STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of CONSUMERS ENERGY COMPANY for authority to increase its rate for the distribution of natural gas and for other relief. /

Case No. U-13730

Proceedings had in the above-entitled matter before James N. Rigas, J.D., Administrative Law Judge, at the Michigan Public Service Commission, 6545 Mercantile Way, Lansing, Michigan.

SESSION OF WEDNESDAY, AUGUST 27, 2003

VOLUME 3

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APPEARANCES:

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APPEARANCES: (Continued)

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I N D E X

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Lansing, Michigan
Wednesday, August 27, 2003
1:35 P.M.

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(The hearing was resumed pursuant to the adjournment.)

(Documents were marked Exhibits A-64 through A-70 by the reporter.)

JUDGE RIGAS: We'll go on the record.

Good morning, or good afternoon. This is a continued hearing before the Michigan Public Service Commission in Case No. U-13730. This matter is being continued from the session held yesterday, August 26th of this year.

My name is James N. Rigas. I'm an administrative law judge for the Michigan Public Service Commission.

May I have the appearances, please.

MR. SHEA: John Shea and Richard Chambers for Consumers Energy Company.

MR. ERICKSON: Donald E. Erickson appearing on behalf of Attorney General Michael A. Cox.

MR. STRONG: Kristin Smith on behalf of the staff.

JUDGE RIGAS: Thank you.

Are there any other appearances? I hear none.

Mr. Strong contacted me by telephone earlier today and advised me that he would be unable to attend the hearing this afternoon, but he did indicate that he believed the parties would accommodate his interests for purposes of our proceeding today.

How do you wish to proceed, Mr. Shea?

MR. SHEA: Your Honor, the company has the testimony of Mr. Barba and his exhibits to bind into the record. I believe staff has a witness as well, and the parties have all agreed to bind Mr. Phillips, the witness for ABATE's testimony into the record as well.

So if you would like, I can proceed with our witness and we could go down the list from there.

JUDGE RIGAS: That would be fine. It's my understanding that the parties are going to proceed pursuant to the stipulation that we incorporated yesterday with respect to waiving physical appearance of individuals, we're waiving cross-examination, et cetera, for purposes of the interim hearing?

MR. SHEA: That is correct.

JUDGE RIGAS: All right.

MR. SHEA: I have one small set of corrections to make to a single exhibit of Mr. Barba that

I would like to place on the record. I have distributed corrected copies to yourself and to the parties.

I do it for informational purposes only, and with your permission I will proceed.

JUDGE RIGAS: Please.

MR. SHEA: On Exhibit A-64 (GPB-1R), on line 11 in column (c), the numeral present there should be deleted and the following numeral should be inserted (3,266).

On that same line in the next column, column (b), the numeral that is there should be deleted and the following numeral should be inserted, 5,764.

On line 13, column (c), the numeral there should be deleted and the following numeral inserted, 17,017. An on line 13, column (b), the numeral there should be deleted and the following numeral inserted, 10,468.

Although we are not offering workpapers of Mr. Barba, I would also like to make equivalent corrections for the purposes of information as well.

On WP-GPB 31R, line 1, column (c), that numeral should be replaced with the following numeral (22,313). On line 1, column (d), the numeral should be deleted and replaced with the following numeral, 20,214.

On workpaper WP-GPB 32R, on line 1, column (c), the numeral should be deleted and the following numeral inserted, (22,313). And the following column, column (d), the numeral should be deleted and the following numeral inserted, 20,214. And that completes my corrections, your Honor.

JUDGE RIGAS: Very good. Would you address the testimony and the exhibits of Mr. Barba?

MR. SHEA: Yes, your Honor. Mr. Barba has prepared, and a copy has been presented to the court reporter, of direct testimony of Glenn P. Barba on behalf of Consumers Energy Company, dated March 2003, consisting of a cover sheet and 29 pages of question-and-answer testimony.

Pursuant to the stipulation of the parties, we would ask that that testimony be bound into the record at this time.

Mr. Barba's Exhibits GPB-1R through GPB-7 have been assigned official numbers by the court reporter of A-64 through A-70, and pursuant to the stipulation of the parties we would ask that those exhibits be admitted into the record in this proceeding.

JUDGE RIGAS: Thank you.

Pursuant to the stipulation of the parties, then, the prepared direct testimony of Mr. Glenn P. Barba in Case No. U-13730, consisting of 29 pages of questions and answers, will be bound into the record, and Exhibits A-64 through A-70 will be received at this time.

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STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of CONSUMERS ENERGY COMPANY for authority to increase its rates for the distribution of natural gas and for other relief	)))))	Case No. U-13730

DIRECT TESTIMONY

OF

GLENN P. BARBA

ON BEHALF OF

CONSUMERS ENERGY COMPANY

March, 2003

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Q. Please state your name and business address.

A. Glenn P. Barba, 212 West Michigan Avenue, Jackson, Michigan.

Q. By whom are you employed, and in what capacity?

A. I am employed by Consumers Energy Company as Vice President, Controller and Chief Accounting Officer for both CMS Energy Corporation and Consumers Energy Company.

Q. How long have you been employed by Consumers Energy?

A. Since 2001.

Q. Please state your educational background and work experience.

A. I graduated from the University of Michigan in 1988 with a master's degree in accounting and a bachelor's degree in business administration, completing these degrees concurrently.

From August 2002 until February 2003, I held the position of Vice President and Controller for Consumers Energy. From June 2001 until August 2002, I held the position of Controller for Consumers Energy. From 1997 to 2001, I held the position of controller at CMS Generation, a subsidiary of CMS Energy. From 1988 to 1997 I was employed by Arthur Andersen, focusing on the energy industry.

Q. What are your responsibilities in your present position?

A. As Vice President, Controller and Chief Accounting Officer of Consumers Energy, I am responsible for the preparation and control of all accounting records and systems of Consumers Energy, including financial statements and reports. I am also responsible for income tax compliance and accounting, regulatory reporting, and analysis of business operations. I provide direction and assistance to the Transmission and Distribution Field Operations and Generating Plant organizations with respect to accounting standards, policies and procedures. I am responsible for developing accounting methods and procedures. These methods and procedures are designed to provide adequate internal accounting controls. I am responsible for interpretation of the accounts prescribed by the Michigan Public Service Commission (MPSC) and the Federal Energy Regulatory Commission (FERC) in their Uniform System of Accounts. My ongoing responsibility for the Company's accounting also involves consideration of MPSC, FERC, Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) accounting proposals and pronouncements. I am responsible for corporate budgeting and the development of the Company's financial forecasts.

Q. Are you a member of any professional societies or organizations?

A. I am a certified public accountant and a member of the Michigan Association of CPAs.

Q. Have you previously testified before this Commission?

A. No.

Q. What is the purpose of your testimony in this proceeding?

A. I am presenting testimony supporting the operation and maintenance (O&M) expenses relative to corporate services and capital investments for information technology in specific support of corporate services. I am also presenting testimony to discuss special accounting issues including: manufactured gas plant costs from both a rate base and annual amortization expense perspective, depreciation expense, asset retirement obligations (SFAS 143), property taxes, injuries and damages, and certain retirement benefits including pension, SERP and the savings plan.

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Q. Are you sponsoring any exhibits in this proceeding?

A. Yes. I am sponsoring the following exhibits:

Exhibit A-64 (GPB-1) Summary of 2004 Corporate Services O&M Expense-Gas Portion

Exhibit A-65 (GPB-2) Summary of Corporate Capital Investment – Gas Portion

Exhibit A-66 (GPB-3) Manufactured Gas Plant Amortization Expense

Exhibit A-67 (GPB-4) Manufactured Gas Plant Rate Base Capital

Exhibit A-68 (GPB-5) 2004 Property Tax Rate

Exhibit A-69 (GPB-6) Injuries and Damages Expense

Exhibit A-70 (GPB-7) Summary of 2004 Certain Retirement Benefits Expense

Corporate O&M

Q. Would you name the areas included within corporate services?

A. The Corporate Services categories that I am addressing include those areas common to the administrative functions of a regulated corporation - Human Resources, Controller's Area, Investor Relations, Treasury, Corporate Insurance Administration, Internal Audit, Legal, Corporate Secretary, Governmental and Public Affairs, Corporate Travel, and Rates and Regulatory Affairs. There is another cost category, General Activities, which is an aggregation of expenses and credits that are not attributable to any one department, but are incurred on behalf of the company as a whole. The final category I am presenting cost data for is the Information Services and Technology (IS&T) direct expenses. Company witness P. D. Hopper is the primary sponsor for IS&T charge-back expenses in this case.

