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April 9, 2001

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

Dear Ms. Wideman:

Re: MPSC Case No. U-12752

I am enclosing for filing an original and 4 copies of the Direct Testimony of Ralph E. Miller. I am also enclosing a proof of service. In addition, a copy of this filing is being submitted electronically pursuant to the instructions in the Commission's notice of hearing

Sincerely,

Donald E. Erickson

Donald E. Erickson
Assistant Attorney General

c All Parties
sld/cases/U-12752

PROOF OF SERVICE - U-12752

The undersigned certifies that a copy of the Direct Testimony of Ralph E. Miller 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 9th day of March, 2001

Lois E Gruesbeck

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 Approval of a Gas Cost Recovery Plan and Authorization of Gas Cost Recovery Factors for the 12-month period of April 2001 - March 2002 ____________________________________/	MPSC Case No. U-12752

Direct Testimony of Ralph E. Miller

On behalf of Attorney General Jennifer M. Granholm

April 9, 2001

Qualifications

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

A. My name is Ralph E. Miller. I am an independent consulting economist. My office is at 5502 Western Avenue, Chevy Chase, Maryland 20815.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL QUALIFICATIONS.

A. I am an economist specializing in the fields of utility regulation, industrial organization, and public policy towards business. I have more than thirty years of experience in public utility and related energy work, both as a consultant and in government. I am the author of several published reports and papers on public utility economics and energy matters, and I have testified in more than 30 different jurisdictions in a total of more than 250 public utility and other proceedings. I also have several additional years of experience in government and as a university teacher in antitrust, energy demand forecasting and supply analysis, and other areas of economics and energy.

Over the years, I have addressed almost all the aspects of gas and electric utility regulation, including rate of return, accounting and revenue requirements, rate design and cost of service, electric fuel and purchased gas cost recovery, industry structure and the role of competition, incentive ratemaking and other types of innovative rate designs, gas and electric supply planning and power plant licensing, productivity and efficiency, and the determination of marginal, incremental, and avoidable costs.

Q. WHAT IS YOUR EMPLOYMENT EXPERIENCE?

A. I have been an independent consultant for more than fifteen years. I also have ten years of experience as president or vice president of two different consulting firms specializing in public utility and energy matters. Before that, I spent three years in the federal government, where I was employed in positions at the Federal Power Commission, the Antitrust Division of the U.S. Department of Justice, and the Federal Energy Administration. I was on the faculty of the University of California for three years, where I taught economics courses at both the graduate and undergraduate levels.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I did my undergraduate work at Harvard College, where I received the A.B. degree *summa cum laude* in mathematics in 1961, and I was elected to Phi Beta Kappa. I then went on to graduate work in economics at Harvard, where I received a Master's degree in 1963. I continued my graduate studies there until 1966, and I completed all of the course requirements for the Ph.D. degree, but not a doctoral dissertation.

Q. WHAT IS YOUR EXPERIENCE IN THE SPECIFIC AREA OF GAS SUPPLY PLANNING AND GAS COST RECOVERY?

A. I have more than 20 years of experience in this area. I have reviewed the gas supply planning and/or gas cost recovery arrangements of more than 15 gas distribution companies (GDCs) in numerous regulatory proceedings in seven states, and I have extensive experience in gas pipeline cases at the FERC.

Beginning in 1981, I analyzed the way Southern Union Gas Company acquired gas supplies for its New Mexico distribution system, and I testified on aspects of this subject in U.S. District Court in 1982.

At the FERC, I reviewed requests by three interstate pipelines for recovery of take-or-pay buyout and contract reformation costs under Order No. 500. This work was done on behalf of customers of the pipelines or their representatives. It included detailed analysis of the gas purchase contracts and other materials obtained in the discovery process. I also testified in many pipeline rate proceedings and two pipeline gas inventory charge (GIC) proceedings, and I reviewed the gas supply restructuring plans proposed by two pipelines as part of their Order 636 compliance.

At the state level, I (along with one or more colleagues) have performed many management/performance audits of the gas purchasing practices and policies of the gas distribution companies in Ohio. These reports have audited three of the major LDCs in Ohio, as well as two smaller gas utilities that relied to a large extent on purchases of local production for their system gas supplies.

Here in Michigan, I have reviewed and testified on the gas supply plans and gas cost recovery (GCR) reconciliations of Consumers Energy Company (Consumers) and Michigan Consolidated Gas Company (MichCon) in each year from 1988 until the GCR clauses for these two gas utilities were suspended three years ago. In some years, I have also reviewed and testified on the gas supply plans and GCR reconciliations of Michigan Gas Utilities (MGU) and SEMCO Energy Gas Company.

In New Jersey, I participated in the levelized gas adjustment clause (LGAC) proceedings as a consultant to the Ratepayer Advocate (or its predecessor, the Public Advocate) for ten years. During this period I reviewed the LGAC filings and gas supply planning of all four of the New Jersey GDCs. I also participated extensively in the consideration of gas cost recovery issues in the unbundling proceedings and base rate cases of the New Jersey GDCs.

In Maryland, I have for more than 20 years been reviewing the gas supply planning and gas purchases of several Maryland utilities, including Baltimore Gas and Electric Company ("BGE") and Washington Gas Light Company, in a variety of proceedings in which I have worked on behalf of Maryland People's Counsel. Other states in which I have done similar work include Pennsylvania, Nevada, and Utah.

