STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of **CONSUMERS ENERGY COMPANY** for authority to increase its rates for the generation and distribution of electricity and other relief.	)))))	Case No. U-14347

At the December 22, 2005 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. J. Peter Lark, Chairman
Hon. Laura Chappelle, Commissioner
Hon. Monica Martinez, Commissioner

OPINION AND ORDER

I. History of Proceedings

On December 17, 2004, Consumers Energy Company (Consumers) filed an application, supporting testimony, and exhibits requesting authority to: 1) adjust its retail electric rates for additional electric sales revenue of at least $319.7 million per year ($400.4 million including the transmission-related revenue requirement); 2) receive a rate of return of 12.75% on common equity; 3) establish a process for eliminating all remaining rate skewing;[1] 4) recover its transmission costs through the power supply cost recovery (PSCR) process established by 1982 PA 304 , MCL 460.6h *et seq.*; and 5) other relief as appropriate. Administrative Law Judge Barbara A. Stump (ALJ) conducted a prehearing conference on January 27, 2005 at which the

[1]Rate skewing is the difference between the revenues generated by the rates in effect for each class (i.e. residential, commercial, and industrial) and their cost responsibility, as determined by a cost of service study.

following intervenors were recognized: Energy Michigan, the Association of Businesses Advocating Tariff Equity (ABATE), Midland Cogeneration Venture Limited Partnership (MCV), The Kroger Co. (Kroger), Attorney General Michael A. Cox (Attorney General), the Michigan Cable Telecommunications Association, Dow Corning Corporation and Hemlock Semiconductor Corporation (Dow), Michigan State Utility Workers Council, Utility Workers Union of America, AFL-CIO, New Covert Generating Company, LLC, Michigan Association of Broadcasters, and Constellation NewEnergy, Inc. (NewEnergy). Subsequently, Wal-Mart Stores East, LP, Sam's East, Inc. and Kohl's Department Stores, Inc. (Wal-Mart) filed a petion for late intervention, which was granted. The Commission Staff (Staff) also participated in the proceedings.

On June 3, 2005, the Staff filed its report and recommendations on Consumers' rate relief request. The Attorney General, ABATE, Energy Michigan, Dow, and Kroger also filed testimony. On July 6, 2005, cross-examination of the witnesses commenced and continued on July 7-8, and 11-13, 2005. The record consists of 7 volumes of transcript totaling 2,128 pages. In addition, 222 exhibits were admitted into evidence.

Briefs were filed on August 8, 2005 by Consumers, the Staff, the Attorney General, Energy Michigan, ABATE, Kroger, Dow, and Wal-Mart. On August 19, 2005, Consumers, the Staff, the Attorney General, Energy Michigan, Dow, ABATE, NewEnergy, and Wal-Mart filed reply briefs.

On October 4, 2005, the ALJ issued her Proposal for Decision (PFD). Exceptions were filed by Kroger, Wal-Mart, Energy Michigan, NewEnergy, Consumers, Dow, the Attorney General, the Staff, and ABATE on October 28, 2005. On November 10, 2005, Kroger, ABATE, Energy Michigan, the Staff, NewEnergy, Consumers, the Attorney General, and Wal-Mart filed replies to exceptions.

II. Description of Consumers' December 17, 2004 Filing

Consumers application originally sought to increase rates by not less than $319.7 million per year (or $400.4 million, including $80.8 million in transmission costs) above the retail electric base rates established in the February 5 and November 14, 1996 orders in Case No. U-10685, as modified by 2000 PA 141 (Act 141), MCL 460.10 *et seq.* Consumers subsequently accepted the Staff's position on a number of issues and reduced its requested rate relief to $206.2 million or, if transmission related revenue were included, $297.5 million.

Consumers proposed that its rates be based on a 2006 projected test year. Starting with 2003 historical data, Consumers made adjustments for known and measurable changes occurring before 2006 and a projected budget for the 2006 test year. Consumers asserted that this method would allow the rates established in this case to more closely reflect the conditions that will exist at the time that the rates will be in effect.

Consumers claimed that its current rates are unreasonably low, noting that the utility had already invested over $500 million in Clean Air Act (CAA)[2] compliance costs and expected to invest an additional $200 million by the end of 2006, none of which is reflected in its current rates. Consumers also stated that the levels of capital investment necessary to adequately maintain, strengthen, and expand the existing distribution system and to assure reliable service to its customers have likewise increased significantly beyond the levels reflected in Consumers' current rates. Consumers highlighted the fact that it had lost, and would continue to lose, customers to retail open access (ROA), estimating that its projected revenue deficiency included sales losses to ROA of 10,426 gigawatt hours (GWh).

[2]*See*, 42 USC 7401 *et seq.*, and 42 USC 7651 *et seq.*

Consumers also requested that the rates approved by the Commission reflect an overall rate of return of 8.10%, after tax, with a rate of return on common equity of 12.75%. Consumers stated that it had calculated a 2006 test year revenue deficiency of at least $319,700,000. Consumers further requested that the Commission establish a process that will allow the gradual, but certain elimination of the currently existing rate subsidization. In support of this request, Consumers filed a summary of present and proposed revenue by rate schedules for the test year.

III. Proposal for Decision

The ALJ recommended use of a 2003 historic test year, adjusted for known and measurable changes, as recommended by the Staff, rather than the 2006 projected budget approach used by Consumers.

The ALJ found that Consumers' jurisdictional rate base should be set at $4,838,297,000, which reflects several changes to the Staff's originally proposed rate base of $4,838,960,000.

The Staff and Consumers initially agreed to adopt Consumer's estimate of $4,625,763,000 for net utility plant as a reasonable amount to use for purposes of determining rates. Subsequently, Consumers made changes to fossil generation plant and proposals to stiffen the distribution plant planning guidelines, to adopt a more aggressive life cycle replacement program, and to adopt a corporate accounting and work in progress system replacement. As a result of these adjustments, Consumers calculated a reduction in net plant of $663,000. In its reply brief, the Staff accepted Consumers' adjustments. The ALJ therefore recommended a net plant amount of $4,625,100,000.

Consumers originally proposed a jurisdictional electric working capital requirement of $43,871,000 for the 2006 test year. The Staff, however, proposed adjustments to Consumers' calculation and recommended an electric working capital requirement of $216,003,808. Subsequently, Consumers accepted the Staff's working capital calculation. The ALJ therefore

recommended that the Commission adopt a 2006 jurisdictional electric working capital amount of $213,197,000. The ALJ therefore recommended that Consumers total jurisdictional rate base be set at $4,838,297,000.

Consumers initially proposed a permanent capital structure of approximately 50% equity and 50% debt using a hypothetical capital structure formula. The Staff, however, used Consumers' projected capital structure for 2006 of 55.13% long-term debt, 0.65% preferred stock, and 44.22% common equity. Consumers accepted the Staff's proposed capital structure, and the ALJ recommended its adoption.

Consumers agreed with the Staff's recommendation to use a 5.7% cost figure for long-term debt, 5.39% for short-term debt, and 4.46% for preferred stock. The ALJ adopted these figures. Consumers requested that the Commission approve a 12.75% return on common equity and an overall rate of return of 7.66%.[3] The Staff, however, calculated a range from 10.75% to 11.25% as an appropriate level for Consumers' cost of common equity and recommended that the Commission adopt the higher end of the range, 11.25%, to account for Consumers' higher risk. The ALJ recommended a cost of common equity of 11.25% and an overall, after-tax, cost of capital of 6.82%

The ALJ accepted the Staff's estimate of $2,414,745,637, including PSCR revenue, for the total jurisdictional electric operating revenue for 2006. The ALJ also largely adopted the Staff's calculations of Consumers' adjusted net operating income (NOI) of $258,427,000, including transmission expenses.

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[3]Consumers initially filed testimony requesting an overall after-tax rate of return of 8.10%. On April 29, 2005, Consumers filed updated testimony and exhibits to reflect updated long-term debt issuances and retirements and equity infusions, updated deferred tax, and debt balances to December 31, 2004 amounts. As a result, Consumers' requested overall after-tax rate of return was reduced from 8.10% to 7.66%. Consumers subsequently made additional adjustments as discussed *infra*.

Consumers did not contest the Staff's adjustment of $7,071,633 for other revenue or the Staff's adjustment of $1,633,000 for miscellaneous service charges. These adjustments were therefore adopted by the ALJ.

The ALJ adopted the Staff's projection of electric fuel and purchased power expenses of $1,004,177,637 including transmission expenses. The ALJ also accepted the Staff's recommendation that Consumers' employee incentive compensation plan, its expenses for lease changes and blackouts, and its expenses for lobbying be disallowed.   Furthermore, the ALJ agreed with the Staff that an estimated $100,000 expenditure for a preliminary investigation into the feasibility of broadband over power lines (BPL) be disallowed. In addition, the ALJ agreed with Consumers' estimate for employee savings plan match expenses of $6,371,000 and its estimate of $36,511,000 for employee healthcare, life insurance, and disability programs. Consumers did not contest, and the ALJ therefore adopted, the Staff's recommendations for injuries and damages expenses ($7,956,000), low-income energy efficiency funds (LIEEF) of $26,720,000, risk management and corporate insurance ($13,566,000), hydrological power expense ($12,469,000), information services expense ($12,118,000), and a pro-forma income tax increase of $6,620,000.

