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July 15, 2002

Ms. Dorothy Wideman
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
Lansing, MI 48911

Dear Ms. Wideman:

Re: <u>MPSC Case No. U-13000</u>

I am enclosing for filing an original and 4 copies of the **Attorney General's Replies to Exceptions** together with a Proof of Service. I will be sending a copy of this via email to the parties listed on the attached proof of service. In addition, a copy of this filing is being submitted electronically.

Sincerely,

Donald E. Erickson

Donald E. Erickson
Assistant Attorney General

c All Parties

PROOF OF SERVICE - U-13000

The undersigned certifies that a copy of the **Attorney General's Replies to Exceptions** was served upon the parties listed below by mailing the same to them at their respective addresses with first class postage fully prepaid thereon, or by State Interdepartmental mail as indicated, on the 15th day of June, 2002.

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Lois E. Gruesbeck

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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

MPSC No. U-13000

/

Attorney General's Replies to Exceptions

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July 15, 2002

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Introduction

On June 3, 2002, the Administrative Law Judge (ALJ) issued a Proposal for Decision (PFD) in this case along with a Notice of Proposal for Decision. The notice set June 24, 2002, as the deadline for filing exceptions and set July 8, 2002, as the deadline for filing replies to exceptions.

On June 21, via email message, counsel for the Attorney General requested the ALJ to extend the deadline for filing of the Attorney General's Replies to Exceptions from July 8 to July 15. On June 21, the ALJ sent an email reply granting counsel's request (see the attached copy). The Attorney General submits the following replies to exceptions.

Replies to Consumers Energy

Consumers Energy Company (CECo or the Company) submitted 55 pages of written exceptions together with four appendixes (Appendix A through Appendix D). The Attorney General requests the Michigan Public Service Commission (MPSC or Commission) to reject those exceptions.

I. Replies to CECo's Introduction

Pages 2-4 of CECo's Exceptions argue that the PFD does not provide a reasonable basis for a decision in this case and that the ALJ's reliance upon the Staff's position is misplaced. In the context of its first argument, CECo presents arguments in support of CECo's Appendix A. That appendix outlines adjustments to the revenue deficiency recommended on page 65 of the PFD, and those adjustments attempt to reconcile the PFD's recommended level with the level supported by evidentiary positions and briefs presented by CECo and the Staff. This reconciliation rests upon certain concessions made to the Staff in CECo's briefs as well as upon certain concessions made to CECo in the Staff's briefs.

Appendix A and pages 2-3 of CECo's Exceptions argue that the revenue deficiency recommended by the PFD should have been $41,476,000 instead of $31,629,000. Page 1 of the Staff's Exceptions and Appendix 1 to those exceptions concur in CECo's arguments.

If the Commission's final order in this case fundamentally adopts <u>all</u> of the ALJ's recommendations without any modifications, then the adjustments are mathematically supported by the record and concessions in CECo's and Staff's briefs. But, exceptions filed by the Attorney General, the Staff, and/or Mr. Thomas C. DeWard would significantly reduce the final revenue deficiency, while CECo's exceptions would significantly increase the final revenue deficiency. The Attorney General continues to support her exceptions and supports the exceptions filed by the Staff.

With regard to the ALJ's reliance upon the evidence presented by the Staff, his reliance upon the record is not misplaced as CECo argues. MCL 24.285 requires the Commission to base its final decision upon the whole record, and other than the issues raised in her exceptions, the Attorney General believes the whole record supports the ALJ's reliance upon evidence and arguments submitted by the Staff.

Much of CECo's argument rests upon the Company's implicit assumption that the details of the Company's evidence must be adopted. A utility has the burden of persuasion as well as the burden of going forward with evidence sufficient to prove that its proposed revenue deficiency is just and reasonable. *See, In re The Detroit Edison Co,* MPSC Case No. U-8020-R, Opinion & Order dated 7-16-87 [sic 7-9-87], pp 16-17. Furthermore, even uncontradicted evidence may be rejected. *Woodin v Durfee,* 46 Mich 424,427 (1881), and *S C Gray, Inc v Ford Motor Co,* 92 Mich App 789,804; 286 NW2d 34 (1979). In other words, the mere fact that CECo has presented evidence that would support its position if CECo's evidence were adopted does not require the ALJ or the Commission to adopt CECo's position.