Q. WHAT IS YOUR EXPERIENCE IN THE ANALYSIS OF CUSTOMER CHOICE PROGRAMS IN THE GAS INDUSTRY?

A. I have worked on customer choice programs involving numerous gas utilities in six states. My experience with third-party gas supply arrangements goes all the way back to the mid-1980s, when gas distribution companies first began introducing gas transportation programs for their largest customers in response to FERC Order 436. More recently, I have participated in all phases of the comprehensive unbundling proceedings involving all four gas utilities in New Jersey from 1994, when they began, until 1999; and I submitted testimony there in 1999 in the unbundling proceedings under the New Jersey Electric Discount and Energy Competition Act. In Maryland, I have participated in the gas roundtables for Washington Gas and Baltimore Gas and Electric Company, as well as those for several smaller gas utilities. In Pennsylvania, I submitted testimony in 1999 and 2000 on behalf of the Office of Consumer Advocate in the restructuring proceedings of four of that state's gas utilities under Pennsylvania's Natural Gas Choice and Competition Act. I also testified as a witness for the Georgia PSC staff in Atlanta Gas Light Company's comprehensive unbundling case, and I was one of the principal consultants to the Delaware PSC staff in the 1995 gas service restructuring by Delmarva Power & Light Company (now Conectiv). In addition, I have extensive experience with unbundling and transportation issues at FERC, including participation in several of the pipeline unbundling proceedings pursuant to FERC Order 636. Here in Michigan, I participated in the collaborative activities in Case No. U-12550, and I have also testified on gas transportation issues in two base rate cases.

Prepared Direct Testimony

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by the Michigan Department of Attorney General to make an independent analysis of Consumers' GCR plan for the 12 months ending March 2002, and the accompanying 5-year forecast. I sometimes refer to the 12 months ending March 2002 as the "GCR plan year", or the "current GCR plan year".

Q. WHAT ISSUES HAVE YOU IDENTIFIED IN YOUR ANALYSIS OF CONSUMERS' GCR PLAN?

A. I have identified the following issues:

(1) The most important issue in this year's GCR proceeding is Consumer's commodity purchasing strategy in a competitive market environment. The principal question is whether Consumers should continue to purchase a large part of its gas supplies under fixed price contracts, as the Company did throughout the 1990s, or instead rely primarily on spot purchases and index-based pricing, as the Company is now proposing.

(2) The second major issue is the Company's proposal that the Commission authorize a maximum GCR factor $1.00 per Mcf higher than Consumers' projected average GCR cost of gas purchased and produced.

(3) The third issue that I address is Consumers' portfolio of pipeline capacity. The specific problem I have identified in this area is Consumers' recently completed contract with its new affiliate, Panhandle Eastern Pipeline Company, to purchase firm

transportation services for just the summer months in the current GCR plan year, from April through October 2001.

Q. WOULD YOU SUMMARIZE THE CONCLUSIONS YOU HAVE REACHED AS A RESULT OF YOUR ANALYSIS?

A. Yes. I have reached the following conclusions:

(1) It is unreasonable and imprudent for Consumers to maximize its reliance on spot and index-based pricing for the purchase of its GCR supplies. Consumers should instead use fixed-price contracts with 12-month terms to purchase half of its GCR requirements, as it did in the 1990s.

(2) The GCR factor of $5.6862 sought by Consumers is excessive, because it exceeds the Company's own estimate of its GCR cost of gas by $1.00 per Mcf. The additional $1.00 per Mcf should not be approved.

(3) Consumers should be instructed to present more information about its pipeline capacity portfolio, including a discussion of its plans for serving as supplier of last resort for its Gas Customer Choice (GCC) customers, in future GCR plans. Consumers' recent contract with its affiliate Panhandle for firm transportation during the months April through October 2001 has not been justified by Consumers in this proceeding, and the issues relating to it should be considered in the GCR reconciliation.

<u>Commodity Purchasing Strategy</u>

Q. WHAT IS CONSUMERS' PLANNED GAS COMMODITY PURCHASING STRATEGY FOR THE GCR PLAN YEAR?

A. Consumers has existing contracts to purchase a total of approximately 40 Bcf of gas supplies during the GCR plan year at fixed prices. These contracts represent approximately 20% of the gas Consumers expects to purchase during the GCR plan year for its GCR gas sales service. Consumers plans to purchase the remaining 80% of its GCR requirements in the spot market or under contracts with index-based pricing that closely approximates spot market prices.

Q. HAS CONSUMERS PROVIDED ADDITIONAL INFORMATION ABOUT ITS FIXED PRICE GAS PURCHASE CONTRACTS?

A. Yes. These contracts are those in Company witness Michael J. Shore's Exhibit A-____ (MJS-3) as originally filed. In the revised version of this exhibit, which includes numerous index based contracts that Consumers has recently entered into, the five fixed price contracts are the two Delta contracts for the purchase of Michigan supplies, the PG&E contract for U.S. supplies, and the Duke and ProGas contracts for Canadian supplies. The prices under these contracts range from $2.22 per Dth to $3.25. Two of the five contracts will expire before the end of the current GCR plan year, but the other three will extend as far as 21 months beyond the end of the current GCR plan year.