Consumers proposed $33,120,000 for pension expenses and $28,344,000 for other post employment benefits (OPEB). The Staff accepted Consumers' calculation of its pension expense and agreed with Consumers' proposed decrease of $5,881,000 in OPEB expense because of the effect of the Medicare prescription drug benefit. The ALJ recommended the adoption of the agreed upon pension expense. The ALJ also recommended that the Commission adopt the pension equalization mechanism and the OPEB equalization mechanism as proposed by Consumers and supported by the Staff.

Consumers proposed an increase, from $16 million in 2003 to $46 million in the 2006 test year, for forestry expenses as part of its electric systems operations expenses. The Staff agreed, provided that Consumers provide annual tracking reports on its expenditures and that any portion of the forestry expense be refunded if not used. The ALJ concurred with the Staff and recommended that the Commission adopt $46 million for forestry and tree-trimming expenses, subject to an annual tracker and the refund to ratepayers of any funds not spent.

Consumers also requested above-inflation increases for certain other operations and maintenance (O&M) expenses including reliability, demand maintenance, O&M associated with construction, distribution system services, and information technology (IT) projects. The ALJ disagreed with Consumers and adopted the Staff's projection using 2003 expenditures adjusted for inflation.

Consumers proposed an O&M level of expense for its fossil generation units of $119,778,893 for 2006. Consumers' proposal was supported by the Staff provided that a yearly tracker mechanism is applied to the above-inflation expenditures ($9,688,000) for this item. On rebuttal, Consumers offered an additional proposal, arguing that its should also be allowed to surcharge customers for any amounts spent in excess of $119,778,893 and suggesting that the excess amount would be at least $10,000,000 in 2006 and more in 2007. The Staff opposed the surcharge. The ALJ found that the additional fossil O&M expense should be approved and that the Staff's yearly tracking mechanism should be adopted for these expenses. The ALJ also rejected Consumers' proposal to surcharge customers for any amounts spent in excess of the $119,778,893 level and recommended that the Commission apply a yearly tracker to any expenditures in excess of $110,091,000.

Consumers proposed adjustments of $2,168,000 for accounts receivable, $231,000 for maritime security, and $87,214,000 for removal of transmission O&M expenses. These adjustments were not opposed and were adopted by the ALJ. Consumers also proposed deferring the establishment of a trust fund for the Ludington facility, and the Staff and ALJ agreed. The Staff proposed adjustments to depreciation, taxes, and allowance for funds used during construction (AFUDC). The ALJ found that there were no material differences between Consumers' and the Staff's proposals and adopted the Staff's adjustments.

As a result of the above adjustments to revenue and expenses, the ALJ calculated net operating income of $273,238,000 and a revenue deficiency of $203,481,000 including transmission expenses for the 2006 test year.

The ALJ recommended that the Commission move towards rates based on the cost to serve. The ALJ recommended that the Commission adopt the Staff's proposal to phase out skewing over 10 years (by 10% per year until otherwise determined) by the imposition of a uniform regulatory adjustment charge (RAC) on all classes, merge choice customers into their native rate class for purposes of certain rate components, require choice and full service customers receiving comparable distribution service to pay the same distribution rates and the same RAC, adopt the Staff's transitional primary rate (TPR) tariff for customers moving from special contracts to full service, and treat Rate E as a rider to each customer's native class but with the appropriate discount.

IV. Discussion

1. Test Year and Method for Calculating Test Year

In each rate case, a test year period and a method for calculating costs and revenues for the test year, must be selected. Consumers proposed to base its rates on a 2003 historic period adjusted for

known and measurable changes coupled with budget projections for 2006. The Staff agreed with the adoption of a 2006 test year but objected to Consumers' projected budget approach on grounds that this method is less objective and more complex than the method proposed by the Staff. The Staff used actual 2003 results as a starting point and adjusted these numbers to reflect known and measurable changes out to 2006. For most costs, the Staff used 2003 expenditures adjusted for inflation. Nevertheless, for a few cost categories the Staff adopted Consumers' estimates, recognizing that projected increases were substantial and reasonably likely to occur.

Kroger argued that Consumers' method, which projected continued rapid growth in ROA load and included capital investments that had not yet been made, resulted in a significant overstatement of the utility's revenue deficiency. Kroger noted that to reach Consumers' projection, ROA load would have to increase 155% in two years.[4] Similarly, Energy Michigan, ABATE, and the Staff disagreed with Consumers' assumptions regarding future ROA sales and recommended that the Commission use 2004 ROA sales as a proxy for Consumers' 2006 ROA sales. Consumers subsequently accepted the Staff's estimate of 4,505 GWh for 2006 ROA sales. The ALJ recommended adopting the Staff's historic test year method and its ROA sales estimate. The ALJ found that the Staff's use of an historic test year adjusted for known and measurable changes, together with specific additional adjustments made by Staff for unusual events, provided an appropriate method to establish rates for Consumers in this case. The ALJ further noted that the Staff's approach was consistent with the Commission's longstanding preference for an historic test year method rather than the projected budget approach advocated by Consumers. There were no exceptions to this recommendation.

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[4] In its initial filing, Consumers projected that its ROA sales would increase from its 2003 level of 2,831 GWh to 10,578 GWh in 2006.

The Commission has repeatedly found that an historic test year adjusted for known and measurable changes "provides a prudent and practical basis for setting appropriate rates for the future." April 28, 2005 order in Case No. U-13898, p. 7. *See also,* November 23, 2004 order in Case No. U-13808, pp. 20-22. In accordance with past practice, therefore, the Commission adopts the ALJ's recommendation that Consumers' rates be set based on the 2003 historic year adjusted for known and measurable changes as proposed by the Staff.

2. Rate Base

A utility's rate base consists of the capital invested in used and useful plant, less accumulated depreciation, plus the utility's working capital requirements. Consumers identified a jurisdictional rate base totaling $4,669,633,000 for the 2006 test year, comprised of net plant of $4,625,761,000 and working capital of $43,871,000. Michael Torrey, Consumers' Director of Revenue Requirements, Cost Analyses, and Planning testified regarding the development of Consumers' 2006 test year net utility plant. Consumers began with actual December 31, 2003 plant balances. Adjustments were then made for 2004, 2005, and 2006 plant additions and other known and measurable changes to arrive at a net plant for the 2006 test year of $4,625,761,000. The Staff accepted Consumers' net plant amount but proposed increasing working capital by $169,328,000. The Staff thus identified a jurisdictional rate base totaling $4,838,960,000 for the 2006 test year.[5] Consumers accepted the Staff's adjustment.

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[5]The difference between Consumers' and the Staff's figures was primarily attributable to different proposals regarding the ratemaking treatment for a major contribution made by Consumers to its pension plan in 2003. In its filing, Consumers proposed the creation of a Pension Contribution Regulatory Asset. It requested that it be allowed to amortize the electric portion of this contribution, which totals $501,000,000, over a 20-year period, including interest at 7% per year. In return for this requested amortization with interest, Consumers reduced its working capital request by $254,000,000.

Subsequently, Consumers proposed a net plant reduction of $663,000 to account for changes to fossil generation plant and to account for Consumers' proposals to stiffen the distribution planning guidelines, to adopt a more aggressive life-cycle replacement program, and to adopt a corporate accounting and work-in-progress system replacement. The Staff concurred with Consumers' adjustment to net plant.

The Attorney General objected to the adoption of a projected rate base that included many capital additions that he claimed may never be made. The Attorney General noted that Consumer's and the Staff's projections of the rate base represented an increase of 10-15% over the previous base and that this was unjustified and an unreasonable result for ratepayers. The Attorney General therefore recommended that the proposed increase be reduced by at least 2%. The ALJ rejected the Attorney General's arguments on grounds that there was no basis in the record to support his recommended decrease in the rate base.

In his exceptions, the Attorney General again asserts that the Commission should reduce the recommended rate base downward by 2%. The Attorney General argues that the Commission has discretion to determine what is just and reasonable, to assess the credibility of witnesses, and to reject testimony. The Attorney General claims that Consumers is proposing to increase its rate base by approximately $454 million and that Consumers' projection includes many investments that have not been, and may never be, made. The Attorney General concludes that the Commission should seriously weigh a 10-15% increase in the rate base where there is no quantitative analysis of the benefits to customers in terms of offsetting savings.

The Commission agrees with the ALJ that Consumers' and the Staff's calculations of the rate base are reasonable. Consumers and the Staff are the only parties that engaged in exhaustive investigation of the reasonableness of Consumers' rate base, and their agreement on the

appropriate level of Consumers' rate base is entitled to significant weight. The Commission finds that the Attorney General's arguments are not supported by the record. Although the Attorney General provides a general statement that there are capital investments proposed that may never be made, he fails to provide any specific evidence supporting the need for a 2% decrease in the rate base. The Commission therefore adopts a rate base of $4,838,297,000, comprised of $4,625,100,000 in net plant and jurisdictional working capital of $213,197,000.

