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May 15, 2006

Ms. Mary Jo Kunkle
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

**Re: Case No. U-14547
(Consumers Energy Company's Gas Rate Case)**

Dear Ms. Kunkle:

Included in this electronic file for filing are the "Reply Brief of Consumers Energy Company" and a proof of service. This is a paperless case and is therefore being filed only in PDF format.

Sincerely,



Digitally signed by H.
Richard Chambers
Date: 2006.05.15 15:26:54
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H. Richard Chambers

CC: Hon. James N. Rigas, ALJ
Parties per Attachment 1 to
Proof of Service

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)
CONSUMERS ENERGY COMPANY)
for authority to increase its rates for the)
distribution of natural gas and for other relief)
_____)

Case No. U-14547

REPLY BRIEF OF CONSUMERS ENERGY COMPANY

May 15, 2006

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REPLY BRIEF APPENDICES

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Case No. U-14547

REPLY BRIEF OF CONSUMERS ENERGY COMPANY

I. REPLY TO THE MPSC STAFF

A. General Reply

There remain only limited areas of disagreement between Consumers Energy Company (“Consumers Energy” or the “Company”) and the Staff in this case. One area of disagreement results from the significant reductions in throughput levels that the Company has been experiencing. Consumers Energy has proposed throughput-related adjustments to the Staff’s revenue deficiency calculation to adjust for: (i) updated weather-normalized sales, (ii) normalization of the impact of conservation which has been experienced, and (iii) new business capital expenditure and related costs which evidence indicates will not otherwise be recovered. Throughput adjustments are needed in order for Consumers Energy to have a reasonable opportunity to recover its gas operating expenses and capital costs, including a reasonable opportunity to earn its authorized return on equity.

The other main areas of disagreement relate to the three capital structure adjustments the Company is proposing, the recommended return on equity, four Other O&M adjustments that the Company is proposing, and an adjustment to the manufactured gas plant (“MGP”)-related portion of rate base that corresponds to an MGP-related O&M adjustment. The

Company submits that the adjustments to the Staff proposals that the Company is seeking represent known and measurable changes that should be included in this case.

Staff at pages 4-6 of its brief seeks to draw a distinction between the manner in which Staff developed construction expenditures and Other O&M expense in this case and the manner in which the Company developed these amounts. Consumers Energy disagrees with Staff's interpretation that the approach that the Company used in its filing was not based on known and measurable changes. However, given that the Company in its brief accepted the Staff's total net plant and working capital balances and Staff's Other O&M expense level, with four limited exceptions, this issue is moot.

B. Throughput-Related Adjustments

1. Sales and Transportation Revenues (Staff brief, pp. 51-53)

Consumers Energy discusses this issue on pages 32-36 of its initial brief. Sales and transportation volumes delivered to end-users compose throughput. Staff witness Aldrich states: "Volumetric changes should only be recognized when they are known and measurable, are reasonably expected to also occur in the projected test year, have a substantial impact on the revenue deficiency calculation, and are not offset by corresponding changes in other revenues or expenses." 8 TR 1389-1390. Staff's use of the historical throughput levels fails to include changes that meet all of these criteria.

Based on the high gas prices, media coverage, and Consumers Energy's encouragement of customers to conserve, Consumers Energy's throughput levels have significantly declined in the recent past. 5 TR 800. Due, at least in part, to the continual downward trend in throughput levels, the Company has not been earning its authorized gas equity rate of return; the exclusion of the known and measurable changes to the level of

throughput will result in a continued inability of the Company to earn its gas business authorized equity return. 5 TR 798. Recognition in this case of reduced throughput levels is critical if Consumers Energy is going to have a reasonable opportunity to earn its authorized return on equity. Adjustments which will increase revenue deficiency in the amount of \$21.3 million should be made due to the decline in throughput levels that have been and are being experienced by Consumers Energy.

a. Use of Updated Actual Data Through February 2006

On page 51 of Staff's initial brief, Staff claims adjustments made by Consumers Energy in its throughput calculation are based on unrealized conservation. Exhibit A-73 shows that usage has continued to decline since 2003 and is not stable.¹ Gas prices remain high. Staff's claim that the reduction in throughput may be a short-term phenomenon is not supported by evidence. Furthermore, Staff's arguments fail to recognize that the Company's first adjustment to Consumers Energy's throughput is based on the Company's **actual** deliveries through February 2006. 5 TR 799-800. Over the twelve-month period ending February 2006, customers greatly reduced their use of natural gas. 5 TR 799-800. The actual deliveries through February 2006, are a known and measurable change that should be made to the historical deliveries and reflected in the test year throughput level. Therefore, the historical throughput volume should be reduced 9.3 Bcf. This increases the revenue deficiency by \$8.4 million. Exhibit A-74, p. 1.

b. Conservation Normalization for 2006 Test Year

The second adjustment made to historical throughput levels by Consumers Energy is a continuation of the decline in throughput based on the **actual** numbers occurring through

¹ As illustrated on Reply Brief Appendix A, Consumers Energy's revenue requirement has continued to increase while the Company's sales have started and continue to decrease.

February 2006. Because the Company is experiencing a decline in throughput, as evidenced by the actual numbers for the 12 month period ending February 2006, the known and measurable adjustment which would continue through the rest of the 2006 test year should be made. 5 TR 802. In its interim Order in this case, the MPSC recognized that gas prices are increasing.² These rising gas prices have worsened the declining gas deliveries that the Company has experienced over the last few years. 5 TR 799. There is no reason to expect that higher gas prices will not continue. 5 TR 801. Therefore, Consumers Energy's 2006 test year throughput volumes should be reduced by an additional 3.8 Bcf. This increases the revenue deficiency by \$5.6 million. Exhibit A-77.

2. New Business Capital Expenditures (Staff brief, p. 55)

Page 50 of Consumers Energy's initial brief explains the adjustment that needs to be made to the revenue requirement based on the decline in sales. It is assumed that new customers will generate incremental revenues that will allow the Company to recover the expenses incurred to serve those new customers. 5 TR 803. However, as previously explained, Consumers Energy's total throughput is declining, even with the addition of new customers. *Id.* In its initial brief, Staff states that it is illogical that new customers do not create new sales. Consumers Energy is not arguing that new sales are not created; rather, Consumers Energy is arguing that the total volume of sales is declining, *even as new customers are added*. 5 TR 825. There is no new revenue on a total throughput basis to compensate for the investment.

Staff also makes the argument at page 55 of its initial brief that Consumers Energy's adjustment for new business capital expenditures is a double-count of the decline in throughput. This argument is quite interesting given the fact that Staff does not want to recognize that the **actual** throughput level has declined and continues to decline. See

² In its May 10, 2006 Order, the Commission recognized a May GCR factor of \$9.0746/Mcf.

Section I.B.1. However, Consumers Energy is not double-counting the loss. The decline in throughput needs to be recognized separately from the additional cost of new capital expenditures. In times of increasing deliveries, the revenue provided by new customers would pay for their hookup and related costs. However, as total deliveries to existing and new customers continue to decline, there is no incremental revenue to support new customers, resulting in additional costs to the Company to construct new customer installations. Therefore, 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 so as to allow funds to serve the new load, resulting in a total revenue requirement adjustment of \$7,272,000. 5 TR 803; Exhibit A-78.

C. **The Equity Infusion Adjustment and Other Capital Structure Adjustments** (Staff brief, pp. 17-20, 32-33)

Consumers Energy has accepted the Staff's 2006 projected capital structure as a starting point for purposes of this case. Consumers Energy submits that three adjustments should be made to Staff's proposed 2006 capital structure: (i) an adjustment to recognize \$200 million of historical 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 to reflect the effect of a change in federal regulations.

1. **Equity Infusion Adjustment**

Staff's witness Mr. Megginson agreed that the Company should strive to increase its equity ratio. 6 TR 1101. The equity balance in Staff's capital structure should be increased by \$200 million to reflect the actual, historical, known and measurable equity infusions that occurred in January and March 2006. Making this adjustment is consistent with the

Commission's recognition of earlier equity infusions in its May 10, 2006 Interim Order in this case. At page 13 of its order it stated:

“Further, it must be remembered that in granting Consumers a temporary rate increase on October 14, 2004, the Commission urged the company to improve its capital structure. There is irrefutable evidence in this case that Consumers has done as requested through much needed equity infusions.” Order, p. 13

The same is true with respect to the additional equity infusions the Company is asking to have included. If these infusions are not recognized in the capital structure approved in the final order in this case in addition to earlier infusions, investors will be deprived of a return on their investment, Consumers Energy's ability to raise capital in the future will be hindered, the Company's ability to earn its authorized return will be impaired, and customers will ultimately suffer. 5 TR 607, 613, 614,-635, 639, 641. The Company discusses the importance and need for this adjustment at pages 5-10 of its initial brief.

2. Securitization Adjustment

Consumers Energy discusses its proposed capital structure adjustment to exclude the effects of securitization at pages 10-12 of its initial brief. This adjustment adds \$296.6 million to Staff's long term debt balance and \$164.2 million to the common equity balance.

3. Deferred Tax Adjustment

Consumers Energy discusses its proposed capital structure adjustment to reduce the deferred tax balance at page 12 of its initial brief. The adjustment results from an Internal Revenue Service Treasury Regulation issued in August 2005. 5 TR 643. Staff argues at page 33 of its brief that the simplified service cost method change resulting from the regulation is a one-time event. However, Staff's argument fails to recognize that the effect of this event is a decrease in the deferred income tax balance, which will have an ongoing impact on the capital

structure. 5 TR 643. Given that Staff has made other 2006 adjustments to the capital structure for projected changes, it is appropriate to also make this adjustment. The evidence indicates that the IRS regulation requires recognition of the adjustment in 2005 and 2006, with payments in 2006. 5 TR 643, 673, 675. Consumers Energy requests that a deferred tax adjustment be made to the capital structure in this case as proposed by the Company. This adjustment will reduce the deferred income tax balance by \$131.25 million.

D. Return on Equity and Overall Rate of Return

1. Return on Common Equity (Staff brief, pp. 20-35)

Staff recommends in its brief that the return on common equity for Consumers Energy's gas business be set at 11.15%, the midpoint of a recommended range of 10.90% to 11.40%. For reasons discussed in Consumers Energy's brief (see pp. 13-31) and in this reply brief, it is the position of Consumers Energy that a return of 11.15% understates the investor-required return on equity for Consumers Energy.

Staff agrees at page 20 of its brief that the criteria for establishing a fair rate of return for a public utility are rooted in the landmark cases of Federal Power Commission v Hope Natural Gas Co, 320 US 591, 603; 64 S Ct 281; 88 L Ed 333 (1944), and Bluefield Water Works and Improvement Co v Public Service Commission of West Virginia, 262 US 679, 693; 43 S Ct 675; 67 L Ed 1176 (1923). The principles set forth in the Hope and Bluefield decisions include:

- (i) A utility must be permitted to earn a return equal to that generally made at the same time on investments with corresponding risks;
- (ii) It is important that there be enough revenue both for operating expenses and capital costs, including interest on debt and dividends on stock;
- (iii) The equity return should be sufficient to assure confidence in the financial integrity of the utility;

- (iv) The equity return should be sufficient to allow the utility to maintain its credit and to attract capital.

Hope Natural Gas Co, 320 US at 603, Bluefield Water Works, 262 US at 692-693. Application of these principles supports authorizing a return in this case for Consumers Energy's gas business that is higher than the 11.15% recommended by Staff. At a minimum, the authorized return on equity should be set at the 11.40% high end of Staff's range.

a. Consumers Energy Has Greater Risk Than The Staff Proxy Group

Staff states at page 21 of its brief that Consumers Energy's gas business is not more risky than the average gas utility. This statement, however, is contrary to the evidence on the whole record. The fallacy of this conclusion is reflected in the statement of Staff's own witness Mr. Megginson, who testified:³

"Staff made clear in Mr. Megginson's direct testimony, pages 27 and 28, that it took the higher end of its cost of equity range to account for Consumers Energy's higher risk in comparison to the proxy gas group." 6 TR 1067.

The record evidence shows that Consumers Energy has higher risk than the Staff proxy group (as well as Consumers Energy's proxy group), taken as a whole, by virtually every measure of risk.

Consumers Energy has weaker business profile statistics than the Staff's proxy group averages for: (i) three year average FFO to interest coverage (2.83 for Consumers Energy versus 4.53 for the proxy group), (ii) 2002-2004 FFO to Debt (8.43 for Consumers Energy versus 12.15 for the proxy group), (iii) total debt to total capital (60.75% for Consumers Energy versus 52.65% for the proxy group), (iv) Standard and Poor's ("S&P") bond ratings (BBB- for Consumers Energy versus A for the proxy group), (v) Moody's bond ratings (Baa3 for

³ Mr. Megginson, on behalf of Staff, also acknowledged at 6 TR 1060 that Consumers Energy has "above peer group risk."