Q. HOW DOES THIS PLANNED GAS COMMODITY PURCHASING STRATEGY COMPARE TO THE STRATEGIES CONSUMERS HAS USED IN THE PAST?

A. Consumers' proposed strategy for the current GCR plan year is an almost complete reversal of the strategy used by Consumers during the 1990s. Throughout the 1990s, Consumers purchased at least half of its commodity gas supplies -- and sometimes as much as two-thirds -- under fixed price arrangements. These fixed price contracts generally had 12-month terms, but some had terms as long as 24 months.

Q. DID THIS COMMODITY PURCHASING STRATEGY CONTINUE DURING THE THREE YEARS WHEN CONSUMERS' GCR CLAUSE WAS SUSPENDED?

A. I do not know. During the period of the GCR suspension, Consumers' gas rates included a fixed amount of $2.8364 per Mcf for recovery of purchased gas costs, and this fixed rate did not depend upon what Consumers' gas costs actually were during this period. I am not aware that Consumers has provided a detailed report of its actual gas purchase contracts in effect during this GCR suspension period, but in any event, I have not reviewed those contracts. However, I assume that Consumers hedged its fixed price gas sales commitment by entering into fixed price gas purchase contracts covering a large part of its expected requirements during this suspension period.

Q. WHAT GAS COMMODITY PURCHASING STRATEGY IS CONSUMERS PROJECTING FOR THE REMAINDER OF THE 5-YEAR FORECAST PERIOD, AFTER THE CONCLUSION OF THE CURRENT GCR PLAN YEAR?

A. According to Company witness Shore, Consumers expects to continue moving towards spot or index-based pricing. I assume this means that Consumers does not expect to enter into new fixed price contracts, or to replace the existing fixed price contracts when they expire.

Q. DO YOU AGREE WITH CONSUMERS' PROPOSED GAS COMMODITY PURCHASING STRATEGY FOR THE GCR PLAN YEAR AND THE BALANCE OF THE 5-YEAR FORECAST PERIOD?

A. No, I do not. Consumers should continue the gas commodity purchasing strategy it has successfully used throughout the 1990s. Specifically, it should purchase approximately half of its GCR requirements under fixed price contracts with 12-month terms.

Q. WHAT CHANGES TO CONSUMERS' PORTFOLIO OF GAS PURCHASE CONTRACTS WOULD BE REQUIRED TO ACCOMPLISH THIS OBJECTIVE FOR THE CURRENT GCR PLAN YEAR?

A. Consumers would have to enter into additional fixed price contracts with an aggregate quantity of at least 150,000 Dth per day, and preferably closed to 200,000 Dth per day, to supplement its existing fixed price contracts shown in Exhibit A-____ (MJS-3).

Q. YOUR TESTIMONY IS NOT BEING FILED UNTIL EARLY APRIL, AND THE GCR PLAN YEAR HAS ALREADY BEGUN. HOW DOES THIS TIMING AFFECT YOUR RECOMMENDATION?

A. I believe it was unreasonable for Consumers to have failed to arrange any new fixed price contracts for the GCR plan year during the months immediately preceding its commencement. It was especially unnecessary and unreasonable for Consumers to enter into a large number of new contracts with index-based pricing for terms beginning April 1, 2001, as identified in the revised version of Mr. Shore's Exhibit A-____ (MJS-3). However, the benefits from using fixed price contracts have in past years been highes in the winter months, and there is still ample time for Consumers to procure fixed price contracts or obtain equivalent hedging arrangements for the commodity purchases it will be making during the winter months of the current GCR plan year, from November 2001 through March 2002.

Q. WHY IS IT APPROPRIATE FOR CONSUMERS TO CONTINUE TO PURCHASE HALF OF ITS GCR REQUIREMENTS UNDER FIXED PRICE CONTRACTS, AS IT DID IN THE 1990s?

A. This commodity purchasing strategy is appropriate because it best meets the needs of Consumers' customers, and it satisfies Consumers' obligations under Act 304.

Q. HOW DOES A RELIANCE ON FIXED PRICE CONTRACTS MEET THE REQUIREMENTS OF CONSUMERS' GAS SALES CUSTOMERS?

A. Most gas customers prefer price stability and some predictability about what future gas prices will be, even if those prices are changing and therefore not truly stable. Gas customers do not like to be surprised when they open their monthly bills, and what they like least are large, rapid, and unexpected increases in gas prices. The commodity gas purchasing strategy that I recommend, which relies on fixed price contracts with 12-month terms, is an excellent way of providing customers with the price stability and predictability they desire. Consumers' proposed strategy, in contrast, which is moving towards essentially complete reliance on spot market pricing, provide neither price stability nor any predictability about future prices. In circumstances like those experienced this past winter, it hits customers with exactly what they like least, which is large, rapid, and unexpected price increases.

Q. HOW DOES A GAS COMMODITY PURCHASING STRATEGY BASED ON FIXED PRICE CONTRACTS SATISFY CONSUMERS' OBLIGATIONS UNDER ACT 304?