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Q. Has the corporate environment been affected by post-Enron regulatory and legal changes?

A. The collapse of Enron in the fall of 2001 triggered a massive corporate reform to increase corporate accountability and restore public confidence in the financial markets. The United States Congress rapidly passed legislation in July 2002, the Sarbanes-Oxley Act of 2002 (the "Act"). The Act establishes a reform framework to help restore investor trust and confidence. The details of implementation are still being worked on and depend on the establishment of the new Public Company Accounting Oversight Board and Securities and Exchange Commission rulemaking.

The Act, among other things, requires public companies to:

1) fund a new Public Company Accounting Oversight Board;
2) define and frequently evaluate a broader set of internal controls that include disclosure controls over the preparation and disclosure of financial and non-financial information included in financial reports to the Securities and Exchange Commission;
3) make significant additional disclosures in filings with the Securities and Exchange Commission;
4) certify the financial reports; and
5) increase the role of the Audit Committee of a company's Board of Directors and increase financial expertise.

Other groups such as the Financial Accounting Standards Board are also issuing new accounting and disclosure requirements to improve the quality of a company's financial information.

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Implementing the massive provisions of the Act and related rulemakings will require additional resources both during and on an ongoing basis after implementation. The increased need for more information, new or accelerated processes, and increased oversight will increase the cost for companies such as Consumers Energy to do business.

Q. How do corporate costs get distributed to the gas and electric business units?

A. In most cases the costs are distributed based on customer counts for the gas and electric business units. In some areas, there are special studies completed to more accurately distribute the costs. For example, Human Resources costs are allocated based on employee headcount. Capital and O&M expenditures are used to allocate Accounts Payable, Treasury and Insurance Administration. In some cases, such as a stray voltage litigation case, the costs are allocated specifically to the business unit (electric). These allocation methods have been in place for many years.

Q. Please describe in greater detail the services provided within the Corporate services categories.

A. Exhibit A64 (GPB-1) is a summary of the Corporate Services categories and the associated O&M costs for the Gas business unit, in line item detail.

Q. Please describe Line 1, Human Resources.

A. Line 1 – Human Resources includes services for 8,800 employees, and Human Resource offices at 23 field locations. Also included is the development of workforce strategies including recruiting, hiring, training and development, and succession planning. Labor Relations provides for all interaction with the unionized workforce. Compliance assurance is provided for all legal and regulatory programs including Equal Employment Opportunity, Americans With Disabilities Act, Family and Medical Leave Act, safety and

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health issues. Compensation and benefits administration is also provided. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 59% labor, 41% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, and bringing safety initiatives and recruiting activities back to normal levels. The gas portion of Human Resources expense is $5,646,000 and is based on the customer, headcount and labor allocation methodologies.

Q. Please describe Line 2, the Controller's Area.

A. Line 2 – the Controller's Area includes preparation and control of all accounting records and systems of Consumers Energy, including financial statements and reports. Central Mail Remittance provides for customer payment processing. Systems are managed for budgeting and management reporting, general ledger, accounts payable, payroll and fixed assets. All financial and regulatory reporting is initiated and finalized here, as well as all corporate tax requirements. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 59% labor, 41% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, and significant increases in the regulatory, reporting, and control requirements due to the Sarbanes-Oxley Act of 2002. Additionally, there is increased internal emphasis on policy compliance, system controls and control documentation. The gas portion of the Controller's Area expense is $8,560,000 and is based on the customer, headcount and special study allocation methodologies.

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Q. Please describe Line 3, Investor Relations and Treasury.

A. Line 3 – the Investor Relations and Treasury category includes all aspects of company financing and cash management; negotiation of company credit facilities; treasury operations including initiating cash wire transfer transactions, processing checks for deposit, maintenance of all bank account related activities; borrowing and investing. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 33% labor, 67% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, and increased bank fees. The gas portion of Investor Relations and Treasury expense is $1,593,000 and is based on a special study methodology.

Q. Please describe Line 4, Corporate Insurance Administration.

A. Line 4 – the Corporate Insurance Administration category includes design and management of corporate insurance programs; managing and negotiating insurance claims; managing relationships with surety bond providers and insurance companies; and risk management. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 76% labor, 24% non-labor. Cost increases in this category include personnel wage inflation, and staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints. The gas portion of Corporate Insurance Administration expense is $166,000 and is based on a special study allocation methodology.

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Q. Please describe Line 5, Internal Audit.

A. Line 5 – the Internal Audit category includes the appraisal of business unit efficiency, effectiveness and financial controls. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 96% labor, 4% non-labor. Cost increases in this category include personnel wage inflation, and staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints. The gas portion of Internal Audit expense is $632,000 and is based on the customer allocation methodology.

Q. Please describe Line 6, Legal.

A. Line 6 – the Legal category includes advice and counsel in the areas of regulatory services at the State and Federal levels, litigation, claims, credit and collection, environmental, contracts, labor and property. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 61% labor, 39% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, litigation for Department of Energy Spent Fuel (electric only), and specialized outside services. The gas portion of the Legal expense is $2,713,000 and is based on the special study allocation methodology.

Q. Please describe Line 7, Corporate Secretary.

A. Line 7 – the Corporate Secretary category includes the management of corporate records in electronic, paper and microfilm form; imaging services; corporate library services; keeper of all minutes and records related to Board of Director and shareholder meetings; incorporations, and dissolutions; and shareholder services. The 2004 expense level was

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determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 59% labor, 41% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, and increases in all aspects of document processing due to regulatory requirements. The gas portion of the Corporate Secretary expense is $751,000 and is based on the customer allocation methodology.

Q. Please describe Line 8, Governmental and Public Affairs.

A. Line 8 – The Governmental and Public Affairs category includes all aspects of internal and external communications; public media relations and inquiries, corporate news releases, employee and executive communications; charitable giving, foundations and community programs; economic development and administration, which works in close cooperation with state and local economic development offices. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 57% labor, 43% non-labor. The expense change for 2004 versus 2002 is negligible. The gas portion of Governmental and Public Affairs expense is $2,588,000 and is based on the customer allocation methodology.

Q. Please describe Line 9, Corporate Travel.

A. Line 9 – the Corporate Travel category includes providing safe and reliable employee transportation, and all aspects of travel arrangements. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 94% labor, 6%

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non-labor. Cost increases in this category include personnel wage inflation, and staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints. The gas portion of Corporate Travel expense is $135,000 and is based on the customer allocation methodology.

Q. Please describe Line 10, Rates and Regulatory Affairs.

A. Line 10 – the Rates and Regulatory Affairs category includes determination and management of tariffs, management of all regulatory filings, advocacy with regulators and standard setters, and management of the interface between the Company and regulatory staff. The 2004 expense level was determined by an analysis of historical costs as well as assessing strategic changes in the business and levels of service to be provided. Costs are made up of 78% labor, 22% non-labor. Cost increases in this category include personnel wage inflation, staffing vacancies not filled in 2002 and 2003 due to corporate cost constraints, and increased federal regulatory activities related to Regional Transmission Organizations (electric only). The gas portion of Rates and Regulatory Affairs expense is $2,041,000 and is based on the customer allocation methodology.

Q. Please describe Line 11, General Activities.

A. Line 11 – the General Activities category reflects an aggregation of expenses and credits that are not attributable to any one organization, but are incurred on behalf of the company as a whole. Major categories in General Activities include costs billed from CMS Energy associated with Executive Officers who spend time managing the Consumers Energy business; credits for labor loadings when services are provided to CMS affiliates; credits to O&M for labor and expense when services are charged to

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capital projects; a reserve account for uncollectible customer bills; and the cost of restricted stock and stock grants. The 2004 gas portion of General Activities expense is $2,498,000. Significant cost changes in this category for 2004 versus 2002 include: the sell-off of affiliates and the roll-in of Michigan Gas Storage Company into Consumers Energy results in fewer inter-company services being performed which reduces credits for labor loadings, a smaller uncollectible reserve expense reflecting an adjustment for the People Care Program in 2002, the recording of Ernst and Young re-audit fees in 2002, an adjustment for the now suspended incentive match program for the 401-K savings plan in 2002, and 2002 adjustments for the incentive compensation plan.

Q. Please describe Line 12, Information Services and Technology.

A. Line 12 – the Information Services and Technology (IS&T) category includes the incentive compensation plan expenses for all of IS&T. IS&T infrastructure chargeback costs are addressed in the testimony of Company witness Preston D. Hopper, while other Business Systems operations and support chargeback O&M are included in other witnesses cost projections in support of their operations.