Consumers Energy versus A2 for the proxy group), and (vi) common equity ratio (38% for Consumers Energy versus 47% for the proxy group⁴). Exhibit S-5, Schedule D-5, p. 10.

Mr. Leja compared the Staff proxy companies and Consumers Energy for these six risk factors on Exhibit A-70. Of the 14 utilities, Consumers Energy was the utility with the greatest risk for two of the six risk measures, the utility with the second greatest risk for two others, and the utility with the third greatest risk for the remaining two risk measures.

Credit rating agencies assign separate corporate credit ratings, senior secured debt credit ratings, and senior unsecured debt credit ratings for Consumers Energy. 5 TR 620, 623. Consumers Energy's senior secured debt ratings are at the very bottom of the investment grade ratings, four notches lower than the averages for the proxy group.⁵ This is illustrated visually on Mr. Leja's rebuttal Exhibit A-71.

Staff suggests in its brief that Consumers Energy's low senior secured debt ratings can be attributed to risk of CMS Energy. However, the evidence on the whole record does not support reaching such a conclusion. Consumers Energy's senior secured debt rating is for debt that is secured by the assets of Consumers Energy. 5 TR 634. It represents risk that is attributable to Consumers Energy. 5 TR 634, 637. The focus for the senior secured debt is on Consumers Energy, not the parent. The evidence indicates that senior secured debt ratings "can not be attributed to CMS Energy's influence." 5 TR 637. This conclusion is confirmed by the fact that stand-alone financial indicators for Consumers Energy such as FFO to interest coverage ratio and FFO to debt, which are determined without considering the financials of the parent, are

⁴ Staff's exhibit S-5, Schedule D-5, p. 3 shows a five-year average common equity ratio for Staff's proxy companies, using Value Line reports, of 51.9% versus a Consumers Energy five-year average of 38.6%.

⁵ Consumers Energy's corporate and senior unsecured debt ratings are both below investment grade. 5 TR 623.

lower than those of the proxy group. 5 TR 637. The common equity ratio for Consumers Energy, which is also specific to the utility, is also lower than the average for the proxy group.

The evidence indicates that Consumers Energy also has a lower business profile score than a typical utility. Staff asserts at page 30 of its brief that business profile scores are an “opinion from outside observers” and should be discounted as “subjective”. Staff also states at page 30 of its brief that Staff is “unsure whether or not investors weigh the Company’s business profile score in their investment decisions.” These statements are somewhat disingenuous. The business profile scores are published by S&P. S&P is an independent agency that assesses risk for investors. 5 TR 621. Staff, in its own analyses, recognized that S&P is a resource relied upon by investors in assessing risk. Staff’s witness Mr. Megginson agreed that S&P is one of the two primary credit rating agencies, a conclusion that was also supported by the Company’s witnesses. 5 TR 621, 6 TR 1044. Mr. Ballinger’s criticism of the original business profile scores focused on the argument that they were outdated, not that they were an irrelevant opinion. See 6 TR 1133. The updated S&P business profile scores, issued February 17, 2006, indicated that Consumers Energy continued to be viewed as more risky than most other utilities. Exhibit A-79.

Mr. Webb testified that internal cash generation is not sufficient to meet Consumers Energy’s cash needs. 5 TR 635. Significantly, Mr. Webb testified, in addition, that the Company’s current ratings do not assure access to financial markets at reasonable terms and that, at present, access to even first mortgage bonds is restricted.⁶ 5 TR 626, 635-636. See also 5 TR 620, 622-623. Consumers Energy has been further impacted by the fact that interest rates have been increasing from the low end of an interest rate cycle. 5 TR 618, Exhibit A-64. Given

⁶ Staff acknowledged in its brief at page 22 that Consumers Energy’s near-term flexibility has been reduced.

Consumers Energy's higher risk, this has a greater impact than it would on a typical utility. See section b.(iv), below.

Staff noted in its brief (e.g., pp. 31, 53) that Michigan's economy has been and continues to be in a weakened state. In comparing Consumers Energy's risk with the companies in the proxy group, Staff fails to take into consideration the impact on risk of the weakened economy. Mr. Webb testified that the Michigan economy creates added uncertainty for Consumers Energy. 5 TR 637. This added risk for Consumers Energy must be taken into consideration given the principles set forth in Hope and Bluefield.

Consumers Energy also has greater risk than Michigan Consolidated Gas Company ("MichCon"), notwithstanding Staff's suggestions to the contrary. See 5 TR 626-627. As illustrated by Staff's Exhibit S-5, Schedule D-5, p. 10, MichCon has a 50% equity ratio, a better total debt to total capital ratio, a BBB+ S&P bond rating, and an A3 Moody's bond rating. In addition, MichCon also has a Value Line financial strength rating of B+, compared to Consumers Energy's C++, and has an S&P business profile score of 4 compared to Consumers Energy's score of 6. Exhibits A-66, A-79. By each of these measures, Consumers Energy is more risky than MichCon.

The 2006 test year will be more than half-way over before a final order is issued under the current schedule. It is well established in Michigan that the principle "'Justice delayed is justice denied,' applies with particular force to a rate hearing." Michigan Consolidated Gas v Public Service Commission, 389 Mich 624, 637; 209 NW2d 210 (1973).

The record evidence shows that Consumers Energy has greater investor-perceived risk than the proxy groups. This greater risk needs to be reflected in a higher return on equity than would be required for the proxy companies.

b. Reply Regarding Staff's Rate of Return Analyses

Staff and Consumers Energy witnesses both performed Discounted Cash Flow (“DCF”) analyses, Capital Asset Pricing Model (“CAPM”) analyses, and Risk Premium analyses. The primary differences are not in the analyses themselves, but in the evaluation of the results of the analyses.⁷ In addition, Staff reviewed returns on equity authorized for other utilities during 2002-2004.

(i) DCF Analysis

The results from Staff's DCF analysis were the lowest of its analyses, as was also true with respect to Consumers Energy's DCF analysis. This is not surprising, given current conditions. Mr. Leja testified:

“While the DCF is a well recognized method for estimating ROE, its results should not be relied upon without consideration of other relevant facts. Based on current market conditions, it is not appropriate to give significant weight to the DCF result. At this point in time, the results of the DCF model do not provide a reasonable estimate of the cost of equity for Consumers Energy's gas business.” 5 TR 782

Mr. Leja explained:

“The DCF method specifically determines the cost of equity using the market value – not the book value of a company's stock. The reason for the understatement is that the DCF market return is applied to a book value rate base to determine allowed utility earnings. When market-to-book ratios are greater than one, the application of the DCF model results to a net original cost (book value) rate base understates the earnings necessary to satisfy required expected return. The method for determining the rate of return has to be consistent with its rate base development to provide reasonable results.” 5 TR 783

⁷ An additional difference is that Staff does not recommend flotation cost expense. Consumers Energy submits that flotation costs should be allowed in this case for the reasons discussed at pages 29-30 of its initial brief. Including flotation costs would increase the return by 16 basis points.

The market-to-book ratios for the Company and Staff proxy groups of 1.95 and 1.78 are considerably larger than one. 5 TR 782-783.

The impact of using unadjusted DCF results when market to book ratios are around 1.8 is illustrated on Exhibit A-68. Relying upon the DCF approach in such a situation without adjusting the results upward will result in substantially understating the investor-required return.⁸ 5 TR 783-785.

The Indiana Utility Regulatory Commission has discussed this problem as follows:

“In determining a common equity cost rate, we must again recognize the tendency of the traditional DCF model...to understate the cost of common equity. As the Commission stated in *Indiana Mich. Power Co.* (IURC 8/24/90), Cause No. 38728, 116 PUR4th 1, 17-18, ‘the unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore requires an upward adjustment based largely on the expert witness’s judgment.’

* * *

“It is recognized that ‘there are difficulties in making a good DCF calculation whenever a utility’s stock sells, for whatever reason, above book value.’ *Niagara Mohawk Power Corp.* (NY PSC 2/2/93), 140 PUR4th 481, 491.” *Indiana-American Water Co.*, 150 PUR4th 141, 167, 168 (1994).

In the current case, the DCF approach will underestimate the cost of equity needed to provide a fair and reasonable return on equity.

Mr. Megginson agreed that the Commission should establish rates such that a utility has a reasonable opportunity to earn the authorized return on a ratemaking basis. 6 TR 1098. Given the above considerations, the results of DCF analyses in this case need to be

⁸ In the second example shown on Exhibit A-68, Mr. Leja calculated that a return of 13.2% on book value would be required to earn a 10.0% market return.

discounted (as Mr. Megginson appears to have done in his recommendation) or adjusted upward (as Mr. Leja did in his recommendation).

In addition, some of the methodology that Mr. Megginson indicated was appropriate in the DCF calculation was not followed. For example, Mr. Megginson indicated at 6 TR 1047 that “the current quarterly dividends were annualized.” However, comparing Exhibit A-96 to Exhibit S-5, Schedule D-5, p. 5, illustrates that Mr. Megginson’s calculations did not use the annualized current quarterly dividend, but rather summed the last four dividends. This will result in an understatement of the current annualized dividend for any utility, such as AGL Resources (see Exhibit A-96), where dividends have increased. This provides further support for a conclusion that the results of the Staff’s DCF analysis should be discounted or adjusted upward.

(ii) CAPM Analysis

The results of Staff’s CAPM analysis are also understated. They are understated, first of all, due to certain input data that was used. They are understated secondly, as a result of not having been adjusted upward to compensate investors for the higher risk that Consumers Energy has as compared to the proxy groups.

Staff calculated a range of 10.35% to 10.79% in its CAPM analysis. The basic formula for a CAPM calculation is:

$$\text{return} = \text{risk-free rate} + (\text{beta} \times \text{risk premium})$$

5 TR 774. Mr. Megginson calculated a risk-free rate using forecasts by Global Insights, Value Line, and a forecast from an organization called Financial Forecast Center (“FFC”). Global Insights and Value Line are well-known sources and have been accepted for use in CAPM analyses in previous MPSC cases. 5 TR 789. Global Insights and Value Line are reasonable

sources to use in this case for the risk-free rate forecast. Use in this case of the FFC forecast should, however, be rejected.

There is no basis on the record to conclude that FFC is a recognized forecasting organization used by investors or that it is reliable. See 5 TR 788-789, 6 TR 1097-1098, Exhibits A-89, A-90. Mr. Megginson testified:

- “Q. Do you have any information about the Financial Forecast Center other than what’s contained on Exhibit S-9?
- “A. No.
- “Q. Do you have a subscription to the Financial Forecast Center data?
- “A. No.
- “Q. Do you know how many subscribers the Financial Forecast Center has?
- “A. No.
- “Q. Did you review the terms of service that are on their internet site?
- “A. No.
- “Q. Do you know of any investors that subscribe to the Financial Forecast Center’s forecasting?
- “A. No.” 6 TR 1097-1098.

Mr. Megginson indicated that he had not used FFC data previously in rate case analyses. Exhibit A-89. Exhibit S-9 indicates that the FFC is a small corporation with no ties to brokerage firms, banks, investment houses or other corporations and uses engineering concepts, not economics, in its forecasts. The fact that the forecast may have been available does not make its use in this case appropriate.

Furthermore, the FFC forecast is only for January-June 2006, rather than for a full year. 5 TR 789. Mr. Megginson indicated that he used 6 months of data because this was all the data that was available. Exhibit A-89. Given the evidence of rising interest rates presented by both the Company and Staff and the availability of full-year projections from two recognized sources, the 6 months of FFC data should not be used in this case.

In addition, Exhibit A-93 illustrates that in calculating the Global Insights 2006 average 30-year T-bond rate, Staff used the third and fourth quarter of 2005 with the first and second quarter of 2006, rather than using available data for the first through fourth quarters of 2006. Using the Global Insight projections for the first through fourth quarters of 2006, that Staff provided (see Exhibit A-93, p. 3), increases the forecast of the 2006 average from the 5.0% used by Staff in its calculations to 5.2%. Since the test year is 2006 and since the rate relief granted will not occur prior to the last half of 2006, it is appropriate to use the 2006 full year Global Insights projections in place of a 2005/2006 split year Global Insights projections.

