorney General's Exception No. 1 – Effect of Reclassification of Base Gas on Rate Base

The Attorney General claims that Consumers Energy's working capital allowance in this case should be reduced by $105,982,000 as a result of the Commission's approval in Case No. U-12679 of a reclassification of 74.6 Bcf of gas in storage. The Commission rejected the Attorney General's arguments in its December 20, 2001 Opinion and Order granting partial and immediate rate relief. The ALJ concluded at page 21 of the PFD that:

> "There is nothing presented by the AG which renders the Commission's determination in the interim relief portion of the case suspect or requiring further scrutiny."

The Attorney General's exception should be rejected.

The Attorney General does not dispute that this amount of investment exists, or that it is properly recorded on the Company's books, or that it is the result of proper accounting practices specifically authorized by the Commission, or that there is anything unreasonable or imprudent about this investment. Rather, the Attorney General has simply constructed an unlawful proposal that is based upon the notion that the accounting reclassification of base gas to working gas that was authorized by the Commission in the October 24, 2000 Order in Case No. U-12679 resulted in both the Company and its customers receiving a "benefit", and that there should therefore be a "sharing" of these working capital costs. This proposal is unlawful, unreasonable and illogical, and should be rejected.

The details behind the accounting reclassification of base gas to working gas were briefed by the Company in its "Brief in Support of Motion for Partial and Immediate Rate Relief", filed on October 31, 2000 in this case. The pages from that brief addressing the background of this issue, which the Company incorporates by reference, are attached to these Replies to Exceptions as Appendix 2.

In the December 20, 2001 Opinion and Order issued in this case, the Commission appropriately calculated the interim revenue deficiency including the full impact of the accounting reclassification. Although the Commission indicated it was not necessarily precluding further litigation of the issue in connection with final relief, (Interim Order, p 16), the Commission's ruling in the Interim Order makes it clear that, barring the presentation of new facts not presented during the interim phase, adjustments such as the Attorney General is now proposing would not be accepted. At page 15 of the Interim Order, the Commission discussed the impact of the accounting reclassification on the Company's books, and found that "[n]o one has questioned the accuracy of the adjustments or the fact that Consumers was required to make them." Similarly, at this final stage of the case, the Attorney General is not questioning the accuracy of the accounting adjustments or that Consumers Energy was required to make them. At page 16 of the Interim Order, the Commission stated that it:

> "rejects the characterization of the base gas adjustment as 'controversial.' * * * There is nothing controversial about the need to recognize the ratemaking effects of such an adjustment, particularly when there have been benefits for ratepayers."

The Attorney General claims that she is not challenging the result of the December 20 Order. However, the Attorney General's proposal at the final stage of this case is effectively asking the Commission to reverse its findings in the Interim Order, even though the Attorney General has not presented any new or different facts. For this reason alone, the Attorney General's proposed disallowance should be rejected. The reasons that supported rejection of the Attorney General's position in the Interim Order continue to support rejection.

In addition, the Attorney General's proposal is illogical. The "benefit" that the Attorney General alleges was realized by the Company as a result of the accounting reclassification was the reduction of losses which would have otherwise been incurred by Consumers Energy as a result of the three year GCR suspension. That is, because Consumers Energy was selling, at a fixed price of $2.84 per Mcf, gas that cost in excess of that amount, it was incurring significant losses. One of the byproducts of the accounting reclassification was the reduction in cost of gas, a portion of which offset these losses. This "benefit" to Consumers Energy, however, was also effectively realized by customers, since they paid well below market prices for gas during this period. The reduction in losses experienced by the Company was not somehow achieved at the expense of customers as implied by the Attorney General; indeed, customers realized the same savings by virtue of paying a rate that was below market prices.

The Attorney General's proposal is illogical for the further reason that its calculation is highly dependent upon factors that can be expected to change over time, such as the cost of gas and the extent to which gas is cycled in the Company's storage fields. A disallowance calculated as $105,982,000 today based upon the assumptions utilized by the Attorney General, could be significantly more or less tomorrow under a different set of assumptions. The Attorney General's proposal is not designed to establish rates that allow the recovery of actual utility costs; it is simply an approach to creating a large disallowance.

Finally, the Attorney General's proposal is unlawful. It would be confiscatory and a denial of due process for the Commission to order such a massive disallowance of working capital. The $105,982,000 amount represents real dollars provided by real investors to enable

Consumers Energy to provide gas utility service to its customers. There is nothing phantom or fictional about that investment. As matter of constitutional law, the Company is entitled to earn a return on that investment, and the Attorney General's proposal would deprive it of an opportunity to do so. The Attorney General's proposal is unlawful for the further reason that it represents retroactive ratemaking. The proposal reaches back into a prior period, characterizes an accounting entry as a "benefit" to the utility, brings that alleged benefit forward into the test year, and then transforms it into a rate reduction. This is clearly retroactive ratemaking, which the Michigan Supreme Court long ago found was unlawful. See Michigan Bell Telephone Co. v MPSC, 315 Mich 533; 24 NW2d 200 (1946).

B. Reply to the Attorney General's Exception No. 2 – Recognition of the January 2002 Equity Infusion in Capital Structure

The Attorney General takes exception to the ALJ's conclusion that there is no valid reason not to include the $150 million equity infusion that occurred in January 2002 in the capital structure. The Attorney General essentially adopts the Staff position. Consumers Energy responded in an earlier section of these Replies to Exceptions to the arguments raised by Staff. The Company respectfully refers the Commission to the Company's response to Staff's Exception No. 7.