Q. What is the total level of expense for the Corporate Services categories that you are sponsoring?

A. The total level of gas expense for the 2004 test year is $27,485,000, as shown on line 13 of Exhibit A-64 (GPB-1).

Q. Are there other significant influences on O&M?

A. Yes. Long-term investments are required to provide the core tools, equipment and software supporting daily operating needs. We balance additional long-term investment against increasing O&M expense by continually assessing business changes, growth, obsolescence and applicability to the needs of serving utility customers.

Corporate Capital

Q. Please describe Exhibit A-65 (GPB-2), Summary of Corporate Capital Investment-Gas Portion.

A. Exhibit A-65 (GPB-2) is a three-page exhibit that identifies the gas portion of certain corporate capital expenditures for 2003 and 2004 by project. Page 1 provides a summary of capital investments by major project or category. Column (a) provides a brief description of the projects. Column (b) provides the proposed expenditure (PE) category applicable to the projects for each line. Column (c) is the Year 2003 gas portion of the expenditures. Column (d) is the Year 2004 gas portion of the expenditures. Column (e) provides a source reference.

Q. What information is provided on pages 2 and 3 of Exhibit A65 (GPB-2)?

A. Pages 2 and 3 describe in greater detail the 2003 and 2004 components of these corporate projects included within each PE. Page 2 provides additional detail for 2003. Page 3 provides additional detail for 2004.

Q. Please describe the expenditures for PE 60 shown on Page 1, Line 1 of the exhibit.

A. Line 1 includes expenditures for certain corporate computer system expenditures that are needed in 2003 and 2004. These projects will provide needed technology changes to enable the Company to better serve its gas customers. Pages 2 and 3 of the exhibit provide additional detail for the capital expenditures for PE 60. The PE 60 expenditures are comprised of the following projects:

1. Corporate Accounting and Work In Progress System Replacement

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2. Electronic Transaction Processing and Central Mail Remittance (CMR) System Upgrades
3. Integrated Planning and Forecasting System
4. Employee/Manager Self-Service Project
5. Learning Management System Project

Q. Please describe the Corporate Accounting and Work In Progress System Replacement.

A. This project reflects the investment required to replace the Company's current Corporate Accounting System and Construction Work In Progress processes due to the age of the existing systems. The current systems are over 20 years old and utilize outdated technology. The systems are becoming increasingly expensive to operate and there is increasing difficulty in finding vendors who will support the systems with their old technology. The new system architecture will serve as the basis for integrating all financial subsystems that will provide common data collection, information access and financial reporting while maintaining data integrity, auditability and control. The expenditures for this project for 2004 are shown on Page 3 of Exhibit A-65(GPB-2). The company had originally planned to make expenditures for this project in 2003. However, due to cash constraints this had to be deferred until 2004. Consequently, no expenditures are shown on Page 2 for 2003.

Q. Please describe the Electronic Transaction Processing and CMR System Upgrades.

A. These expenditures reflect the cost of system upgrades for several accounting systems to replace older application servers associated with electronic forms and our customer payment center. This project has begun in 2003 and will continue through 2004.

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Expenditures for 2003 are shown on Page 2 of the exhibit. Expenditures for 2004 are shown on Page 3 of the exhibit.

Q. Please describe the Integrated Planning and Forecasting System.

A. This project reflects the investment required to replace the current Financial Forecasting and Financial Planning systems. Consistent with the changes that all companies are facing as a result of increased scrutiny, increasing types of analyses, and the importance of credibility of data, it is necessary to replace the 11-year old modular application with an integrated application that is more flexible, provides for more and different types of analyses, and is more secure and stable. The expenditures for this project for 2004 are shown on Page 3 of the Exhibit A-65 (GPB-2). The company had originally planned to make expenditures for this project in 2003. However, due to cash constraints this had to be deferred until 2004. Consequently, no expenditures are shown on Page 2 for 2003.

Q. Please describe the Employee/Manager Self-Service Project.

A. Advancements in technology offer a tremendous opportunity to provide faster and more accurate employee and manager services while decreasing costs. Using state of the art technology, this project will provide employees and managers the opportunity to conduct employee-based transactions via self-service methodology, online, at their convenience and at their location; and creates the opportunity to handle other employee contacts through a "service center" methodology. The overall result will be process efficiency, improved service levels and reduced cost of operation. Expenditures for 2004 are shown on Page 3 of Exhibit A-65 (GPB-2).

Q. Please describe the Learning Management System Project.

A. The Company is transitioning its current classroom-based skills and management training programs and legacy record-keeping system to an integrated learning management system which better utilizes technology in the assessment, delivery, management, measurement and tracking of training and development. Successful implementation will result in reduced costs, expanded utilization, improved compliance reporting, streamlined administration and enhanced measurement of employee performance. This system will provide the Company with the opportunity to better leverage learning opportunities with local colleges and the World Wide Web. Expenditures for 2004 are shown on Page 3 of Exhibit A-65 (GPB-2).

Q. Please describe the expenditures for PE 87/89 shown on Exhibit A-65 (GPB-2), Page 1, Line 2.

A. Line 2 includes expenditures to replace obsolete and worn out office equipment.

Q. What information is provided on Pages 2 and 3 of Exhibit A-65 (GPB-2) relative to PE87/89?

A. Pages 2 and 3 describe in greater detail the 2003 and 2004 components of the office equipment replacement activity.

Q. Do the preceding capital investments represent typical annual spending levels?

A. Referring to Exhibit A-65 (GPB-2), the items classified as PE 60 are multi-year projects with spending levels based on the individual project requirements and schedule. PE 87/89 comprises continuous investments that are managed to maintain predictable spending patterns to better prioritize needs and to improve management of equipment replacement.

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Manufactured Gas Plant Expenditures

Q. What is the current ratemaking treatment for environmental investigation and remediation expenditures at former manufactured gas plant ("MGP") sites?

A. In Case U-10755, the Commission approved deferred accounting for these expenditures, with amortization over ten years, beginning the year after expenditures are incurred. The approach adopted by the Commission envisioned that prudence reviews would occur in rate cases and that following a prudence review (i) the amortization expense would be included in rates and (ii) the deferred balance would be included in rate base and would earn a return at the authorized rate of return. The approach adopted by the Commission also provided for deferred accounting and amortization of third-party recoveries in excess of the costs of recovery over ten years and deferred tax accounting. In Case U-13000, the Commission upheld this accounting treatment, and provided for the amortization of expenditures incurred through October 2001 to be included in rates.

Q. What ratemaking treatment is the Company proposing in this proceeding for MGP environmental costs?

A. The Company is requesting that the Commission find (i) that costs for the period covering November 2001 through December 2003, as testified to by Company witness Gary Kelterborn, are prudent (given that the Commission has previously approved costs incurred through October 2001), (ii) authorize recovery of amortization expense in the amount of $1,071,000 as provided on Exhibit A-66 (GPB-3), and (iii) include the deferred unamortized balance in the amount of $9,999,000 in rate base as provided on Exhibit A-67 (GPB-4).

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Q. Are there any changes related to third-party recoveries subsequent to the Commission's order in Case U-13000?

A. In Case U-13000, net insurance recoveries estimated at $17.7 million were included as an offset by the Commission in its final order. The Company's request in this case reflects the net insurance proceeds applicable to MGP costs received to date of approximately $18.7 million as shown on line 2 of Exhibit A-66 (GPB-3).

Q. Please explain Exhibit A-66(GPB-3), which provides the annual amortization of MGP-related environmental costs.

A. The deferred cash expenditures for MGP clean-up costs of $2,580,000 for 1999, $4,279,000 in 2000, $7,447,000 in 2001, $6,442,000 in 2002, and $8,670,000 in 2003 are shown on Line 1. The amortization level reflects use of stratified 10-year amortization periods for expenditures made through 2003 (as shown on Lines 4 through 8). Amortization of the $18.7 million of third-party recoveries (as shown on Lines 2 and 9), acts as a credit to the amortization of expenditures identified in this case. It should be noted that amortization expense will continue to increase each year as expenditures are incurred and amortized over a ten-year period. The earliest year for which expenditures included in determining the amortization expense being requested in this case by the Company were incurred in 1999. Amortization of the 1999 expenditures will not be completed until the year 2009. Therefore, as expenditures are incurred in future years, amortization will increase beyond the level requested in this case. Until these expenditures are incorporated in a future case, the Company is required to absorb the associated carrying cost and amortization of these costs.

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Q. Please explain Exhibit A-67(GPB-4) related to the rate base treatment.

