

STATE OF MICHIGAN
STATE OFFICE OF ADMINISTRATIVE HEARINGS AND RULES
FOR THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of)	
CONSUMERS ENERGY COMPANY)	
for authority to increase its rates for the)	Case No. U-14547
distribution of natural gas and other relief.)	
_____)	

NOTICE OF PROPOSAL FOR DECISION

The attached Proposal for Decision is being issued and served on all parties of record in the above matter on July 14, 2006.

Exceptions, if any, must be filed with the Michigan Public Service Commission, P.O. Box 30221, 6545 Mercantile Way, Lansing, Michigan 48909, and served on all other parties of record on or before August 2, 2006, or within such further period as may be authorized for filing exceptions. If exceptions are filed, replies thereto may be filed on or before August 16, 2006. **The Commission has selected this case for participation in its Paperless Electronic Filings Program. No paper documents will be required to be filed in this case.**

At the expiration of the period for filing of exceptions, an Order of the Commission will be issued in conformity with the attached Proposal for Decision and will become effective unless exceptions are filed seasonably or unless the Proposal for

Decision is reviewed by action of the Commission. To be seasonably filed, exceptions must reach the Commission on or before they are due.

STATE OFFICE OF ADMINISTRATIVE
HEARINGS AND RULES
For the Michigan Public Service Commission

**James N.
Rigas**

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James N. Rigas
Administrative Law Judge

July 14, 2006
Lansing, Michigan
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PROPOSAL FOR DECISION

Issued and Served: July 14, 2006

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PROPOSAL FOR DECISION

HISTORY OF PROCEEDINGS

Consumers Energy Company (Consumers Energy or the Company) is a public utility engaged in purchasing, storing, transporting, distributing, and selling natural gas to more than 1.7 million customers in the State of Michigan. The gas system of Consumers Energy is an integrated and interconnected entity and is operated as a single utility system in which the same rates and tariffs apply.

Prior to the commencement of this proceeding, Consumers Energy's rates were last reviewed by the Michigan Public Service Commission (Commission) on October 14, 2004 in Case No. U-13730. As a result of that review the Commission authorized Consumers Energy to increase annual gas revenues for a two-year period by \$58.1 million above levels established in the November 7, 2002 order in Case No. U-13000. The Commission also directed Consumers Energy to file a general gas rate case on or before the expiration of the increase authorized in Case No. U-13730.

Consumers Energy filed this application with the Commission on July 1, 2005 requesting authority to increase its rates for the distribution of natural gas by \$132.4 million annually and that the Commission make permanent the \$58.1 million annual increase established in Case No. U-13730. Consumers Energy asks the Commission to set rates that will produce a rate of return on common equity of not less than 12.00% and an overall rate of return of not less than 7.09% on an after-tax basis. In addition, Consumers Energy requests the Commission to approve other modifications of its rates, rules, and regulations.

Contemporaneous with this application Consumers Energy filed a motion for partial and immediate (interim) rate relief pursuant to Section 6a of 1939 PA 3, as amended, MCL 460.6a, seeking an interim rate relief increase of \$75.1 million above levels established in Case No. U-13730.

Pursuant to due notice a prehearing conference was conducted by this Administrative Law Judge on August 10, 2005. At that time Attorney General Michael A. Cox (Attorney General), the Association of Businesses Advocating Tariff Equity (ABATE), the Michigan Schools Electric Cooperative and the National Energy Marketers Association (NEMA) were recognized as intervenors. The Staff also entered its appearance and participated in the case. A schedule was then established for the remainder of the proceeding.

On November 14 and 15, 2005 the evidentiary hearing on Consumers Energy's interim rate relief request took place. Consumers Energy presented the testimony and exhibits of six witnesses. Staff presented the testimony of a single witness who

sponsored the Staff Report. The Attorney General also presented the testimony of a single witness.

On December 2, 2005, Consumers Energy, Staff, the Attorney General and ABATE filed briefs addressing Consumers Energy's motion for interim rate relief.

The evidentiary hearing in this matter reconvened on March 20-23, and 27, 2006. Consumers Energy presented the testimony of 10 witnesses and Exhibits A-1 through A-96. Staff presented the testimony of 11 witnesses and Exhibits S-1 through S-22. The Attorney General presented the testimony of three witnesses and Exhibits AG-1 through AG-59. ABATE presented the testimony of a single witness who sponsored Exhibits AB-1 through AB-4. NEMA presented the testimony of a single witness.

Pursuant to the established schedule Briefs and Reply Briefs have been filled by Consumers Energy, Staff, the Attorney General ABATE and NEMA.

On May 10, 2006 the Commission issued its order granting Consumers Energy interim relief in the annual amount of \$18,434,000. The Commission also approved a temporary extension of the two-year rate increase approved in Case No. U-13730 until such time as the final order is issued in this proceeding.

POSITIONS OF THE PARTIES

Consumers Energy

Consumers Energy's final rate request case was supported by the testimony and exhibits of 10 witnesses, Mr. Glenn P. Barba, Mr. James F. Bearman, Ms. Elizabeth A. Curtis, Mr. Herbert B. Kops, Mr. Gary L. Kelterborn, Mr. Wayne M. Leja, Mr. Hubert W. Miller, III, Mr. Paul N. Preketes, Mr. Ronn J. Rasmussen and Mr. Thomas J. Webb. At

this time Consumers Energy is requesting final rate relief in the amount of \$118,166,000 based on a 2004 historical test year, adjusted to projected 2006 level of expenses and revenues.¹ Consumers Energy's final rate relief request is based on a recommended capital structure that includes common equity of 35.60%, long-term debt of 48.36%, and preferred stock of 0.49%. Consumers Energy is requesting a rate of return on equity of not less than 12% and an overall after tax rate of return of 7.19%.² Consumers Energy also asks that the \$58,124,000 increase authorized in Case No. U-13730 be made permanent. Consumers Energy has accepted Staff's position regarding rate design.

Staff

Staff's final rate relief recommendation case is supported by the testimony and exhibits of 11 witnesses, Mr. William G. Aldrich, Mr. Brian Ballinger, Mr. Daniel M. Birkam, Mr. Michael L. Collins, Ms. Lisa M. Kindschy, Mr. Steven D. Koehler, Mr. Kirk D. Megginson, Mr. Robert G. Ozar, Ms. Heidi J. Raymond, Ms. Susan J. Sims, and Mr. Robert E. Tuttle. Staff recommends the approval of \$70.7 million of final rate relief, based on the 2004 historical test year, adjusted for known and measurable changes through 2005.³ Staff's recommendation is based on a capital structure that includes common equity of 40.92%, long-term debt of 58.44% and preferred stock of 0.63%.⁴ Staff recommends including a short-term debt balance of \$90 million in the ratemaking capital structure. Staff recommends a rate of return on equity range of 10.90% to 11.40% and adopts the range's midpoint of 11.15% in its overall cost of capital

¹ Consumers Energy Initial Brief, App. A.

² *Id.* App. E.

³ Exhibit S-2, Schedule A-1.

⁴ Exhibit S-5, Schedule D-1.

determination. Staff recommends an overall after tax rate of return of 6.64%.⁵ Finally, Staff proposes that the resulting revenue deficiency be recovered from customer rate classes on an equal percent of revenue basis, excluding gas costs.

The Attorney General

The Attorney General's position was supported by the testimony and exhibits of three witnesses, Mr. Charles W. King, Mr. Michael J. McGarry, and Ms. Donna H. Mullinax. The Attorney General recommends final rate relief in the amount of \$55,069,000.⁶ The Attorney General's recommendation is based on a capital structure including common equity of 38.24%, long-term debt of 56.01%, short-term debt of 5.16% and preferred stock 0.59%.⁷ The Attorney General recommends a rate of return on equity of 9.78% with an overall after tax rate of return of 6.14%.⁸

ABATE

ABATE's position was supported through the testimony of a single witness, Mr. Nicholas Phillips, Jr. ABATE takes the position that anything higher than an 11.0% return on equity for Consumers Energy's is unwarranted. With regard to rate design, ABATE opposes the Staff proposal for an equal percentage increase to all rates with the exception of Rate GL. ABATE supports a rate allocation of 23% to sales customers and 18% to transportation customers.

⁵ 6 Tr. 1055-57.

⁶ Exhibit AG-59 (Revised May 4, 2006).

⁷ Attorney General Initial Brief p. 33.

⁸ Exhibit AG-11 (Revised May 4, 2006).

NEMA

NEMA supported its position through the testimony of a single witness, Mr. Scott White. NEMA asks that the Commission order certain changes to Consumers Energy's Gas Customer Choice Program, or in the alternative, initiate a working group to address issues related to the delivery of gas to customers of competitive gas suppliers participating in gas choice programs in Michigan.

TEST YEAR

In each rate case, a test year must be selected. A test year is a device employed to determine representative levels of revenues, expenses, rate base and capital structure for use in the rate-setting formula. A test year may be historical, future or a combination of historical and future data. A historical test year employs actual operating data that is ordinarily adjusted for known and measurable changes. A future test year uses projections to determine the levels of revenues, expenses, rate base and capital structure for a future period of time.

Consumers Energy, Staff and the Attorney General utilized a 2004 historical test year, adjusted for known and measurable changes to arrive at a 2006 projected test year. The differences in the parties' respective determinations center around how various known and measurable changes should be calculated. Consumers Energy, in its Initial Brief, accepted the Staff's total net plant and working capital balances and Staff's Other O&M expense level, with four limited exceptions.

Based upon the record presented, the Administrative Law Judge recommends that the Commission adopt a 2004 historical test year adjusted for known and measurable changes to arrive at a 2006 test year.

RATE BASE

Consumers Energy, Staff and the Attorney General have addressed the issue of the appropriate rate base for this proceeding. In Exhibit A-8, Consumers Energy identified a 2006 rate base totaling \$2,279,606,000. In Exhibit S-3, Schedule B-1, the Staff identified a 2006 rate base totaling \$2,250,633,000. In Exhibit AG-59, the Attorney General identified a 2006 rate base totaling \$2,128,387,000. These rate base amounts include three components; net utility plant, working capital and unamortized expenses for environmental cleanup costs at former manufactured gas plant sites

In its Initial Brief, Consumers Energy accepted the Staff level for net plant and working capital for purposes of developing rate base. Consumers Energy identifies a difference of \$614,000 between its proposed rate base of \$2,251,247,000 and Staff's proposed rate base of \$2,250,633,000 relating to the amount of the unamortized MGP remediation costs to be included in rate base.

The Attorney General recommends reducing net utility plant for construction work in progress (CWIP). The Attorney General also recommends a \$107,674,594 reduction in working capital for storage gas. Finally, the Attorney General asks the Commission to reconsider its prior decisions and find that MGP costs are not legally recoverable current costs of service.

Construction Work in Progress

Exhibit S-3, Schedule B-1 identifies \$33,968,000 for CWIP. Staff used Consumers Energy's average of 2003 and 2004 CWIP year-end balances in Net Plant and adjusted for the five-year average of new customer construction.

The Attorney General takes the position Consumers Energy should not be allowed to include CWIP in its plant-in-service. The Attorney General argues using the average of 2003-2004 amounts, which is already included in plant-in-service, effectively double counts a volatile annual number and significantly increases revenue requirements. Since 2006 capital additions have been included in Consumers Energy rate base, the Attorney General asserts revenue requirements should not be increased by a significant estimate of CWIP related to plant that will not be used and useful or in service during 2006. At most, the Attorney General states the Commission should adopt Consumers Energy original amount of \$21,086,000.

The Administrative Law Judge finds the Attorney General's position with respect to CWIP unpersuasive. Consumers Energy correctly observes that there was a CWIP balance at the end of the historical period and there is a CWIP balance at the end of the projected 2006 test year. Further the Commission has a longstanding policy of including CWIP in the rate base with a corresponding offset of Allowance for Funds Used During Construction in the income statement.

Finally the writer agrees with the Staff that the purpose of projecting 2006 CWIP is to take into account that Consumers Energy will in fact have construction work in progress costs for that year and to estimate the average dollar amount of those costs.

Accordingly the Administrative Law Judge recommends that the Commission adopt Staff's calculation for net utility plan of \$1,254,716,021 including \$33,968,000 for CWIP.

Working Capital

Staff calculated 2006 test year balance sheet working capital of \$975,832,000. (See Exhibit S-3, Schedule B-3). Staff states its determination is consistent with the balance sheet working capital methodology prescribed by the Commission in its June 11, 1985 order in Case No. U-7350. Consumers Energy has accepted Staff's determination.

The Attorney General represents the volume and working capital cost supported by the Staff in this case is significantly higher than that adopted by the Commission for ratemaking purposes in Case No. U-13730. The Attorney General recommends a \$107,674,594 reduction in working capital for storage gas. (See Exhibit AG-58).

The Attorney General states that Consumers Energy calculated a 13-month average of 130,051 MMcf of natural gas in storage and an average cost of gas in storage of \$954,202,000. (See Exhibit A-32, page 2). The Attorney General states further that the Staff calculated a 13-month average of 131,616 MMcf of natural gas in storage and an average cost of gas in storage of \$1,061,620,000. (See Exhibit S-3, Schedule B-3-1). The Attorney General notes the Commission adopted an average gas storage inventory balance totaling 115,377,866 Mcf at a working capital cost of \$741,879,681 in its October 14, 2004, Opinion and Order in Case No. U-13730.

The Attorney General maintains that neither the testimony submitted by either Consumers Energy or the Staff supports increasing the volume in inventory above that used by the Commission for setting rates in Case No. U-13730. The Attorney General

contends that no explanation was offered as to why or how customers benefit from increasing the storage volumes by approximately 14,600,000 Mcf and gas inventory working capital by approximately \$319.7 million. The Attorney General concludes the record does not demonstrate that the changes are just and reasonable and therefore recommends that the Commission reduce working capital by \$107.675 million.

Staff states its determination of 2006 net working capital requirements is based on historical working capital requirements adjusted for known and measurable changes. Staff represents it replaced forecasted volumes and costs from April through December 2005 with the booked volumes and used more recent NYMEX futures prices to estimate the cost of gas injected into storage in the forecasted months.

With regard to volume of gas in storage, Staff states its 13-month average volume of gas in storage is comparable to the previous two years of booked volumes. The 13-month average volume of gas in storage for December 2003 to December 2004 was 130,401 MMcf and the average volume for December 2004 to December 2005 was 129,821 MMcf (See Exhibit S-3, Schedule B-3-1, lines 14 and 28). Staff observes its proposed volume of gas in storage of 131,616 MMcf is within 0.9% of the 13-month 2004 volume and 1.4% of the 13-month 2005 volume.

Staff states it did not price gas in storage for working capital solely at NYMEX prices. Only one component of storage, summer injections, was re-priced using more current NYMEX information because the purchases were yet to be made. Staff states that gas withdrawals made during the months of November 2005 through March 2006 are withdrawn at the average cost of gas in storage, which is derived from booked prices and volumes already in storage and does not change over the winter. As a result

the cost of gas in storage is primarily determined by the volume of gas that was in storage from the previous injection season. Staff contends that its update does not begin to impact the cost of gas in storage until injections are made in April of 2006.

Finally, with regard to the Attorney General's reliance on Case No. U-13730, Staff points out that in that case the Commission employed an alternative method to determine a conceptual volume (115,377,866 Mcf) in conjunction with an increase in the cost per Mcf to recognize the impact of the rise in natural gas prices on gas in storage. This volume was derived by dividing the 13-month average cost of gas from the previous rate case (\$462,896,000), by the average cost of gas sold for 2002 (\$4.012 per Mcf), not the average cost of gas in storage. Accordingly, Staff argues the Attorney General's comparisons are flawed as a result of the use of an inaccurate volume as the foundation for his calculations and conclusions.