Mr. Ballinger presented evidence indicating that Consumers Energy's equity ratio is lower than other gas companies. See Exhibit S-117, Schedule D-5, p 3. As discussed previously, Mr. Vlisides testified that in order to maintain or improve Consumers Energy's financial rating, all other things being equal, it is necessary to maintain or increase the Company's common equity ratio. 5 TR 509. Other adjustments to the capital structure reduced the equity ratio. Failure to include the equity infusion would increase business risk (5 TR 486) and, for reasons discussed previously, would be unlawful and unreasonable. The Attorney General's exception should be rejected.

C. Reply to the Attorney General's Exception No. 3 – Rate Design

The Attorney General states that the Commission should modify the recommendations in the PFD in order to avoid rate decreases for some customers given the overall rate increase. The Attorney General's exception should be rejected. Rate reductions for transportation customers are supported by the cost of service studies presented in this case by Consumers Energy and the Staff. Rates that are not based on costs create uneconomic incentives. Rates should be based upon costs to the extent possible.[9]

III. REPLY TO ABATE

A. Reply to ABATE's Exception No. 1 – Cost of Service

ABATE takes exception to the ALJ's rejection of the cost of service study proposed by ABATE's witness Mr. Phillips. The Company and Staff each presented cost of service studies. The differences between the Company and Staff studies were relatively minor. In an effort to simplify issues and focus on more important disagreements, the Company, with one exception, accepted Staff's cost of service study. That one exception related to customer costs for calculation of the residential customer charge, which is addressed in Consumers Energy's Exceptions.

Except for understating the residential customer charge, the Staff's cost of service study reasonably allocates costs among the different classes of customers. The new XLT rate for

[9] At page 15 of her exceptions the Attorney General references the residential customer charge. That issues is discussed at pages 51-53 of Consumers Energy's Exceptions.

large transportation customers reflects the costs of serving transportation customers who use at least 500,000 Mcf annually. 9 TR 1408-1409, 1420. ABATE's exception should be rejected.

B. Reply to ABATE's Exception No. 2 – Elimination of Subsidies

ABATE excepts to the lack of a specific finding that rates designed in this proceeding will eliminate all subsidies. ABATE apparently believes that the rates should be lower for transportation customers. The Attorney General apparently believes the rates should be higher for transportation customers. The real question is whether the cost of service study presented by Staff provides a reasonable allocation of costs to the various customer classes for purposes of this case. That is the finding that the Commission should make.

C. Reply to ABATE's Exception No. 3. – Company Use and Loss and Unaccounted for Gas

ABATE disagrees with the ALJ's conclusion at page 86-87 of the PFD that the Company use and loss and unaccounted for gas percentage for transportation customers should be set at 1.72%. At page 5 of its exceptions ABATE requests that the Commission reject the ALJ's recommendation and maintain the current percentage of 1.03%.

While the Company agrees that maintaining the current allowance of 1.03% is certainly more reasonable than reducing the allowance to 0.82% as proposed by Staff, the Company submits that the evidence supports the increase recommended by the ALJ. The Company discussed the appropriateness of using 1.72% earlier in these Replies to Exceptions in response to Staff's Exception No. 3.

Contrary to ABATE's assertions, Mr. Sosinski provided support for use of the 1.72% allowance. He noted that the largest amount of fuel used is in compressors that are used on the transmission system to boost the pressure and move gas down the pipeline, as well as at storage compressor locations. 6 TR 893. ABATE claims in its exceptions that Mr. Sosinski did not know if the data was indicative of normal usage. However, Mr. Sosinski testified at 6 TR 895 that he felt the data was more reflective of what conditions would be on the system on a go forward basis than using an average over a longer period of time. Use of a 1.72% allowance is appropriate.

IV. <u>REPLY TO MR. DEWARD</u>

Mr. DeWard filed fairly short exceptions in which he objected to the ALJ's rejection of his positions. Mr. DeWard provides no identification or discussion of specific issues and his statements are conclusory in nature. Rule 341 of the Commission's Rules of Practice and Procedure, R 460.17341, states that a party filing exceptions must identify the findings or conclusions to which an exception is taken, include references to the record as appropriate, and support exceptions by a reasoned discussion of the evidence and the law. Mr. DeWard has not even attempted to do so and therefore his exceptions should be rejected. If the Commission nevertheless considers any of his positions, reference should be made to pages 78-98 of the Company's Reply Brief, where the Company replies to Mr. DeWard. As stated in the Company's Reply Brief, the Company does not question the sincerity of Mr. DeWard's views, but that does not mean that they are appropriate for purposes of establishing rates in Case No. U-13000.

Mr. DeWard includes a section in his exceptions in which he asserts that the MPSC should initiate an investigation "to ensure that the price of natural gas was not artificially inflated by Enron and other energy traders." There is no basis to conclude that the cost of gas that is reflected in the gas stored underground was artificially inflated by Enron or other energy traders. It is unclear what jurisdiction the Commission might have for the type of investigation

Mr. DeWard appears to envision. However, Case No. U-13000 is not a proper forum for such an investigation in any event.

V. REPLY TO METRO BUREAU GROUP SERVICES

Metro Bureau Group Services filed nine exceptions, one with seven subsections. All relate to Metro Bureau Group Services' claim that schools should receive preferential treatment through a special transportation tariff or a transportation tariff that provides special treatment for schools. The ALJ correctly rejected Metro Bureau Group Services' arguments at pages 74-77 of the PFD.