A. Line 1 of the exhibit provides the deferred expenditures less the net insurance recoveries for the years 1999 – 2003. Line 2 provides the net amortization through 2003. Line 3 provides the unamortized balance that should be included in rate base for the test year, in accordance with the Commission's prior orders. Company witness J. F. Bearman includes the $9,999,000 amount in the rate base calculation.

Depreciation

Q. What is the Company's proposal as it relates to depreciation expense?

A. The Company is initially proposing depreciation expense be based on existing MPSC approved depreciation rates until they can be updated.

Q. Does the Company have an ongoing gas depreciation case?

A. Yes, MPSC Case No. U-12999 is an open case. The case is scheduled to resume no later than October 1, 2003.

Q. Are the results of that case to be included in rates?

A. Yes.

SFAS 143 – Asset Retirement Obligation

Q. What are the requirements of Statement of Financial Accounting Standard (SFAS) No. 143, Accounting for Asset Retirement Obligations (ARO)?

A. SFAS No. 143 – Accounting for Asset Retirement Obligations provides that any legal obligations to incur expenditures after the useful life of a long-lived tangible asset be recorded as a liability, at its present value. These liabilities may be the result of enacted law, statute, ordinance or written or oral contract.

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Q. Does the Company have any legal liabilities as it relates to its gas business?

A. Yes. At a minimum, the Company has two such obligations. 1) The Company has committed in MPSC Case No. U-13156 to moving any gas meters, regulators and risers that remain inside of customer's homes to the exterior, also known as the Meter Move Out Program and 2) a commitment to the Michigan Department of Environmental Quality to seal wells at the Northville Trenton Storage Field that is scheduled to be abandoned.

Q. What is the effective date of this new standard?

A. January 1, 2003.

Q. What is the accounting related to this standard?

A. The Company must do several things:

<u>Transition Adjustment</u>

1. Record the present value of the future liability of the legal obligation.
2. Establish an ARO plant asset equal to the present value of the future obligation at the time the asset was put into service.
3. Record a depreciation reserve related to the depreciation to date for the ARO plant asset.
4. Reduce the existing depreciation reserve for the cost of removal recorded to date for this obligation.
5. Establish a regulatory asset or regulatory liability equal to the net overage or underage for the above four items.

<u>Ongoing Entries</u>

1. Record depreciation of the ARO asset.

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2. Record amortization of the regulatory asset/liability.

3. Record accretion expense to increase the liability since the transition adjustment was present valued.

Q. What is the impact of this accounting?

A. From a balance sheet standpoint the asset side of the balance sheet will be increased to accommodate the recording of a liability. From an income statement perspective, a regulatory asset or regulatory liability will be required to match the timing difference of the revenue in rates to the new accretion and depreciation amounts.

Q. What is the Company's proposal as it relates to the accounting and ratemaking for SFAS 143?

A. The Company specifically seeks regulatory asset / regulatory liability treatment for any timing differences related to this standard. The FERC Notice of Proposed Rule-Making issued on October 30, 2002 relating to the accounting for asset retirement obligations supports this request with the following quotes:

Paragraph 10. "We specifically note that the proposed accounting will not affect jurisdictional entities' ability to recover costs arising from asset retirement obligations in rates."

Paragraph 15. "The accounting standards for asset retirement obligations rely on the general standards of accounting for the effects of regulation for regulated entities in accordance with FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation, (FAS 71). Therefore, an entity must recognize a regulatory asset or regulatory liability if the requirements of FAS 71 are met."

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Paragraph 16. "The Commission is of the view that the accounting for asset retirement obligations to be an improvement in financial accounting and reporting practices."

Q. Is the Company proposing any adjustment in this rate case?

A. Since the assignment of existing depreciation rates will be applicable to asset retirement obligations, it is best handled in the existing Gas Depreciation Case No. U-12999.

Property Taxes

Q. How were real and personal property taxes estimated for the 2004 test year in this case?

A. A tax rate for the gas business was calculated using the Company's 2003 tax expense estimate divided by the total of 2002 year-end plant in service plus one-half construction work in progress. This tax rate was then applied to the 2004 base, which is the total of the 2003 year-end plant in service plus one-half construction work in progress.

Q. How was the 2003 tax expense estimate determined?

A. Please refer to my Exhibit A-68 (GPB-5), which shows the calculation of the 2003 tax expense estimate.

Q. What is included in the 2002 Gas Property Taxes Paid on the first line?

A. The Consumers Energy 2002 taxes paid of $33.5 million on behalf of the gas portion of the business was the result of actual billings. These billings reflect some taxing authorities utilizing the new State Tax Commission (STC) multiplier tables issued in 2000 and some taxing authorities still using the old tables from prior to 2000. The resolution of whether the new STC multiplier tables are valid is currently before the Michigan Court of Appeals.

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Q. What is included in the Increased Gas Plant Investment line?

A. The increased gas plant investment of $2.7 million is the estimated property taxes on the 2002 capital additions that will be included in the 2003 property tax liability. This is calculated by taking the capital additions less retirements times the first year STC multiplier table value to recognize a depreciation allowance, which is then multiplied by the statutory reduction of 50% of true cash value to get the assessed value, then multiplied by a composite millage rate of 47.4798 to obtain the estimated tax amount.

Q. What is the next addition for the roll-in of Michigan Gas Storage?

A. The roll-in of Consumers Energy's Michigan Gas Storage Company subsidiary (MGS), which was authorized by the Commission in Case U-13000 on November 7, 2002 is to recognize the current ratemaking treatment for the prior MGS.

Q. What is the addition for the new company headquarters?

A. The next addition of $.7 million is for the property tax increase for leased property, specifically the new company headquarters.

Q. What is the addition for common plant?

A The $.1 million for 2002 common plant net additions is for items that are not specific to electric or gas. This item is calculated similar to the gas property additions, with the additional step of allocating between electric and gas based on the common plant allocation study.

Q. Please continue with your explanation.

A. The result is an estimated 2003 property tax amount to be paid for the gas business of $38.6 million.

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Q. How is this amount paid converted to an expense amount?

A. Since the Company expenses property taxes based on the fiscal year of the taxing authority, 45.67 % of the 2002 property tax payments for Consumers Energy and Michigan Gas Storage are added to the 2003 payments since that amount will be expensed in 2003 while subtracting 45.67 % of the 2003 payments that will be expensed in 2004, arriving at a total 2003 tax expense of $37 million.

Q. What is the next step in calculating the tax rate?

A. The 2003 tax expense is divided by the 2002 year end plant in service amount plus one-half of construction work in progress to arrive at an average tax rate of .013653865. This rate was then used, by Company witness J. F. Bearman, in the financial model by applying it to the comparable estimate of the 2003 year end balances to arrive at the 2004 gas property tax expense.

Injuries and Damages

Q. What type of expenses are included in injuries and damages?

A. Gas injuries and damages include liabilities that arise in the normal course of business for various types of expenses that cover items such as compensation for damaged trees and crops, restoration of driveways, lawns and fences, accidents, gas explosions, lawsuits, etc., that are up to the $0.5 million deductible per occurrence and workers compensation costs.

Q. What is the Company proposing for recovery as part of the 2004 expenditures?

A. The Company is proposing that $3,033,000 be included for recovery for 2004.

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Q. How was this amount determined?

A. Please refer to my Exhibit A-69 (GPB-6). The first item is all the property damage and liability amounts that equal $1,736,000 based on a five-year average calculation. The second item is worker's compensation costs of $994,000, which is also a five-year average.

The last item is $303,000 of legal costs that are charged to injuries and damages. This amount was derived by increasing the 2002 actual expense by the projected 2003 and 2004 inflation indices.

The total 2004 increase for injuries and damages versus 2002 is within the inflation indices.

Retirement Benefits

Q. How are pension, SERP and savings plan expenses that are common to electric and gas operations allocated to the gas portion of the business?

A. Expenses common to both electric and gas operations associated with employee pension, employee savings plans and supplemental retirement plans are allocated on the basis of the relationship of employee labor dollars charged to gas operations compared to the total labor dollars charged in both electric and gas operations.

Q. Would you please explain Line 1 of your Exhibit A-70 (GPB-7)?

A. Line 1 represents the gas expense associated with the Company's employee pension plan of $15,072,000 attributable to the gas portion of the business.

Q. How does Consumers Energy determine its expenses for its pension plan?

A. Consumers Energy follows Generally Accepted Accounting Principles (GAAP) for its financial statements. Under the provisions of GAAP, Statement of Financial Accounting

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Standard (SFAS) No. 87 describes the methodology and assumptions to calculate and account for pension. The calculations required by this accounting standard are performed annually by Consumers Energy's actuary (Hewitt Associates). In addition, the actuarial assumptions are reviewed by the Company's auditors (Ernst & Young) to insure consistency with GAAP.