II. <u>Replies Concerning the Test Year</u>

Pages 4-17 of CECo's Exceptions argue that the ALJ erred in adopting an unduly restrictive view of known and measurable changes and urge the MPSC to adopt the Company's version of a fully projected test year.

The MPSC's standard for determining what are just and reasonable rates in a general rate case is to consider a utility's rate base, capital costs, revenues, and expenses to determine whether existing rates should be altered. The MPSC's standard for analyzing gas rates cases has been stated as follows:

> In each rate proceeding, the Commission must identify an appropriate test year as a basis for evaluating the utility's rate base, capital costs, revenues, and expenses to determine whether existing rates should be altered. This methodology begins with booked amounts for a historical year, which are then adjusted for known and measurable changes that are reasonably expected to occur prior to and during the projected test year.
>
> *In re Michigan Gas Utilities,* MPSC Case No. U-10960, Opinion and Order dated March 27, 1997. *Accord, In re Peninsular Gas Co,* MPSC Case No. U-11127, Opinion and Order dated July 31, 1997.

Perhaps, even more importantly, these standards are reflected in the MPSC-approved settlement accepted by CECo and other gas companies in Case No. U-10039. Those standards have been followed in reviewing gas rates for all gas companies since Case No. U-10039. So, even if it believes that it should revise the previously adopted standards, the MPSC should not change a method created by settlement in the context of this single-utility rate case.

Mr. King testified on behalf of the Attorney General that several of CECo's proposed adjustments to net operating income should be rejected under this standard. Mr. King testified that the MPSC should be wary of approving CECo's proposed adjustments from the 2000 historical test year to CECo's proposed levels for 2002 because neither the gas industry in general nor CECo in particular has displayed increasing cost characteristics (11 T 1705-1706). Mr. King testified that the Commission should disallow 12 of the specific adjustments proposed by CECo and that other proposed adjustments may be improper (11 T 1706-1707). All utilities have an incentive to adjust historical results to reduce their apparent earnings in a historical period and to increase rate base and expenses (11 T 1709).

Mr. King testified that the MPSC should be wary of approving CECo's proposed adjustments from the 2000 historical test year to CECo's proposed levels for 2002 because neither the gas industry in general nor CECo in particular has displayed increasing cost characteristics (11 T 1705-1706). Mr. King testified that the Commission should disallow 12 of the specific adjustments proposed by CECo and that other proposed adjustments may be improper (11 T 1706-1707). All utilities have an incentive to adjust historical results to reduce their apparent earnings in a historical period and to increase rate base and expenses (11 T 1709).

The record as a whole supports the ALJ's recommendations. CECo seems to argue that its projections should be adopted mostly because all of the Company's adjustments to the historical test year have been quantified in detail. This argument misses the point. Quantification of a projection does not demonstrate that it represents a known and measurable change. The disputed issues in this case generally concern the level of cost (revenue requirement) that will arise from the projected activities, not whether or not the projected activities will occur--though some of the disputes do concern whether CECo will actually spend amounts during the test year.[1]

CECo argues that its 2001 actual expenses exceeded the Staff's proposal. During unexplained redirect examination, Mr. Preketes did identify total O & M expense for 2001, but without more, CECo has not demonstrated how much of that expense should be modified by normalization or represented one-time costs that should not be reflected in MPSC ratemaking or what part of the actual expense reflects disputed costs. In any events, the PFD present rational grounds for the ALJ's recommendations.

Pages 11-17 of CECo's Exceptions discuss details of several projections by the Company. CECo's testimony does present the projections outlined on those pages, but the Company's testimony fails to prove that the changed cost level represents known and measurable changes. CECo might spend that sum, but CECo has not met its burden of proof to show that it will or must spend more than the amounts supported by the Staff.

III. Replies Concerning Rate Base

Pages 4-24 of the PFD address the ratebase issues in this case. The Attorney General's Exception No. 1 addresses one revision to the PFD's recommendations concerning rate base. Pages 17-20 of CECo's Exceptions argue that the MPSC should adopt the Company's proposed level.