The evidence does not support the assertions and conclusions made by Metro Bureau Group Services in its exceptions. Further, there is no basis in law or fact for the Commission to require Consumers Energy to undertake a cost of service study on behalf of the schools. Metro Bureau's request that it do so must be rejected.

Consumers Energy's witness Mr. Brockett identified a number of reasons why Metro Bureau Group Services' position should not be adopted in this case. See 11 TR 2010-2013. Among other things, he noted that (i) other governmental or non-profit organizations could make similar arguments, (ii) the proposal would result in subsidization by other customers, (iii) the State Legislature and local school districts are better positioned to provide assistance, (iv) small transportation customers have not experienced any measurable rate increases for delivery, and (v) there is no evidence that the load characteristics of schools support such special treatment or that they have significantly lower per unit costs. 11 TR 2011-2012.

Mr. Brockett explained that Consumers offers no end-use rates for the purpose of income redistribution or assisting institutions imbued with the public interest. The Company believes that its efforts to minimize total costs and rate subsidies have significantly benefited all transportation customers, including schools. 11 TR 2011-2012. The exceptions of Metro Bureau Group Services should be rejected.

On June 26 Metro Bureau Group Services filed what it labeled a "supplement" to its exceptions. Metro Bureau Group Services attaches a brochure to the supplement, apparently from a seminar on credit and collections for utilities. The brochure is not part of the record in this proceeding and constitutes impermissible hearsay. Consumers Energy objects to the supplement on the grounds that it is not timely, that the document attached to it is not part of the record and cannot legally be considered, and that the document is not relevant in any event. The supplement and the attachment cannot properly be considered, but even if considered would not support Metro Bureau Group Services claims that it is entitled to special relief.

VI. REPLY TO NEMA

A. General Reply

NEMA asserts in its exceptions that the Commission should require Consumers Energy to implement fully allocated embedded cost-based unbundled rates for services listed by the Commission in its July 11, 2001 Order in Case No. U-12550. NEMA presented no witnesses in the case. It essentially claims that it had no obligation in this case other than to assert that it advocated unbundling. The ALJ correctly concluded at page 90 of the PFD that NEMA had not met its burden in this case.

Before addressing NEMA's specific unbundling proposals, Consumers Energy wishes to emphasize that the Commission has already implemented the unbundling of most significance and potential benefit to customers -- the unbundling of the sale of the gas commodity from the sale of delivery services. The Company believes that further unbundling would offer negligible benefits at best, and raise significant concerns regarding safety, stranded costs, and allocative efficiency. Consequently, the Company does not support the further unbundling of retail gas services at this time. Further, no party presented evidence proposing any further unbundling in this case, despite the invitation of the Commission. This suggests a lack of interest by allegedly prospective suppliers. NEMA states that it is incorporating its brief by reference. Below the Company responds to the specific unbundling proposals NEMA offers and discusses in its initial brief.

B. Additional Reply

1. Timing

NEMA argues that the Commission should order the Company to unbundle its services based on an embedded cost of service study first, so that potential "competitive suppliers will be able to develop plans to enter the Michigan market based on adequate price information." (p 5). As pointed out by the Staff in this case, it is impossible to calculate costs/back-out charges for metering and billing services without knowing what those services are. Until alternative providers identify exactly what types of services they wish to provide, it is impossible to know what costs should be included in the back-out credits.

2. Metering capital costs and O&M expenses

In its rebuttal testimony in this case, the Company took the position that the back-out charge for metering activities should not include metering capital costs and O&M expenses for the reason that selling those meters or turning over maintenance to a third party would be contrary to good business practice and would present serious safety issues. 11 TR 1997. NEMA argues that this position is inconsistent with the Commission's intent expressed in its Order in Case No. U-12550. NEMA contends that the Commission envisioned that alternative suppliers would provide "metering equipment as well as operating and maintenance activities."

NEMA's proposal suffers from several deficiencies. First, it is premature for the reason identified above in paragraph 1. Second, NEMA fails to address how the Company would collect its stranded costs if new suppliers replaced Consumers Energy's metering and related equipment with their own. Third, in the case of existing customers, it is simply inefficient to replace existing meters with duplicates. Stated differently, there is little opportunity to realize the types of gains in economic efficiency that are commonly cited to justify the unbundling of services. In fact, total metering costs (including stranded costs) would almost certainly increase. Fourth, NEMA fails to even acknowledge the serious safety/maintenance/reliability concerns that are presented by NEMA's position.

Fifth, MCL 460.10q(5) states, "An electric utility will not be prohibited from metering and billing its customers." While this statute applies to electric utilities, the clearly stated legislative intent is equally valid to the gas industry. It makes little sense to promote conflicting policies in the two regulated industries.

3. Pricing services at embedded versus marginal costs

In its brief NEMA asserts that the backout credits should be based upon Consumers Energy's embedded cost of providing a given service. NEMA presents arguments that are completely unsupported by any evidence in this case. If NEMA believed this was an important issue, then it should have submitted testimony, subjected a witness to cross-examination and rebuttal evidence on this contention. In fact, Consumers Energy strongly disagrees with NEMA's conclusions regarding the alleged efficiency and equity of relying upon embedded costs as the basis for establishing back-out credits. The unbundling program apparently being promoted by NEMA would require that the utility be limited to one price while competitors would be free to price their products/services at any price they deem necessary to maximize their net income or market share. One immediate problem caused by this approach is that it necessitates the calculation of stranded costs and the establishment of a recovery mechanism for such costs. Such problems are reduced if the back-out credit is set at the marginal cost of service. Unless marginal costs are used, customers who do not choose competitive suppliers will simply subsidize those who do. Pricing at the marginal or avoided cost is more equitable than pricing at the embedded cost.[10]

On Page 4 of its brief NEMA summarizes its efficiency justification for embedded-cost pricing:

> "As long as utilities collect marginal revenues based on embedded costs (that are presumably just and reasonable), then the most economically efficient, just and reasonable unbundled rates should also be based on the same embedded costs."