SFAS 87 requires an annual determination of pension expense. Expense is determined based on actuarially reviewed employee census data, the plan provisions and plan assets. Year-end disclosure information is also produced, based on these accounting standards, to show a reconciliation of plan assets and liabilities at the end of the Company's fiscal year.

Q. What are the components of annual pension expense?

A. There are four components of expense:

1. Service cost
2. Interest cost
3. Expected earnings on plan assets
4. Amortization of gains or losses, prior service costs, and any transitional amounts.

The accounting standard referenced above describes the calculation of these expense components. A very brief description of each component is as follows:

- The plan's service cost represents the value of the benefits earned during the year. This is determined individually for each participant based on his or her specific employee demographics.
- Interest cost represents interest on the plan's liabilities. All future benefits are discounted back to the valuation date based on a discount rate assumption. This

assumption is made each year by the plan's actuary and reviewed by the Company's auditor. The discount rate should reflect the economic conditions at the time that the expense is being determined.

- Similarly, there is an assumption made on the expected earnings of plan assets. The expected earnings on plan assets each year is a reduction in the determination of annual expense. The expected earnings assumption is reviewed periodically by the actuary and is intended to be a long-term assumption based on the best estimate of the expected long term investment earnings of the plan assets.
- The last component represents amortizations of various plan experiences that are not anticipated by the plan's actuarial assumptions. For example, plan experience gains or losses and any plan design changes would be amortized and included as a part of this component of plan expense. The amortizations can be either positive or negative.

Q. Did the calculations of fiscal year 2002 and 2004 expense for the pension plan follow the described methodology of SFAS 87?

A. Yes. The amounts for both years were based on SFAS 87 and calculated based on information specific to the Company.

Q. Why did pension expense increase between 2002 and 2004?

A. The primary reasons for the significant increase are the amortization of the prior net losses and the component related to the investment earnings. The 2004 expense for pension includes an estimate of investment earnings for the long-term and an amortization of actual fund net losses for recent years. This is consistent with the requirements of SFAS 87. Over the long-term, investments are expected to earn a rate of

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8.75% for pension assets. However, due to the negative investment return experienced in 2001 and 2002, the fund earned significantly less than the investment earnings projected for the long term. The shortfall in investment earnings not only results in the amortization of those losses, but also results in a lower balance in the fund, which will in turn earn less, causing an increase in expense for 2004.

In addition to the low investment fund earnings, the expense increase reflects planned growth in benefits as the participants earn additional years of service and their salaries increase.

Q. What assumptions have you made regarding funding scenarios for purposes of the FAS 87 expense?

A. The Company's preferred scenario is to make contributions to the pension fund that are sufficient to exempt the Company from the Pension Benefit Guaranty Corporation ("PBGC") variable premium insurance. However, absent sufficient cash flow it will be unable to do so. Consequently, for purposes of my calculation of FAS 87 expense I have assumed that the Company makes only the minimum required contribution. Under this assumption, the Company would make no payment in 2003, but would make a \$192 million payment in 2004. This amount is a portion of both the \$92 million for the 2003 plan year and the \$185 million for the 2004 plan year. Under the preferred approach, the cash flow requirements for Consumers Energy would be over \$150 million in 2003 and over \$200 million in 2004. The preferred approach would be less expensive in the long term.

Q. Does the FAS 87 assumption you have used trigger a payment to the Pension Benefit Guaranty Corporation?

A. Yes, a $5 million payment would be required for 2003 and 2004.

Q. Is there anything that can be done to decrease the significance of the increase in pension expense?

A. Yes. A significant infusion of cash to the external pension trust fund would increase the fund balance that would provide the potential to have higher fund earnings, creating a higher offset to pension expense.

Q. Does the company plan to fund a substantial amount to the pension trust?

A. The Company has an Application filed in Case No. U-13715 that seeks to securitize the electric portion of the $425 million additional pension minimum liability amount required to be recorded by SFAS 87. This additional accrual stems from the fact that as of December 31, 2002, the fair value of the Plan assets was less than the accumulated benefit obligation (ie. the benefits that all employees have earned to date) of the Company pursuant to the Plan provisions. If the additional minimum pension liability amount is allowed to be securitized, the Company would be able to make a significant contribution to the pension fund.

Q. What would be the estimated impact on gas pension expense if a significant cash payment was made to the pension fund on behalf of the utility?

A. If a $158 million payment and a $209 million payment is made to the pension fund on behalf of the utility by September 15, 2003 and September 15, 2004, respectively, the 2004 gas portion of the pension expense reduction is estimated at $5.4 million, resulting in a pension expense of $9.64 million.

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Q. Would the Company agree to a lower pension expense for this proceeding if the securitization of the additional minimum pension liability amount is approved in Case No. U-13715?

A. Yes.

Q. Would you please explain Line 2 of your Exhibit A-70 (GPB-7)?

A. Line 2 reflects $465,000 of Supplemental Executive Retirement Plan (SERP) 2004 gas expense which is part of the compensation package for certain employees of the Company. The SERP amount for the total utility was provided by the Company's actuary. The increase from 2002 is negligible.

Q. Would you please explain Line 3 of your Exhibit A-70 (GPB-7)?

A. Line 3 reflects $320,000 of 2004 gas expenses related to the savings plan. These are costs paid to Fidelity to administer the program. The Corporate match provision for the 401(k) plan has been eliminated through 2004 as a cost cutting measure.

Q. Does this conclude your testimony?

A. Yes, it does.

MR. SHEA: Thank you, your Honor. That concludes the company's presentation.

JUDGE RIGAS: And all the outstanding exhibits have now been addressed?

MR. SHEA: We're checking.

JUDGE RIGAS: Off the record.

(There was a discussion off the record.)

JUDGE RIGAS: We'll go back on the record.

Mr. Erickson?

MR. ERICKSON: Your Honor, Mr. Strong representing ABATE had previously provided to the court reporter prefiled testimony of Mr. Nicholas Phillips, Jr. consisting of a cover sheet together with 11 numbered pages of questions and answers and an appendix of three pages, and the parties have agreed to have that bound into the record by stipulation.

JUDGE RIGAS: O.K. He sponsors no exhibits; is that true?

MR. ERICKSON: That's correct, your Honor.

JUDGE RIGAS: Very well, then.

Pursuant to the stipulation of the parties, the prepared direct testimony of Mr. Nicholas Phillips, Jr. in Case No. U-13730, consisting of 11 pages of questions and answers and a three-page appendix, will be bound into the record.

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Before the

Public Service Commission

of the State of Michigan

Case No. U-13730

CONSUMERS ENERGY COMPANY

Direct Testimony of

Nicholas Phillips, Jr.

Regarding Partial and Immediate Rate Increase

On Behalf of

ABATE

August 8, 2003
Project 7993

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

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CONSUMERS ENERGY COMPANY

Before the
Public Service Commission of the State of Michigan

Case No. U-13730

Direct Testimony of Nicholas Phillips, Jr.
<u>Regarding Partial and Immediate Rate Increase</u>

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Nicholas Phillips, Jr.; 1215 Fern Ridge Parkway, Suite 208; St. Louis, MO 63141-2000.

Q WHAT IS YOUR OCCUPATION AND BY WHOM ARE YOU EMPLOYED?

A I am a consultant in the field of public utility regulation and a principal with the firm of Brubaker & Associates, Inc., energy, economic and regulatory consultants. Our firm and its predecessor firms have been in this field since 1937 and have participated in more than 1,000 proceedings in forty states and in various provinces in Canada. We have experience with more than 350 utilities, including many local distribution companies (LDCs), gas pipelines, and electric utilities. I have testified in many gas and electric rate proceedings on virtually all aspects of ratemaking. More details are provided in Appendix A of this testimony.

Q ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A I am testifying on behalf of the Association of Businesses Advocating Tariff Equity (ABATE), a group of businesses including many of Michigan's largest employers and energy users.

Q HAVE YOU PRESENTED TESTIMONY IN PRIOR CONSUMERS ENERGY COMPANY (CONSUMERS OR COMPANY) PROCEEDINGS BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION (COMMISSION OR MPSC)?

A Yes. I have been involved in many prior Consumers proceedings before this Commission.

Q WHAT IS THE SUBJECT MATTER OF YOUR TESTIMONY?

A The subject matter of my testimony is directed toward Consumers' request for a partial and immediate (interim) rate increase and the associated interim surcharges by rate class as proposed by Consumers.