The Administrative Law Judge finds that Staff's working capital methodology is consistent with the methodology prescribed by the Commission in Case No. U-7350. The dispute regarding the calculation of working capital centers on the determination of the cost of stored gas. The record shows that Staff calculated Consumers Energy's gas storage volumes and average cost of gas in storage using updated data, reflecting the actual storage volumes and costs through 2005 with updated forecasts of volumes and costs for 2006. In doing so, Staff replaced forecasted volumes with booked volumes when recalculating the 13-month cost of gas in storage. Contrary to the assertions of the Attorney General, Staff's volume of gas in storage is in line with Consumers Energy's previous two rate case determinations, differing by only 2.7%. Furthermore, the record shows that Staff's use of current NYMEX prices was only one component of

the 13-month average cost of gas used in working capital. Finally, Staff has demonstrated that the Attorney General's analysis and comparisons are grounded in an incorrect understanding of the Commission's determinations in Case No. U-13730. The Administrative Law Judge therefore recommends that the Commission reject the adjustment proposed by the Attorney General and adopt a 2006 test year balance sheet working capital of \$975,832,000.

Manufactured Gas Plant Recovery

Consumers Energy has identified 23 sites that formerly housed manufactured gas plants (MGP) at which it has a present or former ownership interest. Consumers Energy states that the Commission has previously found that prudently incurred MGP environmental response costs are recoverable costs. The Commission has determined that the costs should be amortized over 10 years with rate recovery beginning after review of the costs in a rate case. In addition, the Commission has held that the unamortized balance should be included in rate base.

Consumers Energy is requesting that recovery of MGP remediation expenditures from November 2001 through the end of 2005 be approved in this case. Expenditures prior to November 2001 have been reviewed and approved in prior rate cases. MGP remediation expenditures incurred from November 2001 through 2005 total \$29,959,847. These costs are shown by year, by site, and by phase of remediation on Exhibits A-35 and A-36. The calculation of the resulting amortization and rate base amounts are shown on Exhibit A-25.

Consumers Energy and Staff are in general agreement with regard to MGP costs. The only difference between Consumers Energy and Staff positions with regard

to MGP amortization and rate base amounts relates to the amount of 2005 costs that should be included in the current case. During 2005 Consumers Energy incurred costs totaling \$8,968,175. (See Exhibit A-35, p. 6). Staff has proposed including \$8,452,651 of these 2005 costs in the current case and deferring consideration of the remaining 2005 costs until a future rate case. (See Exhibit S-4, Schedule C-7, line 2). Consumers Energy asks that the Commission include the costs incurred during 2005 in their entirety when determining MGP amortization and rate base amounts in this case.

Consumers Energy states the 2005 costs it seeks approval of are the actual costs incurred and are known and measurable. These costs were all incurred prior to the 2006 test year and prior to the presentation and cross-examination of Consumers Energy witnesses in this case. Using the full year's actual 2005 costs, Consumers Energy states, will increase MGP amortization expense by \$46,000 and rate base by \$614,000 above the levels proposed by Staff.

Staff states it reviewed Consumers Energy's MGP expenses through November 2005 and cannot attest to the December expenses. For this reason, Staff takes the position that only the amount through November of 2005 should be used for expense and amortization purposes.

The Attorney General takes the position that MGP costs are related to decades-old operations and are not current costs of service and, are therefore not lawfully recoverable from customers taking service during the 2006 test year. The Attorney General requests that the Commission reconsider its prior decisions and find that MGP costs are not legally recoverable, current costs of service related to 2006 operations.

In support of his position the Attorney General maintains current customers are not responsible for the toxic contamination problems that have given rise to environmental cleanup costs. The Attorney General asserts Consumers Energy's liability for environmental cleanup costs was not created or caused by any activities designed to serve current customers, and current customers do not receive benefits from an environmental cleanup which differ from the benefits which customers and non-customers receive as members of society.

The issue in this case, the Attorney General argues, is whether or not the Commission properly ruled that Consumers Energy can recover those costs from customers. The Attorney General contends the fact that a utility is currently booking an expense and the fact that the government requires a utility to incur a cost do not standing alone justify recovery from the utility's customers. For support the Attorney General cites *In re Arizona Public Service Co*, 91 PUR 4th 399 (1988) and *In re Boston Gas Co*, 96 PUR 4th 538 (1988). The Attorney General states the point of these cases is that even when a utility has a current cost; even when the current cost may have been reasonably incurred; and even when the current cost is state-mandated and unavoidable, a utility is not necessarily entitled to recover such costs.

In the alternative, the Attorney General states that the previous deferral method used in rate cases is consistent with the Staff's analysis and should be adopted in this case.

Consumers Energy correctly points out that the Commission has addressed the recoverability of these costs and held for over 10 years that MGP environmental response costs that are prudently incurred are recoverable. In its March 11, 1996 Order

in Case No. U-10755 the Commission established procedures for amortization and recovery of such costs by Consumers Energy. In addition, the Court of Appeals has upheld the Commission's authority to allow recovery of such costs from utility customers. In *Charter Township of Calumet v MPSC*, 1999 WL 33441243 (Docket No. 205802, June 18, 1999) the Court rejected the arguments that (i) environmental cleanup costs were not current operating expenses upon which rates can be based, and (ii) allowing recovery was retroactive ratemaking.

In this case, Consumers Energy has presented evidence that the investigation and remediation costs it seeks to recover were prudently incurred. The differences between the MGP amortization and rate base amounts proposed by Staff and the Company are minimal. As a result and for purposes of this proceeding, the writer is persuaded that including the full year's 2005 costs in this case is reasonable. This avoids the necessity to address the recovery of the 2005 MGP costs in two separate cases. The Administrative Law Judge therefore recommends that the Commission approve the recovery of MGP remediation expenditures from November 2001 through the end of 2005 as proposed by Consumers Energy.

Based upon the foregoing determinations, the Administrative Law Judge recommends that the Commission determine a rate base in this case of \$2,251,247,000 as proposed by Consumers Energy. (See Attachment A).

RATE OF RETURN

Capital Structure and Cost Rates

Staff recommended a capital structure for Consumers Energy consisting of a permanent capital structure of 58.44% long-term debt, 0.63% preferred stock and 40.92% common equity. Staff's capital structure and overall cost of capital is summarized in Exhibit S-5, Schedule D-1. The basis for Staff's capital structure recommendation derives from Consumers Energy's historical 2004 capital structure with known and anticipated changes to long-term debt, short-term debt and common equity balances for the 2006 test year.

Staff reviewed all of Consumers Energy bond classes and took note of the additions and redemptions that would affect Consumers Energy long-term debt profile for the 2006 test year. Staff estimated that Consumers Energy would issue an additional \$298 million in first mortgage bonds in 2006 at a 6.00% cost rate. Staff forecasted a Consumers Energy long-term debt balance of \$4,057,054,000 with an imbedded cost rate of 5.63% for the 2006 test year. This amount represents 58.44% of the permanent capital structure and 47.88% of the ratemaking capital structure. (See Exhibit S-5, Schedule D-2).

Staff recommended a preferred stock balance of \$44 million with a cost rate of 4.46%. (See Exhibit S-5, Schedule D-4).

Staff developed its 13-month average 2006 common equity balance by estimating Consumers Energy's equity balance through the end of 2005 and adjusting that balance by \$63 million in estimated retained earnings for 2006. Staff recommended a common equity balance of \$2,840,717,000. Staff's recommended

common equity balance amounts to 40.92% of the permanent capital structure and 33.52% of the ratemaking capital structure. (See Exhibit S-5, Schedule D-5, page 1 of 10).

Staff recommended a short-term debt balance of \$90,000,000 with a cost rate of 5.75%. Staff's short-term debt recommendation represents 1.06% of the ratemaking capital structure. (See Exhibit S-5, Schedule D-3).

Staff recommended a customer deposits amount of \$28,000,000 with a cost rate of 9.00%. This represents 0.33% of the ratemaking capital structure. Other interest bearing accounts were estimated at \$35,000,000 with a cost rate of 5.57% and a corresponding 0.41% of the ratemaking capital structure. Staff recommended a deferred FIT amount of \$1,309,000,000 and a deferred investment tax credit amount of \$0, both with zero percent cost rates. Both components represent 15.45% of the ratemaking capital structure. Staff also recommended \$70,000,000 in Job Development Investment Tax Credits (JDITC) with a blended permanent capital structure cost rate. JDITC constituted 0.83% of the ratemaking capital structure. Staff's non-permanent ratemaking capital structure components, with the exception of short-term debt, were identical to the non-permanent ratemaking capital structure components recommended by Consumers Energy. (See Exhibit A-10, Schedule D-1, page 1).

Consumers Energy has accepted the Staff's 2006 projected capital structure as a starting point for purposes of this case. Consumers Energy proposes three adjustments to Staff's proposed 2006 capital structure: (i) an adjustment to recognize \$200 million of equity infusions that occurred in January and March 2006, (ii) an adjustment to remove the effects of electric securitization from the capital structure, and (iii) an adjustment to

reduce the deferred tax balance by \$131 million to reflect the effect of a change in federal regulations.

The Attorney General takes the position it is important to employ a capital structure in calculating the overall return to capital that would be appropriate for a financially healthy, well-managed gas distribution company. For this reason the Attorney General begins his analysis with a proxy capital structure.

The Attorney General's witness, Mr. King, developed an overall return on capital on the basis of the composite capital structure of 13 proxy gas distribution companies. He then applied that overall return to Consumers Energy's capital structure, using Consumers Energy's cost of debt and preferred stock. In this manner, Mr. King calculated a rate of return of 9.62% for common equity and overall rates of return. (See Exhibit AG-11).

In addition, the Attorney General contends that as long as gas inventory is included in rate base, then the capital that finances that inventory must be incorporated into the capital structure used to compute the return on that rate base. The Attorney General therefore included short-term capital resources and imputed \$387 million in short-term debt.

The two primary differences between the position of Consumers Energy and Staff and the position of the Attorney General relate to the basis for calculating capitalization and the amount of short-term debt that should be included in the capital structure.

The record shows that the capital structure developed by the Attorney General's witness does not represent a projected 2006 gas ratemaking capital structure that is

specific to Consumers Energy. Mr. King attempted to develop a hypothetical overall cost of debt and equity capital for a group of proxy companies. The witness acknowledged that he did not have access to actual debt costs for the proxy companies and instead used current bond yields as a surrogate for the cost of debt. Mr. King then endeavored to back into an allowed return on equity for Consumers Energy that would result in an overall cost of debt and equity capital for Consumers Energy that matched the hypothetical cost of debt and equity capital that he calculated for the proxy group. This approach is not consistent with established Commission policy or practice. The Administrative Law Judge agrees with Consumers Energy that the cost rates and the overall rate of return should be developed in this case using rates that are specific to Consumers Energy.

The Attorney General also imputed into the capital structure \$387 million of short-term debt, arguing that the cost of selling accounts receivable should be treated as short-term debt. The record shows that the cost of selling accounts receivable results from off balance sheet transactions and are not part of the capital structure. The treatment of accounts receivable financing costs outside of the capital structure is consistent with the way that the Commission has traditionally treated accounts receivable financing program costs. In addition, use of a \$90 million balance for short-term debt, as proposed by Staff, is consistent with the short-term debt balance used by the Commission in its December 22, 2005 Order in Case No. U-14347. The Administrative Law Judge therefore recommends that the Commission reject the Attorney General's short-term debt adjustment and adopt the Staff proposal. An

adjustment for the discount associated with the sale of accounts receivable is addressed in the discussion of O&M expense.

Finally, the Attorney General has taken issue with Staff's inclusion of \$298 million in new debt at a cost of 6.0%. The Attorney General states this cost represents an increase over the 5.63% cost of the \$910 million in debt that Consumers Energy issued in 2005 to redeem a corresponding amount of high-cost debt. The Attorney General argues Staff's forecasted cost increase is based on the expectation that the Federal Reserve would continue its tighter short-term monetary policy by increasing bank rates from the current 4.25% to the range of 4.5% to 5.0%. The Attorney General maintains there is no correlation between the Federal funds rate and yields on Moody's Baa corporate bonds. The Attorney General asserts that increases in the Federal funds rate may in fact hold down corporate bond yields because they demonstrate that the Federal Reserve is actively seeking to head off inflation, which is the principal risk to bondholders. (See Exhibit AG-56).

The Administrative Law Judge finds the Attorney General's criticism unpersuasive. The writer observes that the Federal Reserve has continued to raise the Federal funds rate. Accordingly, the Administrative Law Judge finds Staff's inclusion of \$298 million in new debt at a cost of 6.0% reasonable.

Based upon the foregoing, the Administrative Law Judge recommends that the Commission reject the Attorney General's proposed capital structure and adopt the capital structure and costs proposed by Staff.

As noted above, Consumers Energy has accepted Staff's capital structure with three adjustments. The first adjustment is to increase Staff's proposed equity balance by \$200 million based upon January and March 2006 equity infusions.

Consumers Energy states the Staff's 2006 capital structure includes the equity infusions that occurred through December 2005, but does not include equity infusions made in January 2006 in the amount of \$100 million and on March 17, 2006 in the amount of \$100 million. Consumers Energy takes the position that these 2006 equity infusions should also be included in the capital structure that is adopted in this case.

In support of this position, Consumers Energy states these equity infusions are historical, known and measurable events and were accomplished prior to the close of the record in this case. Consumers Energy states further its capital structure remains skewed and the equity ratio remains below the equity ratio of a typical gas utility. Even with recognition of the \$200 million of 2006 equity infusions, Consumers Energy represents its equity ratio as a percentage of permanent capital will be below the 44.21% equity ratio that was contained in the capital structure approved by the Commission in its December 22, 2005 order in the Company's electric rate case, Case No. U-14347.

Consumers Energy contends it would be unreasonable not to recognize the positive impact on the equity ratio of the \$200 million of equity infusions given that the negative impact on the equity ratio resulting from the MCV impairment is being recognized in this case. Consumers Energy also notes that the projected 2006 debt issuances are also included in the capital structure.

Finally, Consumers Energy states the Commission has previously recognized historical, known and measurable equity infusions in determining Consumers Energy's capital structure. In Case No. U-13000, the Commission agreed to consider a historical \$150 million equity infusion. Furthermore, in Consumers Energy's Cases Nos. U-10335 and U-10685 the Commission allowed recognition of equity infusions that were made no later than 14 calendar days after the issuance of the rate orders, subject to verification that the infusions were made. Consumers Energy states that it is willing to agree to the use of the verification procedures adopted in Cases Nos. U-10335 and U-10685 for purposes of this proceeding. The effect of making this change on the Staff capital structure is shown on Exhibit A-82, pages 1 and 4, columns (a) through (d) and on Appendix E to Consumers Energy's Initial Brief.

Staff states that Consumers Energy provided no indication in its direct testimony that it was to receive additional equity infusions from its parent company in the 2006 test year. Staff states further that it was not until it was ready to file its case did the Company announce a \$100 million equity infusion from its parent in January 2006 and then on the witness stand informed everyone that an additional \$100 million infusion was made in March 2006.

Staff leaves the decision of whether to recognize any 2006 equity additions to the Commission. Staff states, however, that in recommending the midpoint of its cost of equity range of 10.90% - 11.40%, it took in consideration the Company's lower equity profile due to the MCV impairment and other risk factors. If the Commission decides to recognize the \$200 million equity infusions, Staff states the Commission should consider Staff's cost of equity recommendation revised from the mid-point of 11.15% to

the lower end of the range of 10.90%-11.00% to arrive at a more appropriate return on common equity recommendation.

The Administrative Law Judge recommends the Commission adjust Staff's proposed equity balance by \$200 million to reflect the January and March 2006 equity infusions. The writer is persuaded that it would be reasonable to recognize the positive impact on the equity ratio of the \$200 million of equity infusions given the recognition of the negative impact on the equity ratio resulting from the MCV impairment and the inclusion of projected 2006 debt issuances in the capital structure. In prior cases the Commission has recognized historical, known and measurable equity infusions in determining Consumers Energy's capital structure. Consumers Energy states that it is willing to agree to the use of the verification procedures adopted in Cases Nos. U-10335 and U-10685 for purposes of this proceeding. The Administrative Law Judge recommends that the Commission adopt a similar verification procedure in this case. Lastly, the Administrative Law Judge finds that the Commission should consider Staff's cost of equity recommendation revised from its original mid-point of 11.15% to the lower end of the range of 10.90%-11.00%.