3. Overall Rate of Return

The criteria for establishing a fair rate of return for public utilities is rooted in the language of the landmark United States Supreme Court cases *Bluefield Water Works Co* v *Public Service Comm of West Virginia*, 262 US 679; 43 S Ct 675; 67 L Ed 1176 (1923) and *Federal Power Comm* v *Hope Natural Gas Co*, 320 US 591; 64 S Ct 281; 88 L Ed 333 (1944). The Supreme Court has made clear that in establishing a fair rate of return, consideration should be given to both investors and the customers. The rate of return should not be so high as to place an unnecessary burden on ratepayers, yet should be high enough to ensure investor confidence in the financial soundness of the enterprise. Nevertheless, the determination of what is fair or reasonable, "is not subject to mathematical computation with scientific exactitude but depends upon a comprehensive examination of all factors involved, having in mind the objective sought to be attained in its use." *Meridian Twp* v *City of East Lansing, Mich*, 342 Mich 734, 749; 71 NW2d 234 (1955). With these principles in mind, the Commission turns to the factors that form the basis for determining the rate of return for Consumers.

a. Capital Structure

Consumers originally proposed a permanent capital structure of approximately 50% equity and 50% debt using a hypothetical capital structure formula. The Staff, however, used

Consumers' projected capital structure for 2006 of 55.13% long-term debt, 0.65% preferred stock, and 44.22% common equity. Kroger objected to Consumers' proposed capital structure on grounds that it was unreasonable given Consumers' actual percentage of common equity. Kroger concluded that adopting Consumers' proposal would result in an overcharge to ratepayers and a windfall to investors. Kroger therefore recommended setting common equity at 36.3%.

Consumers subsequently accepted the Staff's proposed capital structure. The ALJ found that the Staff's analysis and development of Consumers' capital structure was reasonable and did not artificially increase Consumers' equity ratio for ratemaking purposes. There were no exceptions to this recommendation. The Commission therefore adopts the ALJ's recommendation that Consumers' projected capital structure be used for the 2006 test year.

b. Costs of Capital

i. Long-Term Debt Cost

The Staff reviewed all of Consumers' bond classes and took note of the additions and redemptions that would affect the company's long-term debt profile for 2006. Through April 2005, Consumers issued $700 million in first mortgage bonds and redeemed over $700 million of its higher expense debt. The Staff estimated that Consumers would issue an additional $47.5 million in tax-exempt bonds and have similar unamortized debt expense of $56.7 million. The Staff concluded that Consumers' forecasted long-term debt balance for the 2006 test year was $3,725,420,000 at a cost rate of 5.70%. This amount represents 55.13% of the permanent capital structure and 45.28% of the ratemaking capital structure. Consumers did not dispute the Staff's estimate, which the ALJ adopted, and no exceptions were filed. The Commission agrees with the ALJ's finding and determines Consumers' long-term debt cost to be 5.70%.

ii. Short-Term Debt Cost

The Staff recommended a short-term debt balance of $90,232,000 with a cost rate of 5.39%. There was no dispute between Consumers and the Staff concerning short-term debt cost and no exceptions were filed. The Commission therefore adopts the ALJ's recommendation of 5.39% for the cost of short-term debt.

iii. Preferred Stock

The Staff recommended a preferred stock balance of $44 million with a cost rate of 4.46%. The Staff's figures agreed with Consumers' recommended balance and cost. Consumers did not oppose this value and no exceptions to the PFD were filed on this issue. The Commission therefore accepts the ALJ's recommendation that 4.46% be adopted as the cost for preferred stock.

iv. Rate of Return on Common Equity

The utility's cost of common equity is the return investors expect, or require, in order to provide the utility with capital. The cost of capital is an opportunity cost; in order to induce investors to purchase common stock or bonds, there must be the prospect of receiving earnings that are sufficient to make the investment attractive compared with other investment opportunities.

In determining the cost of common equity, the Staff and Consumers used the discounted cash flow (DCF), the capital asset pricing model (CAPM) methods, and risk premium approaches, and reviewed the results using the comparable earnings approach. The DCF and CAPM models are widely used by regulatory agencies in deciding what rate of return to permit regulated utilities to earn, as are the risk premium and comparable earnings approaches.

In calculating its return on common equity, Consumers selected a group of 17 companies that met its criteria for percentage of revenue derived from electric operations, net plant levels, stock

dividend payment, and bond rating. Consumers asserted that because the companies selected are less risky than Consumers, the return on equity for Consumers needs to be adjusted upward. Consumers did additional analyses (DCF and CAPM) for 60 publicly traded electric companies.

Consumers requested a rate of return on common equity of 12.75 % based on its proxy analyses. Wayne M. Leja, Consumers' Principal Financial Analyst, testified that he had selected his proxy group of 17 companies that met the following criteria: 1) 60% or more of the proxy's operating income derived from electric operations; 2) net plant was over $5 billion for the selected companies; 3) the proxy companies were currently paying dividends; and, 4) the selected companies had bonds rated at a minimum investment grade of Baa by Moody's Investor Services (Moody's) and BBB by Standard & Poor's (S&P). Mr. Leja opined that taken as a whole, his proxy group companies were less risky than Consumers and that therefore, it was necessary to make adjustments to reflect Consumers' higher risk. For the proxy companies, Mr. Leja calculated an average return on equity of 8.93%, without flotation costs, and 9.10% including flotation costs.[6] Mr. Leja noted that the average bond rating for the proxy companies was A3 and A- for Moody's and S&P respectively, compared to Baa3 and BBB- for Consumers. Mr. Leja also observed that the proxy group had an average Value Line Safety Rating of 2.2, compared to 4 for Consumers' parent company, CMS Energy Corporation (CMS), which was used as a proxy for Consumers. Mr. Leja concluded that under all three methods, the less risky companies produced return on equity results that would be lower than a return on equity appropriate for Consumers.

Mr. Leja also testified that he had undertaken a CAPM analysis of CMS, and DCF and CAPM analyses for the entire set of publicly traded electric utilities reported in the *Value Line Investment*

[6]Flotation costs are the costs associated with the issuance of new securities, including the money earned by investment bankers from the spread between their costs and the price offered to the public, along with the accounting, legal, printing, and other costs associated with the issuance of new securities.

Survey. Again, Mr. Leja testified that he found that this group was less risky as a whole than Consumers, and observed that for this group of electric utilities the DCF analysis resulted in an average return on equity of 9.05% without flotation costs and 9.21% with flotation costs.

Mr. Leja testified that given current market conditions, the DCF results do not accurately reflect an appropriate return for 2006, noting that both the CAPM and risk premium analyses reflect a higher rate of return. Therefore, Mr. Leja asserted that the DCF results should be given less weight and should be adjusted by adding 110 basis points to reflect the effect of the expected increase in the risk free rate between November 2004 and 2006 and that the return should be adjusted upward an additional 188 basis points to reflect the higher risk of Consumers as compared to the proxy group.

For his CAPM analyses, Mr. Leja used the yield on 30-year treasury bonds for the risk-free rate of return, then adjusted that rate by a market premium derived from 2004 Ibbotson Associates *Yearbook for Stocks, Bonds, Bills and Inflation for the period 1926 – 2003* and beta data from Value Line. Mr. Leja testified that the CAPM results for the proxy companies showed that the average return on equity for 2006 without flotation costs was 10.64%, and 11.74% with flotation costs and before applying any risk premium. Mr. Leja noted that the CAPM returns for 2006 are approximately 110 basis points higher than for November 2004 due to an expected increase in interest rates.

Mr. Leja testified that he performed a CAPM analysis for CMS that resulted in a required return, without flotation costs, of 14.16% for November 2004 and a return, without flotation costs, of 15.26% for 2006. Mr. Leja asserted that when his analysis was adjusted for the appropriate beta value and safety rank the results without flotation costs were 11.42% and 12.52% for November 2004 and 2006, respectively. Thus, Mr. Leja concluded that this analysis provided additional

support for his conclusion that a 12.75% rate of return for Consumers' electric business was reasonable.

Thomas J. Webb, Chief Financial Officer of Consumers and CMS, testified that based on the analyses that were done by Mr. Leja, and his own risk assessment, he recommended that the return on equity be set at 12.75%. According to Mr. Webb, a critical issue is investor perception of risk and that in his opinion, Consumers' electric business is viewed by investors as substantially more risky than a typical electric utility. Thus, Mr. Webb opined that a return on common equity of 12.75% was appropriate in order to compensate for risk, restore investor confidence, and help Consumers improve its financial profile.

Mr. Webb further noted that the return on equity required by investors will generally increase as interest rates increase in order to compensate investors for the risk differential between debt and equity. According to Mr. Webb, the return on equity that investors will require in 2006 will be higher than the return on equity that investors currently require because the Federal Funds rate is moving up from the low end of an interest rate cycle and is projected to increase even further in the future.

Mr. Webb stated that in general, investors perceive electric utilities as riskier than gas utilities and that Consumers' electric business is viewed as more risky than its gas business and more risky than a typical electric utility. Mr. Webb further noted that in his view, investors viewed Consumers as a riskier investment than The Detroit Edison Company (Detroit Edison). Mr. Webb stated that the perceived risk associated with Consumers results from the fact that the utility relies on many older generating plants subject to expensive CAA requirements, it owns a large nuclear power plant, which is viewed as more risky, particularly in the post-9/11 era, and because electric utilities no longer control transmission systems and thus have less control over the utility's ability

to deliver electricity to its customers. Mr. Webb also highlighted the risks and uncertainties associated with ROA sales.

Mr. Webb further testified that Consumers' lower bond ratings and investment safety ratings were evidence of its higher risk as an investment, noting that Consumers has senior secured debt ratings one notch above "junk bond" status and three notches below the average for the proxy companies selected for the analyses. Furthermore, Mr. Webb testified that Consumers' senior unsecured debt ratings are below investment grade and are a better reflection of investor perceived risk.

Mr. Webb also testified that in June 2004, S&P assigned new business profile scores for U.S. Utility and Power Companies and published an updated U.S. Utility and Power Company Ranking List. According to Mr. Webb, Consumers is ranked in the Integrated Electric, Gas, and Combination Utilities sector. Approximately two-thirds of the companies in this sector have a business profile score of five or less, where one represents the lowest risk. Consumers was assigned a score of six, indicating that its business profile is worse than two-thirds of the utilities in the sector.