Q HAVE YOU REVIEWED CONSUMERS' APPLICATION FOR AUTHORITY TO INCREASE GAS RATES IN THIS PROCEEDING?

A Yes. Consumers' application states that it is basing its $156 million rate increase request on a projected 2004 test year including a request to increase the allowed return on common equity to 13.50%. Consumers is also requesting that it be granted partial and immediate rate relief for the entire $156 million request.

Q IS THIS INTERIM REQUEST UNUSUAL WITH RESPECT TO PAST PRACTICE?

A Yes. By way of background, Consumers received final rate relief in Case No. U-13000 on November 7, 2002. Interim rate relief in that case was granted on December 20, 2001. MPSC Case No. U-13000 was based on a historic year 2000 and a test year of projected 2002. In Case No. U-13000, Consumers' request for interim was based on the historic year 2000 and the final rate request was based on the projected year 2002. Consumers' filing in Case No. U-13000 stated that gas rates had not been increased in 16 years, which is certainly not the current situation.

Consumers' request and the Commission order for interim rate relief granted on December 20, 2001 in Case No. U-13000 were properly based on the historic 2000 test year, the last approved rate of return on common equity, a historic year capital structure, without controversial adjustments or adjustments viewed as clear departures from past ratemaking policies.

The Staff performed an audit of the historic test year and verified the booked income statement and balance sheet as reflected in Consumers' Section A filing before the Commission. The Staff was able to state in testimony that Consumers' Section A filing was "an accurate representation of the results of the actual unadjusted 2000 historical test year gas operations as reflected on the Company's General Ledger and in its Annual Report to the Michigan Public Service Commission."

Q IS THE BASIS FOR THIS REQUEST FOR AN INTERIM RATE INCREASE A DEPARTURE FROM PAST PRACTICE?

A Yes. In this case, the magnitude of the interim request is the same as the final increase request. The entire revenue increase request is based on projections of 2004. The projected year cannot be audited or verified as accurate booked quantities. Consumers' entire interim request represents a change in policy from past practice as just evidenced from the policy used in Case No. U-13000.

Q **HAVE YOU REVIEWED CONSUMERS' REVENUE AND OPERATING INCOME ON GAS OPERATIONS?**

A Yes. A review of Consumers' revenues and net utility operating income indicates an increase since the year 2000, which was the basis for the interim rate increase granted by the Commission in Case No. U-13000. Consumers' gas utility revenues and net operating income (return) for the years 2000-2002 are shown in the following table.

Consumers Energy
Gas Utility

Year	Revenues $(000)	Net Operating Income $(000)
2000	$1,189,754	$58,532
2001	$1,334,621	$65,864
2002	$1,518,224	$87,080

The net operating income (return) for 2002 (the historic year in this proceeding) has increased to $87.1 million from $58.5 million in 2000, the year used for interim in Case No. U-13000. Therefore, Consumers' return on gas operations for the year 2002 has increased by $28.5 million or 49% from the year 2000.

Clearly, it is not in Consumers' interest to use the historic year 2002 as a basis for interim. Consumers is requesting a change in policy from booked, audited, verifiable quantities to projections for the year 2004. Booked income statements show a 49% increase in net operating income (return) for Consumers' gas operations. It is important to note that 2002 booked revenues include the interim increase granted by the MPSC on December 20, 2001, but very little of the final rate increase granted on November 7, 2002. The entire impact of the final rate relief will not be reflected until the 12 months ending October 2003.

Q WHAT RATE OF RETURN IS CONSUMERS REQUESTING FOR INTERIM IN THIS CASE?

A Consumers is requesting a rate of return on rate base of 9.60% based on a rate of return on equity of 13.50%. It is ironic that Consumers is requesting a rate of return on equity for interim purposes that is 210 basis points higher than that found reasonable by the Commission on November 7, 2002. It is common knowledge that the United States Federal Reserve again lowered interest rates on June 25, 2003 to their lowest level in 45 years. The federal funds rate was lowered by 25 basis points to 1%. The discount rate was also lowered by 25 basis points to 2%.

It would certainly be a change in policy and past practice to change a return on equity found appropriate by the Commission in November 2002 for interim in 2003. In fact, the Commission used the same rate of return on common equity of 11.60% approved in Case No. U-10755 on March 11, 1996 for establishing the interim revenue requirement in Case No. U-13000, Consumers' last rate proceeding.

Q HAVE YOU EXAMINED CONSUMERS' PROPOSED INTERIM RATE DESIGN?

A Yes. Consumers' proposal is to collect the entire $156 million final rate increase request based on the projected 2004 cost of service study. Consumers' methodology is to calculate the class revenue requirements based on the projected 2004 class cost of service study and subtract the projected 2004 revenues by class. After the $156 million rate increase is apportioned to each class by this process, Consumers divides the apportioned increase to each class by forecasted 2004 net throughput less forecasted 2004 premium and market-based volumes. Subtracting the premium and market-based volumes increases the proposed surcharges to the remaining customers.

Q SHOULD CONSUMERS' PROPOSAL BE ADOPTED?

A No. *Consumers' proposal should be rejected in its entirety.*

Q WHY SHOULD CONSUMERS' PROPOSAL BE REJECTED?

A The reasons that Consumers' proposal should be rejected are listed below:

1. The projected basis for Consumers' request for a $156 million interim increase is completely at odds with past Commission practice.

2. Consumers' request to increase the authorized rate of return on common equity by 210 basis points from the level ordered on November 7, 2002 is inappropriate for interim purposes.

3. Consumers' projected 2004 revenues, expenses, taxes and rate base cannot be audited and verified by the Staff as an accurate representation of the results of actual booked quantities.

4. The forecast year 2004 cost of service study is completely dependent on all of the assumptions involved in the 2004 projections associated with revenues, expenses, taxes, investment, capital structure, authorized rate of return, including 13.50% on equity, allocation factors using these and other projections, etc.

5. In addition to the problems inherent with all forecasts, the 2004 cost of service study is not consistent with the 2002 test year study recently adopted in Case No. U-13000. The projected 2004 study filed in this case uses significantly different costing parameters for Rate XLT than those filed by Consumers, Staff, Intervenors and as adopted by the Commission in Case No. U-13000.

6. Adjustments such as revenues associated with transportation discounts should be performed consistent with past Commission policy and practice. Consumers' approach does not start with an audited booked year to which specific non-controversial adjustments are set forth. It appears that the adjustments normally examined for consistency with Commission policy are part of the forecast and not explicitly and separately stated in Consumers' interim proposal.

7. The Commission should not allow an increased revenue deficiency for interim purposes for transportation discounts. In the interim order issued in Case No. U-13000, the Commission found that the imputation of additional revenues in the amount of the discounts negotiated by Consumers with its T-2 transportation service customers is reasonable and should be followed for interim purposes. The Commission also found that Consumers' approach was a departure from established Commission ratemaking policy and inappropriate for interim.

8. The level of discount is dependent on whether it is measured against Rate LT or Rate XLT.

9. Consumers' forecast is based on only half of the volumes that qualify by usage level of Rate XLT being allowed on Rate XLT. This is completely at odds with Consumers' presentation and the Commission order in Case No. U-13000 in which Rate XLT was approved.

10. Any interim surcharges allowed in this case should not be based on a forecasted revenue requirement or the results of the forecasted 2004 cost of service study or on throughput with discounted volumes removed.

11. Gas operating revenues have increased each year from 1998 through 2002.

12. Net operating income and return on common equity are at their highest levels in 2002 over the entire 1998 through 2002 period reported by Consumers.

13. For 2002, Consumers reports net operating income of $87 million and a return on common equity – gas of 13.51%.

14. Consumers claims a 2002 revenue deficiency of $27.3 million on Exhibit A-1 (DSA-1). However, the $55 million rate increase granted on November 7, 2002 is not annualized to show adjusted revenues based on year end approved rates. An appropriate annualization of the final rate increase would be in excess of $27.3 million and instead show a revenue sufficiency.

15. Consumers makes no showing of an emergency condition or inadequate rate of return warranting an interim increase.

Q HAVE YOU FOUND COMPELLING CIRCUMSTANCES THAT REQUIRE INTERIM RATE RELIEF FOR CONSUMERS?

A No. Consumers' revenues and earnings are reported at all-time high levels for the year ended December 31, 2002. The year 2002 financial data is extremely strong for Consumers' gas operations. The $55 million rate increase granted on November 7, 2002 will make these results even stronger. The rate relief granted by the Commission needs time to work.

Q ARE THERE OTHER REASONS THAT ARGUE AGAINST INTERIM RATE RELIEF?