Excluding the FFC forecasts from the Staff's CAPM calculation and then averaging the 2006 Global Insights forecast of 5.2%, discussed above, with the Value Line 2006 forecast of 5.2% results in a 2006 risk free rate average of 5.2%. Using this 5.2% average increases the average for the proxy group as a whole from 10.57% to 10.79%. Reflecting this 22 basis point increase, along with a risk adjustment to reflect that Consumers Energy's risk is higher than the proxy group's risk, supports a conclusion that the Staff's 11.15% recommendation is too low.

(iii) Risk Premium Analysis

Staff's risk premium analysis is the analysis that best illustrates the risk of Consumers Energy. Staff calculated a range, using the risk premium approach, of 10.45% for A/A2 rated utilities to 11.49% for BBB-/Baa3 rated utilities. Two adjustments to these results should be made. One of the inputs used for the 2006 long term risk-free rate was the FFC data discussed above. See Exhibit S-5, Schedule D-5, p. 9, note (a). Excluding the FFC data and using the updated Global Insight forecast for 2006, as discussed above, results in a forecasted long-term treasury bond yield of 5.2%. Using the more recent corporate spread data compiled by

Staff increases the corporate utility spread that needs to be added from a range of 0.99% to 1.60% to a range of 1.10% to 1.60%. Exhibit A-95, p. 2. Using the updated corporate spread range of 1.10% to 1.60% in the calculation shown on Exhibit S-5, Schedule D-5, p. 9, in combination with use of the corrected 5.2% long-term treasury bond rate (discussed above) results in a revised cost of equity range from a low of 10.99%⁹ (or approximately 11.00%) to a high of 11.49%¹⁰.

Exhibit A-95 illustrates that the low end of the calculated risk premium range is the equity return for a utility with an A/A2 rating while the high end is the equity return that is required for a utility with a BBB-/Baa3 rating. Thus, this analysis supports conclusions that (i) the required return for a utility with Consumers Energy's senior secured debt ratings is substantially higher than for a utility with the proxy group average rating, (ii) the return for a typical utility would be approximately 11.00%, and (iii) the return for a utility with the senior secured debt rating of Consumers Energy is approximately 11.50%.

(iv) State Commission Rate of Return Decisions

Staff states in its brief that it also reviewed returns on equity authorized by state commissions from January 2002 through June 2004. Staff's testimony states that the average authorized return allowed in those decisions was 11.00%. 6 TR 1053. This Commission determined that the appropriate return on equity for Consumers Energy's gas business should be set at 11.40% in its November 7, 2002 order in Case No. U-13000. The Commission maintained this return in its October 14, 2004 Order in Case No. U-13730. Thus, during the time period that the 11.00% average returns were being set for utilities in general, Consumers Energy's required return was 11.40%. There is no record evidence that would suggest during the subsequent period

⁹ $4.69 + 5.20 + 1.10 = 10.99\%$.

¹⁰ $4.69 + 5.20 + 1.60 = 11.49\%$.

of time Consumers Energy's investor-perceived risk has declined in any substantial manner. If Staff's apparent position is accepted that a return on equity of 11.00% would be appropriate for a typical utility based on returns during the 2002-2004 time period, then it should follow that the existing authorized return of 11.40%, set during the 2002-2004 time period, should be maintained for Consumers Energy's gas business in this case.

In addition, interest rates were at the low end of a rate cycle in the 2002-2004 time period. See Exhibit A-64. The Company presented evidence that, while there is not a one-for-one correlation, as interest rates increase, investor required returns for equity investments will also increase. 5 TR 618, 640. Staff states at page 19 of its brief that: "Since June of 2004, the Federal Reserve has raised the target for its key overnight bank lending rate 350 basis points to its current rate of 4.50% (recently raised to 4.75% in March 2006)." As the Commission is aware, and can take official notice of, the Federal Reserve increased the overnight lending rate on May 10, 2006 to 5.00%. The increase in interest rates since June 2004 provides support for a conclusion that required returns have increased since the 2002-2004 time period and provides support for a conclusion that the current required return for Consumers Energy is higher, rather than lower, than 11.40%.

c. Ratemaking Return Versus Book Return

Staff is critical at pages 28-29 of its brief of evidence presented by Mr. Rasmussen that Consumers Energy has not been earning its authorized return on the gas business on either an actual or normalized ratemaking basis for a number of years. Staff relies as support for its argument on Mr. Bearman's Exhibit A-1, Schedule A-3, which Staff says shows different calculated returns than Exhibit A-72. However, there is a fundamental difference between the two exhibits. Mr. Bearman's exhibit is simply a book number that is calculated as

part of the general rate case filing requirements. It is not calculated on a ratemaking basis and does not take into consideration adjustments and normalizations that would typically occur in the ratemaking process including, but not limited to, weather. Mr. Bearman specifically testified:

“Exhibit A-1 (JFB-3), Schedule A-3 shows the unadjusted Gas Rate of Return on average common equity for the historical 2004 period, the four years preceding the historical period, and 12 months ended April 2005. This exhibit characterizes the financial return for the gas utility and does not incorporate necessary ratemaking adjustments.” 2 TR 160 (Emphasis added)

“It’s not adjusted for typical ratemaking. Adjustments are normalization that would typically occur in the ratemaking process like we’re in now. For instance, it wouldn’t adjust for weather.” 2 TR 183.

Mr. Rasmussen’s evidence presents ratemaking returns on equity and is calculated using a ratemaking equity ratio. This is made clear on Exhibit S-22, which shows the underlying calculations.

Staff’s main argument appears to revolve around the statement at page 29 of its brief that investors view the Company’s business performance on a financial basis and that the ratemaking return therefore “isn’t germane to this proceeding.” This conclusion, however, is contrary to the record evidence. Mr. Webb testified:

“Mr. Rasmussen is presenting rebuttal testimony indicating that Consumers Energy’s gas business has not earned its authorized return on its gas business for the past five calendar years on an actual or weather normalized basis. If investors perceive that due to regulatory lag or other reasons the gas utility business will be unable to consistently earn its authorized return, this will increase the perceived risk to the investor.” 5 TR 638

“There are instances where investors question us regularly about our authorized rate of return on a ratemaking basis and how we’re performing against that. So there’s a keen level of interest by investors in that.” 5 TR 734

“Investors – a lot of investors are keenly interested and ask us on a regular basis how we’re doing against the authorized rate of return on a ratemaking basis. There’s a keen interest in that because investors have watched us raising equity through the parent, through investors, to put more into our company, Consumers...Maybe there’s more interest than there has been in the past, but there’s certainly interest today.” 5 TR 735

Mr. Webb, as Chief Financial Officer of Consumers Energy and CMS Energy, is directly involved in investor relations and in maintaining relationships with commercial and investment banking communities. 5 TR 601. The evidence shows that CMS Energy infused \$1.15 billion into Consumers Energy from August 2004 through March 2006. 5 TR 607, 635. There is no record evidence refuting Mr. Webb’s testimony that investors are, at present, “keenly interested” in the ratemaking return on equity. The evidence shows that Consumers Energy’s ability to earn its authorized return on a ratemaking return is of interest to investors and will affect investor perceived risk.

d. Dividend Payout Ratio

Staff indicates at page 31 of its brief that Consumers Energy’s 80% dividend payout policy is higher than the Staff proxy group’s average dividend payout of 64%.¹¹ Mr. Webb explained Consumers Energy’s 80% dividend payout policy at various places during his testimony. See e.g., 5 TR 657, 659-660, 662-663, 748-751. Mr. Webb testified that over a three-year period through 2003 the average payout by wholly owned peer companies was 76%, while for a five-year period through 2003, the average was 89%. 5 TR 663. The record evidence indicates that Consumers Energy’s 80% dividend payout ratio policy is consistent with what other wholly-owned companies are paying out to parent companies.¹² 5 TR 663.

¹¹ The payout ratio for individual Staff proxy companies ranged up to 106%. Exhibit S-5, Schedule D-5, p. 10. Staff shows MichCon’s dividend payout ratio as 263%. *Id.*

¹² Staff used the 80% dividend payout ratio assumption for purposes of its calculation of retained earnings. 6 TR 1038.

e. **Additional Reply Regarding Staff's 11.15% Recommendation**

Staff argues in its brief that it has compensated Consumers Energy for its higher risk. Consumers Energy agrees that Staff's recommendation of 11.15% reflects part of this higher risk. However, it does not reflect all of the higher risk and should be adjusted upward.

Consumers Energy presented evidence that the risk adjustment for a utility with Consumers Energy's risk when compared to an A/A2 rated utility would require an upward adjustment of 40 basis points to 157 basis points. 5 TR 625. Consumers Energy made a 100 basis point adjustment in calculating its requested return on equity of 12.00%. 5 TR 625-626, 765, Exhibit A-39. Staff's risk premium analysis, as originally filed, showed a risk premium of about 60 basis points, and if revised as discussed above a risk premium of about 50 basis points. Evidence presented by both the Company and Staff would support a conclusion that a return for typical utility would be around 11.00%. Making a 40 basis point adjustment to the 11.00% return would move the required return to 11.40%, the high end of Staff's recommended return on equity range. Staff's risk premium analysis supports making an upward adjustment of at least 50 basis points.

Staff states at page 32 of its brief that its 11.15% recommendation took into consideration the effects of the MCV impairment on the equity ratio. However, even with recognition in the capital structure of the \$200 million additional equity infusions that occurred in 2006, Consumers Energy's equity ratio will be at a level below the equity ratio prior to the impairments and at a level below the equity ratio adopted by the Commission in its December 2005 Order in Case No. U-14347 authorizing an 11.15% return on equity for the Company's electric business. See Consumers Energy's brief, pp. 20-21, Exhibit A-10, Exhibit A-82, pp. 3, 6, 6 TR 1039. The lower equity ratio in the current case provides additional support that the

authorized return on equity should be set at a level higher than the 11.15% return recommended by Staff in this case.

Staff's witness Mr. Megginson testified at 6 TR 1056 that:

"Staff's cost of equity range...doesn't overburden ratepayers. The Commission should...adopt Staff's cost of equity range of 10.90% - 11.40%." 6 TR 1056

At a minimum, the high end of Staff's range of 11.40% should be adopted. Consumers Energy submits that evidence would support a return of 12.00%.

2. Overall Rate of Return

The Staff in its initial brief is recommending an overall rate of return of 6.64%. Consumers Energy in its initial brief requested an overall rate of return of 7.19% be used. The differences between these two returns are attributable to the three adjustments that Consumers Energy made to the Staff capital structure and the use of a 12.00% return on equity rather than an 11.15% return on equity. Reply Brief Appendix B, which is attached, shows the impact of each of these adjustments on the overall rate of return.

E. Other Adjustments to Staff's Calculations

1. Employee Incentive Compensation Plan Adjustment (Staff brief, pp. 40-41, 44-46)

Consumers Energy discussed this issue in its initial brief on pages 38-45. The Company's modified request regarding the Employee Incentive Compensation Plan is \$4,068,000, which includes incentive payments for all of the eligible non-officer employees. Staff acknowledged that the incentive compensation was a portion of the employees' compensation, rather than an addition. 8 TR 1305. However, because this portion of the employees' overall compensation is based on financial earnings, Staff recommends the disallowance of this portion of the employees' overall compensation. Staff's initial brief, p. 45.

What Staff omits in its argument, but is not disputed on the record, is that the overall compensation of Consumers Energy's employees is reasonable. 4 TR 409; 8 TR 1464.

Citing the Commission's Order in Consumers Energy's most recent electric rate case, Case No. U-13437, Staff states that ratepayers should not pay for an incentive compensation that mainly benefits shareholders. Staff's initial brief, p. 40. In the current case, Consumers Energy presented undisputed testimony illustrating how competitive compensation allowed Consumers Energy to retain qualified and experienced employees, therefore benefiting customers. 4 TR 411. Staff even recognizes that these benefits have merit. Staff's initial brief p. 45. However, Staff argues that there is no evidence of the values of these customer benefits. Id. As evidenced by the facts that Consumers Energy's total pay level goals are generally within 5% of the 50th percentile in the market¹³ and that Consumers Energy has won the J.D. Power and Associates award for highest customer satisfaction for large business customers in the Midwest three times since 2002, ratepayers and shareholders can simultaneously receive benefits by having qualified and experienced employees provide gas service. 4 TR 409, 415, and 451. Staff fails to recognize these concurrent benefits.

Staff witness Aldrich indicated that there are no concerns regarding the Company's gas maintenance programs. 8 TR 1464-1465. Therefore, as presented by the undisputed evidence that 1) Consumers Energy's gas customers receive a benefit by having qualified and experienced employees providing gas service, 2) the Employee Incentive Compensation Plan is part of, not in addition to, the overall compensation and 3) Consumers Energy's overall compensation is reasonable, Consumers Energy should be able to collect the

¹³ Consumers Energy's overall pay levels are slightly under the market average. 2 TR 32.

amount of the non-executive portion of the Employee Incentive Compensation Plan, which amounts to \$4,068,000 for 2006.