[1] For example, as pages 13-14 of the PFD notes, the projected general office facility will not be completed until 2003 after the test year. In the context of a standard requiring known and measurable changes, it is also interesting to note the CMS Energy Company now plans to occupy part of the facility as a new headquarters. In other words, at least some of this capital expenditure is not a known and measurable change to the costs to be incurred by CECo.

Pages 7-21 of the PFD discuss CECo's proposals in detail and describe why the ALJ has recommended adopting the Staff's position. For example, several of the increased capital expenditures relate to a new headquarters building that will not be in service during the test year. This is an excellent example of CECo's "projection" approach to test year costs. So, for the reasons stated in the Staff's testimony and briefs and in the PFD, the Commission should adopt the PFD's recommended plus the adjustment to gas reclassification costs described in the Attorney General's exceptions.

CECo proposed to increase the $1,076,788,000 amount proposed for net plant in Exhibit A-8 to $1,085,875,000 to reflect $9,087,000,000 added by Staff witness Mogis for MGS (CECo's Brief, p 10 and Appendix B, p1). In other words, CECo argues that the Staff's proposed reductions to the Company's numbers are not appropriate, but CECo was ready to recognize a Staff correction in its favor.

In discussing net plant, CECo describes the Company's proposals as "actual capital expenditures for 2001 and 2002." Of course, the 2002 increases to net plant are not actual expenditures yet, and 2002 expenditures represent much more than half of CECo's proposed increases to net plant. And, CECo may never spend the amounts identified. The difference between the Staff and CECo is $39 million, and for example, Mr. Gladney's proposed $10.3 million general office facility is not expected to even be in service until 2003--after the 2002 test year. Furthermore, as explained in the Attorney General's initial brief and by Mr. King's testimony, in many instances CECo has projected increases that represent supposedly economic decisions without including any resulting savings in the Company's revenue requirements.

IV. <u>Replies Concerning O & M Expenses</u>

Pages 42-57 of the PFD discuss CECo's disputed adjustments to O & M expenses for 2002. Pages 20-28 of CECo's Exceptions argue that the ALJ's recommendations are unreasonably low.

As indicated above, the Attorney General's witness Charles W. King testified that several of CECo's proposed adjustments to the 2000 historical test year O & M expenses should not be treated as known and measurable changes. Historical period results adjusted only for normal weather yield only a $17.2 million revenue deficiency, but CECo is now requesting a revenue increase of $105 million increase (CECo's Exceptions, p 1). CECo has not been experiencing a similar level of increased annual costs, and CECo's experience is representative of the gas industry (11 T 1710-1711 and Exhibit I-132).

In any event, the MPSC should reject proposed changes that are speculative and uncertain (11 T 1712-1713). For example, when services increase at a rate lower than the projected increase in cost, the MPSC should not treat the cost increase as a known and measurable change in the absence of evidence showing why productivity will decline and without evidence related to corresponding revenue increases (11 T 1720). For example, CECo forecasts a 47% ($2.06 million) increase in damage prevention expenses from $5.52 million to $7.58 million with only a 5% increase in excavation requests to the Company (11 T 1721). CECo forecasts a 7-fold increase from $320,000 to $2,310,00 for succession planning to process hiring of replacement personnel, but CECo does not forecast a 7-fold increase in the number of employees retiring (11 T 1721). CECo forecasts operating expense increases of $5.8 million and $5.93 million for gas compression, transmission, and storage; yet, CECo has projected no resulting revenue growth (11 T 1722). The point should be clear. CECo has projected rather specific cost increases, but CECo quantification of those increases did not represent known and measurable changes in costs.

V. <u>Replies Concerning Capital Structure and Rate of Return</u>

Pages 26-41 of the PFD address capital structure and rate of return. Pages 28-41 of CECo's Exceptions argue that the PFD should have recommended the Company's proposed 12.25% rate of return on common equity. Pages 41-43 of CECo's Exceptions argue that the ALJ erred in recommending the Staff's proposed long term and short-term debt costs. Page 44 0f CECo's Exceptions argues that the ALJ erroneously excluded other interest bearing items from the Company's capital structure.