A Yes. Consumers has a gas cost recovery mechanism in place that provides for recovery of purchased gas costs. Purchased gas costs are Consumers' single largest operating expense. Consumers reports GCR cost of gas sold as $960.6 million in 2002, which is almost 70% of total operating expense. Consumers projects GCR cost of gas sold to increase to $1.279 billion in 2004, a $327 million increase. The GCR will allow Consumers to recover this cost increase from ratepayers eliminating this large risk from Consumers' gas operations.

It is generally recognized that the economy is in a slump (see Economic Newsletter dated May 2003 by Ron Radke on the MPSC website). Consumers is reporting strong earnings growth despite the economic slump. To the extent economic recovery occurs, Consumers has a rate increase in place that should provide for even greater earnings growth, without interim rate relief. The previously mentioned Economic Newsletter also reports significant declines in interest rates including a 1.3% decrease in rates for utility bonds from a year ago. Interest rates are continuing to decline from data reviewed just 12 months ago during Consumers' most recent gas case. Therefore, the cost of capital has downward cost pressure. In addition, the Economic Report references the issuance of $250 million of first mortgage notes by Consumers on May 20, 2003.

Q DO CONSUMERS' ACTUAL EARNINGS JUSTIFY INTERIM RATE RELIEF?

A No. Consumers' revenues and earnings are strong and appear to be getting even stronger. The utility earnings report section on the MPSC website reports that Consumers is earning a 16.3% rate of return on common equity on gas operations for March 2003. The allowed return on equity is 11.4%. Obviously, Consumers' earned rate of return is not unreasonably low and not confiscatory. To the contrary, Consumers' earnings are strong, growing and in excess of the level authorized. In summary, there are no compelling reasons to provide interim rate relief to Consumers and the rate of return earned by Consumers on gas operations is not unreasonably low or confiscatory.

Q WHAT DO YOU RECOMMEND?

A With respect to the amount of any interim increase, I recommend that the Commission follow past practice and base any interim deficiency on a fully audited and verifiable historic booked test period. Only adjustments that are non-controversial and consistent with past Commission ratemaking policy should be allowed.

The Commission should be aware that Consumers' revenues and earnings on is gas operations have increased significantly since the year 2000 as used for interim in Case No. U-13000. In fact, Consumers Exhibit A-1 (DSA-3) shows that Consumers' earned 13.51% on equity for the year 2002, which is significantly in excess of the 11.40% was authorized in Case No. U-13000. Consumers' booked 2002 data does not contain the majority of the $55 million rate increase granted on November 7, 2002 which is $40 million above the interim amount granted.

With respect to the allocation of any interim increase granted to classes, I recommend that each class be increased by an equal percentage amount. The forecast year 2004 cost of service study is inappropriate for use as previously explained.

The final order in Case No. U-13000 moved all rate to cost of service and stated:

> "The Commission agrees that the rates established by this order should not contain any interclass subsidies. Moreover, the Commission finds that the attached rate schedules achieve that goal." (U-13000, page 60)

Therefore, on November 7, 2002, the Commission ordered cost-based rates for all classes of customers. If any interim increase is granted, all classes should be increased by the same percentage. It should be noted that the historic cost study for 2002 filed by Consumers continues to show that transportation customers are providing Consumers with a rate of return in excess of the 7.45% granted in U-13000.

The design of interim surcharges should be developed by dividing the apportioned interim increase by <u>all</u> throughput for each class.

Mr. Brockett does not use total gas throughput to develop his proposed interim surcharges by class. Mr. Brockett subtracts substantial amounts of transportation throughput for premium and market-based volumes, which erroneously increases the interim surcharge for transportation customers not receiving discounts. It appears that Mr. Brockett arrives at his proposed interim surcharges by dividing transportation class interim revenues by throughput levels that are much lower than the throughput levels associated with the revenue. If Mr. Brockett is going to exclude market-based volumes from interim surcharges, he should also exclude revenues associated with market-based volumes in the revenues he uses to allocate the proposed interim revenue requirement to classes. To the extent Mr. Brockett bases the interim increase to transportation customers on revenues that include market-based volumes and non market-based volumes and derives a surcharge only on non market-based volumes, he is overcharging transportation customers by creating an interim surcharge that is much higher than it should be.

Q WHAT ARE THE IMPLICATIONS OF MR. BROCKETT'S USE OF ONLY NON MARKET-BASED VOLUMES TO DERIVE HIS PROPOSED INTERIM SURCHARGE FOR THE TRANSPORTATION CLASS?

A In essence, Mr. Brockett is proposing to overcharge non market-based transportation customers to avoid charging or provide a discount to market-based transportation customers. The irony of this proposal is that Consumers identifies the non market-based transportation rate segment as cost based, but proposes charges that are quite the opposite of cost based. Interim rates should not force customers not receiving discounts to subsidize customers that are receiving discounts, especially when the customers could be competitors.

Q DOES THIS CONCLUDE YOUR TESTIMONY REGARDING INTERIM RATE RELIEF AT THIS TIME?

A Yes, it does.

Appendix A

Qualifications of Nicholas Phillips, Jr.

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Nicholas Phillips, Jr. My business mailing address is P. O. Box 412000, 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000.

Q PLEASE STATE YOUR OCCUPATION.

A I am a consultant in the field of public utility regulation and am a principal in the firm of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EMPLOYMENT EXPERIENCE.

A I graduated from Lawrence Institute of Technology in 1968 with a Bachelor of Science Degree in Electrical Engineering. I received a Master's of Business Administration Degree from Wayne State University in 1972. Since that time I have taken many Masters and Ph.D. level courses in the field of Economics at Wayne State University and the University of Missouri.

I was employed by The Detroit Edison Company in June of 1968 in its Professional Development Program. My initial assignments were in the engineering and operations divisions where my responsibilities included the overhead and underground design, construction, operation and specifications for transmission and distribution equipment; budgeting and cost control for operations and capital expenditures; equipment performance under field and laboratory conditions; and emergency service restoration. I also worked in various districts, planning system expansion and construction based on increased and changing loads.

Since 1973, I have been engaged in the preparation of studies involving revenue requirements based on the cost to serve electric, steam, water and other portions of utility operations.

Other responsibilities have included power plant studies; profitability of various segments of utility operations; administration and recovery of fuel and purchased power costs; sale of utility plant; rate investigations; depreciation accrual rates; economic investigations; the determination of rate base, operating income, rate of return; contract analysis; rate design and revenue requirements in general.

I have held various positions including Supervisor of Cost of Service, Supervisor of Economic studies and Depreciation, Assistant Director of Load Research, and was designated as Manager of various rate cases before the Michigan Public Service Commission and the Federal Energy Regulatory Commission. I was acting as Director of Revenue Requirements when I left Detroit Edison to accept a position at Drazen- Brubaker & Associates, Inc., in May of 1979.

The firm of Drazen-Brubaker & Associates, Inc. was incorporated in 1972 and has assumed the utility rate and economic consulting activities of Drazen Associates, Inc., active since 1937. In April 1995 the firm of Brubaker & Associates, was formed. It includes most of the former DBA principals and staff.

Our firm has prepared many studies involving original cost and annual depreciation accrual rates relating to electric, steam, gas and water properties, as well as cost of service studies in connection with rate cases and negotiation of contracts for substantial quantities of gas and electricity for industrial use. In these cases, it was necessary to analyze property records, depreciation accrual rates and reserves, rate base determinations, operating revenues, operating expenses, cost of capital and all other elements relating to cost of service.

In general, we are engaged in valuation and depreciation studies, rate work, feasibility, economic and cost of service studies and the design of rates for utility services. In addition to our main office in St. Louis, the firm also has branch offices in

Denver, Colorado; Chicago, Illinois; Asheville, North Carolina; Corpus Christi, Texas; and Plano, Texas.

Q **WHAT ADDITIONAL EDUCATIONAL, PROFESSIONAL EXPERIENCE AND AFFILIATIONS HAVE YOU HAD?**

A I have completed various courses and attended many seminars concerned with rate design, load research, capital recovery, depreciation, and financial evaluation. I have served as an instructor of mathematics of finance at the Detroit College of Business located in Dearborn, Michigan. I have also lectured on rate and revenue requirement topics.