2. Injuries and Damages Adjustment (Staff brief, p. 41)

As discussed in the Company's initial brief (see pp. 45-46), the difference between the Staff's injuries and damages expense and the Company's is a total of \$776,000. The main difference between the two calculations is that Staff failed to include any inflation factors in its calculations. 8 TR 1290. Additionally, in the worker's compensation component of the injuries and damages, Staff's five-year average included the 2004 actual expense of \$2,192,000, which included a non-recurring adjustment. As stated in the Company's initial brief, the averages calculated by Staff are very similar to those calculated by the Company; however, in order to correctly reflect the injuries and damages factor in the O&M expense, an inflation adjustment needs to be made to those averages.¹⁴ The overall result is that Staff's injuries and damages figure of \$3,761,000 should be increased by \$776,000.

3. Union Contract Impacts (Staff brief, p. 43)

As discussed on page 47 of the Company's initial brief, Staff did not provide any response to Company witness Preketes' testimony that the recently ratified union contract would increase the 2006 O&M expense by \$1,126,000. Exhibit A-58. Other than the pension plan payments (Staff's initial brief, p. 43), Staff's initial brief fails to mention or adjust for the impacts of the union contract. The Company testimony that the union contract will increase O&M expense by \$1,126,000 is undisputed. The Company requests this amount be included in the Company's O&M expense in the ALJ's Proposal for Decision and the Commission's Order.

¹⁴ Inflation needs to be factored into damage costs; otherwise, the Company has no opportunity to recover its gas damage expenses. In addition, the appropriate inflation factor for Worker's Compensation should be 10% as indicated by Consumers Energy's actuary, Hewitt Associates. 2 TR 36.

4. **MGP-Related Adjustments** (Staff brief, pp. 16, 47-48)

a. **MGP Rate Base Adjustment** (Staff brief, p. 16)

Consumers Energy included \$20,699,000 of unamortized MGP-related expenditures in rate base. Staff included \$20,085,000. The difference of \$614,000 is attributable to whether all of the 2005 actual expenditures are included in the current case, as proposed by the Company, or whether a portion of the 2005 actual costs are deferred until a future gas rate case, as proposed by Staff.¹⁵ Since the 2005 expenditures are known and measurable, actual and historical, were incurred prior to the 2006 test year and prior to evidentiary hearings, uncontested record evidence supports the prudence of the expenditures, and the difference between the Staff amounts and the year-end amounts are minimal, it would be reasonable and more efficient to include the full year amounts in the MGP rate base and amortization calculations. MGP-related recovery is discussed further at pages 47-49 of the Company's initial brief and below.

b. **MGP Amortization Expense Adjustment** (Staff brief, pp. 47-48)

Staff calculated 2006 MGP amortization expense of \$2.332 million, which is an increase of \$1.449 million above the amount in the historical test year expense. Staff brief, p. 47, Exhibit S-4, Schedule C-7. Consumers Energy calculated 2006 MGP amortization expense of \$2.378 million, which is an increase of \$1.495 million above the historical test year expense. See Initial Brief, Appendix D, Exhibit A-25 (GPB-9R). The difference, as with the MGP rate base amount, is a result of Consumers Energy including the full amount of 2005 expenditures while Staff proposed to defer recovery of a portion of the expenditures until after the next gas rate case. No projected costs have been included in the Company's request. The 2005 costs are

¹⁵ This is the only remaining area of disagreement with regard to the calculation of total rate base between the Company and the Staff.

all actual, incurred costs. 4 TR 466. Consumers Energy requests that the full year's actual 2005 costs be included when determining the MGP-related amortization amount and rate base amount in this case for the reasons discussed at pages 47-49 of the Company's initial brief.

In addition to addressing amortization amounts, Staff has proposed a change in procedures related to amortization of any future third-party recoveries of MGP costs. Staff indicated that it had adjusted the amounts on Staff's Exhibit S-4, Schedule C-7 to reflect this change. 6 TR 895. Staff's exhibit clarifies that the effect of the proposed change is that if the net amortization expense in a particular year would otherwise be negative due to insurance recoveries, then the amortization of the negative portion will be temporarily deferred and used to offset future year positive amortization expense until the negative amount has been eliminated. Consumers Energy will accept the Staff's proposal to modify insurance amortization in the manner illustrated on Exhibit S-4, Schedule C-7 if the net amortization expense would otherwise be negative.¹⁶

5. Michigan Single Business Tax (Staff brief, p. 49)

Appendix C of the Company's initial brief outlines the Michigan Single Business Tax. The difference between the Company's and Staff's numbers reflects the impact of other adjustments.

6. Federal Income Tax (Staff brief, p. 50)

Appendix C of the Company's initial brief outlines the Federal Income Tax. The difference between the Company's and Staff's numbers reflects the impact of other adjustments.

¹⁶ Since the negative amount that occurred in 2002 was eliminated before 2006 (see Exhibit S-4, Schedule C-7, lines 13 and 14), the change in procedure does not affect the amortization amount for the 2006 test year in this case. As noted previously, the difference between the Company and Staff proposals for the amortization amount for 2006 is due to a difference in whether the full year 2005 expenditures are included or whether a small portion of the year's expenditures is deferred for recovery in a future case.

F. Reply Concerning Other Issues

1. WPS Buy/Sell Revenue (Staff brief, pp. 36-39)

Staff in its case proposed reclassifying certain revenues related to a buy/sell transaction with WPS from interest revenue to miscellaneous revenue for purposes of the ratemaking calculations. Consumers Energy has agreed to Staff's treatment of this revenue for ratemaking purposes in this case. However, the Company respectfully disagrees with Staff's suggestion that the accounting originally used was improper under generally accepted accounting principles or that any further action is necessary or appropriate at this time. The appropriate classification of future transactions may be fact dependent and should not be prejudged at this time.

2. Company Use and Lost Gas (Staff brief, pp. 39-40)

As stated on page 37 of the Company's initial brief, Consumers Energy accepts the total amount calculated by the Staff of the Company Use and LAUF gas. As stated by Staff, the Lost and Unaccounted For percentage is 0.3912%. Staff's initial brief, p. 39. Staff witness Collins calculated the total percentage for both Company Use and Lost and Unaccounted For Gas as 1.18%. Exhibit S-6, Schedule F-2-4.

3. Agreement With Staff Proposal To Discontinue Monthly Rate Summary Report Filing Requirement (Staff brief, p. 61)

Consumers Energy agrees with Staff's proposal to "discontinue filing a Monthly Rate Summary report with Staff." Staff's initial brief p. 61.

4. Agreement With Staff Opposition to NEM Proposals (Staff brief, pp. 65-67)

Consumers Energy agrees with Staff's recommendation to reject the proposal offered by National Energy Marketers Association ("NEM"), as discussed on pages 65-67 of

Staff's brief. Consumers Energy also addresses NEM's proposal in Section IV of this reply brief.

II. REPLY TO THE ATTORNEY GENERAL

A. Reply Concerning Rate Base Issues (AG brief, pp. 6-13)

1. Net Plant (AG brief, pp.6-7)

At pages 6-7 of his initial brief, the Attorney General recommends that the Commission reduce the Company's rate base relative to capital additions and construction work in progress. These arguments can be summarily dismissed as the Company has adopted the MPSC Staff's calculation of the Company's rate base, including the Staff's calculations for these items. *See*, initial brief of Consumers Energy at 3. The Staff's recommendation can be found at 6 TR 891-893; Staff initial brief at 7 et seq. Notwithstanding the Company's acceptance of the Staff's position, the Attorney General's arguments are flawed and should be disregarded by the Commission.

First, the Attorney General asserts that the capital additions proposed by the Company do not reflect "known and measurable changes in plant investment." AG brief at 6. The basis for this contention appears to be that certain capital additions appear on one of Mr. Preketes' workpapers, WP-PNP-42, under the heading "Construction Expenditure Forecast," 8 TR 1530, and, according to the Attorney General's witness McGarry, these expenditures are not accompanied with sufficient "documentation." 8 TR 1531. This argument completely ignores the testimony and exhibits of Company witness Preketes regarding the capital expenditures which the Company included in rate base. *See*, 2 TR 104 et seq.; Exhibits A-50 (PNP-6) through A-55 (PNP-11), and the detailed explanation for each of those expenditures set forth therein.

The Attorney General also argues that the Company's presentation concerning Construction Work in Progress ("CWIP") is "duplicative." Attorney General's initial brief at 7. However, Company witness Rasmussen explained that the Attorney General is incorrect in this regard:

- "Q. Attorney General witness McGarry is recommending that the Commission exclude the Construction Work-in-Place (CWIP) balance for the 2006 test year. Do you agree with this proposal?
- "A. No. The normal course of utility construction programs does not provide for closing all expenditures at the end of each month or at the end of each calendar period. There was a CWIP balance at the end of the historical period, and there is a CWIP balance at the end of the projected test year of calendar 2006. The Company's presentation recognizes an average CWIP balance for year-end 2005 and 2006.
- "Q. What is the longstanding Commission policy, and the traditional ratemaking formula, at the MPSC regarding allowance of CWIP in rate base?
- "A. The Commission allows CWIP in rate base with a corresponding offset for Allowance for Funds Used During Construction (AFUDC) in the income statement. This methodology appropriately recognizes the investment in infrastructure made to provide safe and reliable customer service.
- "Q. Do you agree with Mr. McGarry's statement, on page 14 of his testimony that CWIP is for small dollar projects expected to be in service within 12 months.
- "A. No. Upon reviewing just a few of the capital projects shown on Exhibit A-51 (PNP-7) it is clear that there are tens of million of dollars associated with the Company's construction program that pass through CWIP prior to being placed in service. Mr. McGarry is wrong in his assumption." 5 TR 806-807.

Further, the Company supports the MPSC Staff's argument concerning the Attorney General's witness's views on CWIP:

“Also concerning CWIP, it is Staff's position the AG's witness Mr. McGarry is misrepresenting the nature of CWIP. Mr. McGarry argues in his testimony that '[b]y including CWIP, the ratepayers are in effect being asked to pay a rate of return on these dollars twice' (8 TR 1533). Mr. McGarry attempts to support this position by stating that '...since CWIP is for small dollar projects expected to be in service within 12 months, then most, if not all, of the 2004 CWIP balance (\$30,274,000) is already included in the 2005 capital additions' (8 TR 1534). While his statement is true, it is also irrelevant; the purpose of projecting 2006 CWIP is to take into account that Consumers will, in fact, have construction work in progress costs for that year, and to estimate the average dollar amount of that cost.” Initial Staff brief at pp. 7-8.

2. Working Capital (AG brief, pp. 8-9)

The Attorney General also contends that the Company's calculation of working capital is flawed. According to the Attorney General, the Company should be required to maintain the exact same gas storage inventory as the Company utilized in MPSC Case No. U-13730. Such an approach would ignore the differences that have occurred since the order in that case. Both Company witness Kevin Daly and Staff witness Lisa Kindschy calculated the Company's gas storage volumes and average cost of gas in storage using updated data. 2 TR 242, 6 TR 1143-1144. Staff's calculations, which the Company has accepted, reflect the Company's updated actual storage volumes and costs through 2005 with updated forecasts of volumes and costs for 2006 (see Exhibit S-3, Schedule B-3-1), not historical experience as of the date of a previous rate order. The Attorney General's contention that there is no explanation or support for this level of storage or cost, initial brief of Attorney General at page 9, is incorrect.

3. **Unamortized MGP Expenditures** (AG brief, pp. 10-13)

The Attorney General argues in his brief that MGP remediation costs do not fall within the scope of costs lawfully recoverable from customers. The recoverability of these costs was previously addressed by the Commission in multiple cases and the Commission has correctly held for over 10 years that such costs are recoverable costs. The arguments raised by the Attorney General offer nothing new or different from arguments previously rejected.

Prior to the availability of natural gas, gas was manufactured. 4 TR 462. Manufactured gas plants were an integral part of gas utility service. 4 TR 462. As mentioned in Consumers Energy's initial brief, Consumers Energy has identified 23 sites that formerly housed manufactured gas plants at which it has a present or former ownership interest. 4 TR 461.

The level of environmental awareness has increased significantly since the time when manufactured gas plants were operated. 4 TR 462. The manufacture of gas resulted in various by-products which now are recognized as being environmentally harmful. 4 TR 462. There is significant risk that reasonable and typical industry practices during the manufactured gas plant era may have resulted in environmental contamination that is unacceptable under current environmental standards and laws. 4 TR 460.