This reasoning is suspect. NEMA correctly recognizes that, putting aside any elasticity considerations, prices set at the embedded cost of service result in marginal revenues equal to the embedded cost. By the same token, prices set at the marginal or avoided cost generate marginal revenues equal to the marginal cost. Yet neither observation sheds much light on appropriate unbundling policy. Regardless of the impact of traditional utility pricing on marginal revenues, back-out credits based on avoided costs promote economic efficiency better than credits based on embedded costs. NEMA's exception should be rejected.

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[10] The Staff apparently agrees; at page 113 of its brief, it recognizes that the backout credits should be based upon "avoidable" utility costs.

VII. CONCLUSION

Prior to the interim increase granted December 20, 2001, Consumers Energy's gas distribution rates had not increased for over 16 years. The last prior increase was in Case No. U-7650, in an order issued August 17, 1984. Company witnesses presented evidence that Consumers Energy needs to spend increasing amounts on its gas distribution and transmission systems to assure the continued supply of safe and reliable service to customers. Failure to recognize known and measurable changes identified by the Company in rates in the increasing cost environment that exists will result in rates that are inadequate.

A rate increase is urgently and expeditiously needed in this case. Consumers Energy respectfully requests that the Commission issue a final order consistent with the positions expressed above and in the Company's Exceptions.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

Dated: July 8, 2002

By: Richard Chambers

Jon R. Robinson (P27953)
H. Richard Chambers (P34139)
Raymond E. McQuillan (P24100)
John C. Shea (P36854)
212 West Michigan Avenue
Jackson, Michigan 49201
Attorneys for Consumers Energy Company
(517) 788-1482

Appendix 1

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

OBJECTION OF CONSUMERS ENERGY TO STAFF'S REQUEST THAT THE COMMISSION TAKE OFFICIAL NOTICE OF TWO DOCUMENTS

I. INTRODUCTION

Consumers Energy Company ("Consumers Energy" or the "Company") files the following objection to the requests of the Michigan Public Service Commission Staff in its February 28, 2002 Reply Brief that the Administrative Law Judge ("ALJ") or Commission take official notice of information contained in Attachments B and C to Staff's Reply Brief.

At page 57 of its Reply Brief, the Staff states that the ALJ or Commission can take official notice of Attachment B to its Reply Brief. At page 60, it makes the same statement with respect to Attachment C. It is the position of Consumers Energy that official notice should not be taken and that these attachments and the associated references in the Reply Brief should be disregarded in reaching a decision in Case No. U-13000.

The Company will respond to Attachments B and C in reverse order.

II. RESPONSE REGARDING ATTACHMENT C INFORMATION

Staff describes Attachment C as a report by Regulatory Research Associates, Inc. ("RRA") dated January 24, 2002 that shows authorized returns on equity allowed by state commissions in the year 2001. In order to justify taking of official notice of the document and associated information Staff must overcome two hurdles. First, the document must be a proper subject for official notice. Second, there must be a valid evidentiary foundation for the document to be considered. Attachment C does not meet either prerequisite.

A. Attachment C Is Not a Proper Subject for Official Notice

Rule 327 of the Commission's Rules of Practice and Procedure, R460.17327, states that:

> "Except as otherwise provided by law, the commission and the presiding officer may take official notice of judicially cognizable facts and may take notice of general, technical or scientific facts within the commission's specialized knowledge." (Emphasis added)

The data on Attachment C are not general, scientific or technical facts that the Commission knows by reason of its specialized knowledge within the meaning of Rule 327. If the Commission and the ALJ can take notice, the requirements for judicial notice must be satisfied.

Rule 201(b) of the Michigan Rules of Evidence states:

> "A judicially noticed fact must be one not subject to reasonable dispute in that it is either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned."

The data on Attachment C are not generally known. Neither are they capable of accurate and ready determination. Further, opinions cannot properly be judicially noticed. Attachment C is not a proper subject of judicial notice. Consumers Energy objects to taking notice of the data on Attachment C and disputes the materiality of that data to Case No. U-13000. Further, as discussed below, there are evidentiary problems with use of the data.

RRA would have compiled the Attachment C data from other sources. Not only would it be necessary to verify each item of data, it would also be necessary to verify that the data used are actually the universe of data for 2001.

The authorized returns on equity consist of the opinions of regulators based on the evidentiary records in front of them. Assuming that the summarized state commission determinations of authorized returns on equity were verified, questions would still remain as to how the determinations were made, what assumptions were used in developing the data, and whether the regulated companies are comparable to Consumers Energy's gas business. Consumers Energy disputes that they are comparable. (See Section B.1. below). Three of the seven gas returns on equity that RRA identified as allowed by state commissions in the year 2001 appear to have been in cases where the order followed stipulation or settlement.

Further, the underlying data in the cases listed would have been developed at various times which would predate the order dates. The Company indicated in its Case No. U-13000 Reply Brief that evidence in Case No. U-13000 supports a conclusion that required returns for proxy companies used by both the Company and Staff in DCF calculations, as a group, increased during 2001. See Consumers Energy's Reply Brief, Appendix 2, pages 4-5. This is another reason not to take notice of the Staff's Attachment C data.