Q **HAVE YOU PREVIOUSLY APPEARED BEFORE A REGULATORY COMMISSION?**

A Yes. I have appeared before the New Jersey Board of Public Utilities, the Public Service Commissions of Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Michigan, Missouri, Montana, New York, North Carolina, Ohio, Pennsylvania, South Carolina, South Dakota, Virginia, West Virginia, and Wisconsin, the Lansing Board of Water and Light, and the Council of the City of New Orleans in numerous proceedings concerning cost of service, rate base, unit costs, pro forma operating income, appropriate class rates of return, adjustments to the income statement, revenue requirements, rate design, integrated resource planning, power plant operations, fuel cost recovery, regulatory issues, rate-making issues, environmental compliance, avoided costs, cogeneration, cost recovery, economic dispatch, rate of return, demand-side management, regulatory accounting and various other items.

(Documents were marked Exhibits S-71 and S-72 by the reporter.)

JUDGE RIGAS: Ms. Smith.

MS. SMITH: Yes, thank you, your Honor.

Again pursuant to stipulation of the parties, I'm presenting today and have given to the court reporter two copies of the direct testimony of William J. Celio, which consists of a cover page and five pages of questions and answers.

Mr. Celio as staff is also sponsoring two exhibits which have also been agreed to by stipulation by the parties to be admitted. They have been provided to the court reporter and have been marked Exhibit S-70, WJC-1, which is the Staff Report on Consumers Energy's Motion for Partial and Immediate Rate Relief, and S-71 -- excuse me. I'm sorry. The first one was S-71 and -- the Staff's Report is S-71, and S-72 is the workpapers of William J. Celio, and I would at this time, pursuant to the stipulation, move their admission and bind in the testimony.

JUDGE RIGAS: Very well.

Pursuant to the stipulation of the parties, then, the prepared direct testimony of Mr. William J. Celio in Case No. U-13730, consisting of some five pages of questions and answers, will be bound into the record, and Exhibits S-71 and S-72 will be received at this time.

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STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

* * * *

In the matter of the application of CONSUMERS ENERGY COMPANY for authority to increase its rates for the distribution of natural gas and for other relief	))))))	Case No. U- 13730

QUALIFICATIONS AND DIRECT TESTIMONY OF

WILLIAM J. CELIO, P.E.

MICHIGAN PUBLIC SERVICE COMMISSION

August 8, 2003

QUALIFICATIONS OF WILLIAM J. CELIO, P.E.
CASE NUMBER U-13730
PART I

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Q. Please state your name and business address.

A. My name is William J. Celio. My business address is 6545 Mercantile Way, P.O. Box 30221, Lansing, Michigan 48909.

Q. What is your position with the Michigan Public Service Commission?

A. I am the Director of the Energy Operations Division.

Q. What is your educational background?

A. In 1967, I received a Bachelor of Science Degree in Electrical Engineering from the University of Illinois at Urbana, Illinois. In 1969, I received my Master of Business Administration Degree also from the University of Illinois. I have also taken several graduate courses in electrical engineering, other courses and seminars related to the energy and telecommunications industries.

Q. Would you briefly outline your work experience?

A. As a student engineer for the Chicago Transit Authority I performed scheduled testing and maintenance of relays and control circuits in the various substations on the CTA system.

In 1969, I began my employment with the Illinois Power Company where I designed and monitored construction of electric transmission lines of 69,000 volts and above. I also prepared and supervised the preparation of long-range studies that outlined the development of distribution, sub transmission and transmission systems.

In June 1974, I joined the Michigan Public Service Commission where my initial duties consisted of preparation of cost-of-service studies, various other investigations concerning presentation of rate cases for the Commission Staff,

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review applications for electric line extension permits and review of various tariff-related filings.

In 1979 I was assigned to the Chief of Staff's office where I was responsible for activities involving policy setting or implementation in each of the Staff's utility and support divisions.

In January 1982, I was transferred to the newly created Operational Development Division as Supervisor of the Operational Analysis Section responsible for the strategic planning efforts of the Commission and its Staff. The first effort of this section was the development of a comprehensive strategic plan for MPSC involvement in federal activities in the natural gas arena.

In August 1983, I transferred to the Communications Division where I ultimately served as its Director for over 14 years. In March 1999, I was transferred to the Electric Division as its Director. In October 2002 I became Director of the Energy Operations Division.

Q. Have you previously testified before the Commission?

A. Yes. Further, I have testified on behalf of the State of Michigan and the Michigan Public Service Commission before the Federal Energy Regulatory Commission. I have also supported the Chairman and Commissioners in developing positions and testimony before Congress.

Q. What other activities have you undertaken in the regulatory area?

A. I have been a guest lecturer at an American Gas Institute's course on regulatory accounting at Michigan State University. From January 1977 through October 1987, I was the NARUC representative to the American National Standards

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Institute (ANSI) Subcommittee Number 3 of Committee C2 that is involved with revising portions of the National Electric Safety Code. In September 1978, I was appointed to the NARUC Subcommittee on Cost Allocation.

I am a Registered Professional Engineer in Illinois and Michigan.

Q. Do you have any other general comments concerning your experience and education?

A. Yes. Since 1979, my assignments at the Commission have involved developing, recommending, and implementing regulatory policy. I have dealt with electric, natural gas, and telecommunications issues. In addition, in the telecommunications area, I served as a member of the Michigan Divestiture Research Fund's Board of Directors. I was a 10-year member of the Advisory Board to the Michigan Relay Center. I also served as a member of the 313 Area Code Split Citizen's Committee. I also was appointed by the Governor as a member of the Michigan Council on Telecommunications Services for Public Education.

I have worked with the Michigan Legislature in the development of major pieces of legislation including 1986 P.A. 32, the Emergency Telephone Service Act, 1986 P.A. 305, amendments to the Telephone Act, and 1991 P.A. 179, the Michigan Telecommunications Act and its amendments. I have co-authored, with staff persons Elizabeth Durbin and Louis Passariello, a paper published by the NRRI on a methodology for determining long-run incremental costs for telecommunications providers. Additionally, I was a member of an internal Commission task force that issued a report on stray voltage.

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Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present the Staff Report on Consumers Energy Company's (CE) Motion for Partial and Immediate (P&I) Rate Relief. This report includes a description of the Staff's investigation and concludes that CE is experiencing a forecasted revenue deficiency of $80,466,000. Staff recommends that the Commission grant CE P&I rate relief in that amount, subject to the provisions Staff's Utility Cash Flow Stability Plan.

Q. What is the Utility Cash Flow Stability Plan?

A. It is a necessary condition of the Staff's recommendation for P&I Rate Relief that is designed to ensure that increased revenues are used for the intended purpose. By definition, P&I Rate Relief is only required when the utility's financial condition is such that it justifies an early rate increase prior to the completion of the full case. In computing the proposed revenue deficiency, Staff calculated those gas revenues needed for the utility to maintain its financial health. However, it is widely recognized that the utility's parent, CMS Energy, is financially distressed. If no limitation were to be placed on transactions between CE and CMS, the funds from the P&I rate increase that were intended to maintain the utility's financial health could be transferred to the parent, which would defeat the fundamental purpose of P&I rate relief. Accordingly, the Staff's recommendation of an $80,466,000 P&I rate increase is conditioned upon CE's voluntary agreement that it will limit dividend payments to its parent to no more than $190,000,000 annually.

Q. Are you sponsoring any Exhibits relating to P&I rate relief in this proceeding?

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A. Yes. I have prepared Exhibit S-_____ (WJC-1) Staff Report on Consumers Energy Motion for Partial and Immediate Rate Relief that recommended a P&I rate increase of $80,466,000.

Q. What is Staff's recommendation regarding P&I rate design?

A. Staff recommends that any P&I relief awarded by the Commission be allocated on the basis of equal percentage of revenue increase by rate class. Intra rate class increases are proposed consistent with the rate design concepts approved by the Commission in CE's previous rate Case No. U-13000.

Q. Does this complete your testimony?

A. Yes, it does.

JUDGE RIGAS: Anything further with respect to the interim portion of this case from any party at this time?

We have previously established a schedule for the filing of an initial brief. It is my understanding that at that time the matter will be then ripe for Commission consideration, and that is a fact which I will advise them of shortly.

There being nothing further, this matter is adjourned to November 4, 2003 at 9:00 A.M. Thank you all very much.

MR. CHAMBERS: Thank you.

MS. SMITH: Thank you.

(At 1:45 P.M., the hearing was adjourned to Tuesday, November 4, 2003.)

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C E R T I F I C A T E

We, the undersigned, do hereby certify that we reported stenographically the foregoing proceedings had in the within-entitled matter, being Case No. U-13730 before James N. Rigas, J.D., at the Mercantile Building, Lansing, Michigan, on August 27, 2003, and that the foregoing transcript, exclusive of the prepared direct testimony, constitutes a full, true and correct transcript of our said stenographic notes.

Evelyn K. Merrill

Marie A. Schroeder

Dated: August 27, 2003