Mr. Kelterborn, Consumers Energy's director of Environmental Services, testified with regard to the investigation and remediation costs:

"The costs of environmental investigation and remediation with respect to former MGP sites are necessary and ongoing costs of doing business which were not, and could not have been, anticipated during the time MGPs were in operation. Awareness of the environmental risk associated with these by-products did not exist during the MGP era. The costs of investigation and remediation are prudent expenditures and are based on public policy considerations of protecting the environment and natural resources of the State. These costs are unavoidable, are based on public policy considerations, and do not arise out of any failure to

meet standards at the time the plants were in operation.”
4 TR 462-463. (Emphasis added)

There is no record evidence to the contrary.

The environmental investigation and remediation costs are current ongoing costs of business. The MPSC has previously held that manufactured gas plant environmental response costs that are prudently incurred by Consumers Energy are recoverable costs. In its March 11, 1996 Order in Consumers Energy’s Case No. U-10755 the Commission established procedures for amortization and recovery of such costs by Consumers Energy. Consumers Energy presented evidence in the current case that the investigation and remediation costs it seeks to recover in this case were prudently incurred. See generally 4 TR 460-476. There is no evidence to the contrary.

The Court of Appeals has previously 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 arguments of the Attorney General that environmental cleanup costs were not current operating expenses upon which rates can be based and that allowing recovery was retroactive ratemaking. The Court of Appeals stated among other things:

“Appellants have not shown that the PSC abused its discretion in exercising its legislative ratemaking authority. *Detroit Edison v PSC, supra* at 524....The fact that the contamination arose from a different utility service provided to different customers in past years or that some of the environmental expense is associated with contamination which leached into property not owned by Peninsular and which never provided utility service, does not change the fact that Peninsular is incurring a significant expense in the course of its business in the present....

* * *

“Nor is there merit in the Attorney General’s argument that the PSC’s order constitutes illegal retroactive ratemaking. See *Detroit Edison v PSC*, 221 Mich App 370, 376; 562 NW2d 224 (1997). There is no retroactive ratemaking in this case because the rate established by the PSC is prospective. Environmental cleanup

costs were not previously factored into rates. The environmental expense is currently being incurred. The fact that the expense is caused by past conduct does not make this a case of retroactive ratemaking. See *ABATE v PSC*, 208 Mich App 248, 261; 527 NW2d 533 (1994).”

The Attorney General’s disagreement with long-standing Commission practice of allowing recovery of MGP investigation and remediation costs through an amortization process is not a reason to reverse that practice. The Attorney General’s legal objections to recovery of MGP investigation and remediation costs are without merit.

B. Capital Structure and Rate of Return (AG brief, pp. 13-33)

As an initial response to the Attorney General, it should be noted that many of the statements in the section of the Attorney General’s brief discussing overall rate of return are conclusory in nature and without any clear record support. The Attorney General’s witness Mr. King did not undertake comprehensive Consumers Energy specific analyses as was done by Consumers Energy’s and the Staff’s witnesses. Mr. King, in essence, created a hypothetical capital structure for a group of proxy companies with hypothetical cost rates. He then used them to calculate a hypothetical overall rate of return for debt and equity.¹⁷ Mr. King then imputed this hypothetical overall debt and equity rate of return to Consumers Energy and used it to back into a return on equity number for Consumers Energy. Neither Mr. King’s analyses nor the Attorney General’s brief provide a valid or meaningful roadmap for determining capital structure, return on equity, or overall rate of return. Mr. King’s proposed approach is not consistent with established MPSC policy or practice, is not a methodology that has previously been recognized in Michigan, and should be rejected summarily.

¹⁷ Mr. King included long term debt, short term debt, common equity, and preferred stock in calculating the hypothetical rate of return. See e.g., Attorney General brief at p. 33.

1. Capital Structure (AG brief, pp. 14-18)

Both Consumers Energy and the Staff's 2006 capital structure proposals are based on forecasts of Consumers Energy capital structure balances for the 2006 test year. There are three adjustments that the Company has proposed to the Staff capital structure. These are discussed in Consumers Energy's initial brief and in the reply to Staff in this reply brief. In contrast, the capital structure developed by the Attorney General's witness Mr. King does not represent a projected 2006 gas ratemaking capital structure that is specific to Consumers Energy. The 2006 capital structure developed by the Staff, after having made the three adjustments proposed by the Company, should be used in this case.

The Attorney General is particularly critical of the inclusion in the Staff capital structure of a short term debt balance of \$90 million, arguing that an imputed balance of \$387 million should instead be used. Use of a \$90 million balance for short term debt, as proposed by Staff and agreed to by Consumers Energy, is consistent with the short term debt balance used by the Commission in its December 22, 2005 Order in Case No. U-14347 (page 14). Consumers Energy projected an average short term debt balance of zero in its original filing based on the 13-month average historical amount. 5 TR 610.

The Commission should reject the Attorney General's claim that the cost of selling accounts receivable should be treated as short term debt. These costs result from off balance sheet transactions¹⁸ and are not part of the capital structure. See 5 TR 689, 722, 8 TR 1400, Exhibit S-4, Schedule C-5. Contrary to the Attorney General's claims, there is no

¹⁸ Mr. King admitted during cross examination that these were off balance sheet transactions and would not be treated as short term debt on the Company's books. 6 TR 974. Mr. King admitted that he has no personal knowledge of where accounts receivable financing was included in the rate case filings in this case. 6 TR 979. Mr. King also admitted that he did not know if Staff had made an adjustment elsewhere for accounts receivable financing. 6 TR 975. Staff's treatment is discussed by Mr. Aldrich at 8 TR 1400. Mr. Aldrich indicated that the net effect of the approach used by Staff was a reduction in the revenue deficiency of about \$5.6 million. If the Staff and Company approach was not used, working capital would be higher with the result that rate base would be higher.

double-counting since appropriate ratemaking adjustments are made to reflect the use of accounts receivable financing. See 8 TR 1400.

The treatment by the Company and the Staff of accounts receivable financing costs as being outside of the capital structure is consistent with the way that the Commission has traditionally treated accounts receivable financing program costs. 6 TR 1094. The Attorney General's attempt to impute a short term debt balance of \$387 million is based on speculation, has no valid basis, and is inconsistent with accepted ratemaking policy.

2. Cost Rates (AG brief, pp. 18-33)

a. General Response

As noted previously, the Attorney General's witness Mr. King attempted, in this case, to develop a hypothetical overall cost of debt and equity capital for a group of proxy companies based on various speculative and unsupported assumptions. Mr. King admitted that since he did not have access to actual debt costs for the proxy companies he used costs that he admitted "do not reflect the cost of debt." 6 TR 920. In addition, he used a return on equity for the proxy group that was based on faulty and incomplete analyses, as illustrated during cross examination and in Company rebuttal evidence by Mr. Leja and Mr. Webb. Mr. King then endeavored to "back into an allowed return on equity for CEC" (AG brief, p. 33) 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. Use of this non-traditional approach would be unlawful and unreasonable. Cost rates and the overall rate of return should be developed in this case using rates that are specific to Consumers Energy and the return on equity should reflect Consumers Energy's higher risk. 5 TR 645.

b. Rate of Return on Common Equity

Consumers Energy discusses the various analyses by Company and Staff witnesses at length in its initial brief and in its response to Staff in this reply brief. An examination of relevant factors shows that adopting the return on equity for Consumers Energy of 9.78% that the Attorney General advocates would be unlawful, unreasonable, and confiscatory. Adopting such a return would be an unconstitutional taking of Consumers Energy's property and would violate Consumers Energy's state and federal constitutional due process and equal protection rights.

Some of the numbers that the Attorney General identifies in his return on equity discussion are different than appear in the record in the current case. For example, on page 20, Mr. Leja's CMS Energy CAPM should be 15.32% (Exhibit A-39) rather than 13.17%.¹⁹ On pages 20 and 30, the Staff's DCF results as shown on column g of Exhibit S-5, Schedule D-5, p. 7, should show as a range from 7.25% to 14.90%, with a midpoint of 11.08%,²⁰ not a range of 9.90% to 10.02% with a midpoint of 9.96%. However, in any event, it would be inappropriate to simply rely upon numbers without the exercise of analysis and judgment.

The 9.78% return the Attorney General advocates ignores the principles of Hope and Bluefield and would be unreasonably and unlawfully low for Consumers Energy's gas business. Indeed, the Attorney General even admits at page 17 of his brief that Mr. King used the proxy companies for the very reason that they did not have the risk characteristics of Consumers Energy. While the Staff's witnesses Mr. Megginson and Mr. Ballinger and the

¹⁹ Contrary to the apparent assumptions in the Attorney General's brief, the return sought in this case by Consumers Energy is based on the risk characteristics of Consumers Energy, not CMS Energy. The Attorney General's speculation that Consumers Energy's debt level has somehow "filtered down" from the parent has no evidentiary basis. The debt levels in the capital structure recommended by the Company in its brief and in this reply brief are those of the utility.

²⁰ Making the revisions discussed earlier in the Company's reply brief would increase the results.

Company's witnesses Mr. Webb and Mr. Leja disagreed as to whether the return should be at the midpoint of Staff's range of 10.80% to 11.40% or at a level higher than the 11.15% midpoint, all four agreed that the risk characteristics of Consumers Energy require a return higher than using unadjusted average returns for the proxy groups. The Attorney General's claim at page 31 of his brief that Consumers Energy's greater financial risk should be ignored is contrary to well-established Constitutional principles.²¹

The Attorney General's witness Mr. King relied primarily on DCF analyses as support for his rate of return recommendation for proxy companies, which he then used to "back into" his return on equity recommendation for Consumers Energy. Contrary to claims of the Attorney General at page 22 of his brief, there is considerable disagreement with Mr. King's implementation of the DCF approach. First, as discussed above in the response to Staff, DCF analyses will understate the investor required return under the current circumstances and, therefore, it is not appropriate to give significant weight to the DCF results at this time. Second, it is inappropriate to rely only upon one form of analysis. 5 TR 766. Third, numerous problems were identified with the Attorney General's analyses during cross examination and in Company rebuttal testimony (see e.g., 5 TR 782-788). Fourth, as noted above, his recommendations are inconsistent with the principles of Hope and Bluefield. For all these reasons, the Attorney General's reliance on Mr. King's DCF analyses and Mr. King's return on equity recommendation (as revised) of 9.78% must be rejected.

²¹ The Attorney General makes the statement at p. 17 of his brief: "CECo's witness Webb believes that CECo's customers should pay in the form of a 157 basis point adder to CECo's allowed return on equity." Mr. Webb testified that, due to Consumers Energy's greater risk, he was recommending a risk adjustment of 100 basis points be made. 5 TR 625. He stated that this was approximately the average of the risk differential of 40 basis points for the difference between senior secured bond ratings of Consumers and the proxy group and 157 basis points for the difference between corporate ratings of Consumers as compared to the proxy group. 5 TR 625-626. Mr. Webb did not recommend an adjustment of 157 basis points. 5 TR 625. Adjusting the returns to reflect Consumers Energy's higher risk is consistent with, and required by, the principles set forth in Hope and Bluefield.

Numerous problems with Mr. King's capital structure and rate of return analyses were identified in rebuttal testimony of Mr. Webb and Mr. Leja (see 5 TR 644-646, 782-788) and during cross examination of Mr. King (see generally 6 TR 978-1004, 1017-1020). These included selectively updating data when changing Mr. Megginson's numbers (6 TR 979-980), inconsistencies among exhibits (6 TR 997), and multiple calculation errors on Exhibit AG-8 (6 TR 999-1001, 1012-1013).²² While the Attorney General claims that Mr. King corrected various errors in his calculations, Mr. King acknowledged that his changes were based on a calculation of "one or two" numbers and "back-of-the-envelope." See 6 TR 1013, 1019-1020.

The inadequacy of the Attorney General's 9.78% return on equity recommendation is illustrated on Mr. King's Exhibit AG-8. In column E of Exhibit AG-8, Mr. King calculated the Value Line expected average ROE on book value for Mr. Leja's proxy group companies. The mathematical average of the ROEs shown in column E of Exhibit AG-8 is 11.0%. This expected return cannot be realized by adopting Mr. King's recommended ROE of 9.78%. The Value Line expected ROE result of 11.0% is consistent with the ROE results for Mr. Leja's and Mr. Megginson's proxy groups. Since Consumers Energy has more risk than either of those proxy groups, the investor required return for Consumers Energy would be higher.