CECo presented its year 2000 capital structure and overall rate of return in Exhibit A-4 (SBW-12). CECo proposed various different costs of capital for components of its projected 2002 capital structure and proposed a 2002 overall rate of return (weighted cost of capital) at 8.2762% in Exhibit A-10 (NAV-6). The Staff has proposed a 2002 capital structure and an overall rate of return (weighted cost of capital) in Exhibit S-117. Staff's proposed overall rate of return is 7.14%.

The Attorney General takes the position that the MPSC should adopt the analysis presented by Mr. Ballinger in support of Exhibit S-117 (10 T 1477-1505). CECo's position lacks credibility. In the last rate case, CECo was authorized to recover an 11.6% rate of return on common equity, and during the past year the Federal Reserve Board has cut interest rates many times. CECo's request to recover 12.25% moves in the opposite direction, while the Staff's position is consistent with external trends in capital markets.

Pages 26-30 of the PFD recommend inclusion of a $150 million equity infusion from CECo's parent company in the calculation of CECo's capital structure. The Attorney General's Exception No. 2 addresses that recommendation, as does the Staff's Exception No. 7. So, these replies will not discuss that issue.

Turning to the cost of common equity, the Attorney General notes that CECo is requesting an increase from an 11.6% authorized rate of return to 12.25% despite that fact that interest rates have been declining for the past year. The recognized capital attraction test would suggest that the rate of return required by investors in CECo would decline in the light of declining rates available from alternative investments. Most investments entail varying levels of risk perceived in varying ways by varying investors. CECo's arguments might accurately describe some of the risks faced by CECo, but on the whole record, the testimony and exhibits presented by Mr. Ballinger represent a just and reasonable estimate of the likely level of return investors would require to invest in CECo. CECo's witnesses carefully avoid quantifiable claims that specific risks faced by CECo reduced the availability of capital to CECo or its parent. In fact, there is no credible evidence that CECo will be unable to attract capital at the rates recommended by the PFD.

Page 41 argues that the MPSC should consider flotation costs in setting the rate of return on common equity. There is no evidence that CECo will incur flotation costs in issuing stock to its parent; thus, flotation costs should be excluded. *In re Michigan Gas Utilities,* MPSC Case No. U-10960, Opinion & Order dated March 27, 1997.

VI. Replies Concerning Manufactured Gas Plant Expenditures

Pages 21-24 of the PFD discuss CECo's manufactured gas plant expenditures and recommend including some of the proposed expenses and deferring some of them. Pages 45-50 of CECo's Exceptions argue that the PFD erred in failing to adopt the Company's entire position.

The key point is that CECo has projected $9 million in 2002 expense, which is neither known nor measurable. Since the MPSC has already authorized deferred recovery in U-10755, the Attorney General agrees with the PFD and the Staff that the MPSC should not pass judgment on those projections at this time.

VII. Replies Concerning Cost of Service and Rate Design

Pages 51-54 of CECo's Exceptions address issues concerning cost of service and rate design. However, page 51 of CECo's Exceptions addresses "Company Use and Lost and Unaccounted For Gas." That issue is discussed in the net operating income section of the PFD on pages 63-64 and again on pages 86-87.

Page 51 of the PFD notes that CECo agreed to the percentage proposed by the Staff for sales customers, but disputed the percentage for transportation customers. Page 51 of CECo's Exceptions fails to note this distinction and argues that the Staff's approach should be rejected -- apparently based upon pages 86-87 of the PFD. CECo's Exception is not consistent with its agreement regarding the Staff's sales percentage, so CECo's exception should be rejected. In fact, the Attorney General believes the Commission should adopt the Staff's position supporting a consistent percentage for sales and transportation customers, which is discussed on page 9 of the Staff's Exceptions.

As page 65 indicates, CECo accepted the Staff's cost of service study except for calculation of the residential customer charge. Pages 67-69 of the PFD recommend adoption of the Staff's proposed residential charge because the Staff calculated its charge in a manner consistent with MPSC precedent. Pages 51-53 of CECo's Exceptions disagree with this recommendation, but CECo attempts to distinguish the precedent. The MPSC should reject CECo's exception because it does not truly follow the precedent and because it would result in an unjust and unreasonable increase in CECo's residential customer charge.