The Commission must decide the investor required return in Case No. U-13000 based on the record in Case No. U-13000, not the record in some other case in some other jurisdiction. Even if relevant to that determination, which the Company disputes, the return on equity data reflected in Attachment C would not be material. This is discussed further below. The question that must be addressed in Case No. U-13000 is what is the investor required return for Consumers Energy's gas business, not what returns were authorized by other commissions for other regulated companies in other states.

B. There is No Evidentiary Foundation that Would Justify Admissibility of Attachment C

Even if notice of Attachment C were taken, this would not permit a conclusion that the information was relevant and material to the return on equity determinations to be made in Case No. U-13000 or allow the information to be accepted for the truth of the matters set forth.

1. Attachment C Is Not Relevant or Material

Judicially noticeable material must be relevant to be considered. Winekoff v Pospisil, 384 Mich 260 at 266; 181 NW 2d 897 (1970). Rule 401 of the Michigan Rules of Evidence defines relevant evidence as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." The issue here is what the investor required return is for Consumers Energy's gas business. The Attachment C data are not comprised of investor required returns for Consumers Energy's gas business and there is no record evidence that the results shown would be appropriate for Consumers Energy's gas business.

Mr. Vlisides and Mr. Ballinger both agreed that it is important to pick representative proxy groups in determining the investor required return for Consumers Energy's gas business. Neither witness used the electric utilities represented on Attachment C in their proxy groups. Only one of the gas companies represented on Attachment C, Southwest Gas, was included by Mr. Vlisides and Mr. Ballinger in their proxy groups.[1] There is no indication that the

[1] The return on equity shown as authorized for Southwest Gas in 2001 was higher than calculated by either Mr. Ballinger or Mr. Vlisides for that utility in their DCF calculations.

returns of either electric or gas utilities whose returns are summarized on Attachment C are representative as a group, or individually, of the required return on equity for Consumers Energy's gas business.

The information in Attachment C does not have a legitimate influence or bearing on a decision in Case No. U-13000. It does not have a substantial bearing on the merits of the controversy. The results of the RRA compilation are not relevant or material for purposes of Case No. U-13000.

2. <u>Attachment C Constitutes Inadmissible Hearsay</u>

Rule 801(c) of the Michigan Rules of Evidence defines hearsay as follows:

> "'Hearsay' is a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted."

Clearly the statements in Attachment C are not made by a declarant while testifying. Clearly Staff is submitting this information for the truth of the matters asserted. There should be no question that this document comes within the definition of hearsay.

Rule 802 of the Michigan Rules of Evidence states:

> "Hearsay is not admissible except as provided by these rules."

Staff does not specify what hearsay exception it thinks applies to this document. Staff's footnote 66 on page 60 of its Reply Brief refers to the document as "an industry publication," states that it is received "on a subscription basis" and that the Staff "uses it as a basis of technical knowledge." These statements do not meet the threshold for any of the hearsay exceptions.

Staff indicates that the information is a compilation by RRA, taken from other sources. This does not meet the criteria for a record of a regularly conducted business activity as defined by MRE 803(6). Further, MRE 803(6) requires, among other things, the testimony of a custodian or other qualified witness. Neither does it meet the criteria for a public record or report as defined by MRE 803(8).

The Michigan Supreme Court in <u>Bradbury</u> v <u>Ford Motor Company</u>, 419 Mich 550; 358 NW 2d 550 (1984) held:

> "The history of MRE 803(8) demonstrates that evaluative and investigative reports are not within the provision excepting from the hearsay rule 'matters observed pursuant to a duty imposed by law as to which matters there was a duty to report'....
>
> "Contrary to the conclusion reached by the Court of Appeals, MRE 803(8)(B) does not allow the admission of investigative reports. Rather, that clause reflects the narrow common-law rule which limits public reports of matters observed by agency officials to reports of <u>objective data</u> observed and reported by these officials." 419 Mich at 553-554. (Emphasis added)

See also <u>Attorney General</u> v <u>John A. Biewer Co., Inc</u>, 140 Mich App 1, 16-17; 363 NW 2d 712 (1985) (holding that MRE 803(8)(A) should be construed to apply to records and reports of overall activities such as annual reports of activities) and <u>Slayton</u> v <u>Michigan Host, Inc</u>, 144 Mich App 535 at 547-548; 376 NW 2d 664 (1985) (holding that evaluative factual findings of the NLRB did not fall within any exception to the hearsay rule).

Further, there is a second layer of hearsay. Staff states that the document shows returns on equity allowed by state commissions during 2001. As noted above, the authorized returns are not numbers developed by RRA but obtained from other sources. Hearsay included within hearsay is admissible only if each part is covered by an exception. MRE 805. No exception exists for either part.

The initial wording of footnote 66 suggests Mr. Ballinger used Attachment C. However, Staff admits later in its footnote 66 that Attachment C was <u>not</u> available at the time of Mr. Ballinger's testimony. Consequently, accepting for purposes of argument that Attachment C may be similar to a document Mr. Ballinger used, it is <u>not</u> a document that actually was used by him in preparing his testimony in this case. It is not necessary to address whether the document could have been admitted if Mr. Ballinger had used it for purposes of this case, because <u>it was not used by Mr. Ballinger in forming his opinion</u>. Nor does it constitute "use of learned treatises for impeachment" addressed by MRE 707. No evidentiary foundation has been laid sufficient for it to be used in this case.