Mr. King attempted to support his reliance on the DCF model by indicating that the Federal Communications Commission ("FCC") had concluded the DCF should be given the greatest weight. This would not be binding in any event. However, on cross examination Mr. King admitted that his source citation on page 17 of his testimony²³ was wrong (6 TR 981, 1009), that he was unaware of the FCC's current position (6 TR 982), that he would probably

²² Exhibit A-88 provides data supplied by Mr. King indicating how the columns on Exhibit AG-8 were calculated. 6 TR 998-999, Exhibit A-88, p. 1

²³ Page 17 in the prefiled testimony is located at 6 TR 926 in the transcript.

agree that cost of equity methodologies may not withstand the test of time²⁴ (6 TR 982), and that he did not believe that the FCC had a current position (6 TR 982). Title 47 CFR §65.301, which is part of the Code of Federal Regulations for the FCC, states that “The cost of equity shall be determined...after giving full consideration to the evidence in the record...”²⁵ There is no indication that the FCC has a current preference for the DCF method. The FCC rejected this view in a decision adopted March 30, 1995 in: In the Matter of Amendment of Parts 65 and 69 of the Commission’s Rules to Reform the Interstate Rate of Return Represcription and Enforcement, 1995 WL 156764 (FCC), 10 FCC Rcd. 6788 (Common Carrier Docket No. 92-133, FCC 95-134), paragraphs 88-90. A copy of these paragraphs is contained in Reply Brief Appendix C, attached to this brief.

The Attorney General seeks to downplay the CAPM model on the theory it involves judgment. However, all models involve judgment.²⁶ 5 TR 785. The CAPM and risk premium approaches are accepted methodologies in MPSC proceedings. Mr. King’s criticism of the beta used in the CAPM analyses is, like his other criticisms of the CAPM, without merit. The Value Line betas used in the CAPM analyses were appropriately adjusted by Value Line using the Marshall Blume method. 5 TR 785-786. Mr. Leja explained that use of Value Line betas in the CAPM analyses is consistent with past practice and is reasonable. 5 TR 786. Mr. King’s reservations about the risk-free rate and market risk premium are also without merit, as discussed by Mr. Leja at 5 TR 786-787.²⁷ The rationale for using long-term data is not

²⁴ In other words, an equity method that is used at one point in time may not be appropriate at another point in time.

²⁵ Consumers Energy requests that the Commission take notice of this regulation pursuant to MRE 202 and Rule 327 (R460.327) of the Commission’s Rules of Practice and Procedure.

²⁶ His witness Mr. King admitted, during cross, that judgment is also required in a DCF calculation. 6 TR 991.

²⁷ Contrary to the assertion made by the Attorney General at pp. 26-27 of his brief, both Mr. Leja and Mr. Megginson used the average common stock return and long-term government bond returns for 1926-2004 in their CAPM analyses. Exhibit A-42, Exhibit S-5, Schedule D-5, p. 8. (The difference between the risk premium of 7.17% used by Mr. Leja and the risk premium of 7.16% used by Mr. Megginson is attributable to differences in rounding. Id.)

because stocks are held by an individual shareholder in perpetuity, but because the time period should match the time horizon of what is being valued. 5 TR 786. Use of long-term data in a CAPM analysis is reasonable and long-term data is frequently used for this purpose. 5 TR 786.

Mr. King's attempt to undertake a CAPM analysis based on DCF formulations (6 TR 935, 984-985) was highly subjective in nature and used inappropriate inputs. 5 TR 787. Mr. Leja noted that using a three year stock appreciation period instead of a four-year period, would increase Mr. King's CAPM return from 9.4% to 11.8%. 5 TR 787. As illustrated, over a short period of time, the equity risk premium can be quite volatile. 5 TR 775. Over a long period the risk premium is relatively stable and it is less likely an analyst can justify any number he or she wants. 5 TR 775. Mr. King, in the current case, used a capital appreciation method, even though he had, himself, previously criticized witnesses in other cases for using capital appreciation approaches in CAPM analyses. 6 TR 986-989.

Mr. King's criticism of the Company's separate risk premium analysis is similarly without merit. 5 TR 787. Contrary to Mr. King's claims, Mr. Leja's risk premium analysis used return data from 1954 through 2000, a total of 47 years, versus only the three year period indicated by Mr. King. 5 TR 787. Exhibit A-44. Mr. Megginson's risk premium analysis used return data from 1953 through 2003. Exhibit S-5, Schedule D-5, p. 9, 6 TR 1052.

The Attorney General argues in his brief pages 19-20 that flotation costs should not be considered. The Court of Appeals has previously recognized that the Commission has discretion to include flotation costs.²⁸ Consumers Energy has argued that it would be appropriate to include flotation costs in this case for reasons discussed in the Company's initial brief at pages 29-30.

²⁸ Attorney General v Public Service Comm, 136 Mich App 515, 521; 338 NW2d 351 (1984)

The Attorney General appears to suggest (as an alternative to his recommendation of a 9.78% return on equity) that the return should be set at the 10.63% midpoint of the results from Staff's analyses. The midpoint is actually higher than calculated by the Attorney General. However, leaving that aside for the moment, just as the Attorney General's 9.78% recommendation is without merit and must be rejected, his alternative approach of using the midpoint of the results is without merit and must be rejected. The Attorney General's alternative approach fails to even attempt to weigh and evaluate the analyses or the risk of Consumers Energy as compared with the proxy group.

Mr. King admitted that Consumers Energy is significantly more risky than a typical gas distribution utility (e.g., "I haven't dealt with a gas distribution company...that is in such sorry financial shape" 6 TR 1003). However, instead of adjusting the return on equity upward to reflect the higher risk, he intentionally disregarded Consumers Energy's higher risk.

Mr. King admitted that he had not previously used the type of approach he was recommending in any prior testimonies. 6 TR 1003. His attempts to use such an approach here and his recommendations should be rejected. The Attorney General's recommended return is hardly commensurate with returns on investments having corresponding risks.

C. Adjusted Net Operating Income (AG brief, pp. 34-41)

As discussed in the Company's initial brief at pages 37-38, the Company accepted Staff's operating revenue of \$664,227,000. The Attorney General also accepted the Staff's adjustments to the Company's operating revenue. Attorney General's initial brief, p. 34. Likewise, the Company accepted most of the Staff's position on Other O&M expense except for only four categories of expense: (i) the Employee Incentive Compensation Plan, (ii) injuries and damages, (iii) union contract expenses, and (iv) MGP amortization. Therefore, the Company

will not make specific responses to the Attorney General's adjustments. The four adjustments that the Company is requesting that the Commission make to the Staff's calculation of Other O&M expense are shown on Appendix D to the initial brief and discussed in subsection VII.C.2 of the Company's initial brief.

D. Revenue Deficiency (AG brief, pp. 41-42)

The Attorney General recommends that the Company's revenue deficiency as reflected in his Exhibit AG-59 be adjusted for MGP costs, certain Staff revenue adjustments and proposed overall rate of return. The Company does not support the Attorney General's proposals and recommends that the \$58,124,000 increase authorized in Case No. U-13730 be made permanent and that Consumers Energy's gas distribution rates be increased in the additional amount of \$118,166,000.

III. REPLY TO ABATE

A. Rate Design Issues

Consumers Energy discusses the issue of rate design in its initial brief at pages 54-55. The Staff proposed to allocate the revenue deficiency among all rate classes, except rate GL, outdoor lighting, as an equal percentage of each class's revenue, excluding GCR revenue. 8 TR 1501. For purposes of minimizing issues in dispute, Consumers Energy accepted Staff's position with regard to rate design. Consumers Energy's initial brief p. 55. As discussed by Staff witness Collins, Consumers Energy's current rates are very closely aligned with the cost of providing service to each class of customers. 8 TR 1501. Therefore, Staff recommended that the revenue deficiency be allocated on the basis of each class's current percentage. 8 TR 1501-1502. Staff's method is much simpler to implement. Staff's initial brief p. 56. Because the numbers of Staff's proposal and the cost of service study are essentially the same, for purposes of ease, the

Staff's proposal of allocating the revenue deficiency on the basis of each class's current percentage should be used.

B. Company Use/LAUF Gas Percentages

On page 37 of the Company's initial brief, Consumers Energy accepted Staff's recommendation for Company Use and Lost and Unaccounted for Gas. Staff based this recommendation on the historic calculation of five-year average LAUF percentage and the Staff's projected sales and transportation volumes. 8 TR 1508. Due to the historical approach of the calculation and the fact that ABATE merely states its disagreement with the actual occurrence of Company Use and Lost and Unaccounted for Gas, the Staff's position should be adopted by the Commission in this case.

IV. REPLY TO NATIONAL ENERGY MARKETERS ASSOCIATION

A. Reply Regarding Gas Customer Choice Issues

As previously stated in Section I.F.4. Consumers Energy agrees with the Staff's recommendation to reject NEM's proposals with regard to the Gas Customer Choice ("GCC") issues. Consumers Energy also supports the Staff's position that a collaborative on reviewing the annual reconciliation process of the GCC program is not necessary and that NEM proposal should be rejected. Staff's initial brief, p. 65. Company witness Elizabeth Curtis presented undisputed evidence concerning Consumers Energy's current GCC Program. Ms. Curtis stated that Consumers Energy's GCC program carefully balances the need to protect Consumers Energy's Gas Cost Recovery ("GCR") customers with the need to fairly administer the GCC program. 4 TR 487. The GCC program was carefully designed to make sure that GCR customers and the operating integrity of the Company's gas system were not adversely affected. 4 TR 488. The Company aims to minimize any imbalance between customer load and supplier

delivery in a pool at the end of the GCC year. 4 TR 489. 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. 4 TR 492. The cap is to prevent the suppliers from manipulating the GCC Program to their advantage; otherwise the Company's GCR customers could be hurt. Id.

The Company 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. 4 TR 493. This reconciliation produces a fair and reasonable result for the GCC suppliers and protects the interests of the GCR customers. 4 TR 493-494. Changing one variable of the program could affect other aspects of the program and adversely affect GCR customers. 4 TR 494.

NEM did not suggest any specific tariff changes that would improve Consumers Energy's current GCC reconciliation procedures. 7 TR 1186. In fact, in its initial brief, NEM stated "that no single, detailed proposal has yet been formulated and offered for review and study." NEM's initial brief, p. 3. NEM stated it is aware:

"that there is no detailed aggregate reconciliation proposal on the table. Quite simply, NEM is not in a position to formulate a uniform proposal that takes into account the concerns of its members as well as all Michigan utilities, the Commission Staff, the Attorney General's office and other interested parties, for those concerns have not yet been voiced." NEM's initial brief, p. 10.

NEM's witness White has not gone through reconciliation with Consumers Energy and did not have any suggestions on how that process could be improved. 7 TR 1240-1241. When asked for specific examples, White was not able to provide any at the time and

admitted that his testimony was not based on any existing documents. 7 TR 1195-1197. In fact, it appears that NEM's witness may have concerns with Mich Con and not Consumers Energy. 7 TR 1244. In its initial brief, NEM made an attempt to propose changes to Consumers Energy's tariff language, but this attempt was made too late and is not part of the record. Since NEM did not make any specific proposal as part of the record, admits that it was not in the position to make any such proposal, and there appear to be no problems with Consumers Energy's reconciliation, NEM's vague proposals should be rejected.

B. Objection to Attachment of Non-Record Materials

NEM attaches two non record documents to its initial brief which it refers to as "Exhibit A" and "Exhibit B." These documents were not offered as exhibits during the proceeding, are not part of the record in this case, and are not summaries of record evidence. The documents do not meet the criteria of MRE 201(b) for taking official notice and NEM provides no valid basis for considering them in this case.

a. The Exhibits are Irrelevant

The "Exhibits" attached to NEM's initial brief should not be considered; not only are the exhibits irrelevant, but they are also hearsay. What is shown are supposed to be examples of how other states' reconciliation processes work. These supposed examples do not have any bearing on Consumers Energy's current GCC plan. Rule 401 of the Michigan Rules of Evidence defines relevant evidence as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." The issue here is Consumers Energy's GCC reconciliation procedures. The "Exhibits" have no effect on Consumers Energy's tariffs and there is no record evidence that the results shown would be appropriate for Consumers Energy's GCC plan. The

information in the “Exhibits” does not have a legitimate influence or bearing on a decision in this case. It does not have a substantial bearing on the merits of the controversy. The results of the NEM compilation are not relevant or material for purposes of this case.

b. The Exhibits are Inadmissible Hearsay

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

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

Clearly the statements in the “Exhibits” are not made by a declarant while testifying. NEM is submitting this information for the truth of the matters asserted. There should be no question that this comes within the definition of hearsay. Rule 802 of the Michigan Rules of Evidence states:

“Hearsay is not admissible except as provided by these rules.”