A. Consumers has an obligation under Act 304 to minimize its GCR cost of gas. In today's gas market, the most appropriate way to interpret this requirement of Act 304 is to apply it to the management of price risk, and specifically to the avoidance of unnecessarily high purchased gas prices. Further, by purchasing half of its GCR requirements under fixed price contracts with 12-month terms, Consumers is more likely to minimize its costs than if it relies on spot and index-based pricing, as the Company is proposing.

Consumers' proposed strategy of relying on spot or index-based prices fails to meet the cost minimization requirement because it involves far too much price risk. Under Consumers' proposed strategy, Consumers would frequently pay the highest prices at which the gas supplies for some months are ever offered in the market, and such a result is the exact opposite of what Act 304 requires. A strategy of relying instead on fixed price contracts, as I recommend, does meet the requirements of Act 304 because it reduces the commodity price risk through diversification, and also because it avoids the danger of paying the highest possible price except for a small fraction of Consumers' total purchases.

Q. CAN YOU EXPLAIN YOUR POSITION IN MORE DETAIL?

A. Yes, but the best way to present that explanation is with an example relating to gas supplies to be purchased in a single month. I will use the month of October 2003 to illustrate this explanation, but the principles apply to purchases for any month.

The contract for gas to be delivered in October 2003 was trading on the NYMEX in late March 2001 at a price near $4.00 per Dth. That October 2003 contract has already been trading on the NYMEX since October 2000, and during this six-month period its price has ranged from a high of $4.46 per Dth to a low of $3.48. No one knows now how far the price of this October 2003 contract will go up or down (or perhaps both up and down, albeit at different times) between now and the end of September 2003, when trading of the October 2003 contract will end. The lowest price at which October 2003 gas supplies could be purchased will therefore not be known until September 2003. However, if Consumers tracks the price trends as they develop, and also investigates other sources of future supply between now and September 2002, the Company can make a prudent decision, ignoring hindsight, to obtain a price that avoids the highest price. In contrast, Consumers' proposed strategy abdicate**s** its responsibility to make a prudent decision about purchase timing, and instead wait**s** for the spot or index-based price for October 2003 supplies to appear in late September 2003. That strategy leaves far too much to chance.

Q. HOW DOES CONSUMERS' PROPOSED STRATEGY OF RELYING ON SPOT OR INDEX-BASED GAS PURCHASES EXPOSE CONSUMERS TO EXCESSIVE PRICE RISK?

A. Consumers' proposed strategy is to purchase all of its gas supplies for any one month (except those supplies already under contract in its existing fixed price contracts) at or near a single price, namely the spot market or first-of-the-month price available during bid week, which occurs near the end of the prior month. Continuing the example I have been using, all of Consumers' purchases for October 2003 would be priced at the prices available during the last week of September 2003. None of these purchases would be made at any of the prices available for the October 2003 gas purchase contract during the preceding 35 months, from October 2000 through August 2003; but October 2003 gas supplies will have been readily available for purchase on the NYMEX and from other suppliers throughout the 35 months preceding September 2003.

A second problem with Consumers' proposed strategy is that the determination of the prices for each month's purchases is concentrated in bid week, which is precisely the time when price risk is highest. As Mr. Shore himself points out at page 17 of his testimony, and as he illustrates in his Exhibit A-____ (MJS-9), there is "extreme daily variance in [the] prices for front month contracts." But "front month" contracts are the contracts for gas supplies to be delivered in the immediately following month, so Consumers' proposed strategy is therefore to purchase all of its gas supplies under "front month" pricing, when price volatility and therefore price risk is extremely high. Prices for more distant months, in contrast, are much less volatile than front month prices, so a strategy of using fixed price contracts with 12-month terms automatically uses prices subject to much less price volatility and therefore less price risk than the spot and index-based pricing strategy proposed by Consumers.

The most serious price risk in Consumers' proposed strategy is the risk of price spikes that may occur in the spot market. There have been numerous monthly gas contracts for which the highest price occurred in the last month the contract was traded on the NYMEX, often in the last week of trading. For some contracts, including January 1997 and January 2001, the spot or index price, which is based on trading in that last month, has been $1.00 per Dth higher than the highest price paid for that month's gas supplies in the forward market at any prior time. Consumers' proposed strategy thus courts the danger of paying the highest possible price for all of its gas supplies in some months. It is completely unnecessary and unreasonable for Consumers to use a pricing strategy that exposes its customers to this danger.

Q. HOW DOES A STRATEGY OF RELYING ON FIXED PRICE CONTRACTS WITH 12-MONTH TERMS REDUCE PRICE RISK THROUGH DIVERSIFICATION?

A. It reduces price risk because the gas supplies for any one month would be purchased at a variety of different prices. The prices would be different because the supplies for any one month would be purchased under many different 12-month contracts, and these 12-month contracts would have different prices because they would have been entered into at different times and under different gas market conditions.

In the October 2003 example that I have been discussing, some supplies would be purchased in the spot market, at prices available during bid week in September 2003, but most of these supplies would be purchased instead under fixed price contracts. Some of those fixed price contracts might be entered into as early as the summer of 2002, for purchases spanning the 12-month period from November 2002 through October 2003. Other might be entered into during the first few months of 2003, for supplies to be purchased during the 12 months from April 2003 through March 2004. Indeed, with a gas purchase program as large as Consumers' is, it would be feasible for the Company to purchase one or more 12-month contracts for a total volume of at least 15,000 Dth per day to begin in each and every calendar month, and to maintain a portfolio with staggered start and expiration dates. Consumers could thus maintain pricing diversity within a portfolio of fixed price contracts, and thus it would greatly reduce the price risk of purchasing gas supplies for October 2003 (or for any other month) at the "wrong" time, when prices for that month happen to be high. This strategy may also help achieve lower prices for Consumers, because it may help satisfy sellers' desires for a reliable revenue stream.