In sum, Consumers argued that an upward adjustment in the authorized return on equity is needed to reflect the higher interest rates that are projected for 2006 and that it was necessary to reflect Consumers' higher risk. Furthermore, Consumers argued that an upward adjustment is needed for flotation costs and that the inclusion of such costs was upheld in *Attorney General v Public Service Comm*, 136 Mich App 515; 338 NW2d 351 (1984). Exhibit A-138 summarizes Consumers' positions.[7]

In assessing Consumers' risk, the Staff looked at Consumers' background and corporate relationship with its parent company, CMS. The Staff also examined Consumers' business

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[7]In its initial brief, Consumers asserted that, at a minimum, an 11.60% return on equity is necessary to adequately compensate investors for risk. *See*, Consumers' brief, p. 40.

operations to provide a basis for analyzing the risk that the company faces in those operations. The Staff noted that Consumers operates as a wholly-owned subsidiary of CMS, an exempt holding company, and does not have the same business or financial risk as its parent, or its sister subsidiary CMS Enterprises.

The Staff used a DCF model for determining the cost of equity for each company in its proxy group. The dividend yield was 4.03%, which was calculated by using the average of high and low share prices for each month from October to December 2004. The latest quarterly common dividend was annualized in calculating the dividend yield. The growth rate used in the DCF study was determined by looking at the proxy group's projected growth rates of earnings, as forecasted by three sources (*Institutional Brokers Estimate System*, *Zacks*, and *Value Line Investment Survey*) for the companies in the proxy group. The Staff's DCF cost of equity estimate, based on the above analysis, resulted in a cost of common equity for the proxy group of 8.88%. The result for the Staff's DCF proxy group was very close to Mr. Leja's proxy group DCF results of 8.93%.

In its CAPM analysis, the Staff determined that the cost of equity, using the proxy group beta value and the risk premium for the 1958-2003 time period was 10.31%, and 11.07% for the entire period of 1926-2003. The Staff used a projected long-term treasury rate of 5.4% in its CAPM cost of equity analysis. The Staff also averaged the projected 2005 and 2006 long-term treasury rates from two sources, *Global Insight* and *Value Line Investment Survey*, to arrive at a rate of 5.4% for long-term treasuries.

For its risk premium analysis, the Staff calculated the historical realized return for a group of natural gas distribution utilities from 1932 to 2001. *See* Exhibit S-4, Schedule D-5, p. 11. According to the Staff, the average risk premium spread between the market return of the group's stocks and the bond yield was 4.17%. Using that 4.17% risk premium, with a projected 30-year

treasury bond rate in 2004 of 5.4% and a current interest rate spread on Baa1/Baa3 rated utility bonds of 1.16%-1.41%, resulted in a cost of equity range of 10.73% to 10.98%.

The Staff recommended that flotation expenses not be considered when calculating the cost of equity because Consumers' parent, CMS, is the company that issues new common equity. CMS is able to subtract those expenses as a business expense, and no common equity issuance expenses are on Consumers' books.

The Staff also examined rates of return granted by regulatory utility commissions across the country. According to the Staff, the average authorized return on common equity in rate cases decided in 2004 was 10.73% for electric utilities and 10.59% for gas utilities. Thus, the Staff concluded that its recommendation of a return on common equity of 10.75% to 11.25% is strongly supported by the average authorized equity return for electric and gas utilities allowed by state regulatory commissions across the United States.

The Attorney General argued that Consumers' claims regarding its higher risk "are specious at best,"[8] observing that Consumers had failed to provide a quantitative analysis of these issues. The Attorney General further argued that the Commission has not denied recovery of environmental costs that are reasonably and prudently incurred and that, in any event, these are not risks unique to Consumers. The Attorney General and ABATE also objected to the Staff's recommended rate of return of 11.25% on grounds that the Staff had made no specific adjustment to the rate in light of the risk reduction mechanisms (e.g. OPEB equalization and O&M tracking) supported by the Staff. The Attorney General thus argued that the Commission should reduce the approved rate of return on common equity to the mid-point of the Staff's range – 10.875%.

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[8] Attorney General's brief, p. 39.

In its reply, Consumers stated that, at a minimum, the return on equity should be 11.93%, although a higher return would better reflect increases in interest rates and the company's risk characteristics. Consumers argued that the Staff's analysis failed to recognize the effect of higher interest rates projected for 2006 and claimed that, contrary to the Staff's assertion, its 12.75% return on equity did not include the higher risk associated with CMS. Consumers further asserted that the Staff's CAPM analysis understated the required return because the Staff used the 2005 risk-free interest rate rather than the higher 2006 projected interest rate, which results in adding 20 to 40 basis points. Second, Consumers argued that the Staff used results from an analysis of risk premiums from 1958-2003 rather than the more complete 1926-2003 period that Consumers used. By using this more comprehensive time period, 76 basis points are added. Consumers also asserted that the Staff's comparison of authorized rates of return for other utilities in the United States is not relevant to this proceeding.

In its reply, the Staff argued that Consumers' proposed 12.75% rate of return was not a fair or reasonable rate of return on common equity because Consumers' analyses included inappropriate risk adjustments. The Staff argued that the record does not contain persuasive evidence that long-term interest rates will be increasing from 2004 and 2005 levels, observing that interest rates on long-term treasuries have declined. Furthermore, the Staff argued that Consumers' regulatory risk is no higher than that faced by any other utility. Finally, the Staff claimed that the higher risk that Consumers does present, as compared to the proxy group, was accounted for by the Staff's recommendation of an 11.25% return on common equity.

The ALJ observed that Consumers made three upward adjustments to the Staff's 11.25% recommended return on equity to arrive at the company's requested rate of 12.75%. Those adjustments were an interest rate adjustment of 0.20% to 0.50%, a risk adjustment of .33% to

1.63%, and a flotation cost adjustment of 0.15% to 0.17%, resulting in a range of 11.93% to 13.55%.[9] The ALJ found that all of these adjustments should be rejected because they were based on judgments that are not supported by the evidence.

The ALJ agreed with the Staff that the record does not support Consumers' contention that 2006 interest rates will be increasing above 2004 and 2005 levels. Second, the ALJ found that Consumers' risk premium of 1.88% was inflated because the company included risk exposure that it has because of it parent CMS. Finally, the ALJ found that Consumers' claim that it has greater business and regulatory risks than the proxy group was exaggerated, noting that the company did not provide a quantitative analysis of the concerns that would justify a return of 12.75% and that Consumers faces the same regulatory risks that all utilities face in Michigan and elsewhere in the United States.

The ALJ also found that Consumers' upward adjustment for flotation costs should be rejected and that the Staff's analysis resulted in a rate of return on common equity that will allow Consumers to maintain its financial integrity, attract capital under reasonable terms, and provide investors with returns commensurate with those of investors in enterprises of comparable risk. The ALJ therefore recommended that the Commission authorize a rate of return on common equity of 11.25%.

In its exceptions, Consumers requests that the Commission authorize a rate of return on common equity of 11.60%, to reflect the company's higher risk and to include flotation costs. Consumers argues that the evidence shows that Consumers has higher risk than: 1) the Staff's proxy group of companies; 2) Consumers' group of proxy companies; 3) the typical utility; and 4) Detroit Edison, whose authorized rate of return is 11%. *See*, November 23, 2004 order in Case

[9]Consumers' reply brief, p.15.

No. 13808. Consumers asserts that the ALJ erred in her conclusion that all of the added risks that Consumers identified were either risks that all utilities were facing or were risks associated with Consumers' parent company, and that even if this were correct, Consumers' downward adjustment in its proposed rate of return, from 12.75% to 11.60%, accounted for any risk that might be attributed to CMS.

In his exceptions, the Attorney General again urges the Commission to adopt a rate of return on common equity of 10.875% because, according to the Attorney General, there is insufficient evidence of Consumers' higher level of risk exclusive of the effects from its relationship with CMS. The Attorney General asserts that the Commission should not establish a regulated rate of return that reflects the results of unregulated, albeit affiliated organizations, such as CMS. Furthermore, the Attorney General reiterated that the Staff failed to make any explicit adjustments to risk analysis for several of the new regulatory proposals in this case.

The Commission concludes that Consumers' return on common equity should be set at 11.15%. The Commission finds that a return on equity of 11.15% is consistent with both the Staff's analyses and with the higher risk that Consumers and the Staff found for the company. While 11.15% is close to the high-end of the Staff's range, it is also within the range presented by Consumers' witnesses, without including flotation costs. Furthermore, this reduction recognizes the reduction in risk resulting from the new regulatory proposals approved in this case. The Commission also determines that an 11.15% return on equity is appropriate in light of the 44.21% equity ratio adopted above. The Commission is well aware of the interplay between a company's capital structure and return on equity and establishes an appropriate balance here.