There is no reason for the irrelevant, hearsay documents to be considered. NEM admitted that “Exhibit B” was not even composed at the time of its witness’s testimony. Therefore, NEM obviously cannot argue that its witness relied on “Exhibit B” while forming his opinions. Accordingly, the documents attached to NEM’s initial brief should not be given any weight as they are not part of any record evidence.

V. CONCLUSION

For the reasons set forth in Consumers Energy's initial brief and in this reply brief, the ALJ should recommend and the Commission should order, that: (i) the \$58,124,000 increase authorized in Case No. U-13730 be made permanent and (ii) Consumers Energy's gas distribution rates be increased in the additional annual amount of \$118,166,000, and that the Commission grant Consumers Energy such other and further relief as is just and reasonable.

Respectfully submitted,

CONSUMERS ENERGY COMPANY

H. Richard Chambers

Digitally signed by H. Richard Chambers

Date: 2006.05.15 15:27:58 -04'00'

Dated: May 15, 2006

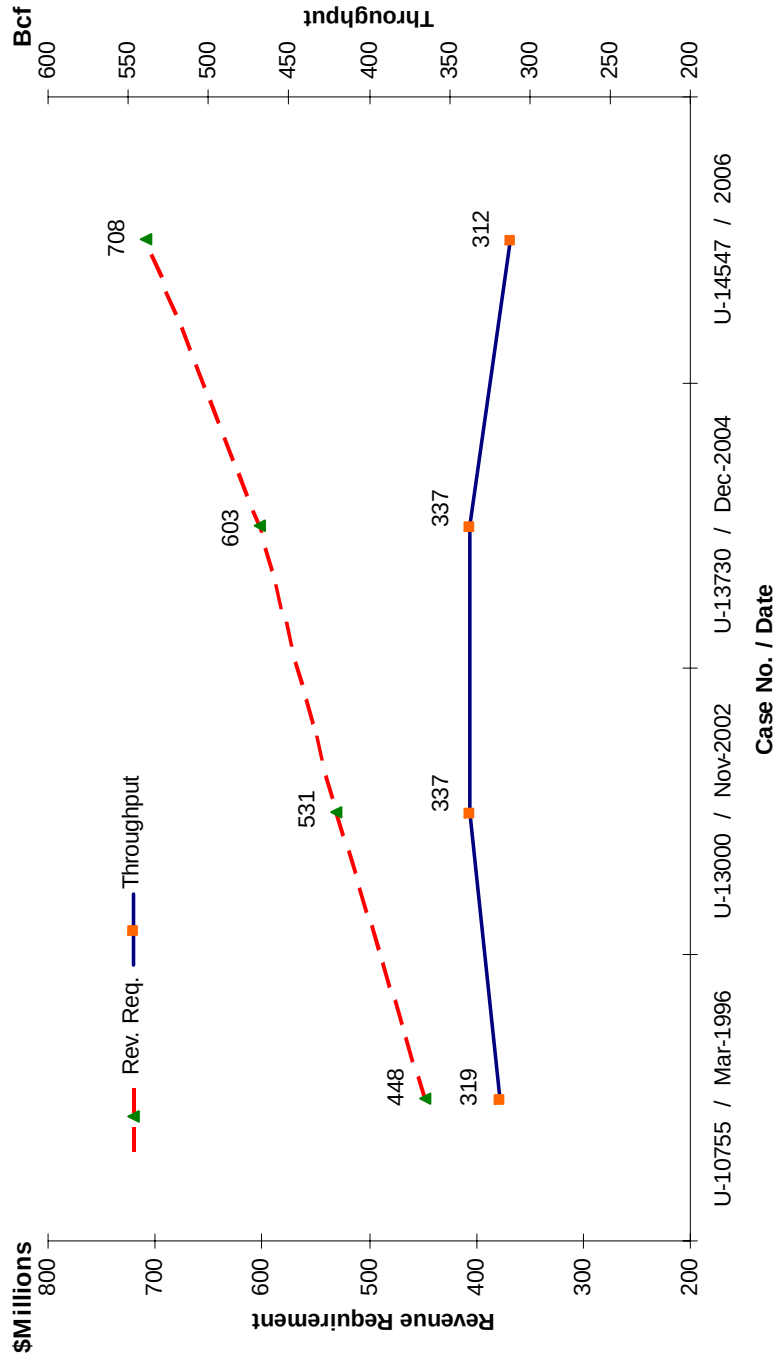
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CONSUMERS ENERGY COMPANY

Comparison of the Gas
Revenue Requirement and
Total Throughput for Case No.
U-10755, U-13000, U-13730, and U-14547

REPLY BRIEF



Consumers Energy Company
Development of the Incremental Changes
in the Overall Rate of Return from the Staff Position
as-filed to CEC's Position in the Initial Brief

Appendix B
Page 1 of 6

Case No. U-14547

Line No.	Description	After-tax Overall Rate of Return				
		MPSC Staff Position as-filed	Adjusted to Include the Equity Infusion	Adjusted to Recognize Securitization	Adjusted to Recognize Section 263A	Adjusted for a 12% ROE
	(a)	(b)	(c)	(d)	(e)	(f)
1	Long Term Debt	2.70%	2.63%	2.68%	2.72%	2.72%
2	Preferred Stock	0.02%	0.02%	0.02%	0.02%	0.02%
3	Common Equity	3.74%	3.91%	3.91%	3.97%	4.27%
4	Subtotal					
5	Short Term Debt	0.06%	0.06%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	0.02%	0.02%	0.02%	0.02%	0.02%
7	Customer Deposits	0.03%	0.03%	0.03%	0.03%	0.03%
8	Deferred FIT	0.00%	0.00%	0.00%	0.00%	0.00%
9	Deferred ITC	0.00%	0.00%	0.00%	0.00%	0.00%
	JDITC					
10	Def. JDITC - Long-term Debt	0.03%	0.03%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	0.00%	0.00%	0.00%	0.00%	0.00%
12	Def. JDITC - Common Equity	0.04%	0.04%	0.04%	0.04%	0.04%
13	Total Required Return	6.64%	6.74%	6.78%	6.88%	7.19%
14	Incremental Change from Previous Column		0.10%	0.04%	0.10%	0.31%

Source:

Column (b) - Appendix A, page 2 of 6.

Column (c) - Appendix A, page 3 of 6.

Column (d) - Appendix A, page 4 of 6.

Column (e) - Appendix A, page 5 of 6.

Column (f) - Appendix A, page 6 of 6.

Consumers Energy Company
Overall Rate of Return - 2006
Staff's Initial Brief Position

Appendix B
Page 2 of 6

Case No. U-14547

Line No.	Description	Amount Outstanding (millions)	% of Total Capital	Cost Rate	Total Capital	Wtd Cost of Debt	Pretax Rate of Return
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	Long Term Debt	\$ 4,057	47.88%	5.63%	2.70%	2.70%	2.75%
2	Preferred Stock	44	0.52%	4.46%	0.02%		0.04%
3	Common Equity	<u>2,841</u>	33.53%	11.15%	3.74%		5.86%
4	Subtotal	\$ 6,942					
5	Short Term Debt	90	1.06%	5.75%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	35	0.41%	5.57%	0.02%	0.02%	0.02%
7	Customer Deposits	28	0.33%	9.00%	0.03%	0.03%	0.03%
8	Deferred FIT	1,309	15.45%	0.00%	0.00%		
9	Deferred ITC	-	0.00%	0.00%	0.00%		
	JDITC						
10	Def. JDITC - Long-term Debt	41	0.48%	5.63%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	-	0.01%	4.46%	0.00%		0.00%
12	Def. JDITC - Common Equity	<u>29</u>	<u>0.34%</u>	11.15%	<u>0.04%</u>		<u>0.06%</u>
13	Total	<u>\$ 8,473</u>	<u>100.00%</u>		<u>6.64%</u>	<u>2.84%</u>	<u>8.85%</u>

Source - Exhibit S-5 (KDM), Schedule D-1.

Consumers Energy Company
Overall Rate of Return - 2006
Staff's Initial Brief Position
Adjusted for the Equity Infusion

Appendix B
Page 3 of 6

Case No. U-14547

Line No.	Description	Amount Outstanding (millions)	% of Total Capital	Cost Rate	Total Capital	Wtd Cost of Debt	Pretax Rate of Return
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	Long Term Debt	\$ 4,057	46.78%	5.63%	2.63%	2.63%	2.68%
2	Preferred Stock	44	0.51%	4.46%	0.02%		0.04%
3	Common Equity	<u>3,041</u> ¹	35.06%	11.15%	3.91%		6.13%
4	Subtotal	\$ 7,142					
5	Short Term Debt	90	1.04%	5.75%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	35	0.40%	5.57%	0.02%	0.02%	0.02%
7	Customer Deposits	28	0.32%	9.00%	0.03%	0.03%	0.03%
8	Deferred FIT	1,309	15.09%	0.00%	0.00%		
9	Deferred ITC	-	0.00%	0.00%	0.00%		
	JDITC						
10	Def. JDITC - Long-term Debt	41	0.47%	5.63%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	-	0.01%	4.46%	0.00%		0.00%
12	Def. JDITC - Common Equity	<u>29</u>	<u>0.33%</u>	11.15%	<u>0.04%</u>		<u>0.06%</u>
13	Total	<u>\$ 8,673</u>	<u>100.01%</u>		<u>6.74%</u>	<u>2.77%</u>	<u>9.05%</u>

Source - Exhibit S-5 (KDM), Schedule D-1.

¹ Determination of the Revised Equity Balance:

Staff Position as-filed	\$ 2,841	Appendix A, page 2 of 6.
Equity Infusion	<u>200</u>	Exhibit A-82 (TJW-12), p. 4/5 of 6.
Revised Balance	<u>\$ 3,041</u>	

Consumers Energy Company

Overall Rate of Return - 2006

Staff's Initial Brief Position Adjusted to Recognize

Equity Infusions and to Remove Effects of Securitization

Appendix B

Page 4 of 6

Case No. U-14547

Line No.	Description	Amount Outstanding (millions)	% of Total Capital	Cost Rate	Total Capital	Wtd Cost of Debt	Pretax Rate of Return
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	Long Term Debt	\$ 4,354 ¹	47.67%	5.63%	2.68%	2.68%	2.74%
2	Preferred Stock	44	0.48%	4.46%	0.02%		0.03%
3	Common Equity	<u>3,205 ¹</u>	35.09%	11.15%	3.91%		6.14%
4	Subtotal	\$ 7,603					
5	Short Term Debt	90	0.99%	5.75%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	35	0.38%	5.57%	0.02%	0.02%	0.02%
7	Customer Deposits	28	0.31%	9.00%	0.03%	0.03%	0.03%
8	Deferred FIT	1,309	14.33%	0.00%	0.00%		
9	Deferred ITC	-	0.00%	0.00%	0.00%		
	JDITC						
10	Def. JDITC - Long-term Debt	41	0.45%	5.63%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	-	0.01%	4.46%	0.00%		0.00%
12	Def. JDITC - Common Equity	<u>29</u>	<u>0.32%</u>	11.15%	<u>0.04%</u>		<u>0.06%</u>
13	Total	<u>\$ 9,134</u>	<u>100.00%</u>		<u>6.78%</u>	<u>2.81%</u>	<u>9.09%</u>

Source - Exhibit S-5 (KDM), Schedule D-1.

¹ Determination of Revised LTD Balance:

Staff Position as-filed	\$ 4,057	Appendix A, page 2 of 6.
Securitization Impact	<u>297</u>	5 TR 642-643.
Revised Balance	<u>\$ 4,354</u>	

² Determination of Revised Equity Balance:

Staff as-adjusted	\$ 3,041	Appendix A, page 3 of 6.
Securitization Impact	<u>164</u>	5 TR 642-643.
Revised Balance	<u>\$ 3,205</u>	

Consumers Energy Company

Overall Rate of Return - 2006

Staff's Initial Brief Position Adjusted to Recognize
Equity Infusions, Remove Effects of Securitization
and Remove Section 1.263A-IT

Appendix B

Page 5 of 6

Case No. U-14547

Line No.	Description	Amount Outstanding (millions)	% of Total Capital	Cost Rate	Total Capital	Wtd Cost of Debt	Pretax Rate of Return
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	Long Term Debt	\$ 4,354	48.36%	5.63%	2.72%	2.72%	2.78%
2	Preferred Stock	44	0.49%	4.46%	0.02%		0.03%
3	Common Equity	<u>3,205</u>	35.60%	11.15%	3.97%		6.23%
4	Subtotal	\$ 7,603					
5	Short Term Debt	90	1.00%	5.75%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	35	0.39%	5.57%	0.02%	0.02%	0.02%
7	Customer Deposits	28	0.31%	9.00%	0.03%	0.03%	0.03%
8	Deferred FIT	1,178 ¹	13.08%	0.00%	0.00%		
9	Deferred ITC	-	0.00%	0.00%	0.00%		
	JDITC						
10	Def. JDITC - Long-term Debt	41	0.46%	5.63%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	-	0.01%	4.46%	0.00%		0.00%
12	Def. JDITC - Common Equity	<u>29</u>	<u>0.32%</u>	11.15%	<u>0.04%</u>		<u>0.06%</u>
13	Total	<u>\$ 9,003</u>	<u>100.00%</u>		<u>6.88%</u>	<u>2.86%</u>	<u>9.23%</u>

Source - Exhibit S-5 (KDM), Schedule D-1.