Q. HAS CONSUMERS EXPLAINED WHY IT IS PROPOSING TO SHIFT ITS GAS COMMODITY PURCHASING STRATEGY AWAY FROM FIXED PRICE CONTRACTS, AND MOVE INSTEAD TOWARDS RELIANCE ON SPOT AND INDEX-BASED PRICING?

A. Yes, at page 9 of his testimony, Company witness Shore claims that Consumers' past policy of using fixed price contracts "to maintain a stable and predictable [gas] price" is "obsolete." He alleges three reasons to support his position. The first is that December 2000, when Mr. Shore was preparing his testimony for this proceeding, was the wrong time to enter into fixed price contracts because gas prices were at their all-time highs. The second is that Consumers does not know how much gas to purchase under fixed price arrangements, because of the risk of loss of load to the Gas Customer Choice

(GCC) program. Mr. Shore's third claim is that a reliance on spot or index-based contracts is appropriate because it is needed to promote gas supply competition.

Q. DO MR. SHORE'S THREE CLAIMS ON THIS ISSUE SUPPORT THE COMPANY'S POSITION?

A. No, they do not. None of these three arguments provides support for a reliance on spot or index-based pricing for all of Consumers' purchases of its GCR gas supplies.

Q. WHAT IS WRONG WITH MR. SHORE'S OBJECTION THAT THE USE OF FIXED-PRICE CONTRACTS IS "OBSOLETE" BECAUSE GAS PRICES WERE AT AN ALL-TIME HIGH DURING 2000?

A. There are two errors in Mr. Shore's argument. The first is factual. He refers to "prices in excess of $9.00 per Mcf, triple the level they were at the beginning of 2000", and that "[e]ntering into any long-term agreements at these prices would be ill-advised." But the prices exceeding $9.00 per Mcf were only for the front month contracts, and occasionally for the month following the front month (*i.e.,* for the February contract during December trading, and for the March contract during January trading). The prices for 12-month contracts never came anywhere near $9.00, and prices for the 12-month period from April 2001 through March 2002 -- the GCR plan year -- have never been much above $6.00 per Dth on the NYMEX. The extremely high prices that Mr. Shore claims make 12-month contracts "obsolete" are prices that Consumers would have been paying only under its proposed new strategy of relying on spot and index-based pricing. If Consumers were using the allegedly obsolete strategy of relying on 12-month contracts, it would have avoided these extremely high prices. Thus the facts actually support a conclusion exactly opposite to the one Mr. Shore proposes.

The second error in Mr. Shore's argument is a logical one. This logical error is his implicit assumption that the only alternative to his proposed policy of relying on spot prices and index-based contracts was to purchase the total requirements for the entire GCR plan year in December 2000, when gas market prices were at an all-time high. But that assumption is absurd. The use of 12-month contracts is entirely consistent with entering into one or more new 12-month contracts each month throughout the year, as I have explained. Under this most appropriate method for implementing a policy of reliance on 12-month fixed price contracts, Consumers would each month be contracting for essentially the same quantity of gas as it would under Mr. Shore's proposed new policy. The only difference would be whether the new contracts each month were for spot purchases or for 12-month purchases at fixed prices.

Q. WHAT IS WRONG WITH MR. SHORE'S CLAIM THAT CONSUMERS' GCR SALES MAY DECREASE AS CUSTOMERS SWITCH TO THE GAS CUSTOMER CHOICE PROGRAM, AND THAT THE USE OF LONG-TERM CONTRACTS THEREFORE EXPOSES CONSUMERS TO THE RISK OF STRANDED COSTS?

A. Mr. Shore's argument might perhaps be a valid criticism of strategies that would rely on contracts with terms two or more years and use them for all or almost all of Consumers' GCR requirements. But that is not my recommendation. I am recommending that Consumers maintain a portfolio with approximately 300,000 Dth per day of gas supplies under 12-month contracts. This policy would provide an annual city gate supply of approximately 100 Bcf, or about half of Consumers' projected GCR gas sales requirements. If the contract expiration dates are staggered as I recommend, then Consumers could each month reduce the quantity under contract by 8 Bcf, simply by not replacing the contracts which expired that month, and it is extremely unlikely that customers will migrate so quickly to the Choice program. Further, only a maximum of

40% of Consumers' customers will be permitted to choose alternative suppliers during the current GCR plan year, so there is no risk at all that Consumers' GCR sales load will fall below the 100 Bcf level during this GCR plan year.

Nor is there much risk for the following GCR plan year, when the Choice program cap is raised to 60% of Consumers' customers. If migration is near the first-year cap of 40% by next winter, and GCR sales have fallen to an annual level near 150 Bcf, then my recommendation would be for Consumers to purchase only 75 Bcf under 12-month fixed price contracts for the GCR plan year beginning April 2002. And for that GCR plan year, the GCC participation cap at 60% of Consumers' customers would leave GCR sales loads far above 75 Bcf.