C. <u>Taking Official Notice of the Document Would Result in Unfair Prejudice to Consumers Energy</u>

This is not the type of document for which official notice is appropriate. If raised by Mr. Ballinger in his direct testimony, Consumers Energy would have, if it so chose, had an opportunity to (i) obtain additional data through discovery, (ii) develop information through cross examination and (iii) present responsive evidence. Moreover, use of decisions of other commissions which form a basis for Attachment C as a basis for a decision in this case would inappropriately shift the focus to what other commission's have decided for other companies rather than what investors require for Consumers Energy's gas business.

D. <u>Even if the Commission Took Notice It Would Not Justify A Return on Equity of 11%</u>

Consumers Energy discussed the return on equity evidence in this case in detail in its Brief and Reply Brief. Even if notice were taken, the record evidence would support a return above Staff's recommendation of 11.00%

III. <u>RESPONSE REGARDING ATTACHMENT B INFORMATION</u>

It is not entirely clear from the Staff's Reply Brief whether it is requesting at page 57, footnote 65, that the ALJ and Commission take notice of numbers as contained in a press release issued on February 4 or from the CMS Energy 10-K Report. Regardless, it is clear that the numbers for which Staff seeks to have notice taken are the fourth quarter 2001 and calendar year 2001 earnings of CMS Energy Corporation.

The purpose of this information appears to be an attempt to show that losses from CMS Energy's non-regulated operations (which Staff indicates occurred primarily during the third and fourth quarters of 2001) were not reflected in statements of Mr. Olson contained in Exhibits S-44 (a document dated April 30, 2001) and S-45 (a document dated August 8, 2001). Mr. Olson testified that there were developments subsequent to the time Exhibits S-44 and S-45 were prepared (5 TR 445-450) and that his opinions in those exhibits regarding CMS Energy should not be assumed to represent his opinions at the time he testified (5 TR 458).

CMS Energy's fourth quarter and year 2001 earnings are not relevant or material to the return on equity issues in Case No. U-13000 and are therefore not a proper subject for official notice. Mr. Olson (5 TR 459), Mr. Ballinger (10 TR 1494) and Mr. Vlisides (5 TR 489, 522) all agreed that CMS Energy should not be used as a proxy for determining Consumers Energy's required return on equity in this case.

IV. CONCLUSION

For the reasons discussed above, official notice is not appropriate of the information in Staff's Attachments B and C.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

Dated: March 8, 2002

By: Richard Chambers

H. Richard Chambers
212 West Michigan Avenue
Jackson, Michigan 49201
Attorney for Consumers Energy Company
(517) 788-1482

Appendix 2

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	)	Case No. U-13000
the distribution of natural gas and	)	
for other relief	)	
	)	

BRIEF OF CONSUMERS ENERGY COMPANY
IN SUPPORT OF MOTION FOR PARTIAL AND IMMEDIATE RATE RELIEF

October 31, 2001

Impact of Commission Decision in Case No. U-12679

The single biggest adjustment proposed by the Staff is obviously that related to the Commission's Order in Case No. U-12679. In an October 24, 2000 Order issued in that case, the Commission approved the accounting reclassification of 75.5 Bcf of base gas in storage to working gas. Consumers Energy had filed an application seeking such approval, explaining that the gas that was recorded in Account 358 as "base gas" could be separated into recoverable base gas (i.e., gas that could be extracted and delivered to customers), and non-recoverable base gas (i.e., gas that must be left in storage to allow for proper operation of the storage facilities). Reclassifying the 75.5 Bcf of recoverable base gas as "working gas" (which is recorded in Account 164.1) therefore was appropriate from an operational perspective, as well as because it would have the effect of reducing the cost of working gas. This is because the booked cost of the 75.5 Bcf reclassified gas was only approximately 63 cents per Mcf, and thus, when mixed with the higher cost working gas, would have the effect of reducing the cost of gas charged to Gas Cost Recovery ("GCR") customers.

The reclassification had the additional accounting and ratemaking effects of decreasing plant in service (since base gas in Account 358 is included in plant in service), and increasing working capital requirements (since working gas in Account 164.1 is a component of the balance sheet working capital calculation used for ratemaking purposes). At the time of the reclassification, there was no net effect on rate base (the sum of plant in service and working capital). Over time, however, as the working gas in storage is cycled (i.e., as gas in storage is delivered to customers, and replaced during the next injection cycle), the total value of working gas will tend to be higher than it would have been absent the accounting reclassification (i.e., because the volume of working gas is greater, and because the gas sold and delivered to customers will be replaced at prices higher than 63 cents per Mcf, thus pushing the average cost of working gas higher).

For purposes of its interim rate relief request in this case, Consumers Energy reflected the anticipated cost of gas in storage at the end of 2001. As Mr. Torrey explained,

> "The Company's natural gas inventory value included in working capital in 2001 is much higher than the amount included in current rates determined in Case No. U-10755, due primarily to higher commodity prices. Working capital in rate base in current rates reflects $170 million in natural gas inventory. As shown by Company witness MJ Shore, the Company's 13-month average natural gas inventory for the period ended December 2001 will exceed $383 million." 3 TR 153.