Consumers Energy's second adjustment removes the effects of electric securitization from the capital structure. Consumers Energy states it issued securitization bonds in November 2001, the proceeds of which were used to retire debt and equity in the same ratio as the Company's capital structure. This resulted in a reduction to the long-term debt balance in the amount of approximately \$297 million and a reduction to the equity balance in the amount of approximately \$164 million. Consumers Energy states further that in Case No. U-13000, a Consumers Energy gas

rate case, the Commission adopted a capital structure that was developed as if securitization had never occurred. Consumers Energy represents this capital structure was maintained by the Commission in Case No. U-13730.

In this case, Consumers Energy states the Staff appropriately excluded the securitization bonds from the long-term debt balance, but did not reverse the retirement of debt and equity that occurred from use of the proceeds of the securitization bonds. Consumers Energy therefore proposes that (i) \$296.6 million be added to the long-term debt balance, to offset the reduction in the debt balance that resulted from use of securitization proceeds, and (ii) \$164.2 million be added to the common equity balance, to offset the reduction in the common equity balance that resulted from use of securitization proceeds. The effect of making this adjustment in combination with recognizing the equity infusion is shown on Exhibit A-82, pages 2 and 5, columns (a) through (d) and on Appendix E to Consumers Energy's Initial Brief.

Staff disagrees with the adjustment and with Consumers Energy's reliance on the Commission order in Case No. U-13000. Staff asserts the Commission's order in Case No. U-13000 expressly rejected the position of a third-party intervenor (Mr. DeWard) who insisted that the issuance of securitization bonds have no effect on the capital structure in Consumers' gas rate case, which is the purpose of the adjustment in this case. (See Case No. U-13000 Opinion and Order dated November 7, 2002, pp. 23-24). As a result, Staff argues Consumers Energy's request to modify Staff's proposed long-term debt and common equity balances based on securitization effects should be rejected by the Commission, as it was in Case No. U-13000.

The Administrative Law Judge agrees with Staff. The Commission's Order in Case No. U-13000 rejected a proposal to exclude the effects of securitization in the ratemaking capital structure and instead adopted a consolidated capital structure adjusted for known and measurable debt and equity changes. The Administrative Law Judge therefore recommends that the Commission reject Consumers Energy's adjustment to remove the effects of electric securitization from the capital structure.

Consumers Energy's third adjustment reduces Staff's deferred income tax recommendation by \$131 million to account for taxable income changes associated with the "Simplified Service Cost" method. Consumers Energy states the adjustment results from an Internal Revenue Service Treasury Regulation issued in August 2005. Consumers Energy states further the IRS regulation requires recognition of the adjustment in 2005 and 2006, with payments in 2006. Consumers Energy represents the cost adjustment decreases the deferred income tax balance, which will have an ongoing impact on the capital structure. Consumers Energy maintains that in light of the other 2006 adjustments to the capital structure for projected changes, it is appropriate to make this adjustment as well. The effect of making this change in combination with recognizing the equity infusion and the securitization adjustment addressed above, is shown on Exhibit A-82, pages 3 and 6, columns (a) through (d) and on Appendix E to Consumers Energy's Initial Brief.

Staff takes the position that the potential deferred tax adjustments associated with the "Simplified Service Cost" method have not yet occurred, are unresolved and subject to dispute. In support of its position Staff introduced copies of the Company's Form 10-K which indicated that significant issues with respect to the simplified service

cost method remained unresolved and subject to dispute and that the Company's potential tax outcome is uncertain and highly judgmental. (See Exhibit S-18). Staff argues the ratepayers should not be asked to bear responsibility for disputable, one-time tax events that could materially affect the Company's ratemaking capital structure and overall rate of return.

A review of Consumers Energy's 2005 Form 10-K supports Staff's contention that revisions to deferred tax balances remain subject to judgment and dispute. The writer is not persuaded that this represents a known and measurable change. Accordingly the Administrative Law Judge recommends that the Commission reject Consumers Energy's deferred tax adjustment and adopt Staff's proposed deferred tax balance as shown on Exhibit S-5, Schedule D-1.

Return on Equity

Consumers Energy's current authorized return on common equity for its gas business is 11.40%. This return was established by the Commission in its November 7, 2002 order in Case No. U-13000. The currently authorized return on equity for Consumers Energy's electric business is 11.15%. This return was adopted by the Commission in its December 22, 2005 order in Case No. U-14347.

Staff has developed a 10.90% to 11.40% range for use in establishing a return on equity for the Company's gas business in this case. Staff originally recommended that the midpoint of the range, 11.15%, be used. As indicated above, Staff modifies its recommendation to the lower end of its range in the event the Commission decides to include an additional \$200 million in equity in the capital structure.

Consumers Energy, in this case, has requested that the authorized return on

equity for the gas business be increased from the current 11.40% return to 12.00%. If the Commission concludes that the return should not be increased to 12.00% then, at a minimum, the return on equity should be set at 11.40%, which is the high end of Staff's recommended return on equity range and the current authorized gas business return on equity.

Using the same proxy group as Consumers Energy and after correcting for certain errors, the Attorney General recommended an equity return of 9.75% for the proxy group. This rate of return was introduced into the capital structure of the 13 proxy companies using their costs of debt and preferred stock. A total return to capital was determined and that was applied to Consumers Energy's actual capital structure, debt and preferred stock costs to back into an allowed return to equity recommendation of 9.78% for Consumers Energy.

A brief discussion of the approach and analyses of the parties is presented below.

Consumers Energy's position regarding the appropriate return on equity for its gas business was presented by Messrs. Thomas J. Webb and Wayne M. Leja. Consumers Energy notes that both it and Staff used Discounted Cash Flow (DCF), Capital Asset Pricing Model (CAPM), and risk premium approaches in order to determine a reasonable cost of equity. Consumers Energy states its witness, Mr. Leja, first identified natural gas distribution companies that are publicly traded and for which public data is available. The companies selected had to: (i) be classified as a natural gas distribution company by the Value Line Investment Survey (Value Line), (ii) be paying dividends, (iii) have bonds that were rated as investment grade by Moody's

Investor Services (Moody's) and Standard and Poor's (S&P), and (iv) have approximately 40% or more of operating revenues from gas operations. A group of 13 companies was identified. The DCF and CAPM methodologies were applied to these proxy companies. Mr. Leja also performed several additional CAPM analyses. The Risk Premium Model was applied using gas utility common stocks as a proxy.

The results of Mr. Leja's DCF analyses of the proxy companies showed a range of returns from 7.33% to 11.35%, with an average return on equity of 9.68% without flotation costs. Including flotation costs increases the average return to 9.84%. (See Exhibit A-41).

The witness' CAPM analysis resulted in an average return on equity for the proxy group for February – April 2005 without flotation costs of 10.13%. The CAPM return on equity without flotation costs for the proxy group for 2006 is 11.07%. The addition of flotation costs would increase these CAPM return averages to 10.29% and 11.23%, respectively. The witness testified that the increase in expected returns between February – April 2005 and the projected test year demonstrate that current returns are not representative of required returns for 2006. (See Exhibit A-43).

Mr. Leja's risk premium analysis determined a 5.34% average risk premium for natural gas distribution utility common stocks over long-term risk-free rates. Adding this premium to the risk-free rate of 5.64% for 2006 results in a return on equity of 10.98% for 2006, without flotation costs. (See Exhibit A-44).

Consumers Energy represents it has identified a number of factors which, when taken into consideration, support the conclusion that the investor required return on equity for a company with risk comparable to Consumers Energy is currently higher

than the 11.15% that was approved last December for Consumers Energy's electric business. Consumers Energy states one factor to be considered is the decrease in the equity ratio resulting from the impairment of its investment in the MCV partnership. A second factor is the continuing weak Michigan economy. An additional factor is increasing interest rates. Consumers Energy maintains the investor required return on equity generally increases as interest rates increase in order to compensate investors for the risk differential between debt and equity.

Consumers Energy argues the evidence presented indicates that it has higher risk than a typical utility and higher risk than the proxy groups. Accordingly, the results of the return on equity analyses need to be adjusted upward in this case to reflect this higher risk. In support of this position Consumers Energy notes the Staff has recommended a capital structure which has an equity ratio, as a percent of permanent capital, of 40.92%. (See Exhibit S-5, Schedule D-1). Consumers Energy is recommending a capital structure which has an equity ratio, as a percent of permanent capital, of 42.16%. (See Exhibit A-82, pp. 3, 6). Both of these equity ratios, Consumers Energy argues, are below the 44.21% equity ratio that was adopted in Case No. U-14347 and even farther below the average equity ratio of approximately 50% for the proxy groups.

Consumers Energy states the senior secured bond ratings for the proxy group are A/A3 (See Exhibit A-40) and for the Staff's proxy group are A/A2 (See Exhibit S-5, Schedule D-5, p.2, as corrected at 6 Tr. 1023). Consumers Energy represents its senior secured bond ratings are three to four notches lower than these proxy group ratings. Consumers Energy maintains a lower credit rating is an indication of higher

investor perceived risk; with higher risk requiring a higher return.

Consumers Energy states that additional indications that it has higher investor perceived risk are limitations on its ability to issue first mortgage bonds and senior unsecured debt and its inability to issue commercial paper. Consumers Energy states further that S&P assigns business profile scores to utilities which are intended to reflect the relative risk among companies in a business sector. Consumers Energy maintains the S&P assigned business profile score for Consumers Energy provides further support for the conclusion that Consumers Energy is perceived as having above average risk.

Consumers Energy states the evidence in this case indicates that it does not have sufficient internal cash generation to meet its cash needs. Consumers Energy's witness, Mr. Webb, testified that Consumers Energy's cash flow for the year 2005 was negative \$560 million. The witness also testified that cash flow was negative in 2003 and 2004 and was projected to be negative in 2006, even with the requested rate relief.

Consumers Energy asserts it has not earned its authorized return on equity on a ratemaking basis for its gas business for the last five calendar years, on either an actual or weather adjusted normalized basis. Consumers Energy argues that if investors perceive that, due to regulatory lag or other reasons, Consumers Energy's gas utility business will be unable to consistently earn its authorized return on equity on a ratemaking basis; this will increase investor perceived risk.

Exhibit A-66, Consumers Energy states, shows the average spread differentials for different corporate ratings for the period January 1995-April 2005. The 10-year industrial spread between a BBB rated bond and a BB rated bond has averaged 157

basis points. The 10-year industrial spread between an A rated bond and a BBB rated bond has averaged 40 basis points. (See Exhibit A-66, p. 2). The average corporate spreads for utilities between 30-year A rated bonds and BBB- rated bonds as of December 12, 2005 was 50 basis points. Based on this analysis, Mr. Webb recommended that a risk adjustment of 100 basis points be added to the results of Mr. Leja's analyses to reflect the greater risk of Consumers Energy's gas business. This is the approximate average between the risk differentials of 40 basis points and 157 basis points.

Consumers Energy asserts it has shown that the impact of CMS Energy on Consumers Energy's ratings is not as great as has been suggested. Consumers Energy states senior secured debt is secured by the assets of Consumers Energy such that the risk reflected in the senior secured debt ratings can appropriately be attributed to the regulated utility company.

Consumers Energy has also proposed an adjustment to include flotation costs. While inclusion of flotation costs is discretionary, Consumers Energy asserts that allowing such costs is appropriate in this case given the substantial equity infusions that have occurred. Consumers Energy states that from the beginning of August 2004 through May 2005, CMS Energy has invested \$800 million into Consumers Energy through equity infusions. In order to raise funds for equity infusions, CMS Energy issued approximately 56 million shares of common stock in October 2004 and April 2005. CMS Energy made additional equity infusions into Consumers Energy of \$150 million in December 2005, \$100 million in January 2006, and \$100 million in March 2006. Consumers Energy states that altogether the infusions from August 2004 through

March 2006 total over \$1 billion. Consumers Energy's witness, Mr. Leja, recommended including a flotation cost rate of 3.6% in determining the required return on equity. Mr. Leja testified that the 3.6% rate was based on the costs associated with CMS Energy's common equity issuances in 2004 and 2005. Consumers Energy asserts that if flotation costs are not included the parent company will have subsidized the equity infusions.

Consumers Energy requests that the Commission set the authorized return on equity at a level higher than the 11.15% recommended by Staff, increasing the return on equity for the gas business to 12.00%. Consumers Energy submits that risk considerations support a return on equity higher than the 11.15% midpoint of Staff's recommended cost of equity range of 10.90% to 11.40%. If the Commission concludes that the return should not be increased to 12.00% then, at a minimum, the return on equity should be set at 11.40%, which is the high end of Staff's recommended return on equity range and the current authorized gas business return on equity.

Citing the *Bluefield*⁹ and *Hope*¹⁰ cases, Staff takes the position that in establishing a fair rate of return, consideration should be given to both investors and ratepayers. Staff maintains the return should not be so high as to place an unnecessary burden on ratepayers, yet should be high enough to insure investor confidence in the financial soundness of the enterprise.

Staff's witness, Mr. Megginson, used the DCF and the CAPM models, and an additional risk premium approach in arriving at a recommended cost of common equity

⁹ *Bluefield Water Works and Improvement Co. v Public Service Commission*, 262 US 679; 43 S Ct 675; 67 L Ed 1176 (1923)

¹⁰ *Federal Power Commission v Hope Natural Gas Company*, 320 US 591; 64 S Ct 281; 88 L Ed 333 (1944)

for Consumers Energy. Staff employed a proxy group of natural gas companies to develop its cost of equity. Staff's risk premium approach examined historical utility stock returns over bond returns and integrated the premium into current utility market data. Mr. Megginson also reviewed a list of 53 state commission gas rate case return on equity decisions from January 2002 –June 2004 as support for the other methods used in the analysis.

Staff states it included market information for CMS Energy where applicable, but did not include this data in the cost of equity recommendation. Staff witness, Mr. Brian Ballinger, made an assessment of Consumers Energy's risk. Staff notes that Consumers Energy operates as a wholly owned subsidiary of CMS Energy, an exempt holding company, and does not have the same business or financial risk as the parent or sister subsidiary CMS Enterprises. In particular, Staff believes CMS Energy and its sister subsidiary CMS Enterprises have considerably more risk than Consumers Energy.

Staff asserts bond rating agencies share this opinion as debt credit ratings for CMS Energy are below that of Consumers Energy. Staff states Consumers Energy's senior secured debt first mortgage bonds are currently rated BBB-/stable outlook by S&P. Moody's rates Consumers Energy's bonds Baa3/negative outlook, while Fitch rates them BBB-/stable outlook. CMS Energy's debt securities are rated non-investment grade by the three bond rating agencies.

Staff represents the bond rating agencies negative listing reflect the recent MCV impairment and its adverse impact on the Company's balance sheet. The impairment suggested a larger than expected decrease in the economic value Consumers Energy

expected to realize over a period of years, reduced the Company's equity profile, and also reduced Consumers Energy's near-term flexibility by limiting its first mortgage bond issuance to approximately \$298 million for the next four quarters.

As indicated above, Staff made a risk analysis for Consumers Energy in its rate of return study. Staff states that even though Consumers Energy's credit rating is higher than its parent, CMS Energy, it remains at the lowest investment grade rating because its parent's credit risk is impacting the rating of Consumers Energy.