The potential load loss risk does not increase to 100% until April 2003. I expect that the evidence accumulated by then will demonstrate that migration to the GCC program remains slow enough to be accommodated by a policy of using staggered 12-month contracts for half the GCR sales requirements, but if not, then there will be ample time to review and modify this policy then. For the present, however, Mr. Shore's stated concern about the risk of loss of loads is misplaced with regard to my recommended strategy for using 12-month fixed price gas purchase contracts.

Q. WHAT IS WRONG WITH MR. SHORE'S ARGUMENT THAT A RELIANCE ON SPOT OR INDEX-BASED CONTRACTS IS APPROPRIATE BECAUSE IT IS NEEDED TO PROMOTE GAS SUPPLY COMPETITION?

A. First, I do not agree that the only or even the best way to promote competition is to have Consumers change its gas purchasing strategy to one of reliance on spot purchases or index-based contracts. But even if it were correct that Consumers' gas purchasing strategy did have an important effect on competition, I do not agree that this effect would be an appropriate reason for Consumers to rely on spot and index-based purchasing.

Q. WHY DO YOU DISAGREE WITH MR. SHORE'S VIEW THAT HIS PROPOSED NEW GAS PURCHASING STRATEGY IS NEEDED TO PROMOTE GAS SUPPLY COMPETITION?

A. Mr. Shore refers to the collaborative process and the Staff Report in Case No. U-12550. But the problems identified in Case No. U-12550 relate specifically to the consequence of the three-year price freezes adopted for Consumers, MichCon, and SEMCO Energy Gas Company. The use of 12-month fixed price contracts with staggered terms will keep Consumers' gas costs much closer to gas market conditions than did the three-year freeze, and there is no basis in the U-12550 consensus for concluding that other gas suppliers cannot reasonably compete against GCR sales based on 12-month fixed price gas purchase contracts. Indeed, 12-month fixed price contracts are exactly what most suppliers offer to small customers in Consumers' GCC and in customer choice programs elsewhere in the United States. If other suppliers are unable to compete with Consumers when Consumers uses the same gas purchasing strategy that the suppliers are offering to potential Choice program customers, it is wrong to blame Consumers' use of this gas purchasing strategy for any supplier's inability to compete. A strategy emphasizing 12-month fixed price contracts actually provides the closest possible match to the gas market conditions relevant for gas supply competition, because it matches the gas market conditions that most other suppliers are offering to potential customers. Consumers' proposed reliance on spot and index-based purchases, in contrast, is frequently out of touch with the gas market conditions relevant for competition, because the prices that most other suppliers will be offering to their customers are prices based on the 12-month gas futures prices, <u>not</u> the spot prices for the current front month.

Q. WHY DO YOU DISAGREE WITH MR. SHORE'S CLAIM THAT THE APPROPRIATENESS OF CHANGING CONSUMERS' GAS PURCHASING STRATEGY SHOULD BE BASED ON ITS EFFECT ON COMPETITION?

A. I disagree because Mr. Shore has failed to distinguish between the fortunes of Consumers' competitors in the gas supply market and the process of competition ~~there~~. Mr. Shore sees Consumers' use of a spot and index-based gas purchasing strategy as beneficial to competition because Consumers' competitors would prefer to compete against this strategy than against the one I am recommending, which relies primarily on the same gas purchasing strategy that the competing suppliers themselves use. But, the process of competition is not advanced by gas purchasing strategies that benefit Consumers' competitors; it is advanced instead by gas purchasing strategies that benefit Consumers' customers. The presence of competitors is merely a means to the end of providing customers with the products and services they want, at the lowest costs available for supplying those products and services. Mr. Shore's proposed strategy would deliberately sacrifice the objective desired by Consumers' gas sales customers, merely to make it possible for other gas suppliers to enter the Michigan retail gas supply market. No such policy is necessary or appropriate at this time.

<u>Consumers' Requested "Market Volatility" Component of $1.00 per Mcf</u>

Q. PLEASE TURN NOW TO THE SECOND ISSUE YOU HAVE IDENTIFIED, AND DESCRIBE CONSUMERS' REQUESTED "MARKET VOLATILITY" COMPONENT OF $1.00 PER MCF.

A. Consumers is requesting a GCR factor of $5.6862 per Mcf. This proposed factor consists of two parts: a projected GCR cost of gas of $4.6862 per Mcf, and a "market volatility" component of $1.00. The market volatility component is thus an increment to

Consumers' proposed GCR factor, above and beyond the Company's own projection of its cost of purchased gas.

Q. DO YOU AGREE WITH THE COMPANY'S REQUEST TO INCLUDE A MARKET VOLATILITY COMPONENT IN THE GCR FACTOR?

A. No, I do not. The factor should be set at $4.6862, which is Consumers' projected GCR cost of purchased gas.

Q. WHY DO YOU OPPOSE THE INCLUSION OF A MARKET VOLATILITY COMPONENT IN THE GCR FACTOR?

A. Consumers' proposed market volatility component should be rejected for at least two reasons. First, it is an unnecessary and improper intrusion into the GCR process. Second, it will impair competition between Consumers and other suppliers in Consumers' service territory.