Replies to Metro Bureau Group Services, Inc.

Pages 74-77 in the PFD address the proposals presented in this case by Metro Bureau Group Services, Inc. The PFD concluded that Metro Bureau failed to prove that the cost of serving schools is less than for any other class of customers. Metro Bureau filed nine exceptions and essentially argues that schools are difference and are not a credit risk, so they should not be charged for recovery of uncollectible expense.

The core reasons for Metro Bureau's claim for relief are: (1) that Michigan school districts are in a precarious financial situation and (2) that it costs less for CECo to serve school districts because they do not create any of CECo uncollectible debt expense.

The Attorney General recognizes the very important public interests served by our public schools as well as the financial difficulties confronting our schools. But, in the context of utility rate making, it is difficult to treat a utility customer's ability to pay as a factor in setting rates without adopting a principle that could be logically extended to allow free service for customers who have no money (recognizing that defining what "having no money" should include can become a very difficult problem).

On the other hand, allocating CECo's uncollectible debt expense is almost a completely unique problem. When there is dissimilarity in services, then a difference in charges is proper. *Bradford v Citizens Telephone Co,* 161 Mich 385, 389-390; 126 NW 444 (1910). But, in this case Metro Bureau has not truly shown that its members are truly in a different position. Uncollectible debt expense represents expenses properly allocated to customers who did not pay them. It is an under recovery of cost, not an additional cost. In the truest sense, uncollectible expense is not caused by any customers to whom that "expense" will be allocated. Even though uncollectible bills may arise within certain customer classes, the other customers in a class do not cause this "expense." The point is this. All customers, other than ones who cannot or do not pay their bills, can say as Metro Bureau says, "We did not cause the expense, so our rates should not include it." Another problem with this issue is that any difference in charge must have some reasonable relationship to a difference in service. *Bradford.*

The forms of relief requested by Metro Bureau rest upon two grounds that should not become the basis for rate relief. On the other hand, if the MPSC decides to grant some of the relief requested, then the MPSC should rest that relief upon explicitly described policy grounds for deviating from standard ratemaking principles.

Replies to National Energy Marketers Association (NEMA)

Pages 69-74 of the PFD address unbundling issues generally, while pages 88-90 address the position presented by NEMA. The PFD recommends finding the NEMA did not adequately support its position.

NEMA argues that the Commission should order CECo to implement fully allocated embedded cost-based unbundled rates and/or back out charges for metering and informationrelated services, filling and customer care services, and related technologies. NEMA argues that less than fully embedded costs create an artificially low, subsidized rate for services that can be rendered by competitive sources and that rates below fully embedded costs force customers selecting alternative suppliers to pay twice, which will slow customer migration and may create new stranded costs.

NEMA's arguments raise issues, but they fail to quantify the nature of proper relief. NEMA's arguments also somewhat misdescribe appropriate goals of customer choice. Ultimately, customer choice is in the public interest if and only if the features adopted as a result of that policy create net benefits for all of CECo's customers. Migration for the sake of migration is not appropriate. That result might create a new market for new suppliers, but if that result does not create net benefits for all customers, then it should be treated as discriminatory cream skimming. As was apparently recognized in *Ishpeming v PSC,* 370 Mich 293, 311-312; 121 NW2d 462 (1963), customers can be grouped into classes for purposes of rate making and not every difference for each customer must be treated different in setting rates. There are always situations in which some customers may receive a benefit without paying a given cost, but pragmatism in setting rates must prevail at some level. *See, Michigan Public Service Co v Maddy* 284 Mich 392, 394; 279 NW 874 (1938). As the Commission once ruled,

> Rates may be fashioned in response to a specific need of a certain type of customer. However, once established, the rate applies to all customers that may qualify for it and the Commission is prohibited from discriminating among similar customers. *In re The Detroit Edison Co,* MPSC Case No. U-7660, Opinion and Order dated March 29, 1988; 1988 Mich PSC LEXIS 81, p 7.

NEMA has not described the nature and rates it desires for separate, unbundled tariffs, so the Commission cannot determine how to avoid discrimination in this sense.