Staff takes the position that Consumers Energy's gas business, on a stand-alone basis, is not much riskier than the average gas utility and is not riskier than its Michigan counterpart, Michigan Consolidated Gas Company (MichCon). Staff cited a number of factors to support this contention. Consumers Energy owns a substantial amount of gas storage compared to other gas utilities. Consumers Energy has a gas cost recovery mechanism that provides the ability to reflect changes in gas costs. Consumers Energy has received interim rate relief consideration, which enhances the Company's opportunity to recover costs earlier. Consumers Energy utilizes an off balance sheet accounts receivable sales financing program for the purchase of natural gas and other items, which reduces the amount of short-term debt. Consumers Energy has approximately 75% of its gas supply in fixed contracts, compared to MichCon's 25%, lessening the effect of market price fluctuations. Consumers Energy has a 0.53% gas uncollectible rate as compared to MichCon's 2.46% gas uncollectible rate. Consumers Energy's primary service area, the Jackson-Lansing area, has lower unemployment rates than MichCon's primary service area of Detroit-Warren-Livonia. Finally, Consumers Energy has a lower gas choice customer participation of 93,184 customers

at year end 2005, compared to MichCon's 134,500 gas choice customers. Staff concludes that for any utility company with a well positioned gas distribution operation, significant - predictable regulated cash flow and limited near-term debt maturities such as Consumers Energy has; a borderline investment grade rating could not or would not be attributable to its utility operations and must be influenced by its parent company's legacy of poor investments and below investment grade credit rating

Staff used four criteria in selecting a representative natural gas utility group for use in its cost of equity analysis. Each natural gas utility was required to have net plant assets in excess of \$500 million, a minimum of 50% revenues from natural gas, an investment grade credit rating from both of the major credit rating agencies, and each natural gas company had to currently be paying dividends to its common equity investors. Using these criteria, Staff developed a list of 13 natural gas companies for the proxy group. (See Exhibit S-5, Schedule D-5, page 2).

Staff used the DCF model to determine the cost of equity for each company in the proxy group. The dividend yield was calculated by using the average closing stock prices for each month from October-December 2005. The latest quarterly common dividend rate was annualized in calculating the dividend yield. The dividend yield for the proxy group was 3.93%. (See Exhibit S-5 Schedule D-5, page 5 of 10).

The growth rate for the companies in the proxy group was determined by looking at the proxy group's projected growth rates of earnings, as forecasted by three sources; Institutional Brokers Estimate System, Zack's and Value Line. (See Schedule D-5, page 6 of 10). Staff's DCF cost of equity analysis resulted in a cost of common equity for the proxy group of 10.02%. (See Schedule D-5, page 7 of 10).

Staff's witness, Mr. Megginson, also used the CAPM in determining a cost of common equity for Consumers Energy. The witness calculated a cost of equity using the proxy's group beta value of 0.78, Staff's projected long-term treasury rate range of 4.77% - 5.20%, and a risk premium of 7.16% derived from historical average returns of stocks over bonds for the 1926-2004 time period. Staff utilized three sources; Global Insight, Value Line and the Financial Forecast Center to project a 2006 average long-term treasury yield range of 4.77% - 5.20%, or risk free rate. The Staff's 10.35% - 10.79% common equity estimate using the CAPM method is shown on Exhibit S-5, Schedule D-5, page 8 of 10.

Staff also used another risk premium approach to determine an estimate of Consumers Energy's cost of common equity. This approach entailed using historical realized rates of return for a group of natural gas distribution utilities for the period 1953 to 2003. Using "Mergent's Public Utility Manual" data Staff determined a 4.69% risk premium spread between the average market return of the group's stocks and bonds. With the 4.69% risk premium, a projected 30-year Treasury bond rate range of 4.77% - 5.20% and a current interest rate spread of 0.99%-1.60% on A/A2 thru BBB-/Baa3 rated utility bonds, Staff calculated a cost of equity range of 10.45% to 11.49%. Staff's risk premium analysis results are presented on Exhibit S-5, Schedule D-5, page 9 of 10.

As part of its analysis Staff reviewed "Major Rate Case Decisions – January 2002-December 2003" and a supplemental study from January-June 2004 published by the Regulatory Research Associates. The study summarized the authorized return on equity for 53 gas utilities granted by regulatory utility commissions across the United States. Staff states in 2004 the average authorized return on common equity awarded

in those gas rate cases was 11.0%. Staff observes this average return is within Staff's recommended cost of equity range of 10.90% to 11.40%.

Staff opposes the inclusion of flotation expenses in calculating the cost of common equity. Staff states Consumers Energy incurred no issuance or underwriting fees and CMS Energy, the parent company, is able to deduct the stock issuance expenses for tax purposes. Staff notes the Commission, in Consumers Energy's electric rate case (Case No. U-14347) did not recognize flotation expenses in the cost of common equity determination.

In response to the contention that Consumers Energy last earned its authorized rate of return on an actual basis in 1997 and on a normalized basis in 2000, Staff argues Exhibit A-1, Schedule A-3 shows that the Company's gas division earned over its authorized rate of return from 2002 thru 2004. Staff contends investors view Consumers Energy's business performance on a financial basis garnered from information that is publicly available through the Company's website, financial literature and the Company's SEC 10-K, 10-Q and 8-K submittals. Staff states it based its rate of return recommendation on a financial basis.

Regarding the Company's negative cash flow concerns and the attendant risk, Staff states Consumers Energy's 80% dividend payout policy is higher than the proxy group's dividend payout of 64%. Staff argues this policy directly contributes to the Company's negative cash flow. Staff maintains that if the Company were to establish a more balanced dividend policy then its negative cash flow concerns could be dissipated somewhat as well as the risk associated with the negative cash flow.

With regard to the Attorney General's 9.78% return on equity and overall cost of

capital of 6.14% recommendation, Staff asserts Mr. King's recommendation is outside the range of the average 11.0% return on equity approved by other State commissions. Staff argues this may not provide the Company a fair rate of return to ensure investor confidence in the financial soundness of the enterprise or enable Consumers Energy to maintain credit and attract capital. Staff contends that a return should not be so high as to place an unnecessary burden on the ratepayers, yet should be high enough to insure investor confidence in the financial soundness of the enterprise.

Finally, regarding Michigan's current weak economy, Staff observes that Consumers Energy has the luxury of a captive customer base that translates into guaranteed revenues. Staff contends all states go through economic ups and downs at one point in time and sees no benefit in unnecessarily burdening ratepayers with a high rate of return for Consumers Energy as a result of Michigan's current weak economy. Staff maintains that its cost of equity range of 10.90% - 11.40% takes into account Consumers Energy's reduced equity balance and other risk factors and that even with short-term borrowing rates returning to more normal levels, Staff's 11.15% return on equity recommendation offers investors a fair and reasonable rate of return that is on par or better than other investments of comparable risk.

The Attorney General's witness, Mr. King, used the identical proxy group as Consumers Energy and conducted DCF analyses that combined estimates of next year's dividend yields with two measures of earnings growth. The first measure employs consensus forecasts of earnings growth by investment analysts. The second measure is the potential for book value growth as measured by retained earnings and sales of stock at prices in excess of book value. Exhibit AG-7 shows that Mr. King's first

DCF analysis yielded a mean return indication of 9.58% and a median value of 9.85% for the 13 proxy companies. Exhibit AG-8 shows a mean book value growth indication of 9.55% and a median indication of 9.44%.

Mr. King also employed a CAPM analysis. (See Exhibit AG-10). Mr. King applied a simplified DCF approach based on Value Line's forecasts of dividend yield and long-term capital appreciation to derive an overall market return indication of 10.4%. The witness accepted Value Line's betas for the 13 proxy companies and the 30-year Treasury bond yield as the risk-free rate. These inputs produced a CAPM rate of return of 9.4%.

The Attorney General states that based on these three tests, Mr. King estimated the equity return requirement for the 13 proxy companies to be 9.6%. When this equity return is combined in the 13-company capital structure with the debt and preferred stock costs of those companies, the resultant return to total capital is 7.19%. This total return was then applied to Consumers Energy's capital structure, debt and preferred stock costs to derive a return to equity of 9.78% for Consumers Energy.

The Attorney General states that all three rate of return witness arrived at a consensus with respect to the DCF formulation at approximately 9.75%.

The Attorney General states that all three rate of return witnesses applied the CAPM analysis to their proxy gas distribution companies. In order to match the beta estimates and risk-free rate used by the other two rate of return witnesses, Mr. King accepted Value Line's betas and the current yield on long-term Treasury bonds. Despite using approximately the same inputs for beta and the risk-free return, the Attorney General states the results of the CAPM analyses differed dramatically. The

Attorney General notes that Mr. Leja derived a 2005 CAPM return indication of 10.13% and a forecast 2006 indication of 11.23%. (See Exhibit A-43). Mr. Megginson estimated a CAPM return indication in the range of 10.35% to 10.79%. (See Exhibit S-2, Schedule D-5, page 9). Mr. King computed a CAPM return of 9.4%. (See Exhibit AG-10).

The Attorney General states the reason for the disparity between the CAPM results of Messrs. Leja and Megginson and Mr. King has to do with their respective estimates of the return requirement of the overall market. Mr. Leja used 12.39%, which is the return to the overall stock market between 1926 and 2004 as measured by Ibbottson Associates. Mr. Megginson used 12.25%, which is Mergent's return to gas distribution companies' stocks between 1953 and 2003. While Messrs. Leja and Megginson used the actual returns experienced over long historical periods, Mr. King employed a DCF formulation using Value Line's prediction of the market's average dividend yield and its forecast of the likely capital appreciation of the market for the period February 2006 and three to five years hence. Mr. King's estimate of the market's return was 10.4%.

The Attorney General argues the extraordinary fluctuations in the historical premiums from year to year render any average meaningless as a predictor of future required premiums. The Attorney General maintains that only Mr. King's approach measures the current spread between risk-free returns and overall market returns by using current Value Line forecasts of average dividends and growth.

As noted above, Consumers Energy's current authorized return on common equity for its gas business is 11.40% and 11.15% for its electric business. In this case

Consumers Energy has asked that at a minimum the Commission establish the authorized return on equity for the gas business at 11.40%, but believes 12.00% is justified. Staff has developed a range of 10.90% to 11.40% for use in establishing a return on equity. The Attorney General recommends a return on equity of 9.78%.

The parties have devoted considerable effort to critiquing the DCF, CAPM, risk premium and other analyses presented. Aside from the computational errors identified¹¹, the primary criticism of each party's presentation is that judgment in the execution of the various analyses was improperly exercised. The Administrative Law Judge concurs with Consumers Energy, Staff and the Attorney General that the exercise of judgment is integral to the performance of these various tests and accordingly the writer's recommendation to the Commission will derive from the reasonable exercise of that judgment.

Turning first to the Attorney General's presentation, the Administrative Law Judge is persuaded that Mr. King's 9.78% return on equity recommendation is inadequate and unjustified on the record taken as a whole. On Exhibit AG-8, column E Mr. King calculated the Value Line expected average return on equity on book value for Mr. Leja's proxy group companies. Consumers Energy has observed that the mathematical average of the returns shown in column E of Exhibit AG-8 is 11.0%. This expected return of 11.0% is consistent with the return on equity results for Mr. Leja's and Mr. Megginson's proxy groups. This expected return cannot be realized, however, by adopting Mr. King's recommended return on equity of 9.78%.

Mr. King's reliance on only the DCF analysis is also suspect. It is reasonable to

¹¹ The writer finds the identified computational errors of no great consequence and immaterial to his recommendations.

look to more than a single form of analysis to support a recommendation. Despite Mr. King's criticism of the CAPM and risk premium approaches, these are accepted methodologies in Commission proceedings. In addition, the use of long-term historical data is frequently used in a CAPM analysis and is reasonable. Over a short period of time, the equity risk premium can be quite volatile. Over a long period the risk premium is relatively stable and it is less susceptible to manipulation.

Finally, although Mr. King acknowledged the gas company's poor financial condition, he failed to weigh and evaluate the risk associated with Consumers Energy as compared with the proxy group.

The writer is persuaded that these observations demonstrate that the Attorney General's recommended return is not commensurate with returns on investments having corresponding risks and accordingly should be rejected.

Turning then to the presentations of Consumers Energy and Staff, the results of their analyses are very similar. The resulting recommendations differ as a result of Consumers Energy's assertions that the common equity return requirement must be adjusted upward to recognize the Company's greater risk and the necessity to include flotation expenses.

After reviewing Consumers Energy's and Staff's presentations, the Administrative Law Judge finds that Staff's cost of equity range of 10.90% - 11.40% takes into account the Company's lower common equity balance risk and its current business and financial risk. Staff focused on Consumers Energy's business risk while Consumers Energy focused on what it perceives is the financial risk as evidenced by its capital structure, debt ratings and cash flow. Business risk relates to the uncertainty of earnings created

by the nature of the business in which an enterprise is engaged. For a utility, it deals with such issues as the level of competition, the effect of unpredictable weather conditions, the security of product supply and the susceptibility of the operations to environmental constraints. Financial risk relates to the capital structure and cash flow of the operation. Both are relevant considerations. The Administrative Law Judge believes that in order to establish a reasonable return on equity, a balance must be struck. The writer agrees with Staff that a return should not be so high as to place an unnecessary burden on ratepayers, yet should be high enough to insure investor confidence in the financial soundness of the enterprise.

Staff has presented a number of reasons demonstrating why Consumers Energy's gas business, on a stand-alone basis, is not any riskier than the average gas utility and is not riskier than MichCon. These include Consumers Energy's storage capability, cost recovery mechanism, off balance sheet financing, fixed price gas purchase contracts, uncollectible rate, service area, and choice customer participation.

In addition, the record shows that each of the concerns raised by Consumers Energy in support of establishing a return on equity higher than 11.15% have been satisfactorily addressed by Staff. Consumers Energy cites its current limited ability to issue debt, its S&P business profile score, its negative cash flow, and the inability to earn its authorized return on a ratemaking basis in support of its position.

The Administrative Law Judge believes Consumers Energy's limited ability to issue debt is a temporary event due primarily to its MCV impairment, a non-gas company related event. Furthermore, Consumers Energy utilizes off balance sheet financing through its accounts receivables sales financing program in lieu of outside

debt instruments. This enables the Company to purchase natural gas and other items, reducing risk. With regard to Consumers Energy's negative cash flow, Staff properly noted that the 80% payout ratio to its parent company directly contributes to the Company's negative cash flow. With regard to the assertion that it has not earned its authorized rate of return on a ratemaking basis, Staff has demonstrated that this contradicts Consumers Energy's financial results (See Exhibit A-1). With regard to Michigan's current weak economy, Staff observes that Consumers Energy has a captive customer base, which provides guaranteed revenues.

The writer is persuaded that Consumers Energy's investment grade rating is not attributable to its utility operations alone, but is influenced by its parent company's below investment grade credit rating. Staff noted that S&P made positive comments regarding Consumers Energy's business and financial outlook. In assessing Consumers Energy's business profile, S&P made note of efficient coal-burning plants, a well positioned gas distribution operation, significant regulated cash flow, a satisfactory regulatory environment and the prospect that high gas prices would subside in 2006, reducing working capital needs. A borderline investment grade rating would not, therefore, be attributable to a well positioned gas distribution operation with significant regulated cash flow and limited near-term debt maturities. S&P has inferred that on a stand-alone basis Consumers Energy's utility operations would not have a borderline investment grade rating, if not for other factors. Based upon the foregoing the Administrative Law Judge finds that Mr. Webb's 100 basis point risk adjustment is not justified.

With regard to the issue of whether flotation expenses should be included in

determining the cost of common equity, the Administrative Law Judge agrees with Staff and the Attorney General that they should not be included. Staff points out that Consumers Energy incurs to issuance or underwriting fees. Furthermore, the Commission declined to recognize flotation expenses in determining Consumers Energy's cost of equity in its most recent electric rate case. The Commission found that these costs are not costs incurred by the regulated utility.¹² Accordingly, the Administrative Law Judge recommends that no flotation or market expenses be added to the cost of common equity in this proceeding.

Staff has argued that in the event the Commission decides to include the additional \$200 million equity infusions in the test year capital structure, the return on common equity should be set at the low end of its recommended range. The Administrative Law Judge concurs and therefore recommends that the Commission set the return on equity for Consumers Energy's gas business at the low end of Staff's 10.90% - 11.40% range. The Administrative Law Judge finds an 11.0% return on equity for the gas business is reasonable in this case.

Summary

Based upon the preceding discussion and findings, the Administrative Law Judge recommends that the Commission establish an overall rate of return for Consumers Energy's gas business of 6.69%. (See Attachment B).

THROUGHPUT

Throughput is the total sales and transportation volumes delivered to end-users.