Q. COMPANY WITNESSES SHORE AND BELKNAP BOTH CLAIM THAT THE MARKET VOLATILITY COMPONENT IS NEEDED TO PERMIT TIMELY ADJUSTMENT OF THE GCR FACTOR IN RESPONSE TO CHANGES IN CONSUMERS' PURCHASED GAS COSTS. WHY DO YOU DISAGREE?

A. This view is based on the premise that Consumers should and will purchase almost all of its GCR requirements at spot or index-based prices, which are indeed volatile. However, as I have explained at length, this commodity purchasing strategy is unreasonable and imprudent, and Consumers should instead rely on fixed-price contracts with 12-month terms for half of its GCR requirements. If Consumers does so, then a market volatility component is not needed, because it will be possible for Consumers to anticipate its gas costs with sufficient accuracy to establish stable GCR factors.

Q. CAN YOU EXPLAIN IN MORE DETAIL HOW THE USE OF FIXED PRICE CONTRACTS WITH 12-MONTH TERMS WILL MAKE GCR GAS COSTS MORE PREDICTABLE?

A. Consumers plans to purchase approximately 125 Bcf of GCR gas supplies during the six months April through September 2001, as indicated in Mr. Shore's Exhibit A-____ (MJS-1). If Consumers uses fixed price contracts as I recommend, it should have purchased roughly half that quantity under fixed price contracts by the beginning of the GCR plan year. But Consumers only expects its GCR sales during the seven months April through October to be about 65 Bcf, so Consumers will already know -- by the beginning of the GCR plan year -- the actual cost of almost all the gas it will be selling during the seven summer months at the beginning of the GCR plan year.

By the end of August, Consumers will have purchased its supplies for the months April through August, and it will know the prices for all of its September purchases, including those in the spot market or at index-based prices. Consumers will therefore have actual costs for the 125 Bcf of gas it plans to purchase during the first six months of the GCR plan year. This information will also give Consumers an extremely good estimate of the cost per Mcf for the gas that will be in storage as of the end of October. By the end of August, therefore, Consumers will know the cost of the gas that will be withdrawn during the coming winter months.

Consumers plans to purchase the remaining 100 Bcf of its annual GCR requirements during the six months October 2001 through March 2002. If Consumers uses fixed price contracts as I recommend, it will have half that quantity under contract by the end of August. It will therefore know at that time the actual cost of all but 50 Bcf of its GCR plan year requirements of 226 Bcf. It would therefore be possible for Consumers to make an interim filing at the end of August, to adjust its GCR factor beginning November, with enough actual gas cost information to avoid any unreasonably large under- or over-recoveries.

Q. WHY WOULD THE INCLUSION OF A MARKET VOLATILITY COMPONENT BE AN IMPROPER INTRUSION INTO THE GCR PROCESS?

A. It would be improper because it is essentially a procedure to permit Consumers to charge whatever GCR factors it chooses, and to vary these factors throughout the year without any oversight by the Commission.

The inclusion of a market volatility component would be improper also because it destroys the price certainty that GCR customers desire. Consumers should minimize the price risk in its gas acquisition procedures, as I have explained, because its GCR customers want to minimize the price risk in their own consumption of natural gas. But the approval of a GCR factor with a market volatility component is sending customers the message that Consumers does not know what price it will be charging during the GCR plan year. One of the underlying purposes of the GCR process was and is to make gas costs more predictable for customers, and a market volatility component would undermine that objective.

Q. WHY WOULD THE INCLUSION OF A MARKET VOLATILITY COMPONENT IN THE GCR FACTOR UNDERMINE COMPETITION BETWEEN CONSUMERS AND OTHER GAS SUPPLIERS CATERING TO RETAIL CUSTOMERS IN THE CONSUMERS SERVICE TERRITORY?

A. It would impair competition because it does not meet the requirements that Consumers' own tariff imposes on all the other suppliers with whom Consumers would be competing.

As Mr. Belknap explains, tariff rules H2.E and H4 require that the marketing materials and contracts used by other suppliers to sell gas to residential customers must state the fixed price offered by the supplier, and if the supplier does not offer a fixed price, the pricing mechanism must be clearly explained. But for itself, Consumers is asking for the freedom to change the price for residential gas sales each month, and to do so in a range with no floor and with a ceiling $1.00 per Mcf higher than Consumers' own estimate of the GCR cost of gas for the GCR plan year. That approach can only serve to confuse Consumers' retail customers, and make it more difficult for them to compare Consumers' gas sales service under the GCR with the gas sales offers of other suppliers under the GCC program.

Q. HAVE YOU ANY FURTHER COMMENTS ABOUT CONSUMERS' REQUEST FOR A MARKET VOLATILITY COMPONENT?

A. Yes. This request provides an additional perspective on Consumers' proposed gas purchasing strategy of relying on spot and index-based pricing for as much of its gas supplies as possible. The Company's witnesses express a concern that Consumers' GCR cost of gas for the GCR plan year may actually be as high as $5.6862. But in December 2000, Consumers could have locked in a gas cost near the Company's ~~own~~ estimate of $4.686, or $1.00 per Mcf less than the requested GCR factor, if Consumers purchased its GCR gas supplies under fixed price contracts with 12-month terms. It therefore would be unreasonable and imprudent for Consumers to purchase its GCR gas supplies at a price as high as $5.6862 when gas was actually available at a cost of $4.686 when the GCR plan was filed.