Mr. Torrey further explained that the Company's filing reflected the accounting ordered by the Commission in Case No. U-12679 in that a portion of the higher gas inventory value was the result of the reclassification ordered by the Commission:

> Q Are higher commodity prices the only reason for the increase in the value of the Company's natural gas inventory?
>
> A No. In October 2000 in Case No. U-12679, the Company was authorized by the MPSC to transfer 75.5 Bcf of recoverable base gas to working gas. At the time of the transfer, there was no customer impact. The benefits of that transfer are currently being flowed through to the Company's GCR customers in the form of a lower GCR factor. The benefits to customers will continue to be manifest through a lower GCR factor for several GCR periods." 3 TR 153-154.

In its filing, the MPSC Staff agreed that using the 13 month average amount of gas in inventory for the period ended December 31, 2001 was appropriate. Staff witness Ms. Devon stated as follows:

> "Staff adopted the Company's proposed 13 month average gas in underground storage estimates for the year ended December 31, 2001 since, <u>in Staff's opinion, the projected balance of $383,874,000 is more representative of the levels expected during the time interim rates would be in effect</u> than the 13 month average

historical test year balance [for period ended December 31, 2000] of $200,046,000. The Company's working gas inventory balance at December 31, 2000 was $271,157,000. The Company's working gas inventory has increased to $545,095,000 as of August 31, 2001 and its 13 month average working gas for the period ended August 31, 2001 was $299,454,000. It is expected that as the historical test year September-December 2000 monthly gas inventory balances are replaced by the September-December 2001 gas inventory balances, the 13 month average balances will continue to increase from the prior historical test year levels." 4 TR 269. Emphasis added.

Although the Staff agreed that using the 13 month average gas inventory for the period ended December 31, 2001 was appropriate for interim purposes, the Staff also argues that the effect of the Commission's decision in Case No. U-12679 should be "backed out" of the interim revenue requirement calculation. 4 TR 249. Staff witness Ms. Devon calculated the increase in working capital requirement resulting from this reclassification to be $130,612,000. See Exhibit S-31, Schedule 3; 4 TR 269-271. This has a revenue requirement impact of $13,845,000. Id. The Staff presented two arguments in support of its position. It argued that to reflect the ratemaking impact of the reclassification would be "controversial" and therefore inappropriate for interim rate relief purposes. 4 TR 250-251. It also contended that customers have not yet received the anticipated benefits of the reclassification. 4 TR 251.

Consumers Energy contends that the Staff proposal to eliminate the effect on working capital of the Commission's decision in Case No. U-12679 should be rejected for the following reasons: (i) it is inconsistent with the Commission's order; (ii) the Staff proposal is one-sided since it accepts the impact of the reclassification for some purposes but not for others; (iii) the Staff argument that Consumers Energy's treatment of this issue would deprive customers of anticipated benefits is incorrect, since customers will receive approximately $77 million of benefits associated with the reclassification during the current GCR period in addition to a refund to customers that only occurs as a result of the Case No. U-12679 Order. This compares with the annual impact of $13.8 million of revenue requirement associated with the increased working capital requirement; (iv) the Staff proposal is confiscatory, in that it accepts the impact of the reclassification when it has the effect of reducing the cost of gas paid by GCR customers, but rejects it when it increases working capital requirements.

In the October 24, 2000 Order, the Commission concluded that "the proposed reclassification is reasonable and in the public interest, and should be approved." Order, p. 3. In reaching that conclusion, the Commission relied upon the ratemaking consequences of the reclassification:

> "In this time of rising prices, the Commission finds that it is prudent to mitigate the effect of the significant increases in natural gas prices on retail customers. Absent any regulatory action, the effect of rising gas prices on customers that is expected to occur when the suspension of Consumers GCR clause ends on March 31, 2001 could be significant.
>
> "To mitigate future increases in the cost of gas on Consumers' GCR customers, the Commission finds that Consumers' proposal to reclassify its recoverable base gas as working gas, to transfer its recoverable base gas from Account 358 to Account 164.1, and to derive the cost of gas by reflecting that transfer is reasonable.
>
> "The Commission agrees with Consumers' request that the cost of the reclassified recoverable base gas be included with the cost of gas previously classified as working gas in determining the average cost of gas in Account 164.1. <u>The reclassification should be followed for all future gas transactions.</u>" Order, pp. 3-4. Emphasis added.

The Commission's Order did not say that the reclassification should be followed for some purposes, but not for others; rather, it stated that the reclassification "should be followed for all future gas transactions." The Staff proposal to "back out" the impact of the Commission's Order is flatly inconsistent with the terms of that Order.

The Staff does not dispute that the Company's filing is consistent with the accounting that was approved by the Commission. 4 TR 257. The Staff also agrees that the Company was, in fact, required to follow that accounting once the Commission issued the Case No. U-12679 Order in October 2000. 4 TR 257. The Staff's proposal to follow the accounting prescribed in Case No. U-12679 for purposes of determining the cost of gas, but to ignore it for purposes of applying the Commission's balance sheet approach for determining working capital, is one-sided, inconsistent and unfair.

The cost reductions that result from this reclassification have been reflected in the current GCR factor that is being charged to customers. 3 TR 99; 4 TR 258. These cost reductions are substantial, and are already being realized by GCR customers. For the period April 2001 through August 2001, these cost reductions equal $11,824,961. See page 3 of Exhibit A-29. For the period April 2001 through March 2002 (the current GCR plan period), the total cost reductions to be realized by GCR customers are approximately $77 million. See 3 TR 99. Thus, GCR customers have already received benefits in excess of the annual revenue requirement associated with the increased working capital requirement, and those benefits will overwhelm that working capital effect by the end of the current GCR period.