¹² Case No. U-14347, Order and Opinion dated December 22, 2005, p.24.

In order to project test year revenues, it is necessary to determine the expected level of throughput. Staff adopted the sales and transportation revenues proposed by Consumers Energy in its direct case. In its rebuttal case, Consumers Energy proposed two adjustments to its sales level reducing throughput volumes to 312,368 MMcf. The first adjustment relates to sales decreases for the 12 months ended February 2006. The second adjustment decreases residential and commercial sales for conservation that would have occurred if the weather had been colder during the 12 months ended February 2006. These two adjustments increase the revenue deficiency by \$14,064,000.

Consumers Energy states that Staff's use of historical throughput levels fails to include changes that are known and measurable. Consumers Energy represents its throughput levels have significantly declined in the recent past. Consumers Energy states the first adjustment to throughput is based on the actual deliveries through February 2006. Consumers Energy asserts that over the 12-month period ending February 2006, customers greatly reduced their use of natural gas. Consumers Energy contends that because the actual deliveries through February 2006, are a known and measurable change, they should be reflected in the test year throughput level. Consumers Energy therefore reduces the historical throughput volume by 9.3 Bcf, increasing the revenue deficiency by \$8.4 million. (See Exhibit A-74, p. 1).

Consumers Energy states the second adjustment to historical throughput levels continues declining gas deliveries through the 2006 test year to reflect the full year impact of increased conservation practices. This adjustment reduces throughput volumes by an additional 3.8 Bcf and increases the revenue deficiency by \$5.6 million.

(See Exhibit A-77).

In support of its position, Consumers Energy presented Exhibit A-73. Consumers Energy states that since the early 1970s there has been a reduction trend in residential and commercial use per customer. Consumers Energy states further weather adjusted actual deliveries for the 12-month period ending February 2006 were 2.8% less (9.3 Bcf) than the 12-month period ending December 2004. This decline includes a 5% reduction (7.7 Bcf) from December 2005 through February 2006. Even though the Company has experienced an increase in the total number of residential and commercial customers, Consumers Energy represents it has experienced a decline in overall sales.

Staff opposes these adjustments. Initially, Staff states it cannot attest to the accuracy of Consumers Energy's calculations due to their complexity and the inability to perform an adequate review in the time allotted. Staff notes that Consumers Energy has recalculated its projected revenues, and states that its new "Weather Normal Tariff Revenue" is \$581,110,000. Staff states this number is not supported by Consumers Energy's exhibits, and does not include the billing determinants necessary to produce rates. The failure to include new billing determinants, Staff asserts, causes Consumers Energy's sales adjustments to be unusable.

Finally, even if the calculations are correct, Staff questions the conclusion that residential and commercial customer sales have been permanently lost in 2006 due to conservation. In response to the representation that Exhibit A-73 depicts the reduction trend in residential and commercial use per customer since the oil embargo in the early 70s; Staff contends Exhibit A-73 shows two distinct time periods. For residential

customers, Exhibit A-73 shows a steep decline in usage per customer between 1973 and 1985, and a very gradual decline from 1985 to date. For commercial customers, Exhibit A-73 displays a similar pattern. Staff opines that conservation measures had their greatest effect in the first half of the 33-year period, and had only a modest impact on gas sales from 1988 to date.

Staff contends a visual examination of Exhibit A-73 shows that residential sales have been quite stable since the beginning of 2003, with the exception of the last few months. Staff asserts the slight dip in the last few months may simply be a short-term phenomenon resulting from customer response to the publicity about high gas prices. Staff takes the position it is too soon to tell if the purported decrease in per customer residential sales is temporary or permanent and it would be a mistake to factor a possible short-term sales loss into the calculation of rates that could be in effect for many years.

The commercial load per customer, Staff states, appears to decline steadily through the entire 2003-2006 period after remaining stable for several years from 1999 to 2003. In light of the stable sales period from 1999 to 2003, Staff offers that an alternative explanation for the commercial customer sales loss is the result of the poor economic climate in Michigan over the past few years. Staff warns that if Consumers Energy's rates are set in this case based on unusually low usage caused by an economic downturn, commercial customers would be hit even harder by higher rates, and will be overpaying when the economic climate improves.

The Attorney General also opposes Consumers Energy's proposed adjustments. The Attorney General argues that Consumers Energy is improperly attempting to rebut

its own direct case.

The Administrative Law Judge is not persuaded that Consumers Energy's two adjustments to throughput should be adopted. Initially the writer finds Staff's inability to test the accuracy of the calculations because of their complexity and the timing of their presentation troubling. In addition, Staff has indicated the sales adjustments are unusable because Consumers Energy did not include the billing determinants necessary to produce rates. Consumers Energy has offered no reply to these arguments.

The Administrative Law Judge also concurs with Staff's review and interpretation of Exhibit A-73. A visual examination of the exhibit supports Staff's contention that the residential and commercial sales declines are not straight line decreases. Residential sales have been relatively stable since the beginning of 2003, with the exception of the last few months. With regard to the decline in commercial usage through the 2003 to 2006 period, Staff's interpretation that the decline is the result of the weak Michigan economy is every bit as plausible as that offered by Consumers Energy. The writer agrees with Staff that Exhibit A-73 does not provide a sufficient basis for the establishment of future rates in this case. Accordingly, the Administrative Law Judge recommends that the Commission reject Consumers Energy's proposed adjustments to throughput levels and instead adopt the throughput level presented in Consumers Energy's direct case and accepted by Staff.

ADJUSTED NET OPERATING INCOME

Net operating income is equal to operating revenues less allowable expenses,

taxes and depreciation. Staff and the Attorney General have proposed adjustments to Consumers Energy's net operating income calculation. Consumers Energy has accepted the Staff positions for a number of the disputed amounts.

Operating Revenues

Consumers Energy accepts the Staff's operating revenue amount of \$664,227,000. (See Exhibit S-4, 4th Revised).

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Staff's operating revenue amount.

WPS Buy/Sell Revenue

Staff proposes an adjustment to miscellaneous revenues to transfer \$1,020,000 that Consumers Energy had accounted for as interest revenue in 2004. This adjustment increases net operating income by \$651,000 (See Exhibit S-4, Schedule C-1, line 8, column o). Staff states the 2004 revenue was the result of a transaction with WPS Energy that Consumers Energy refers to as a gas buy/sell agreement. Staff believes that most of the revenue from the WPS buy/sell agreement was improperly classified "below-the-line" as interest revenue, and should have been recorded "above-the-line" in Account 495, "Other Gas Revenue." The calculation of the \$1,020,000 is shown on Exhibit S-4, Schedule C-3-1.

Staff described the underlying transactions as follows:

In 2004, Consumers Energy entered into a "buy/sell" transaction with WPS. In the months of October and November, Consumers Energy purchased gas from WPS at October 2004 and November 2004 prices. At the same time as it purchased the gas, Consumers Energy resold the same volumes of gas back to WPS at December 2004 prices. Consumers Energy' total purchases of gas were 720,000 Mcf at

\$4,772,000, which it resold to WPS at \$5,942,000, yielding a total margin of \$1,170,000.

Consumers Energy subsequently withdrew the gas from storage, and delivered it to WPS at the prearranged price. Consumers Energy used \$108,000 of the total margin of \$1,170,000 to pay for compressor fuel to inject the gas into storage. The remaining \$1,062,000 was classified as interest revenue. (8 Tr. 1396).

Staff states Consumers Energy characterized the transaction as a short-term loan to WPS, and the net margin of \$1,062,000 was the interest that Consumers Energy charged for the loan. Staff notes the loan to WPS was of a very short term, no longer than two or three months at most. Staff calculated that the size and duration of the WPS loan would reasonably result in interest revenue of approximately \$41,000. (See Exhibit S-4, Schedule C-3-1). For the WPS loan to generate \$1,062,000, Staff maintains the loan would have had to carry an interest rate of almost 120%. Staff contends Consumers Energy's characterization of this transaction as solely a loan to WPS is clearly unreasonable

Staff contends that while \$41,000 of the total margin could reasonably be considered to be interest revenue, the remaining \$1,020,000 of net margin is more appropriately classified as storage service revenue, and should have been recorded in Account 495, "Other Gas Revenue." Staff asserts the economic substance of this transaction is fundamentally a gas storage arrangement, with a purchase and sale of gas superimposed on the storage arrangement. Staff represents the recording of the entire net margin from this transaction as interest revenue is misleading, and inconsistent with generally accepted accounting principles.

In addition to the adjustment, Staff asks that the Commission order Consumers Energy to cease its improper accounting for the margin from any future gas buy/sell

agreements.

Consumers Energy has agreed to Staff's treatment of this revenue for ratemaking purposes in this case. Consumers Energy, however, disagrees with Staff's suggestion that the accounting originally used was improper under generally accepted accounting principles or that any further action is necessary. Consumers Energy maintains the appropriate classification of future transactions may be fact dependent and should not be prejudged.

Consumers Energy has accepted Staff's proposed adjustment to miscellaneous revenues. Accordingly the Administrative Law Judge recommends that the Commission adopt the adjustment and increase net operating income by \$651,000. The Administrative Law Judge also recommends that the Commission order Consumers Energy to cease the improper accounting for the margin from any future gas buy/sell agreements. While future transactions may be fact dependent, the record supports a finding that Consumers Energy's accounting for the transaction described here was improper.

Forfeited Discounts

Forfeited discounts are revenues that Consumers Energy receives when customers do not pay their bills on a timely basis. Staff proposes to increase forfeited discounts revenue by \$3,794,000 to account for the higher level of revenue projected in 2006. The calculation of Staff's adjustment is shown on Exhibit S-4, Schedule C-3-2. This adjustment increases net operating income by \$2,419,000 (See Exhibit S-4, Schedule C-1, line 9, column o).

Consumers Energy accepts Staff's adjustment for Forfeited Discounts.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Staff's adjustment for Forfeited Discounts and increase net operating income by \$2,419,000.

Company Use and Lost and Unaccounted for Gas

The historical test year amount for Company Use and Lost Gas is \$17,740,000. Staff proposes an adjustment to increase the historical level of cost by \$7,076,000 to \$24,816,000. This adjustment reflects Staff's projected \$10.10 per Mcf cost of gas and proposed Lost and Unaccounted for percentage of 0.3912%. (See Exhibit S-6, Schedule F-2-5). Staff's recommendation is based on the historic five-year average LAUF percentage and projected sales and transportation volumes.

Consumers Energy accepts Staff's calculation of Company Use and LAUF Gas.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Staff's calculation of Company Use and LAUF Gas.

Other O&M Expense Levels

Staff projects an increase of \$37,104,000 in certain O&M expenses from 2004 to 2006. (See Exhibit S-4, Schedule C-4). Consumers Energy accepts most of the Other O&M expense levels proposed by Staff. Consumers Energy proposes adjustments to the Staff's Other O&M expense for four categories of expense: (i) the Employee Incentive Compensation Plan (EICP), (ii) injuries and damages, (iii) union contract expenses, and (iv) MGP amortization. The Other O&M expense Consumers Energy is asking the Commission to use in setting rates in this case is \$6,016,000 higher than the level of Other O&M expense calculated by the Staff. The Attorney General proposed

reductions in Consumers Energy's original Other O&M expense in Exhibit AG-30. Those adjustments reduce Consumers Energy's O&M expenses by \$27,365,000. Beginning with Staff's determination of Other O&M expense levels, the various adjustments of Consumers Energy and the Attorney General are discussed below.

Employee Incentive Compensation Plan

Consumers Energy included in the 2006 test year amounts payable pursuant to the EICP. Staff recommends the disallowance of all EICP expense (\$5,673,000) from test year O&M expense. Consumers Energy states the majority of the \$5,673,000 EICP expense relates to compensation of employees who are not officers. Consumers Energy states further that although EICP compensation for both officers and non-officers is a proper expense, for purposes of this case, the Company modified its request to only seek recovery in rates of the \$4,068,000 of EICP expense that is for employees.

In support of its position, Consumers Energy makes the following points: (i) the EICP payments are a part of an overall compensation package designed for the Company's employees, (ii) the overall compensation paid employees is based upon market averages, (iii) paying employees market-based compensation levels is reasonable and is necessary to attract and retain qualified competent employees, (iv) customers are benefited when the utility employs qualified and competent employees, and (v) some of the benefits enjoyed by customers as a result of Consumers Energy having qualified and competent employees are not merely qualitative, but are revealed in the results of industry surveys.

With respect to this final point, Consumers Energy states The American Gas

Association periodically conducts industry surveys that compare utilities based on a variety of measurements. Consumers Energy asserts the most recent AGA survey available (released March 2006) supports the conclusion that the employees of Consumers Energy have been very successful in managing the utility. That survey shows that the Company's costs are below average, thus illustrating that Company employees work efficiently which in turn benefits customers.

Finally, Consumers Energy represents the legal standard on compensation issues allows that unless there is evidence supporting a finding that the expenses are excessive, unwarranted, or made in bad faith, such expenses are properly reflected in rates. Consumers Energy maintains no such evidence regarding EICP payments has been presented in this case.

Staff takes the position that given all the evidence presented, Consumers Energy has failed to prove that the benefits of the EICP program outweigh the costs. Staff cites the most recent Consumers Energy electric rate case and the disallowance of certain non-executive bonuses, executive bonuses and perquisites. There the Commission stated "(t)he benefits of improved employee performance because of Consumers Energy's incentive programs accrue to investors in the form of higher share prices and dividends but benefit ratepayers only tangentially."¹³ The Commission held that:

If Consumers wishes to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it may do so. However, the shareholders that benefit from the plan should pay the costs of the plan.¹⁴

Staff states CMS's 2004 SEC Proxy Statement represents that incentive plans do encourage employees to direct their energy to enhancing shareholder value. Staff

¹³ Case No. U-14347, Opinion and Order dated January 10, 2006, p.34

¹⁴ *Id.* p.35.

states Consumers Energy has failed to show that the benefits of the EICP program outweigh the costs of the program.

With regard to survey data presented in Consumers Energy's rebuttal testimony purporting to show that there is a relationship between offering an incentive plan and suppressing expense levels, Staff points out the comparison of O&M expense levels include GCR related expenses. Since Consumers Energy has the second cheapest gas costs in the country, Staff argues comparing O&M expense levels with other utilities, including GCR items, is not a fair representation. If gas cost items were removed from this analysis, Staff contends Consumers Energy would likely not fair as well as described in the rebuttal testimony.

Staff concludes that it is evident that shareholders are provided a definite benefit as a result of the EICP, but the benefit to customers is yet to be defined.

In Case No. U-14347 the Commission disallowed EICP expense because the incentive plans mostly benefit shareholders. The Administrative Law Judge finds that the record in this case does not support a different determination. The various rationales offered by Consumers Energy in support of its adjustment are only marginally relevant and fail to show that the ratepayer benefits of EICP outweigh their costs.

The discussion of market competitive compensation does not negate the fact that EICP payments are tied to the financial performance of the Company. The industry surveys presented purporting to show that Consumers Energy's operating expenses are at reasonable levels compared with other utility companies, fail to define exactly how the EICP contributes to these results. The direct impact that EICP has on operating expenses has not been demonstrated.

Consumers Energy has argued that compensation expense should not be excluded from rates unless it is proven to be excessive, unwarranted, or made in bad faith. The writer is persuaded that EICP expenses may be excluded in the ratemaking process in this case for the reason that it would be unfair to customers. The EICP payment's link to financial goals creates an obvious benefit to shareholders and it has yet to be determined what benefit, if any, the customer receives from this program. Because EICP benefits shareholders, the expense should be borne by them. Given the Commission's prior determinations, the shareholders should be held responsible for the EICP costs. Based upon the foregoing, the Administrative Law Judge recommends that the Commission reject Consumers Energy's adjustment for EICP expense in this case.

Injuries and Damages

The injuries and damages calculation includes (i) liabilities that arise in the normal course of business, (ii) worker's compensation, and (iii) internal legal costs. Consumers Energy proposes \$4,537,000 for the injuries and damages expense for the 2006 test year, while Staff proposes \$3,761,000. (See Exhibits A-24 and S-4, Schedule C-4).