Pipeline Capacity

Q. WHAT ISSUES HAVE YOU IDENTIFIED WITH REGARD TO PIPELINE CAPACITY?

A. I have identified three issues.

(a) The first issue is the question whether Consumers has sufficient interstate pipeline capacity to meet its GCR gas sales obligations and also its obligations as supplier of last resort for its GCC customers.

(b) The second issue is the question of who should pay the fixed costs of that pipeline capacity. If some of the capacity is needed principally to meet Consumers' obligations as supplier of last resort for its GCC customers, then GCC customers should pay the fixed costs of that capacity.

(c) The third issue is affiliate relationships. Consumers parent company, CMS Energy, has acquired Trunkline and Panhandle. As a consequence of this acquisition, Consumers is now purchasing a majority of its pipeline capacity from affiliated companies. Because of this affiliate relationship, Consumers' pipeline capacity portfolio requires especially careful scrutiny, particularly with regard to the prices and other terms and conditions of capacity purchased from its new affiliates.

Q. IS THERE A PROBLEM WITH THE SUFFICIENCY OF CONSUMERS' INTERSTATE PIPELINE CAPACITY TO MEET ITS GCR GAS SALES OBLIGATIONS AND ALSO ITS OBLIGATIONS AS SUPPLIER OF LAST RESORT FOR ITS GCC CUSTOMERS?

A. I am not aware that the present capacity is a problem in this regard. However, the Company's witnesses say very little about this issue, with only some very general comments by Mr. Shore at pages 5-6 of his prepared testimony. Consumers should be instructed to address this issue in much greater detail in its next GCR plan and 5-year forecast. In particular, Consumers should state how and at what level it intends to protect against the loss of gas supplies required from suppliers participating in the GCC program, and it should justify the selected protection plan.

It is also important for Consumers to maintain a portfolio of interstate pipeline capacity sufficient to obtain a large fraction of its total GCR gas sales requirements from out-of-state gas supply sources, just as it does now. This interstate capacity is needed to avoid an excessive dependence upon Michigan production, because such dependence might impair Consumers' ability to obtain fair and reasonable prices.

Q. IS THERE A PROBLEM WITH PIPELINE CAPACITY IN CONSUMERS' PORTFOLIO OF GCR GAS SUPPLY RESOURCES, WHICH IS NEEDED ONLY OR PRIMARILY TO MEET CONSUMERS' OBLIGATIONS AS SUPPLIER OF LAST RESORT FOR CUSTOMERS IN THE GCC PROGRAM?

A. Again, I am not aware that there is such a problem at the present time. Consumers' is planning to use its pipeline capacity at a high load factor to serve its projected GCR gas sales loads, at least in the current GCR plan year. However, Consumers should be instructed to address this issue in future GCR plan cases, especially if the level of participation in its GCC program increases.

Q. IS THERE A PROBLEM WITH CONSUMERS' AFFILIATE RELATIONSHIPS?

A. Yes, I have identified one possible problem. In a supplemental filing made March 23, 2001, Consumers updated several of its exhibits, including Mr. Shore's Exhibit A-____ (MJS-2), which identifies the Company's interstate pipeline contracts. The one change in the revised Exhibit A-____ (MJS-2) is a new contract with Panhandle for 60,000 Dth per day of transportation capacity for the months April through October 2001. According to the exhibit, this new contract was entered into on March 9, 2001. Neither the new contract nor Consumers' intent to enter into such a contract were disclosed to the parties in this proceeding until Consumers' responses to discovery, served approximately one week before the March 23 supplemental filing.

Q. WHAT ARE THE POSSIBLE PROBLEMS WITH THIS CONTRACT?

A. One problem is the price. Consumers has apparently agreed to pay Panhandle a fee of 20 cents per Dth plus fuel for transportation under this contract, which relates only to the summer months. However, pipeline transportation has generally been available under capacity release during the summer months. Consumers should therefore be required to justify paying its affiliate a transportation charge of 20 cents per Dth plus fuel, and to show that the use of the Panhandle capacity at this price is less expensive than other available alternatives, including supply from other producing areas such as the Gulf Coast.

A second problem is the term of the contract. Because it is less than 12 months, it is my understanding that under FERC regulations Consumers will not have a right of first refusal for extension of the contract when its term expires. If the capacity is needed now, then Consumers should explain why it was prudent to acquire capacity without also obtaining a right of first refusal.

Owing to the time at which this contract was first presented by Consumers in the current proceeding, I recommend that Consumers be required to demonstrate the reasonableness and prudence of this contract in its GCR reconciliation for the GCR plan year ending March 2002, rather than in the present GCR plan proceeding. The mere filing of the revised exhibit disclosing this contract does not even begin to justify its reasonableness and prudence. On the other hand, I would not want to penalize Consumers for disclosing this new contract during the pendency of its GCR plan proceeding, rather than waiting until the end of the proceeding, so I am not recommending any disallowances at this time.

Q. DOES THIS CONCLUDE YOUR PREPARED DIRECT TESTIMONY?

A. Yes, it does.