Finally, it would be confiscatory and a denial of due process for the Commission to require the Company to follow accounting practices that have the ratemaking effect of reducing the cost of gas paid for by GCR customers, while refusing to follow those same accounting practices when they have the ratemaking effect of increasing the Company's revenue requirement. There is simply no possible justification for such inconsistent treatment. The $130,612,000 of investment in gas inventory represents real dollars provided by real investors to enable Consumers Energy to provide gas utility service to its customers. There is nothing phantom or fictional about that investment. As a matter of constitutional law, Consumers Energy is entitled to earn a return on this investment, and the Staff's proposal deprives it of an opportunity to do so. The fact that customers are already enjoying the benefits of the reclassification ordered by the Commission through a lower cost of gas simply exacerbates the unfairness of the Staff position.

True-up Adjustments

The Staff made a series of adjustments to Consumers Energy's interim filing that share a common rationale. These are to Federal Income Tax ("FIT") expense, Michigan Single Business Tax ("MSBT") expense, Executive Incentive Compensation Plan ("EICP") expense, Save & Share expense, and MPSC assessment expense. The basic facts for each of these items are as follows: Each year Consumers Energy accrues (and books) an estimated amount of expense. The following year, when the actual amount of expense is determined, a true-up adjustment is made. Thus, for example, the Company's 2000 books included both an accrual of expense for 2000 and a true-up adjustment to the accrual that had been booked in 1999. In its filing, Consumers Energy eliminated the true-up adjustments for each of the items listed above, since they were all related to a period outside of the historical test year. Although the true-up adjustments can be either positive or negative (i.e., they can reflect either increases or decreases to the prior year's expense), in this instance, the elimination of the true-up adjustments had the impact of increasing the amount of expense reflected on the Company's 2000 books. The Staff recommends rejecting the Consumers Energy adjustment, and leaving the out-of-period true-up adjustments in the 2000 historical test year for purposes of evaluating interim rate relief.

The rationale offered by the Staff for rejecting the elimination of the true-up adjustments is that they are made each year, and are simply normal book accounting adjustments.

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)

Margaret Hillman, being first duly sworn, deposes and says that she is employed in the Legal Department of Consumers Energy Company; that on July 8, 2002 she served an electronic copy of the "**Consumers Energy Company's Replies to Exceptions**" upon the persons listed in Attachment 1 hereto, at the e-mail addresses listed therein. She further states that she served a hard copy of the same document to the addresses listed in Attachment 1, by depositing the same on July 8, 2002, in the United States mail in the City of Jackson, Michigan with first-class postage thereon fully paid.

Margaret Hillman

Margaret Hillman

Subscribed and sworn to before me this 8th day of July, 2002.

Sammie B. Dalton

Sammie B. Dalton
Notary Public, Jackson County, Michigan
My Commission Expires: 01/04/04

ps0702-1-80c

ATTACHMENT 1 -- TO CASE NO. U-13000

Administrative Law Judge

Hon. Daniel E. Nickerson, Jr.
Administrative Law Judge
6545 Mercantile Way, Suite 14
P.O. Box 30221
Lansing, MI 48909
E-Mail: denicke@michigan.gov

Counsel for the Michigan Public Service Commission Staff

Steven D. Hughey, Esq.
Larry G. Watterworth, Esq.
Assistant Attorney General
Public Service Division
6545 Mercantile Way, Suite 15
Lansing, MI 48911
E-Mail: hugheys@michigan.gov
watterworthl@michigan.gov

Michigan Public Service Commission Gas Staff

Susan J. Sims
MPSC Gas Division
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909
E-Mail: sjsims@michigan.gov

Counsel for National Energy Marketers Association

Jennifer L. Frye, Esq.
Dickinson Wright PLLC
215 S. Washington Square, Suite 200
Lansing, MI 48933
E-Mail: jfrye@dickinson-wright.com

Counsel for the Association of Businesses Advocating Tariff Equity

Robert A. W. Strong, Esq.
Clark Hill PLC
255 S. Woodward Ave., Third Floor
Birmingham, MI 48009
E-Mail: rstrong@clarkhill.com

Thomas C. DeWard

Thomas C. DeWard
25806 Glover Court
Farmington Hills, MI 48335
E-Mail: mdw-tdw@ic.net

Counsel for the Attorney General Jennifer M. Granholm

Donald E. Erickson, Esq.
Assistant Attorney General
6520 Mercantile Way, Suite 2
P. O. Box 30736
Lansing, MI 48909
E-Mail: ericksond@michigan.gov
gruesbeckl@michigan.gov

Counsel for Midland Cogeneration Venture Limited Partnership ("MCV")

Michael J. Brown, Esq.
Howard & Howard Attorneys, P.C.
The Phoenix Building, Suite 500
222 North Washington Square
Lansing, MI 48933-1817
E-Mail: mjbrown@howardandhoward.com

Gary B. Pasek, Esq.
Vice President, General Counsel and Secretary
Midland Cogeneration Venture
Limited Partnership
100 Progress Place
Midland, MI 48640
E-Mail: gbpasek@midcogen.com

Counsel for Metro Bureau Group Services, Inc. Gas Consortium

Joseph H. Fields, Esq.
Josh Fields & Associates
4700 S. Hagadorn, Suite 195
East Lansing, MI 48823
E-Mail: joshfields1@juno.com

John H. Norris, Esq.
Thomas D. McLennan, Esq.
Dickinson Wright, PLLC
38525 N. Woodward
Bloomfield Hills, MI 48304-2970
E-Mail: jnorris@dickinson-wright.com
tdmclennan@wayne.edu