The Commission also finds that the exclusion of flotation costs is appropriate. The Commission is persuaded that these costs are not costs incurred by the regulated utility. Consequently, it is not appropriate to include these costs in the calculation of Consumers' return on equity.

v. Cost Rates for Other Capital Structure Components

The cost rates for deferred income taxes and deferred investment tax credit, net of job development investment tax credit (JDTIC) are zero in both Consumers' and the Staff's capital structures. The cost rate for JDTIC is a function of the cost rates for other capital structure components. Because the Commission has adopted 11.15% as the rate of return on common equity, this rate is used in the calculation of the portion of JDTIC cost that is determined using the cost of common equity cost rate.

vi. Overall Rate of Return

Consumers' overall rate of return of 6.78% is calculated as shown on the following table:

Description	Amount	Ratio	Cost Rate	Weighted Cost
Short-Term Debt	90,232,000	1.10%	5.39%	0.06%
Long-Term Debt	3,725,420,000	45.28%	5.70%	2.58%
Preferred Stock	44,000,000	0.53%	4.46%	0.02%
Common Equity	2,987,559,000	36.31%	11.15%	4.05%
Def Investment				
Tax Credit	184,000	0.00%	0.00%	0.00%
Deferred FIT	1,308,911,000	15.91%	0.00%	0.00%
JDITC	70,930,000			
Long-Term Debt	39,106,832	0.48%	5.70%	0.03%
Preferred Stock	461,881	0.01%	4.46%	0.000%
Common Equity	31,361,287	0.38%	11.15%	0.04%
Total JDITC	70,930,000			0.070%
TOTAL	$8,227,236,000	100.00%		6.78%

4. Adjusted Net Operating Income

To determine whether there is a revenue deficiency, it is necessary to establish Consumers' adjusted NOI for the test year. Adjusted NOI constitutes the difference between a company's operating revenue and its operating expenses. Consumers originally calculated a projected 2006 NOI of $174,254,000. Consumers subsequently revised its projection to $173,632,000 due to changes in its requested overall rate of return. *See*, Exhibit A-137, p. 1, line 4. The Staff made several adjustments to Consumers' historical operating income, which were summarized in Exhibit S-3, Schedule C-1. These adjustments resulted in a jurisdictional adjusted 2006 operating income of $267,728,000. The Staff made additional adjustments in its brief and reply brief.

a. Base Tariff and PSCR Revenue

Consumers accepted the Staff's projected 2006 ROA sales level of 4,505 GWh, which is based upon the ROA sales level as of November 2004.[10] Consumers noted that several of its large customers have special contracts that expire on December 31, 2005 and projected that all but one of these special contract customers would remain full-service customers of Consumers instead of migrating to ROA.

The Staff disagreed with this part of Consumers' projection because the sales related to this special contract customer were not quantified, and because Consumers' rationale for the switch to ROA was very broad. The Staff argued that Consumers' projection was therefore speculative and beyond the known and measurable standard used for test-year estimates.

[10] While this figure is comparable to the proposals from other parties on the appropriate 2006 ROA sales load; Energy Michigan proposed 4,466 GWh (4 Tr 788), ABATE proposed 4,152 GWh (5 Tr 1296), and Kroger also supported use of 2004 ROA sales for the 2006 ROA sales load (6 Tr 1686), the Commission is mindful that the company's ROA sales levels are being affected by many factors and have been declining in recent months. Accordingly, the Commission intends to remain vigilant to ensure that any significant changes in ROA sales levels do not go uncorrected.

The Attorney General expressed concern that the Staff's approach failed to demonstrate that the projected PSCR expense was a reasonable and prudent amount related to projected sales and operations. The Attorney General argued that the approach "implicitly creates an over recovery or under recovery for the 2006 test year when compared with forecasts for PSCR plan case purposes." Attorney General's reply brief, p. 4. The Attorney General further claimed that the Staff's approach assumes that the current PSCR base remains appropriate for use in 2006, when it was set in Case No. U-10685 decided in 1996. Citing MCL 460.552, which requires the Commission to approve specific rates based on evidence, and MCL 460.57, which requires the filing of Commission-approved rates, the Attorney General concluded that there was no reason to rely on such outdated information and that the ALJ and the Commission should perform "a more reasonable and specific analysis of PSCR revenues and expenses to set those rates." Attorney General's reply brief, pp. 4-5

The ALJ agreed with the Staff that its projected sales and billing determinants were better supported and recommended that the Commission adopt the Staff's estimate of total jurisdictional electric operating revenue of $2,414,745,637. The ALJ observed that the only item of significant disagreement between Consumers and the Staff was the issue of whether one of Consumers' special contract customers would migrate to ROA. The ALJ agreed with the Staff that Consumers did not quantify the sales related to that customer and that Consumers' rationale for the switch was vague. The ALJ therefore agreed that Consumers' estimate of the effect of the loss of these sales was speculative.

The ALJ also found that the Attorney General's objections were without merit and that his suggestion that she or the Commission perform a more specific analysis of PSCR revenues and

expenses was unnecessary, in light of the fact that Consumers and the Staff had performed a thorough analysis of the issue. There were no exceptions to this recommendation.

The Commission agrees with the ALJ's findings and recommendations and therefore adopts $2,414,745,637 for total jurisdictional operating revenue.

b. Miscellaneous Revenue

The Staff made adjustments to miscellaneous revenue totaling $7,071,633. The Staff proposed an adjustment of $468,868 to include a portion of the gains on the disposition of property recognized upon its sale. The Staff takes the position that the net gains associated with the sale of property should be split between Consumers and its ratepayers on a 50-50 basis. The $468,868 adjustment would include half of the net gain on the sale of utility property in historical year revenues.

Two other adjustments to miscellaneous revenue proposed by the Staff were in the amounts of $1,936,420 and $102,089. These adjustments were made to include revenues received for trenching activities and for lab services that Consumers failed to include in its historical year revenues.

The Staff also proposed a $3,625,256 adjustment to include revenues received from contract work performed for Michigan Electric Transmission Company, LLC (METC) for maintenance performed by Consumers on METC's transmission system. The Staff argued that revenues paid under Consumers' contract with METC should be included in operating revenue because Consumers uses its employees to perform the work and because Consumers' transmission costs are recouped as part of its PSCR expense. By not including these revenues, the Staff argued that Consumers is able to make a profit performing an activity that was formerly an O&M expense.

The Staff asserted that unless this adjustment is adopted, Consumers approach will result in an unnecessary rate increase.

The Staff's final adjustment, in the amount of $939,000, was an adjustment to include the rate of return billed to other companies by Consumers. According to the responses to the Staff's audit requests, Consumers applies a loading rate of return on corporate assets to intercompany service work. This loading rate was increased in 2004 and was not reflected in the historical year. The $939,000 revenue increase would take into account this increase in the loading rate applied to intercompany service work.

Consumers did not contest these adjustments and the ALJ recommended that the Commission adopt the Staff's projections for miscellaneous revenue. No exceptions were filed. The Commission therefore adopts the Staff's adjustment of $7,071,633 for other revenue. In doing so, the Commission cautions that its approval of the $468,868 adjustment related to the 50-50 split of net gains on Consumers' sale of property is limited to this proceeding and should not be considered precedent for any other sale of property in any other proceeding.

c. Miscellaneous Service Charges

Consumers proposed increasing its non-sufficient funds (NSF) charges from $5.00 to $25.00 per returned check, an amount that would cover processing costs and that would provide a deterrent to customers who issue NSF checks. While the Staff supported some increase in NSF charges, it argued that the charge should be cost based. The Staff therefore proposed an increase in NSF charges to $15.00, which increases Consumers' revenue by $256,200.

The Staff agreed with Consumers' proposal to increase its on-premises bill collection charges from $5.00 to $10.00 and Consumers' proposed increase from $20.00 to $45.00 for service

restoration at the meter after shut-off. This resulted in an estimated revenue increase of $184,465 for on-premises bill collection and $1,178,650 for service restoration charges.

The Staff also agreed with Consumers' proposed increase from $25.00 to $80.00 for restoration at the point of connection after a shut-off. This would result in a projected revenue increase of $13,750.

The ALJ adopted the recommended total adjustment of $1,633,000 for NSF charges, on-premises bill collection charges, and service restoration. No exceptions were filed.

The Commission finds that under the current circumstances, where ratepayers are facing exceptionally high energy costs and low and fixed-income ratepayers are therefore particularly vulnerable to shut-offs, it is not reasonable to approve such a substantial increase in the charges associated with service restoration. The Commission therefore approves an increase in charges for service restoration at the meter from $20.00 to $35.00 and for service restoration at the point of connection from $25.00 to $50.00. Based on these approved charges, the Commission adopts $1,154,105 in revenue for total miscellaneous service charges.

d. PSCR Expense

Both the Staff and Consumers included incremental transmission expenses as part of their PSCR expense. In their replies and exceptions, the Attorney General and ABATE argued that transmission costs should not be included as part of PSCR costs, on grounds that the plain language of MCL 460.6j(1)(a) does not permit PSCR treatment for transmission costs within Consumers' service territory. The ALJ disagreed, noting that the argument regarding the propriety of including transmission costs as part of PSCR expense has been consistently rejected by the Commission and by the Court of Appeals in *Michigan Environmental Council* v *Public Service*

Comm, unpublished opinion per curiam of the Court of Appeals, decided May 11, 2004 (Docket Nos. 244354 and 246744).

As the Commission has repeatedly found, incremental transmission expenses are recoverable through the PSCR. The Commission therefore adopts the ALJ's recommendation of $1,004,177,637 for 2006 test year electric fuel and purchased power expense, which includes incremental transmission expense.[11]

e. Other Operations and Maintenance Expense

Consumers requested $719,393,000 for other O&M expense items, an increase of $82,174,000 over 2003 levels. The Staff, however, projected an increase of $5,795,000 in other O&M expenses from 2003 to 2006. Generally, the Staff started with 2003 expenditures and adjusted them for inflation. However, in some areas, the Staff recommended a total disallowance of the expenses, while in other areas it agreed with Consumers that additional amounts above inflation were necessary. The Staff's adjustments are shown in Exhibit S-3, Schedule C-6, page 1, lines 5 through 16 and Exhibit S-3, Schedule C-1, lines 14-18. Exhibit S-3, Schedule C-2, is a comparison of the Staff's and the company's O&M expense. Specific expense items are discussed *infra*.