Consumers Energy states it examined costs for each of the three components separately, while Staff's calculation is based on a five-year average of the injuries and damages expenses. Consumers Energy contends the Staff's injuries and damages calculation should be increased by \$776,000.

With regard to gas damages, Consumers Energy states it and Staff took a five-year average to arrive at an average annual gas damage amount of \$1,602,000. While Staff adopted this amount as its annual gas damages figure, the Company factored in

inflation for 2005 and 2006. Consumers Energy asserts that since inflation increases expenses every year it must be factored in.

With regard to worker's compensation, Consumers Energy states Staff used a five-year average. Consumers Energy began its calculation of the worker's compensation factor with the 2004 actual expense of \$2,192,000. That factor was then increased by the 10% inflation factor, which Consumers Energy maintains is more representative of health care cost inflation according to the Company's actuary, Hewitt Associates. Consumers Energy determined a 2006 worker's compensation component of \$2,652,000. (See Exhibit A-24).

The third component of injuries and damages is the internal legal costs. Consumers Energy states Staff used a five-year average for internal legal costs. Consumers Energy increased the 2004 actual expense by inflation factors for 2005 and 2006 to determine a \$225,000 amount for 2006 internal legal costs. (See *Id.*).

In support of its position, Staff states it relied on a multiple year average because injuries and damages expense is volatile in nature. Staff contends it is inappropriate to apply inflation to the expenses included in injuries and damages because injuries and damages expense fluctuates from year to year with no predictability. Staff contends using a five-year average of injuries and damages expense without inflation is the best estimate available of what level of expense could be experienced in the projected test year.

The Attorney General has addressed this issue and states that Consumers Energy's proposal regarding the workers compensation component is inconsistent with the trend in its actual costs. The Attorney General contends Consumers Energy's costs

should be reduced by \$473,000. With regard to gas damages expense, the Attorney General proposes a \$151,000 decrease to reflect actual 2005 experience and to recalculate a new five-year average. With regard to internal legal costs, the Attorney General recommended increasing Consumers Energy's expense by \$87,000. The Attorney General states the net result of these adjustments is to reduce O&M expense by \$553,000. (See Exhibit AG-40).

The Administrative Law Judge finds Staff has provided the superior method for calculating injuries and damages expense for the 2006 test year. The writer agrees that injuries and damages expense is unpredictable and the use of a five-year average provides the best estimate of future expense. Consumers Energy has not demonstrated that the application of inflation factors to historical levels is justified or appropriate.

Union Contract Impacts

Consumers Energy states that although Staff recognizes some of the contractual obligations under the new union contract, effective June 1, 2005, Staff fails to recognize the impact of the contract on gas operations. Consumers Energy represents the gas operations impact of the Union Contract is \$351,000 in 2005 and \$1,126,000 in 2006. (See Exhibit A-56). Consumers Energy asserts these costs are incurred as a result of its contractual obligations and accordingly, \$1,126,000 should be included in the test year 2006 O&M expenses.

Staff states it recognized the pension expense related to the union contract, but did not include the union specified pay increases in this case. Staff represents it has provided an allowance in rates for pay increases by applying inflation to all O&M

expense. Staff argues that although the pay increases may be slightly higher than the inflation rates utilized, it should be assumed that some O&M expenses will increase at a rate higher than inflation and some will grow at a rate lower than inflation. Staff contends it has included an adequate level of expense for the expected union employee pay increase.

The Attorney General presented Exhibits AG-50 and AG-51, worksheets showing the impact of several adjustments under the union contract. The Attorney General states Consumers Energy has double-counted the rate of inflation. The Attorney General asserts Consumers Energy's \$1,126,000 inflation adjustment should be limited to \$54,000. (See Exhibit AG-52).

The Administrative Law Judge finds that Staff has properly accounted for union employee pay increases in the application of an inflation factor for all O&M expense. The writer agrees with Staff that some O&M expenses will increase at a rate higher than inflation and others will not. An adjustment for this specific item does not appear to be justified. The Administrative Law Judge therefore recommends that Consumers Energy's proposal to include an additional \$1,126,000 in rates for union employee pay increases should be rejected.

Manufactured Gas Plant Recovery

The final adjustment proposed by Consumers Energy to Staff's O&M expense relates to the MGP amortization amount. The difference between the Company and Staff positions with regard to MGP amortization relates to the amount of 2005 costs that should be included in the current case. Consumers Energy asks that the Commission include the costs incurred during 2005 in their entirety when determining MGP

amortization in this case.

This issue was addressed in the discussion of rate base. The Administrative Law Judge found Consumers Energy's position reasonable and recommended that the Commission include all 2005 amounts in rate base. Similarly the writer recommends that the Commission include remediation expenditures from November 2001 through the end of 2005 in this case. Using the full year's actual 2005 costs will increase MGP amortization expense by \$46,000 above the level proposed by Staff.

MGP Expense – Non-Incremental

Staff states that in order to comply with the Commission approved methodology in Case No. No. U-13898,¹⁵ Staff determined that non-incremental costs associated with MGP site cleanup must be excluded from deferrable MGP expenses in this case. Staff notes that in previous years Consumers Energy has deferred the salaries and related costs of its own employees. Staff recommends that, on a going forward basis, Consumers Energy should exclude the costs of its own employees and associated expenses from deferred MGP expenses. Staff includes the 2004 actual amount of \$1,004,735 in projected 2006 O&M expense. (See *Exhibit S-4*, Schedule C-8)

Consumers Energy accepts Staff's adjustment for non-incremental MGP expense.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt the Staff's adjustment for non-incremental MGP expense.

Discount on Accounts Receivable Sold

Staff proposes an adjustment to increase O&M expense by \$6,711,000 for the

¹⁵ Case No. U-13898, Opinion and Order dated April 28, 2005, pp. 28-29.

discount expense on an expected additional sale of accounts receivable in 2006 of \$139 million by Consumers Energy. This adjustment reduces net operating income by \$4,279,000. Staff witness, Mr. Aldrich, testified:

In lieu of other short-term financing options, Consumers sells its customer accounts receivable to outside parties at a discount when this is the most economical alternative. In 2004, Consumers Energy did not fully utilize its accounts receivable financing option, and ended up with a 13-month average balance of gas accounts receivable related assets of \$139,525,000. Consumers Energy has indicated to Staff that it plans to fully utilize its accounts receivable financing option in 2006. Therefore, Staff has reduced Consumers Energy's working capital by \$139,525,000. The adjustment of \$6,711,000 to "Discounts on Accounts Receivable Sold" is necessary to reflect the additional discount expense that Consumers Energy will incur as a result of the higher level of accounts receivable financing. The net effect of reducing working capital, coupled with the additional discount expense, is a reduction in revenue deficiency of about \$5.6 million. (See 8 Tr. 1400).

As noted in the discussion of the capital structure, the Attorney General's witness, Mr. King, imputed \$387 million in short-term debt into the capital structure for funding gas inventory. The Attorney General does not adjust the accounts receivable amount included in rate base and does not reflect any adjustment for related discount expense in adjusted net operating income. Although the Staff's and the Attorney General's adjustments achieve a mathematically similar result for purposes of calculating an income deficiency, the Attorney General contends that his adjustment to Consumers Energy's capitalization has been fully explained and is more consistent with capitalizing and operating a natural gas utility. The Attorney General states the Commission should not adopt both Staff's adjustments to rate base and operating income and his adjustment to short-term debt capitalization

In discussing the capital structure to be used in this proceeding, the Administrative Law Judge rejected the Attorney General's proposal to include \$387

million of short-term debt. The Administrative Law Judge determined that recognition of additional short-term debt in the form of accounts receivable financing to finance gas inventory was preferable to the Attorney General's proposal. Staff has shown that the increase in O&M expense for the discount expense from the expected additional sale of accounts receivable is directly accompanied with an offsetting reduction in working capital. The net effect of reducing working capital, coupled with the additional discount expense, is a reduction in revenue requirements of \$5.6 million.

In addition, Staff has shown that the effect of incorporating this source of financing into the capital structure increases the revenue requirement. Staff explained that if Consumers Energy did not sell their receivables, these accounts receivable would have been included in rate base. If the total company receivable funding of \$347,422,209 is incorporated into the capital structure, rate base will be increased by \$139,524,759. The net effect of these changes increases Consumers Energy's revenue requirement. The Administrative Law Judge therefore finds that Staff's adjustment for the sale of accounts receivable is reasonable and a benefit to ratepayers. The Administrative Law Judge recommends that the Commission adopt Staff's adjustment for the sale of accounts receivable.

The Attorney General's Proposed Adjustments

The Attorney General has accepted the Staff's adjustments to operating revenue and proposed a number of additional adjustments through its witnesses, Ms. Mullinax and Mr. McGarry. With the exception of the Low-Income and Energy Efficiency Fund, Consumers Energy and Staff have not specifically addressed these proposals.

The Attorney General's proposed adjustments for gas property taxes, employee

insurance, compression maintenance, union contract inflation, fleet service expense and safety related expenses address positions taken by Consumers Energy in its direct presentation. As noted above, Consumers Energy accepted the Staff's position on O&M expense except for four items. Given the abandonment by Consumers Energy of its original position, the writer is unable to discern a relationship between Consumers Energy's current position and the adjustments proposed by the Attorney General. Accordingly, the writer finds these six adjustments no longer relevant.

Low-income and Energy Efficiency Fund

Staff proposes that \$17,427,000 be contributed by Consumers Energy to the Low Income Energy Efficiency Fund (LIEEF). This adjustment decreases net operating income by \$11,112,000. Staff's LIEEF funding recommendation is equal to 2% of the total commercial and industrial revenue of \$871,351,000. (See Exhibit S-4, Schedule C-6). Consumers Energy has accepted Staff's proposal.

Staff presented the following four recommendations regarding LIEEF;

- (1) The LIEEF program is very important and should continue;
- (2) Approximately \$17,427,000 in contributions from Consumers Energy customers under Case No. U-14547;
- (3) All Consumers Energy gas customers should contribute to LIEEF, including gas choice customers; and
- (4) Policy considerations that address improving the affordability of basic energy needs for low-income citizens; including shifting an increasing portion of LIEEF funds away from energy financial assistance and towards energy efficiency improvements, directing LIEEF funds to the best, most effective programs for both energy financial assistance and low-income energy efficiency, and augmenting LIEEF funds with other sources of financial support. (See 8 Tr. 1476-1481).

The Attorney General opposes the LIEEF proposal. The Attorney General

acknowledged the importance of the LIEEF, but contends that the statute creating LIEEF¹⁶ only applies to electric utilities that securitize costs. The Attorney General states that since this proceeding concerns Consumers Energy's gas service, the Commission lacks the authority to create a new O&M cost for gas service and increase natural gas rates to recover LIEEF payments. ABATE supports the Attorney General's position on this issue.

The Administrative Law Judge agrees with Staff's assessment of the LIEEF, the need for its continued existence and Staff's recommendations regarding LIEEF. Staff notes that Consumers Energy has concurred in its position. In response to the Attorney General, Staff has argued that the Commission may authorize LIEEF pursuant to its general rate making authority found in MCL 460.6, as amended. Staff also observes that the Commission has in Case No. U-13808¹⁷ chosen to continue LIEEF independent of the requirements of MCL 460.10d(7). The Administrative Law Judge finds that the Commission may continue the LIEEF pursuant to its general rate authority. Accordingly, the writer recommends that the Commission adopt Staff's proposals regarding the LIEEF.

401(k) Savings Plan Match

Staff states that in its direct case it inadvertently excluded Consumers Energy's 401(k) Savings Plan match costs, resulting in a \$3,991,000 understatement of O&M expense. Staff notes it corrected this understatement in its surrebuttal case with the inclusion of the adjustment to increase O&M expense by \$3,991,000. This adjustment reduces net operating income by \$2,545,000.

¹⁶ MCL 460.10d(7).

¹⁷ Case No. U-13808, Opinion and Order dated November 23, 2004, p. 116.

The Administrative Law Judge finds this adjustment reasonable and recommends its adoption.

Depreciation

Staff states it applied Consumers Energy's approved depreciation rates to Staff's projection of plant-in-service to calculate the 2006 depreciation expense. Staff projects this expense to be \$120,557,649. (See Exhibit S-4, Schedule B-9).

Consumers Energy accepts Staff's determination of depreciation expense.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt the Staff's calculation of 2006 depreciation expense.

Property Taxes

Staff states it made several adjustments to the 2006 calculation of property tax expense. Staff adjusted the percentage rate applied to the 2004 and 2005 taxes paid from 45.67% to 56.95%. (See Exhibit S-4, Schedule C-10). Staff also lowered Consumers Energy's estimated 2005 property tax expense to \$36.9 million, based on the actual 2005 property tax expense. Finally, Staff reduced the 2005 property tax expense by \$1.6 million in refunds received in 2005 for property taxes overpaid in 2000-2004. One fifth of this refund is being deducted from the 2005 property tax expense to represent the 2004 amount overpaid.

Consumers Energy accepts Staff's determination of property tax expense.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt the Staff's calculation of 2006 property tax expense.

Other Taxes

Consumers Energy proposed a \$2,141,000 adjustment to increase other tax expense. Staff states it has reviewed Consumers Energy's adjustment and agrees that it is reasonable. This adjustment reduces net operating income by \$1,365,000.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Consumers Energy's adjustment to increase other tax expense.

Michigan Single Business Tax

Appendix C, page two, of the Consumers Energy's Initial Brief develops the projected Michigan Single Business Tax (MSBT) expense beginning with its original filing position of \$3,608,000. Included in this amount is an adjustment to reduce the projected MSBT expense by \$282,000.

Staff accepts Consumers Energy's \$282,000 reduction in MSBT expense.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Consumers Energy's calculation of MSBT expense.

Federal Income Tax

Appendix C, page two, of Consumers Energy's Initial Brief develops the projected Federal Income Tax (FIT) expense beginning with the Company's original filing position of \$12,735,000. Staff states that included in this amount are two adjustments that, in total, reduce FIT expense by \$416,000. These adjustments include a \$1,050,000 reduction in FIT expense related to the replacement of an insurance carrier and a \$634,000 increase in FIT expense related to the tax timing differences caused by differences in depreciation rates. Staff accepts both of these adjustments.

Staff states that it also supports a \$47,000 reduction in FIT expense to reflect the change in the amount of non-deductible meals and entertainment expense reported in the Company's 2004 tax return. Staff represents the difference in the non-deductible expense arose when it was provided with a more current reconciliation of Consumers Energy's book net income with its taxable net income.

Finally, Staff states that in its original filing, it supported a \$505,000 reduction to FIT related to the Consumers Energy's failure to account for a decrease in Deferred Federal Income Tax associated with contributions in aid of construction. After further review, Staff concludes that this reduction in FIT would be completely offset by an increase in current income tax expense in the same amount. Accordingly, Staff no longer supports a \$505,000 reduction to FIT expense.

Consumers Energy has not addressed this change in Staff's position, but may do so in its Exceptions and Replies to Exceptions. For purposes of this Proposal for Decision, the Administrative Law Judge adopts the Staff's calculation of FIT expense.

Allowance for Funds Used During Construction

Consumers Energy accepts Staff's proposed amount for Allowance for Funds Used During Construction (AFUDC). (See Exhibit S-4, Schedule C-1, 4th Revised).

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Staff's calculation of AFUDC.

Pro Forma Income Tax Savings

Staff states the purpose of this adjustment is to calculate the change in income taxes due to the change in interest expense allowed Consumers Energy in this case.

Staff states further that since projected interest expense is greater than the 2004 interest expense, income taxes should be decreased by \$1,422,000. (See Exhibit S-4, Schedule C-13).

Consumers Energy and Staff agree on the calculation of Pro Forma Income Tax Savings, although due to differences in rate base, the actual amount of this adjustment is slightly different. Accordingly the Administrative Law Judge recommends that the Commission adopt an adjustment for Pro Forma Income Tax Savings reflecting the findings and recommendations presented above.