¹ Determination of Revised DFIT Balance:

Staff Position as-filed	\$ 1,309	Appendix A, page 2 of 6.
1-263A-IT Impact	<u>(131)</u>	5 TR 642-643.
Revised Balance	<u>\$ 1,178</u>	

Consumers Energy Company

Overall Rate of Return - 2006

 Staff's Initial Brief Position Adjusted to Recognize
 Equity Infusions, Remove Effects of Securitization
 and Remove Section 1.263A-IT, with a 12% ROE

Appendix B

Page 6 of 6

Case No. U-14547

Line No.	Description	Amount Outstanding (millions)	% of Total Capital	Cost Rate	Total Capital	Wtd Cost of Debt	Pretax Rate of Return
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1	Long Term Debt	\$ 4,354 ¹	48.36%	5.63%	2.72%	2.72%	2.78%
2	Preferred Stock	44	0.49%	4.46%	0.02%		0.03%
3	Common Equity	<u>3,205 ²</u>	35.60%	12.00%	4.27%		6.70%
4	Subtotal	\$ 7,603					
5	Short Term Debt	90	1.00%	5.75%	0.06%	0.06%	0.06%
6	Other Interest-Bearing Accounts	35	0.39%	5.57%	0.02%	0.02%	0.02%
7	Customer Deposits	28	0.31%	9.00%	0.03%	0.03%	0.03%
8	Deferred FIT	1,178 ³	13.08%	0.00%	0.00%		
9	Deferred ITC	-	0.00%	0.00%	0.00%		
	JDITC						
10	Def. JDITC - Long-term Debt	40	0.44%	5.63%	0.03%	0.03%	0.03%
11	Def. JDITC - Preferred	-	0.01%	4.46%	0.00%		0.00%
12	Def. JDITC - Common Equity	<u>30</u>	<u>0.33%</u>	12.00%	<u>0.04%</u>		<u>0.06%</u>
13	Total	<u>\$ 9,003</u>	<u>100.00%</u>		<u>7.19%</u>	<u>2.85%</u>	<u>9.71%</u>

Source - Exhibit S-5 (KDM), Schedule D-1.

¹ Development of the adjustment to remove effects of Securitization:

LTD with Securitization	\$ 4,057	Exhibit S-5 (KDM), Schedule D-1.
Adj. To Remove Secur.	<u>297</u>	5 TR 642-643
LTD w/o Securitization	<u>\$ 4,354</u>	

² Dev. of the adjustment to include infusions and remove effects of Securitization:

Equity Balance	\$ 2,841	Exhibit S-5 (KDM), Schedule D-1.
Equity Infusion	200	Exhibit A-82 (TJW-12), p. 4/5 of 6.
Adj. To Remove Secur.	<u>164</u>	5 TR 642-643
Revised Equity Balance	<u>\$ 3,205</u>	

³ Development of the adjustment to reflect Treasury Reg. Section 1.263A-IT :

Actual DFIT	\$ 1,309	Exhibit S-5 (KDM), Schedule D-1.
Adj. for Sec. 1.263A-IT	<u>(131)</u>	5 TR 642-643
Revised DFIT Balance	<u>\$ 1,178</u>	

⁴ The 12.00% return on equity is recommended by CEC. (See 5 TR 628)

Excerpts from:

In the Matter of Amendment
of Parts 65 and 69 of the
Commission's Rules to Reform the
Interstate Rate of Return Represcription
and Enforcement,
1995 WL 156764 (FCC);
10 FCC Rcd. 6788
(Federal Communications Commission,
Common Carrier Docket No. 92-133,
FCC 95-134, adopted March 30, 1995)

Westlaw.

1995 WL 156764 (F.C.C.), 77 Rad. Reg. 2d (P & F) 615, 10 F.C.C.R. 6788, 10 FCC Rcd. 6788

(Cite as: 1995 WL 156764 (F.C.C.), 10 FCC Rcd. 6788)

H

Federal Communications Commission (F.C.C.)

Report and Order

*1 In the Matter of Amendment of Parts 65 and 69 of the Commission's Rules
to Reform the Interstate Rate of Return Represcription and Enforcement
Processes

CC Docket No. 92-133

FCC 95-134

Adopted: March 30, 1995

Released: April 6, 1995

**6788 By the Commission:

**6789 I. Introduction

1. Part 65 of our rules [FN1] sets forth procedures and methodologies for prescribing and enforcing the rate of return certain local exchange carriers ("LECs") may earn on interstate access service. [FN2] The Commission adopted those rules in 1985. In the Notice in this proceeding, [FN3] we proposed a fundamental reform of those rules in order to reflect the dramatic changes in the telecommunications industry and our regulation of it that had occurred since that time. This Report and Order accomplishes that reform by streamlining our rate of return represcription and enforcement processes in ways that, we believe, will substantially reduce the burden of our regulations on the public and on those LECs still subject to rate of return regulation. The changes achieve a proper balance of regulatory goals by allowing a carrier the opportunity to "maintain its credit and to attract capital" [FN4] and by ensuring that ratepayers are charged reasonable rates for interstate services.

**6790 2. When Part 65 was adopted, the Commission used rate of return principles to regulate the rates for the interstate communications services of the American Telephone and Telegraph Company ("AT & T") and all LECs. Since that time, our price cap initiatives have removed all interexchange and most interstate access revenues from such regulation. [FN5] We have also created optional programs that allow the remaining rate of return LECs to increase their opportunities for increased profit and risks of loss above the levels they would face under traditional, rate of return regulation. [FN6]

3. To reflect the altered environment as well as our experiences in implementing the Part 65 rules, we change virtually every aspect of our rate of return

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1995 WL 156764 (F.C.C.), 77 Rad. Reg. 2d (P & F) 615, 10 F.C.C.R. 6788, 10 FCC Rcd. 6788

(Cite as: 1995 WL 156764 (F.C.C.), 10 FCC Rcd. 6788)

maturity of common stock; Centel recommends thirty-year Treasury bonds or Aa utility bond. [FN255] MCI suggests that the Commission should require LECs to submit, at the outset of a rescription proceeding, classic DCF data for each quartile of the S & P 400, without prespecifying any portion as a possible benchmark. [FN256] SBA is indifferent to whether the DCF and the risk premium methods are used, but believes these methods will be accurate if properly specified. SBA recommends, however, that in applying these methods, we use stock indices for companies that mirror the financial resources of small LECs, rather than relying on the S & P 400, the largest 100 utilities, or other groupings from the New York Stock Exchange ("NYSE"). [FN257]

87. Few commenters address two issues the Notice raised regarding the application of the DCF formula: quarterly compounding of dividends and the inclusion of flotation costs in the cost of equity. Centel and USTA maintain that quarterly compounding is not difficult to apply with current spreadsheet software and that DCF computations should reflect the quarterly payment of dividends. [FN258] Rochester states that the Commission should not prejudice quarterly compounding or flotation costs by adopting rules or methodologies that effectively reject them. [FN259] USTA maintains that we should allow participants in rescription proceedings to seek an adjustment for flotation costs, despite the lack of any separately recorded, out-of-pocket costs for the issuance of equity shares. [FN260] FWA opposes an allowance for flotation costs because small LECs do not sell additional stock through offerings to the general public. [FN261] MCI opposes as unnecessary both quarterly compounding of dividends and an allowance for flotation costs. [FN262]

3. Discussion

88. Equity prices are established in highly volatile and uncertain capital markets. The theories and methodologies analysts use to forecast these prices represent a rapidly expanding field of study. Different forecasting methodologies compete with each other for eminence, only to be superseded by other methodologies as conditions change. In addition, ****6830** each methodology has a number of permutations. Besides the number of methodologies available, there is the problem that each methodology assumes certain conditions that may, or may not, persist over time. [FN263] In these circumstances, we should not restrict ourselves to one methodology, or even a series of methodologies, that would be applied mechanically. Instead, we conclude that we should adopt a more accommodating and flexible position. To the extent resources permit, the final cost of equity in a rescription proceeding should represent a judgment reached after considering a wide variety of data and methodologies.

***26** 89. The flaw in the current rules governing determination of cost of equity is that they ignore these basic principles. Although those rules do not require the Commission to apply any particular methodology in estimating the cost of equity, they require the RHCs to apply two "historical" versions of the DCF formula and to submit the resulting data for inclusion in the record in rescription proceedings. [FN264] In the two rescription proceedings conducted under the Part 65 rules, we gave very little or no weight to these data.

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(Cite as: 1995 WL 156764 (F.C.C.), 10 FCC Rcd. 6788)

[FN265] Those rules also specify criteria for determining when firms have risks characteristics comparable to those of interstate access services. [FN266] In the 1986 represcription proceeding, we found significant problems with these criteria and gave analyses relying on them little weight. [FN267] In Docket 87-463, we proposed to improve the criteria by incorporating a cluster analysis. [FN268] In the 1990 represcription proceeding, we considered several cluster analyses presented by the parties and found them to be entitled to no weight because the analyses had failed to identify firms for which risks were comparable to those of interstate access service. [FN269]

90. These experiences have made us acutely aware that any cost of equity methodology we codify may not withstand the test of time. In these circumstances, we agree with the majority of the commenters that our rules should specify no cost of equity ****6831** methodology on which data would have to be submitted at the start of represcription proceedings. Instead, we will leave open all issues involved in the forecasting of equity costs. These open issues include questions regarding the data that we should use in applying particular methodologies, flotation costs, periods of compounding, and similar issues. In addition to simplifying the rules, this action will avert a potential unnecessary burden on the parties to future represcription proceedings.

91. In taking this action, we emphasize that the rules we adopt in this Order permit the Bureau to require interested persons to submit any information it deems necessary to decide, once the triggering event occurs, whether to institute a represcription proceeding or to develop the record, once a represcription proceeding begins. [FN270] This procedure will minimize the possibility that parties to future represcription proceedings will have to file data that proves useless. It places on interested persons the responsibilities to respond in a timely manner to Bureau data requests and to submit any additional information they believe will help us accurately estimate the cost of equity for LEC interstate access services.

D. Cost of Debt

1. Overview

92. The cost of debt relates to the sale of bonds and other fixed-income securities to finance telephone operations. The debt of a company includes short-term and long-term issues. [FN271] Part 65 requires each of the RHCs to perform detailed calculations to determine their embedded cost of debt, as reflected in the position statements (Form 10-K or 10-Q) the RHC recently filed with the Securities and Exchange Commission. In the 1990 represcription proceeding, we used the average of the RHCs' embedded costs of debt as one component of overall cost of capital calculation. [FN272]

***27** 93. In the Notice, we stated that we intended to consider using groups other than the RHCs in our cost of debt determination. Although the RHCs own the BOCs, they also have expanded into other ventures, both domestic and international. As they expand into new areas, their financial similarity to LECs providing

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)
CONSUMERS ENERGY COMPANY)
for authority to increase its rates for the)
distribution of natural gas and for other relief)
_____)

Case No. U-14547

PROOF OF SERVICE

STATE OF MICHIGAN)
) SS
COUNTY OF JACKSON)

Sammie Dalton, being first duly sworn, deposes and says that she is employed in the Legal Department of Consumers Energy Company; that on May 15, 2006 she served an electronic copy of the "Reply Brief of Consumers Energy Company" upon the persons listed in Attachment 1 hereto, at the e-mail addresses listed therein.

Sammie B Dalton

Digitally signed by
Sammie B. Dalton
Date: 2006.05.15
15:29:01 -04'00'

Sammie Dalton

Subscribed and sworn to before me this 15th day of May, 2006.

Margaret Hillman

Digitally signed by Margaret
Hillman
Date: 2006.05.15 15:30:02
-04'00'

Margaret Hillman, Notary Public
State of Michigan, County of Jackson
My Commission Expires: 06/14/10
Acting in the County of Jackson

ATTACHMENT 1 TO CASE NO. U-14547

Administrative Law Judge

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