[11]The total electric fuel and purchased power expense of $1,004,177,637 (Exhibit S-3 Schedule C-14) was derived by applying an average cost per Megawatt hour (MWh), $30.57, to the Staff's system sales (total sales less ROA sales). The $30.57 per MWh is the sum of the full PSCR base and factor in place in 2003. Consumers' PSCR base has not been updated for many years and the Commission believes that it should be to the extent the record provides. The PSCR base will now reflect the $30.57 per MWh referenced above. Setting that amount to generation level as provided in Rule B-17, results in a PSCR base of $.02814 per kWh, with the loss multiplier remaining at 1.086.

i. Corporate Services/Employee Incentive Compensation Plan

Consumers proposed an O&M expense level of $28,199,000 for corporate services related to the administrative function of the utility. Glenn P. Barba, Vice-President, Controller, and Chief Accounting Officer for both Consumers and CMS testified that this represented a $1,152,000 increase above the actual 2003 expense (3 Tr 623; Exhibit A-11).

The Staff recommended disallowances of the $8,781,000 expense for Consumers' employee incentive compensation plan (EICP), $872,000 for the supplemental executive retirement plan (SERP), $18,000 for the executive incentive separation plan (EISP), and a disallowance of $4,240,000 for stock options. William G. Aldrich, Manager of the Accounting and Auditing Section of the Commission's Regulated Energy Division, testified that the facts in this case are similar to those in Case No. U-13898 where the Commission found that Michigan Consolidated Gas Company (Mich Con) had failed to demonstrate the benefits of executive and non-executive bonuses to ratepayers and that the expenditures for other executive perquisites should be directed to improved service reliability and safety. Mr. Aldrich also observed that Consumers' executives are already compensated at a higher rate than executives working for other utilities, and that it would not be an undue hardship for Consumers to forego bonuses while the company is in the process of improving its financial position.

In rebuttal, John J. Kolewski, Consumers' Director of Compensation, testified that executive and non-executive bonuses were a part of its employee compensation plan and that these bonuses were necessary to attract and retain a qualified workforce. Mr. Kolewski testified that the incentive plan applied to all non-union workers, not just executives and officers. Mr. Kolewski noted that it was preferable to provide a portion of compensation through an incentive plan to motivate employees to provide improved performance and service.

Regarding Consumers' stock options, Mr. Kolewski testified that 20% of the company's stock options were awarded to non-officers and that the award of stock options represented not only financial compensation but served as a means of retaining employees. According to Mr. Kolewski, the SERP represents a common executive benefit structure designed to recognize certain provisions of the Internal Revenue Code relating to the amount of employee pay that can be considered in determining retirement benefits. Mr. Kolewski also claimed that the SERP was beneficial in attracting and retaining experienced employees. Finally, Mr. Kolewski testified that neither Consumers' employee incentive plan nor its executive perquisites were unusual in the utility industry and that the bonuses and incentives that Consumers offered were reasonable and should therefore be approved.

The ALJ agreed with the Staff's disallowances, noting that the "reasonableness" standard offered by Consumers was erroneous; the Commission requires that executive bonus and employee incentive plans show that the plan will benefit ratepayers and that the benefit to ratepayers from these programs will, at minimum, be commensurate with the cost. The ALJ also found that Consumers' EICP payments were substantially based on earnings and cash flow considerations, thus rewarding actions that more closely align employee behavior with shareholder interests rather than ratepayer interests.

In its exceptions, Consumers argues that the ALJ based her recommendation to disallow the expenditures on a standard – requiring a determination that benefits to ratepayers are commensurate with costs – that is "hopelessly subjective."[12] Moreover, Consumers argues that the total base salary plus EICP equals average market compensation and that the benefits to ratepayers from having competent employees provide utility services clearly outweigh the costs. Consumers

[12] Consumers' exceptions, p. 7.

further notes that a review of Consumers' staffing levels and overall administrative costs demonstrate that administrative costs are significantly less than those of similar utilities, as the Commission observed in an order issued October 18, 2005 in Case No. U-14666. Finally, Consumers argues that the benefit/cost determination adopted by the ALJ has never been affirmed by any court and that the proper inquiry is whether the incentive program is a reasonable cost of doing business. Consumers cites *Central Maine Power Co v Public Utilities Comm*, 405 A2d 153 (ME 1979) and *Montana-Dakota Utilities Co, Div of MDU Resources Group, Inc* v *Public Service Comm*, 413 NW2d 308 (ND 1987) for the proposition that issues concerning employee compensation should be deferred to the business judgment of the utility, unless there is evidence that the compensation expense is unwarranted, excessive, or made in bad faith. Consumers claims that the Commission thus should defer to the business judgment of the utility's managers on the issue of EICP payments because there is no evidence that the expenses are excessive, unwarranted, or made in bad faith. Therefore, Consumers requests that the Commission restore $8,781,000 for the EICP expense.

In its reply to Consumers' exceptions, the Staff notes that despite earnings in excess of its authorized rate of return on common equity in 2003, Consumers delayed needed maintenance at the expense, inconvenience, and safety of its customers in order to increase earnings and cash flow. Because bonuses are tied to earnings and cash flow, the Staff argues that shortchanging the customers by cutting back on maintenance resulted in increased bonuses to Consumers' executives and employees in 2003. The Staff also argues that in view of Consumers' failure to adequately maintain its power lines, Consumers' 2003 bonuses were excessive, unwarranted, an abuse of management discretion, and arguably an exercise of bad faith on Consumers' part. The Staff claims that before seeking recovery of bonuses and other executive perquisites in its rates,

Consumers must show that it is serious about improving service quality to its customers. Furthermore, the Staff observes that the Commission has previously disallowed bonuses on the basis of insufficient justification of benefits to customers. *See*, April 28, 2005 order in Case No. U-13898, pp. 19-22.

In Case Nos. U-10149 and U-10150, the Commission determined that executive bonus and employee incentive plans require a showing that the plan will not result in excessive rates and that the benefits to ratepayers from the bonus and incentive plans, at a minimum, will be commensurate with the programs' costs. Moreover, the utility has the burden of establishing how the proposed programs benefit ratepayers. The Staff argued, and the ALJ agreed, that the incentive or bonus plans proposed by Consumers are primarily designed to enhance shareholder value, not to create benefits to ratepayers.

The Commission agrees with the Staff and the ALJ that the cost of Consumers' incentive compensation plans should not be recovered in rates. Consumers failed to make the requisite showing that its bonus payments would provide benefits to ratepayers at least commensurate with their costs. Moreover, the Commission finds that *Central Maine Power Co* and *Montana-Dakota Utilities Co* are inapposite because they involved employee discounts for natural gas service provided in lieu of a portion of base compensation, and these discounts were not tied to employee performance. Although Consumers characterizes its EICP as part of its overall compensation package, it is clear that these payments are significantly related to improving the company's bottom line. The benefits of improved employee performance because of Consumers' incentive programs accrue to investors in the form of higher share prices and dividends but benefit ratepayers only tangentially. Furthermore, while the Commission does defer to the business judgment of the utility, "this policy does not mean that the utility's business judgment should be insulated

from review or that the utility cannot be held to account" for its actions. *See* March 11, 1996 order in Case No. U-10755, p. 38. Specifically, it is within the Commission's discretion to determine whether particular costs, to be covered by ratepayers, are reasonable and prudent. *See*, *Consumers Power Co* v *Public Service Comm*, 226 Mich App 12, 25; 572 NW2d 222 (1997).

Finally, the Commission notes that a decision to disallow recovery of a particular cost is not tantamount to invasion of a utility's management prerogative. If Consumers wishes to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it may do so. However, the shareholders that benefit from the plan should pay the costs of the plan. The Commission therefore adopts the ALJ's disallowance of $13,911,000 for expenses associated with Consumers' EICP, SERP, EISP, and stock options.

ii. Savings Plan Match

Consumers requested $6,371,000 to fund a 3% match to its 401(k) retirement savings program. Although the Staff did not specifically disallow the expenditure, it reduced the cost of the program to $111,000 – the 2003 level of expense adjusted for inflation. The Staff objected to the resumption of the retirement savings program on grounds that the program is discretionary, as demonstrated by the fact that Consumers suspended its previous 401(k) match program in 2003 and 2004. According to the Staff, this allowed Consumers to generate higher income and cash flow, and therefore higher bonuses, in 2003 and 2004. In the Staff's view, there is no assurance that Consumers will not again suspend the program to improve its cash flow and income.

The Staff also noted that the defined contribution program that Consumers proposed to reinstate was in addition to the comprehensive defined benefit pension plan and company-paid life insurance that already provide for the retirement needs of Consumers' employees. The Staff

further observed that many of Consumers' ratepayers have neither a defined contribution nor a defined benefits retirement plan.

In response, Consumers argued that while its current employees are covered by a defined benefits plan, the plan is not designed to fully provide employees with a financially secure retirement and that the pension plan is only part of an overall package that includes a savings plan, a savings plan match, and a pension plan. Moreover, Consumers testified that under a recent collective bargaining agreement with union employees, the matching plan is not discretionary; Consumers is bound to pay the matching funds to union workers until 2010.