Interest Synchronization

Staff states the purpose of this adjustment is to ensure that Consumers Energy receives the pre-tax overall rate of return on gas rate base supported by its deferred JDITC balance. Staff proposes a \$214,000 adjustment for interest synchronization. This adjustment reduces Federal income tax expense by \$214,000. (See Exhibit S-4, Schedule C-14, Revised).

Consumers Energy and Staff agree on the calculation of Interest Synchronization, although due to differences in rate base, the actual amount of this adjustment is slightly different. Accordingly the Administrative Law Judge recommends that the Commission adopt an adjustment for Interest Synchronization, reflecting the findings and recommendations presented above.

Calculation of Adjusted Net Operating Income

Based upon the preceding findings, conclusions and recommendations the Administrative Law Judge finds Consumers Energy's adjusted net operating income is

\$103,278,000. (See Attachment C).

OTHER REVENUE RELATED ISSUES

New Business Capital Expenditures

Consumers Energy takes the position that new business construction expenditures need to be included in determining its revenue deficiency. In support of this position Consumers Energy states the known and measurable approach to ratemaking includes the assumption that year after year, deliveries to customers will increase, thereby providing the incremental revenues required to allow the Company to cover the expenses incurred to serve new customers and earn its authorized return on new investments.

Consumers Energy represents that due to the continued decrease in deliveries there is no incremental revenue available to cover the investment in new business or related increases in operating expenses. Consumers Energy asserts that as a result it will not achieve its authorized return on a ratemaking basis. Consumers Energy proposes that the new business capital expenditures and the related return, depreciation, and property taxes be included as allowable recoverable costs in the calculation of the revenue requirement. This results in a total revenue requirement adjustment of \$7,272,000. (See Exhibit A-78).

Staff and the Attorney General oppose this adjustment. Staff asserts Consumers Energy's proposed adjustment is illogical and double-counts the effect of alleged decreases in sales volume. Staff states it is axiomatic that new customers generate new sales. Staff states further that with its adjustment to reduce sales volumes,

Consumers Energy has accounted for its purported sales decline due to conservation. Consumers Energy then seeks recovery of additional costs using the same lost sales volume as a reason for recovering the new customer plant costs, without recognizing the additional sales generated by the new customers. Staff asserts this adjustment results in a double counting of the purported sales loss.

The Attorney General takes the position the proposed revenue requirement adjustment does not relate to used-and-useful plant-in-service. The Attorney General argues no evidence has been produced to prove that the underlying amounts are or will be reasonably and prudently incurred.

The Attorney General observes that Consumers Energy assumes that rates approved in this case will not recover those new business capital expenditures. The Attorney General states that actual results may be either higher or lower than the results determined in a test year. The future is unknown. For this reason, the Attorney General states, a utility is only entitled to a reasonable opportunity to earn a profit; a utility is not guaranteed a profit or return on its investment. [See *Detroit Edison Co v PSC*, 127 Mich App 499, 517; 342 NW2d 273 (1983), *FPC v Natural Gas Pipeline Co*, 315 US 575, 590; 62 S Ct 736; 86 L Ed 1037 (1942), and *Building Owners & Managers Ass'n v PSC*, 424 Mich 494, 510; 383 NW 2d 72 (1986)].

The Administrative Law Judge agrees with Staff and the Attorney General. Consumers Energy's proposed adjustment fails to recognize the additional sales generated by the new customers. In addition, the Attorney General has correctly observed that Consumers Energy is not guaranteed a certain level of profit in the ratemaking process. The Administrative Law Judge therefore recommends that the

Commission reject Consumers Energy's proposed adjustment for new business capital expenditures.

Gas Storage Regulatory Asset

Consumers Energy originally proposed that the Commission allow recovery of a regulatory asset for gas loss in storage over a three-year amortization period. In its Initial Brief Consumers Energy accepted the Staff's position to include the recovery of these losses in the five-year average of gas losses and withdrew its request.

Pension Contribution Regulatory Asset

Consumers Energy originally proposed in this case that the Commission allow creation of a regulatory asset for the gas portion of the 2003 pension contribution, with recovery over a 20-year amortization period. In its Initial Brief Consumers Energy accepted the Staff recommendation to address the impact of the pension contribution through the working capital calculation and withdrew its request.

Trackers

Consumers Energy proposes the Commission establish a Pension Equalization Mechanism (PEM) in this case. Consumers Energy states the sensitivity of pension expense to changes in interest rates and asset returns creates a significant potential for large variability in pension expense. Since pension expense is recognized in rates, Consumers Energy represents that both customers and the Company would benefit from a mechanism that eliminates the risk of future volatility in pension expense.

Consumers Energy states the PEM would allow the annual difference between the pension expense included in rates and the actual annual pension expense recorded

by the Company pursuant to SFAS No. 87 to be deferred. If the annual pension expense is greater than the expense in rates, the difference would be recognized as a regulatory asset for future recovery. Similarly, if the annual pension expense is less, the Company would recognize a regulatory liability for distribution to customers. (See 2 Tr. 37).

Consumers Energy states that under its proposal, if pension expense should ever become negative, a zero cost would be reflected and a regulatory liability recorded until pension expense became positive. Consumers Energy states further that this process would be monitored by annual submissions to the Commission. Consumers Energy maintains a separate tracking of these costs will likely avoid the need for general gas rate cases as a result of shifts of pension expenses.

Consumers Energy also proposes the establishment of an Other Post Employment Benefits (OPEB) Equalization Mechanism. Consumers Energy offers the same reasoning in support of the OPEB Equalization Mechanism as the PEM and states the OPEB Equalization Mechanism would work in the same way as the PEM. (See 2 Tr. 39).

Consumers Energy asks that these mechanisms be allowed to operate for the entire 2006 year. Consumers Energy contends the sooner these mechanisms are effective, the less exposure the Company will have to expenses that are largely beyond its control. Consumers Energy states its pension expense is projected to increase from \$4.6 million in 2004 to \$22.1 million in 2006. OPEB expense is projected to increase from \$18.5 million in 2004 to \$21.4 million in 2006. If the Company is not allowed to include these mechanisms from the beginning of 2006, Consumers Energy asserts this

increased level of expense will negatively impact its ability to achieve its authorized return on equity.

Consumers Energy states that in Case No. U-13898,¹⁸ the Commission provided for an Uncollectible Expense True-up Mechanism. The Commission based its decision, Consumers Energy represents, on the fact that the single largest influence on uncollectible expense is the cost of natural gas, which has significantly increased recently.

Based on this precedent, Consumers Energy asks that the Commission allow it to incorporate an Uncollectible Expense True-up Mechanism (UETM) in its rates. This true-up mechanism would require the Company to make the appropriate filings on or before March 31 of each year. The filing would compare the Company's actual uncollectible expense for the preceding calendar year with the base level of uncollectible expense included in the Company's rates with the future collection or refund of 90% of the difference. (See 5 Tr. 805-806). Consumers Energy states this mechanism would allow it to recover its uncollectible expense regardless of the level of uncollectible expense included in this case. Consumers Energy asserts this tracking mechanism, similar to the PEM and OPEB Equalization Mechanism, will help protect customers and the Company from uncollectible expense volatility.

Staff supports Consumers Energy's request to implement a PEM and an OPEB Equalization Mechanism and states the equalization mechanisms proposed are based on the PEM and OPEB Equalization Mechanism approved in Consumers Energy's electric rate case, Case No. U-14347. Staff notes that as is the case for the Consumers Energy's electric PEM and OPEB Equalization Mechanism, any pension plan or other

¹⁸ Case No. U-13898, Opinion and Order dated April 28, 2005, p. 71.

post-employment benefit plan enhancements that are not reflected in the pension and other post employment benefit expenses approved in this case would not be recoverable in the PEM or OPEB Equalization Mechanism.

The Attorney General objects to these proposals and argues that while there are statutes that authorize the Commission to adopt adjustment mechanisms, there is no statute that empowers the Commission to adopt a PEM, OPEB Equalization Mechanism or UETM. The Attorney General states that inasmuch as the Legislature has expressly authorized certain adjustment clauses and since the Commission's powers must be identified by clear and unmistakable language, the Commission lacks the power to adopt Consumers Energy's proposed equalization mechanisms. [See *Taylor v Michigan Public Utilities Comm'n*, 217 Mich 400, 402-403; 186 NW 485 (1922), and *Consumers Power Co v PSC*, 189 Mich App 151, 179-180; 472 NW2d 477 (1991)]. The Attorney General concludes that the Commission is therefore required to reject Consumers Energy's proposals because it lacks subject matter jurisdiction.

ABATE concurs with the positions expressed by the Attorney General. ABATE states it is opposed to trackers because they focus on only one aspect of the revenues and expenses experienced by a regulated utility. If implemented, trackers will insulate a utility and its shareholders from the ratemaking process which looks at all expenses and all revenues in determining what are just and reasonable rates.

ABATE maintains that to the extent the number of trackers increase, utilities will have less incentive to control their costs and will avoid rate cases if the trackers result in over earnings. ABATE states that gas utilities such as Consumers Energy already have 80-85% of their costs covered by a form of tracker called the GCR factor. ABATE

contends that if pension, other post employment benefits and uncollectible expenses are given the protection of trackers, then a substantial amount of non-gas costs will be subject to trackers and Consumers Energy's business risk will be reduced and almost eliminated. ABATE urges the Commission to reject the use of trackers in the utility ratemaking process.

The Administrative Law Judge is persuaded that Consumers Energy should be authorized to implement a PEM and OPEB Equalization Mechanism. In light of the Commission's approval of similar mechanisms for Consumers Energy's electric business, it is reasonable to provide for the same trackers for the gas business. The writer is not, however, persuaded that it would be appropriate to permit the implementation of a UETM at this time. The record shows that Consumers Energy's uncollectible expense rate is 0.53%, compared to MichCon's uncollectible expense rate of 2.46%. The Administrative Law Judge is not satisfied that the precedent established by the Commission in Case No. U-13898 is applicable in this proceeding. Accordingly, the Administrative Law Judge recommends that the Commission approve the implementation of a PEM and OPEB Equalization Mechanism for Consumers Energy's gas business and reject Consumers Energy's request to implement a UETM at this time.

REVENUE DEFICIENCY

Based upon the preceding findings, conclusions and recommendations the Administrative Law Judge finds a 2006 test year revenue deficiency of \$74,127,000. (See Attachment D).

Case No. U-13730 Rate Increase

The Attorney General states that the revenues identified by the parties in this case include revenues from the temporary rate increase approved in Case No. U-13730. The Attorney General states further that including these revenues is appropriate since that rate order extends until late in the 2006 test year.

Consumers Energy has asked that the \$58,124,000 increase authorized in Case No. U-13730 be made permanent.

The Attorney General proposes that the Commission defer action on this request until such time as the requirements of the Commission's order in Case No. U-13730 are satisfied. The Attorney General states that the Commission's order authorized Consumers Energy to implement a surcharge of \$58,124,000 for a two-year period. The Commission required that an annual report be filed within 30 days after the end of each of the next two 12-month periods and created a mechanism that would refund to ratepayers surcharge revenues above those intended by the Order, including an evaluation of the rate of return on common equity. (See Case No. U-13730, Opinion and Order dated October 14, 2004, pp.33-34). The Attorney General maintains that it would be premature to make the Case No. U-13730 surcharge permanent at this time.

The Administrative Law Judge agrees with the Attorney General in this regard. The Commission established certain requirements in its Case No. U-13730 order. It is reasonable to provide that those various requirements are satisfied before the issue of whether the \$58,124,000 surcharge should be made permanent is addressed.

RATE DESIGN AND TARIFF ISSUES

Allocation of the Revenue Deficiency

Consumers Energy, the Staff and ABATE submitted testimony on the issue of how the revenue deficiency should be allocated among the various rate classes.

The Staff proposed to allocate the revenue deficiency among all rate classes, except rate GL, outdoor lighting, as an equal percentage of each class' present revenue, excluding GCR revenue. (See Exhibit S-6, Schedule F-1-2, lines 1 through 9). Staff witness, Mr. Michael Collins, testified that the Staff's recommendation is based upon the results of Consumers Energy's 2006 Cost of Service Study (See Exhibit A-11, Schedule F-6). Based on his comparison of the 2006 allocated revenue requirement versus the current revenue by rate class as a percentage of total revenue, the witness testified the results indicated that current rates are closely aligned with the cost of providing service to the three major classes of customers. The Staff concludes that in order to maintain the current rates' close alignment with the cost of providing service; the Commission should apply an equal percentage allocation of any revenue deficiency to all classes.

Consumers Energy accepts Staff's position with regard to rate design. Consumers Energy states its current rates are very closely aligned with the cost of providing service to each class of customers. Consumers Energy asserts that Staff's proposal to allocate the revenue deficiency on the basis of each class's current percentage is much simpler to implement and should be used in this case.

Citing equity, engineering efficiency, conservation and stability, ABATE takes the position that the primary factor and guiding principle in determining the rate design

should be the cost of service. If rates are not based upon cost of service, then some customers necessarily will subsidize other customers. ABATE recommends that the Commission adopt a cost based allocation that would allocate 18% of any rate increase to transportation customers and 23% to sales customers (Residential and General Service classes). (See Exhibit A-11, F-1).

ABATE's witness, Mr. Phillips, sponsored Exhibit AB-1, which presents a summary of Consumers Energy's 2006 test year cost of service study by major rate classes. ABATE maintains this study demonstrates that the transportation service class is significantly above cost of service, the general service class is above cost of service and the residential class is below cost of service. ABATE concludes that the transportation class is entitled to a less than average rate increase in order to move the transportation class closer to cost of service.

ABATE states Exhibit AB-4 compares current rates, including the \$58.1 million temporary increase granted in Case No. U-13730, and Consumers Energy's proposed rates. ABATE represents this exhibit demonstrates how the actual allocations would be translated into individual rates and rate increases. ABATE recommends that this exhibit be used to design rates to recover any revenue deficiency found in this case. ABATE notes, however, that it may be necessary to fine tune rates in order to maintain the economic break even points between the three transportation service classifications.

ABATE concludes that utilizing cost-based rates will lead to better planning by all classes of utility customers as well as provide customers with incentives to minimize their costs, which in turn will minimize the cost to the utility. ABATE asserts its proposal is supported by the record, is theoretically sound, economically efficient, provides

continuity in ratemaking, will promote conservation and result in just and reasonable rates.

After reviewing the positions of the parties, the Administrative Law Judge is persuaded that Staff's proposal to allocate the revenue deficiency among all rate classes, except rate GL, as an equal percentage of each class' present revenue, excluding GCR revenue is reasonable and recommends its adoption in this case. The record shows that Consumers Energy's current rates are very closely aligned with the cost of providing service to each rate class. Consequently an equal percentage allocation of any revenue deficiency will maintain that alignment of rates with costs. Staff witness Mr. Collins testified:

The Residential class percentage of total revenue is currently 73.7% while Consumers Energy's COSS indicates the Residential class should contribute 73.8% of the total revenue requirement for all classes of service. Similarly, the General Service class currently contributes 19.8% of Consumers Energy's total revenue while the COSS indicates they should contribute 19.9%. Finally, the Transportation class currently contributes 6.5% of the total revenue while, according to the COSS, they should contribute 6.2%. This demonstrates that Consumers Energy's current rates are closely aligned with their cost of service. (See 8 Tr. 1501).

Finally, the Administrative Law Judge notes that Staff's allocation on an equal percentage of present revenue achieves results very similar to Consumers Energy's original proposal, but is simpler to implement. The Administrative Law Judge therefore recommends that the Commission adopt the Staff's method for allocating any revenue deficiency.

Rate Design

Exhibit S-6, Schedule F-5 presents a summary of Consumers Energy's current

rates and Staff's proposed rates. Staff states its agreement with Consumers Energy's general proposal to maintain the current rate structures for all classes of customers. Staff also agrees with Consumers Energy's recommendation to increase the monthly customer charge for residential customers, but does not support as large an increase as requested by Consumers Energy. Staff's witness, Mr. Collins, reviewed Consumers Energy's cost of service analysis and testified that the study would support an increase in the monthly customer charge from \$7.50 to \$8.50 for residential customers.