NEMA argues that the Commission should explicitly and affirmatively endorse the rendering of service by competitive suppliers. This misstates the appropriate policy. The MPSC should not unreasonably favor or burden either CECo or alternative suppliers. The MPSC should consider whether or not certain overhead costs related to so-called separate services would make it uneconomic to unbundle them. The MPSC must also consider whether unbundling any specific service is in the net best interest of all customers because it would not be just and reasonable to set any unbundled rate at a level that will increase overhead costs for customers not electing an alternative supplier.

With regard to stranded costs, this concept's underlying foundation is that utilities previously relied upon regulated, cost-of-service recovery and incurred fixed costs that can no longer be avoided and would not be economical in a competitive environment. But, since CECo has agreed to the MPSC-approved choice program, any new costs (fixed or variable) that CECo incurs should not be treated as stranded costs even if they become uneconomic in a competitive environment. Reliance upon regulated recovery does not justify stranded cost recovery of new costs because regulated recovery is no longer assured.

The Attorney General supports customer choice so long as it yield net benefits for utility customers, but the MPSC must be careful and adopt only specific unbundling proposals that yield net benefits. NEMA did not submit evidence or present arguments to quantify what form of unbundling it supports or what rates it wants the MPSC to adopt; therefore, the MPSC is unable act upon NEMA's position.

Replies to ABATE

ABATE's Exceptions to the PFD relate to cost of service and rate design. The Attorney General's Exception No. 3 addresses these issues. The basic point is that cost of service and rate design principles represent policy determinations that should balance the interests of all customers. When rates are being changed, the MPSC should consider the impact of the changes in designing rates. Gradualism is a valid policy consideration. Cost of service is not an exact process, so the MPSC should not reflexively apply that concept--especially in light of the potential for biased views that can motivate positions.

Replies to the MPSC Staff

Earlier in these replies, the Attorney General has supported the exceptions filed by the MPSC's Staff; therefore, the Attorney General will offer no specific replies to the Staff's exceptions.

Replies to Thomas C. DeWard

The Attorney General will offer no specific replies to the positions supported by Mr. DeWard.

Conclusion

Attorney General Jennifer M. Granholm requests the Michigan Public Service Commission to issue a final order in this case consistent with the positions stated in her Exceptions and these replies to exceptions.

Respectfully submitted,

JENNIFER M. GRANHOLM
Attorney General

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July 15, 2002

From: Nickerson, Daniel E (CIS)
To: Erickson. Donald
Date: 6/21/02 9:30AM
Subject: RE: U-13000 Schedule for Replies to Exceptions

Don,

I don't have an issue with your request.

Dan

-----Original Message-----
From: Erickson, Donald
Sent: Friday, June 21, 2002 12:57 AM
To: Nickerson, Daniel E (CIS)
Cc: [clarkhill.com].rstrong; [cmsenergy.com].jrrobinson; [dickinson-wright.com].jdempsey; [howardandhoward.com].mjbrown; [ic.net].mdw-tdw; [juno.com].joshfields1; Hughey, Steven; Lark, Peter; [vrsh.com];.ejschneidewind
Subject: U-13000 Schedule for Replies to Exceptions

Pursuant to the Notice of Proposal for Decision and on behalf of the Attorney General, I will be filing written exceptions to the PFD in U-13000 on June 24, 2002.

The notice also sets July 8, 2002, as the deadline for filing replies to exceptions. I am the sole attorney in our office who is familiar with Case No. U-13000, the numerous pleadings, and voluminous evidentiary record. However, I am getting married on June 22, and I will be out of my office until July 8.

Since I will be absent the entire period designated for drafting replies to exceptions, I am asking you to grant me a one-week extension until July 15. I agree not to review other filed replies during that week.

Mr. Robinson has indicated that CECo would agree to my request under the circumstances, but CECo does not wish to have a general extension of the deadline.

I personally need an extension and can accept Mr. Robinson's proposal. But, you and the other parties may object. Please advise me I you are willing to grant some form of deadline extension. If this cannot be done, please advise Peter Lark, so that he can try something else for the Attorney General.

Donald E. Erickson

– **ATTACHMENT** –