The ALJ found Consumers' plan to be reasonable and rejected the Staff's disallowance. The ALJ observed that unlike Consumers' proposed incentive compensation plans, which are tied to shareholder value, the 401(k) matching plan simply encourages employees to save more of their own money for retirement by providing for a corporate match.

In its exceptions, the Staff reiterates its objection to reinstating the savings plan match because Consumers suspended the matching payments in 2003 in order to pay higher executive bonuses. The Staff argues that by shifting the funds from this program, Consumers demonstrated that the savings plan match has an even lower spending priority than the bonuses that were disallowed by the ALJ. The Staff concludes that its proposed rates have provided Consumers with projected revenues that are sufficient to afford reasonable levels of compensation to Consumers' executives and employees. The Staff strongly objects to reinstating the savings plan because of the possibility that Consumers will suspend the program again in the future.

The Commission finds that the Staff's objections have merit and should be recognized. Despite the purportedly "severe financial hardships" experienced by Consumers in recent years, Consumers' electric operations have continued to achieve earnings at or above its authorized

return on common equity. Furthermore, Consumers has continued to pay bonuses to its executives and employees and provided for a time an additional employee benefit program. However, to maintain its earnings at high levels and to fund employee bonuses and benefits, Consumers has sacrificed the safety and reliability of service to its customers by drastically reducing forestry expenditures, thereby increasing customer exposure to downed power lines and lengthy interruptions of service.

The Commission agrees with the Staff that Consumers must first redirect its focus to customer service. The rate increase approved in this case will provide Consumers with projected revenues that are sufficient to improve the service to its customers, and provide reasonable levels of compensation to Consumers' executives and employees. If Consumers uses the rate increase to improve its service to customers, and still requires additional revenues to improve its executive and employee compensation, it is certainly entitled to file for additional rate relief. However, until Consumers provides a showing of improvement in customer service, the expense of discretionary payments to executives and employees, if made, should be borne by Consumers, and not by its ratepayers.

iii. Healthcare and Other Active Employee Benefits

Consumers calculated a 2006 electric expense for active employee healthcare, life insurance and long-term disability benefit programs of $36,511,000. Exhibit A-36. The development of this expense was described by Herbert B. Kops, Director of Employee Benefits for Consumers. According to Mr. Kops, the primary component of this expense category is healthcare. Mr. Kops further testified that healthcare costs have been rising rapidly and are expected to continue to increase. He testified that cost increases continue to significantly outpace inflation despite measures instituted by Consumers to control healthcare costs. Based on his analysis of healthcare

costs, Mr. Kops concluded that Consumers' 2005 healthcare expenses will be 10% greater than the expected 2004 expenses and 2006 healthcare expenses will be 10% greater than in 2005. He concluded that expenses for life insurance and long-term disability would increase at a more modest annual rate of 4%. 3 Tr 594-597.

The Staff initially proposed the use of a 2006 expense for active employee healthcare, life insurance, and long-term disability of $27,752,000, which is $8,759,000 million less than the level calculated by Consumers. The Staff developed its calculation by applying general inflation rates (e.g., 2.2-2.68%) to actual 2003 expense levels.

The Staff argued that Consumers misunderstood the nature of the Staff's O&M inflation adjustment, which serves as an overall allowance to defray expected cost increases, and not an increase that will exactly cover each component of O&M expense. According to the Staff, some O&M expenses will increase at a higher rate than the Staff's inflation allowance, and some O&M expenses will increase at a lower rate or may even decrease due to productivity increases or cost reductions. With the offsetting effects of lower than average increases for some O&M expense components and productivity increases, the Staff maintained that there is no need, nor would it be appropriate, to provide additional revenues for every component of O&M expense that is expected to increase at a higher than average rate.

Moreover, the Staff argued that Consumers' projected 10% annual inflation/trend rate used to adjust its 2003 actual healthcare expenses to 2006 levels was inappropriate because less than one-half of that increase is due to inflation in healthcare costs; the remainder of the projected increase is tied to increased use of services. Consumers discussed measures that it had taken in 2002 and 2003 to control its healthcare expenses; however, its projections of 2006 costs do not include any similar measures in 2004 through 2006. The Staff expressed its belief that it is reasonable to

expect that Consumers will take further actions to reduce healthcare costs, especially because Consumers' projected cost increases can be reduced by more than 50% while still providing its employees with the same level of services that they received in 2003. Thus, Consumers' request for increases in active healthcare costs above inflationary increases should be denied by the Commission.

Ralph Smith, a senior regulatory consultant retained by the Attorney General, also disagreed with Consumers' estimate and noted that Consumers' 2004 actual expenditure for healthcare was approximately 13% less than its projected expenditure. Mr. Smith testified that based on his calculations, using 2004 as the base year and a 9.8% annual increase, the company's projection for active and retired employees' insurance expense should be reduced by $5,192,000. 7 Tr 2097-2099.

The ALJ agreed with Consumers that the Staff's approximately 2-3% increase for costs that are increasing at a rate that is demonstrably higher was unreasonable and adopted Consumers' projection of $36,511,000 for healthcare and other active employee benefits.

The Staff objected, noting that it presented evidence in this case that demonstrates that medical care inflation, while somewhat higher than the overall inflation rate, is still only 4.3%. Moreover, the Staff argued that Consumers' 10% escalation factor includes a medical care inflation rate of 4.3% plus the projected and assumed increase in usage of services by Consumers' employees, based on trends from prior periods. The Staff claims that such an assumption of increased use of services by Consumers' employees goes beyond the realm of "known and measurable" expense increases into the realm of "predicted by trend-line analysis" expense increases. The Staff concludes that it simply is not known that Consumers' employees will use more medical care services in 2006 than they did in 2003, and demonstration of past trends does

not prove that the trend will continue into the future. Moreover, the Staff claims that Consumers has far more control over the increased use of medical care services by its employees than it does over medical care inflation rates, because Consumers has substantial input into the nature of the services provided under its healthcare plan.

In its reply, Consumers asserts that contrary to the Staff's claim, the utility has in fact taken a number of steps to limit healthcare cost increases including: 1) increased mail order prescription drug co-pays; 2) a restructuring of the method for coordinating benefits when other insurance coverage also applies; 3) revision of HMO benefits to increase participant costs; 4) the requirement that employees pay a portion of the increase in monthly premium costs; 5) increases in deductibles and out-of-pocket limits; and 5) the introduction of a flexible benefits program that increased employee premium contributions.

The Commission disagrees with the Staff and the Attorney General and finds that Consumers' projection for healthcare costs is not overstated. There was ample testimony regarding the fact that healthcare expenses are increasing above ordinary inflation. Thus, the Commission agrees that the use of overall inflation rates of 2-3% to calculate projected healthcare costs is unrealistic. Moreover, the Commission observes that in Case Nos. U-13730 and U-13898, the Commission approved increases in healthcare expenses substantially above the ordinary inflation rate. The Commission therefore accepts the ALJ's recommendation of a 10% increase per year for healthcare costs and adopts $36,511,000 for healthcare and other active employee benefits expenses. The Commission cautions, however, that Consumers must continue to do everything possible to contain healthcare costs. In the future, if the Commission finds that Consumers has not made reasonable efforts toward controlling costs, such sizable increases in healthcare expenses may not be approved.

iv. Injuries and Damages

Consumers estimated $8,504,000 for injuries and damages, which was $2,283,000 less that the 2003 actual expense. The Staff proposed a downward adjustment to $7,956,000 and Consumers accepted this recommendation. The ALJ adopted the agreed upon estimate. The Commission therefore approves $7,956,000 for injuries and damages expenses.

v. Pension Expense and OPEB Expense

Consumers developed its 2006 pension expense of $33,120,000 and and OPEB level of $28,344,000 using actuarial analysis performed in accordance with Statements of Financial Accounting Standards Nos. 87 and 106. The required calculations were performed by Consumers' outside actuary and reviewed by the company's outside auditors. The Staff accepted the company's pension and OPEB expense calculations and the ALJ recommended that the Commission adopt Consumers' calculation of these expenses. There were no exceptions filed. The Commission therefore adopts $33,120,000 for pension and $28,344,000 for OPEB expenses.

vi. Pension Equalization Mechanism

Consumers proposed that the Commission adopt both a pension equalization mechanism and an OPEB equalization mechanism. Consumers argued that these expenses are highly sensitive to changes in interest rates and asset returns and, consequently, that there is a significant potential for large variability in these expenses that should be tracked. Consumers contends that the volatility of these particular costs is well beyond the typical variability that exists for most cost of service items.

Under Consumers' proposal, if actual pension (or OPEB) expenses are greater than the expense amount set in rates, this difference would be recognized as a regulatory asset for future

recovery. If actual expenses are less, the company will recognize a regulatory liability for distribution to customers. If pension (or OPEB) expenses should ever become negative, a zero cost would be reflected and a regulatory liability recorded until pension (or OPEB) expenses became positive. Any negative amount would be carried forward into the next period. According to Consumers, this treatment is necessary because should pension (or OPEB) expenses become negative, the company would not be able to extract cash from the pension plan to fund a rate reduction. The company proposes that reconciliations occur in conjunction with the annual PSCR reconciliations. The Staff supported the company's proposal, noting that the company's proposal is consistent with the pension equalizations mechanisms approved for Detroit Edison in Case No. U-13808. The ALJ likewise observed that the Commission has adopted similar mechanisms for other utilities[13] and recommended the adoption of the proposed pension equalization mechanism here.