Staff states that in addition to the increase in the monthly customer charge for residential customers, Consumers Energy requested an increase in the Excess Peak Demand Charge of \$0.0366 per Mcf to \$0.0421 per Mcf. The Excess Peak Demand Charge is intended to recover customer related costs from the larger Multiple Family Dwelling Service Rate A-1 customers. Staff notes that the charge has not been increased since it was first adopted in 1984. Staff proposes to increase the Excess Peak Demand Charge in proportion to the increase in the residential customer service charge, an increase of 15%.

Staff also recommends that the monthly customer charge for General Service customers in service category GS-1 remain equal to the residential customer charge. This change, along with the overall rate increase allocated to each class requires that the other General Service customer charges be adjusted to maintain the existing economic breakeven points between the service categories GS-1, GS-2, and GS-3. Staff states that with the proposed GS-1 customer charge and the recommended rate increase, it is necessary to increase the monthly customer charge for GS-2 from \$15 to \$16.15 per month, and for GS-3 from \$375 to \$416 per month. If the Commission finds

a revenue deficiency different than that proposed by Staff, it will be necessary to recalculate the customer charges for GS-2 and GS-3 to maintain the economic breakeven points.

Staff supports Consumers Energy's request to increase the Outdoor Lighting Rate GL charges from \$12 to \$15 per month for single mantle fixtures and from \$15 to \$18 per month for double mantle fixtures based on recent increases in gas costs. Staff states these fixtures are not metered so the fixed monthly charges must cover all costs of service, including the cost of gas, which has increased significantly recently.

Staff also supports Consumers Energy's recommendation to maintain the existing economic breakeven points between Transportation Service categories ST, LT, and XLT. Staff states the current breakeven point between Rates ST and LT is 100,000 Mcf per year and 500,000 Mcf per year between Rates LT and XLT. Based on Staff's initially filed revenue deficiency of \$62,385,000 the customer charge for Rate ST should be increased from \$450 to \$500 per month, the customer charge for Rate LT should be increased from \$2,360 to \$2,600 per month, and the customer charge for Rate XLT should be increased from \$6,100 to \$6,700 per month. Each of these proposed customer charges should be adjusted as needed to maintain the current economic breakeven points if the Commission finds a different revenue deficiency.

Staff agrees with Consumers Energy's recommendation to modify the Gas-in-Kind (GIK) percentage for the Transportation Service customers, but proposed a different percentage. Mr. Collins testified that the GIK should be increased from 0.82% to 1.18%. (See Exhibit S-6, Schedule F-2-4, line 29). The GIK percentage is applied to transportation customers' monthly deliveries to compensate Consumers Energy for

Company Use and Lost and Unaccounted For Gas associated with those deliveries.

Finally, Staff recommends that the Commission approve a new Carrying Cost Rate and Discount Rate for Consumers Energy's Customer Attachment Program, Rule B11. (See Exhibit S-6, Schedule F-4, page 5 of 5 and Schedule F-5, lines 56 and 57). Based on Staff's proposed capital structure the Carry Cost Rate would decrease from 11.31% to 10.55% and the Discount Rate would decrease from 8.52% to 6.73%. Staff notes that lowering these interest rates will reduce the cost for new customers to attach to Consumers Energy's gas distribution system. If the capital structure adopted by the Commission is different than Staff's proposed capital structure, these rates should be recalculated.

Consumers Energy states it did not propose any changes to the current rate design, but like Staff, did propose some modifications to its current rates. (See Exhibit A-11, Schedules F-4, F-5, F-9, and F-10). In its Initial Brief, Consumers Energy accepts the Staff's position with regard to rate design.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt the Staff's rate design.

Consumers Energy proposed several modifications to its current rules and rate schedules other than price level changes. These include:

Rule B5.3(B)	Tariff Sheet No. B-41.00
Rule B5.6	Tariff Sheet Nos. B-43.00 and B-44.00
Rule B11(D)	Tariff Sheet No. 61.00
Rule F2.1	Tariff Sheet No. F-2.00

Staff supports Consumers Energy's proposed tariff changes with one exception. Staff disagrees with Consumers Energy's proposal to modify Rule B5.3(B) to provide that separately metered natural gas generators are not typical household equipment as

referenced in Rule B5.3(A) and; therefore, do not qualify as residential usage. Staff asserts a generator that is used by a residential customer to provide back up electricity for their own residential usage should be considered a residential use of gas. Based on Staff's position, Consumers Energy has withdrawn this proposed amendment. The revised tariff sheets are shown on Exhibit A-11.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt Consumers Energy's proposed tariff changes, with the exception noted above, as shown on Exhibit A-11.

Staff recommends that the Commission direct Consumers Energy to discontinue filing a Monthly Rate Summary report with Staff. Staff states this reporting requirement dates back to 1989 and current electronic technology makes this report obsolete. Discontinuing this report, Staff represents, will save resources and reduce paperwork.

Consumers Energy accepts Staff's proposal to discontinue filing a Monthly Rate Summary report.

Based on this concurrence, the Administrative Law Judge recommends that the Commission adopt the Staff's proposal to discontinue this monthly filing.

Gas Customer Choice Reconciliation

The Gas Customer Choice (GCC) Program became available to customers beginning on January 1, 2002 pursuant to Case No. U-12550 (Opinion and Order dated August 4, 2000). Consumers Energy's GCC Program standards and regulations are located in Section H of Consumers Energy's tariffs. Consumers Energy's GCC Program is a buy/sell program which means that when gas is delivered to the Company's system, the supplier is paid the price set by the supplier (with a cap)

whether it is used by the GCC customers or not. Consumers Energy has an end of the GCC-year reconciliation, in which the difference between the amount paid to the supplier is reconciled against the amount billed to the customer and the supplier receives payment for all gas billed to the GCC customers that was supplied by the supplier in that price pool. Volumetric reconciliations between gas delivered and gas consumed in each price pool are also performed.

NEMA contends that the current procedure for a pool by pool annual reconciliation prohibits the development of a truly fair and balanced GCC Program. In order to resolve this imbalance, NEMA recommends that the Commission adopt an aggregate reconciliation of deliveries to replace the pool by pool analysis. NEMA represents that this recommendation will ensure that Consumers Energy's annual reconciliation procedures for the GCC customers are fair and equitable and do not operate as a detriment to the GCC customers. NEMA asserts that adopting and implementing this recommendation will not change deliveries or delivery schedules nor would it change the rules applied to the imbalances at the end of the year. NEMA contends the utility would still be made whole for any gas supplied to GCC customers. NEMA states that the only difference would be the reconciliation of the net imbalance for both price and volume.

In the alternative, NEMA requests that the Commission initiate a collaborative proceeding with interested parties in order to address issues involving the GCC Program suppliers. NEMA states that in addition to the recommendations for change in the annual reconciliation, the Commission should take this opportunity to review the GCC Program in general since more than five years has passed since its

implementation in Michigan and as such, reevaluation of its effectiveness and fairness is necessary.

The Staff, Consumers Energy and the Attorney General oppose the alternative proposals offered by NEMA. Collectively these parties recommend that the Commission reject the proposals submitted by NEMA and instead continue use of the current policy. These parties maintain that the current procedures are fair, effective and reasonable for GCR and GCC Program customers. Citing problems with NEMA's recommendations, the Staff and Consumers Energy conclude that the proposals are vague, unsupported in the record and fail to take into account the financial impact on the reconciliation procedure and the price of gas for each pool as well as their corresponding revenues.

The Administrative Law Judge is persuaded that NEMA's proposals regarding Consumers Energy's GCC Program are not sufficiently developed in this record to merit consideration. In its direct presentation, NEMA did not present any specific tariff changes, had not gone through a reconciliation with Consumers Energy and did not fully explain how the process could be improved. In addition, the financial impact from an aggregate reconciliation is unclear. The writer agrees with Consumers Energy that changing one variable of the program could affect other aspects of the program and adversely affect GCR customers. Any changes to the GCC tariffs would warrant a review of all the GCC tariffs. Accordingly, the Administrative Law Judge recommends that the Commission reject NEMA's proposal for an aggregate reconciliation of deliveries to replace the current pool by pool analysis.

The Administrative Law Judge finds further the record does not support the

initiation of a working group to resolve issues dealing with the delivery of gas to the customers of alternative gas suppliers participating in the GCC Program. The record evidence shows that the current process is working fine. Accordingly, the Commission should also reject NEMA's alternative proposal to establish a collaborative proceeding, there being no demonstration of need for such a proceeding in this record.

CONCLUSION

All contentions of the parties not specifically addressed and determined herein are rejected, the Administrative Law Judge having given full consideration to all evidence of record and arguments in arriving at the finding and conclusions set forth in this Proposal for Decision.

Based upon the foregoing discussion, findings and conclusions, the Administrative Law Judge recommends that the Commission issue its order approving the application of Consumers Energy Company for authority to increase its rates for the distribution of natural gas, as modified by this Proposal for Decision, including the adoption of: a projected 2006 test year; a rate base of \$2,251,247,000; an overall rate of return of 6.69%, including a return on common equity of 11.0%; an adjusted net operating income of \$103,278,000; and a revenue deficiency \$74,127,000, to be allocated among all rate classes, except rate GL, as an equal percentage of each class' present revenue. The decision of whether the Case No. U-13730 surcharge should be

made permanent should be deferred until all the requirements of that order have been satisfied.

STATE OFFICE OF ADMINISTRATIVE
HEARINGS AND RULES
For the Michigan Public Service Commission

James N.
Rigas

Digitally signed by James N.
Rigas
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James N. Rigas
Administrative Law Judge

ISSUED AND SERVED: July 14, 2006

dmp

Attachment A

Consumers Energy Company
Case No. U-14547
Rate Base
Proposal for Decision
(000)

		Staff Rate Base 2005 Test Year
Line	Description	
	Utility Plant	
1	Plant-in-Service	\$3,141,226
2	Construction Work In Progress	\$33,968
3	Total Utility Plant	<u>\$3,175,194</u>
4	Less: Depreciation Reserve	\$1,919,639
5	Less: Retained from Contractors	\$730
6	Less: Customer Advances for Const.	\$109
7	Net Utility Plant	<u>\$1,254,716</u>
8	Unamortized MGP Expense	\$20,699
9	Working Capital	\$975,832
10	Rate Base	<u><u>\$2,251,247</u></u>

Attachment B

Consumers Energy Company
Case No. U-14547
Calculation of Overall Rate of Return
Proposal for Decision
(000)

Line	Description	Amount (000)	Permanent Capital	Total Capital	Cost Rate	Weighted Cost of Permanent Capital	Weighted Cost of Total Capital
		(a)	(b)	(c)	(d)	(e)	(f)
1	Long Term Debt	\$4,057,054	56.81%	46.77%	5.63%	3.20%	2.63%
2	Preferred Stock	\$44,038	0.62%	0.51%	4.46%	0.03%	0.02%
3	Common Equity	3,040,717	42.58%	35.06%	11.00%	4.68%	3.86%
4	Total Permanent Capital	<u>\$7,141,809</u>	<u>100.00%</u>			<u>7.91%</u>	
5	Short-Term Debt	\$90,000		1.04%	5.75%		0.06%
6	Other Interest-Bearing Accounts	\$35,000		0.40%	5.57%		0.02%
7	Customer Deposits	\$28,000		0.32%	9.00%		0.03%
8	Deferred ITC	\$0		0.00%	0.00%		0.00%
9	Deferred FIT	\$1,309,000		15.09%	0.00%		0.00%
10	JDITC - L/T Debt	\$39,765		0.46%	5.63%		0.03%
11	JDITC - P/S	\$432		0.00%	4.46%		0.00%
12	JDITC - C/E	<u>\$29,803</u>		0.34%	11.00%		<u>0.04%</u>
13	JDITC - Total	<u>\$70,000</u>					<u>0.06%</u>
14	TOTAL	<u><u>\$8,673,809</u></u>		<u><u>100.00%</u></u>			<u><u>6.69%</u></u>

Attachment C

Consumers Energy Company
Case No. U-14547
Adjusted Net Operating Income
Proposal for Decision
(000)

Line	Description	Adjusted NOI
	Historical Test Year	
1	Historical Operating Income	\$ 137,290
2		
3	<u>Adjustments:</u>	
4		
5	Sales and GCR Cost	18,919
6	Transportation	(1,988)
7	Miscellaneous Revenue	(307)
8	WPS Buy/Sell Revenue	651
9	Forfeited Discounts	2,419
10	Company Use & Lost Gas	(4,512)
11	Other O&M	(23,659)
12	Discounts on Accounts Rec. Sold	(4,279)
13	LIEEF	(11,112)
14	MGP Amortization	(953)
15	MGP Expense: Non-incremental	(641)
16	Depreciation	(5,162)
17	Property Taxes	(1,243)
18	Other Taxes	(1,365)
19	MSBT	183
20	Federal Income Taxes	463
21	Pro Forma Income Tax Savings	918
22	Interest Synchronization	203
24	401(k) Savings Plan Match	(2,545)
25		
26		
27	Adj. 2006 Operating Income	\$ 103,278

Attachment D

Consumers Energy Company
Case No. U-14547
Revenue Deficiency
Proposal for Decision
(000)

Line	Description	PFD
1	Rate Base	\$2,251,247
2	Rate of Return	6.69%
3	Income Required	\$150,546
4	Adjusted Net Operating Income	\$103,278
5	Income Deficiency	\$47,267
6	Revenue Multiplier	1.5683
7	Revenue Deficiency	\$74,127
8	"Weather Normalized 2006"	\$0
9	"Gas Deliveries Normalization"	\$0
10	"New Business Capital Expenditures"	\$0
11	Total Revenue Deficiency	\$74,127

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

* * * * *

STATE OF MICHIGAN	)		
	)	SS.	Case No. U-14547
County of Ingham	)		
_____	)		

P R O O F O F S E R V I C E

Dawn M. Prawdzik deposes and says that on the 14th day of July 2006, she served a copy of the attached Proposal for Decision, upon those persons shown on Attachment A, by enclosing same in a sealed envelope addressed as indicated above and delivering the envelope to the Commission's mail courier for (1) postage prepayment and deposit with the United States Postal Service, or (2) delivery through interdepartmental mail (I.D.M.).

Dawn M. Prawdzik _____	Digitally signed by Dawn M. Prawdzik DN: CN = Dawn M. Prawdzik, C = US Date: 2006.07.14 09:20:53 -04'00'
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Subscribed to before me this 14th
day of July, A.D. 2006.

Sharron A. Allen _____	Digitally signed by Sharron A. Allen DN: cn=Sharron A. Allen, c=US, o=MPSC, ou=Case Management, email=saallen@michigan.gov Date: 2006.07.14 09:22:51 -04'00'
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Notary Public, Ingham County, Michigan

My Commission expires 8-16-11.

ATTACHMENT A

H. Richard Chambers, Esq.
Consumers Energy Company
One Energy Plaza Rm EP11-223
Jackson, MI 49201

John C. Shea, Esq.
Consumers Energy Company
One Energy Plaza, RM EP11-223
Jackson, MI 49201

Jon Robinson, Esq.
Consumers Energy Company
One Energy Plaza, RM EP11-23
Jackson, MI 49201

Donald E. Erickson, Esq.
Assistant Attorney General
525 W. Ottawa, 6th Floor
Lansing, MI 48913

Robert A. W. Strong, Esq.
Clark Hill
255 S. Old Woodward Ave
3rd Floor
Birmingham, MI 48009

Eric J. Schneidewind, Esq.
Varnum, Riddering, Schmidt
& Howlett
201 N. Washington Square
Suite 810
Lansing, MI 48933

Angie A. Fadley, Esq.
Assistant Attorney General
6545 Mercantile Way
Suite 15
Lansing, MI 48911

Kristin M. Smith, Esq.
Assistant Attorney General
6545 Mercantile Way
Suite 15
Lansing, MI 48911

Jennifer Frye, Esq.
Dickinson Wright, PLLC
215 S. Washington Square
Suite 200
Lansing, MI 48933-1816