ABATE and the Attorney General took exception to this recommendation. They argue that there is no statutory authority for these mechanisms and, therefore, the Commission lacks the power to adopt them. Both parties point out that while various statutes allow for adjustment mechanisms in other contexts, there is no similar provision for pension or OPEB equalization mechanisms.

ABATE further argues that the ALJ failed to recognize that Consumers' return on equity should reflect the reduction of risk which results from the adoption of these mechanisms.[14] The Attorney General argues that these mechanisms create a disincentive to minimize these costs.

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[13] *See,* November 23, 2004 order in Case No. U-13808, pp. 55-57 and April 28, 2005 order in Case No. U-13898, pp. 30-32.

[14] This argument is moot. The Commission did recognize the risk reduction resulting from the adoption of pension and OPEB equalization mechanisms. *See*, pp. 23, *supra.*

Consumers and the Staff respond that adoption of these mechanisms is well within the broad ratemaking powers of the Commission.

The Commission is not persuaded that adoption of these equalization mechanisms, which are designed to ensure that, to the extent possible, rates match expenses, is beyond the Commission's ratemaking powers. *See,* MCL 460.6, 460.6a. The argument that the Commission's statutory authority is silent on this matter is without merit. Almost none of the key aspects of rate regulation are mentioned in the statutes that empower the Commission to set utility rates. For example, there are no provisions authorizing the Commission to determine the utility's rate base or its rate of return on common equity. Giving any credence to the myopic vision of the Commission's authority to set rates, as espoused by the Attorney General and ABATE, would unduly impair the Commission's primary function of determining just and reasonable rates. Therefore, the Commission agrees with the ALJ and adopts the proposed pension and OPEB equalization mechanisms. The Commission further finds that at this time, the equalization mechanism approach represents a reasonable means of protecting both customers and the utility from the volatility inherent in these expense items, and is a satisfactory way to ensure that the utility's pension plan is funded in accordance with the level of pension expense recognized in rates. However, the Commission also finds that these equalization mechanisms should be reviewed again in Consumers' next rate case.

vii. Low Income Energy Efficiency Fund

Consumers proposed a 2006 LIEEF contribution of $15,000,000. The Staff supported Consumers' proposal but recommended contributing a larger amount, a sum equal to 2% of total industrial and commercial revenues. The amount recommended by the Staff, to which Consumers agreed, totaled $26,536,000.

The Attorney General noted that he supported the concept of funding the LIEEF, but claimed that the funding mechanism proposed by Consumers and the Staff was not authorized by any statute and was in fact inconsistent with MCL 460.10d(7), which provides for contributions to the LIEEF, but only if a utility has excess securitization savings. The Attorney General claimed that unlike Detroit Edison in Case No. U-13808, Consumers does not have excess securitizion savings that could be allocated to the LIEEF for six years.

The ALJ rejected the Attorney General's argument on grounds that the Commission's order in Case No. U-13808 permitted the funding of the LIEEF through cost of service. The ALJ further observed that upon issuance of interim relief in Case No. U-13808, the Commission found there would be no excess securitization savings to fund the LIEEF program and that in order for the program to continue it would have to be funded through cost of service. In its exceptions, ABATE objects on essentially the same grounds that the Attorney General did, namely that there is no statutory authority for funding the LIEEF by adding the costs of the program to Consumers' cost of service.

The Commission agrees with the Staff, Consumers, and the ALJ, that the LIEEF may be funded through Consumers' base O&M expense and ultimately recovered from customers. There is nothing in Section 10d(7) that restricts the means by which the Commission may finance the LIEEF; Section 10d(7) merely requires that if excess securitization savings are achieved these funds "shall be allocated" to the LIEEF administered by the Commission. The statute does not provide that no other revenue sources may be allocated to the LIEEF. The Legislature's intent in enacting MCL 460.10d was to have the Commission undertake a broad approach to funding and administering low-income and energy efficiency programs. For example, MCL 460.10s requires the Commission to monitor the extent to which federal funds are available for low-income and

energy assistance programs and, if there is a reduction in federal funds, to hold a hearing to determine the amount of funds available and the need for supplemental funding. Section 10s thus expresses the Legislature's intent that the Commission take the necessary steps to assure that low-income and energy efficiency funds are available.

The Commission notes that the circumstances here, where the utility voluntarily offered to include contributions to the LIEEF as part of its operations expenses, are analogous to those in *The Detroit Edison Co* v *Public Service Comm*, 127 Mich App 499; 342 NW2d 273 (1983) where the Court of Appeals held that it was within the Commission's discretion to allow or disallow operating expense items for charitable contributions. *Id*. at 524. In *Detroit Edison*, the court affirmed the Commission's disallowance of Detroit Edison's recovery from ratepayers of charitable contributions to educational institutions but permitted recovery of a contribution to a local nonprofit on grounds that the Commission had expressed a rational basis for allowing some charitable contributions and disallowing others. Thus, if Consumers chose to contribute directly to certain nonprofits engaged in providing energy assistance to low and fixed-income customers, it would clearly be within the Commission's discretion to permit such expenditures as part of the utility's operating costs. Although the LIEEF is not a nonprofit organization, it does serve as a grant-making entity for passing funds to nonprofit entities for use in subsidizing energy costs or costs for improved energy efficiency for low-income residents. The Commission also observes that contributions to the LIEEF are beneficial to ratepayers because the LIEEF is an appropriate means to reduce bad debt and uncollectible accounts, the costs of which ratepayers must already assume. The Commission therefore adopts $26,536,000 for funding the LIEEF.

viii. Lease Changes and Removal of Blackout Related Expenses

The Staff disallowed $773,000 for leases and $137,000 for blackout expenses on grounds that these were non-recurring expenses. Consumers accepted the Staff's reductions, and the ALJ recommended that the disallowance be adopted by the Commission. There were no exceptions filed, and the Commission agrees that the disallowance for lease changes and blackout related expenses should be adopted.

ix. Governmental and Public Affairs Expenses

The Staff proposed a $70,000 disallowance of Consumers costs for "government and public affairs related expenses" on grounds that the Commission supports disallowance of such expenditures as part of jurisdictional expenses. *See,* December 22, 1988 order in Case No. U-8812, pp. 26-29. Consumers objected, arguing that the Staff offered no support for the recommended disallowance beyond its observation that in a prior case the Commission disallowed costs "related to lobbying." Consumers claimed that there is no explanation of the factual situation in Case No. U-8812 that led to the disallowance nor any justification for a general disallowance of all lobbying expenses.

The ALJ rejected Consumers' argument and adopted the Staff's disallowance of the expense. There were no exceptions to this recommendation. The Commission agrees with the Staff and ALJ's position that governmental and public affairs expenses should be disallowed.

x. Risk Management/Corporate Insurance Expense

Consumers proposed a cost of $15,084,000 for risk management and corporate insurance expenses. The Staff proposed $13,566,000 and the Attorney General recommended a reduction of $1,685,000 in Consumers' estimate. Consumers accepted the Staff's reduction and the ALJ

recommended adoption of the Staff's revised estimate. The Commission therefore adopts the ALJ's recommendation of $13,566,000 for risk management and corporate insurance expenses.

xi. Other Customer Operations O&M Expense

Consumers requested increases in other customer operations expense in excess of inflation. Robert J. Jocis, Manager of Customer Service for Consumers, testified regarding O&M expense related to customer service, revenue recovery, business customer operations, strategy and revenue cycle services, and business support. Mr. Jocis reported that the actual expenditures for 2003 in these categories totaled $44,239,000. 5 Tr 1500; Exhibit A-31, line 6. Consumers adjusted these expenditures using inflation rates of 1.3%-1.5% to arrive at a 2006 subtotal of $46,123,000.

However, Mr. Jocis identified several items that he claimed will experience increases above inflation. *See*, Exhibit A-31, lines 13-19. Mr. Jocis claimed that the above-inflation increases represent additional costs incurred to assure compliance with the performance standards adopted by the Commission in Case No. U-12270. According to Mr. Jocis, the most substantial of these items is the cost of the additional personnel needed to assure that the meter-read performance standard is attained. Mr. Jocis claimed that compliance with the performance standards will require additional full time personnel, system changes, and software enhancements to facilitate the processing, tracking, and payment of customer outage credit applications. Mr. Jocis testified that this will result in an increased cost of $567,000.

In addition, Mr. Jocis testified that there will be additional expenses, totaling $618,000, incurred as a result of an increased number of customer contacts. Mr. Jocis claimed that Consumers has averaged an annual 3.4% electric customer contact volume increase over the past ten years. According to Mr. Jocis, current economic conditions and increased electric consumption will almost certainly cause even higher customer contact volumes due to credit issues

and questions regarding electric bills. Mr. Jocis asserted that while the 2006 average cost per customer contact is projected to decline from 2003, the increased volume of customer contacts will result in an increased expense in 2006 over 2003 actual expense.

Mr. Jocis further testified that Consumers will incur higher costs, totaling $200,000, for additional employees hired in 2004 to improve third party billings and collections. Mr. Jocis calculated that the annual salaries and associated expenses for these additional employees total $200,000. Mr. Jocis testified that additional personnel will also be required in the revenue recovery area to provide assistance in the management of theft, fraud, and bad debt write-offs. According to Mr. Jocis, the cost associated with this item was $61,000.

For the 2006 test year, Consumers calculated a total of $47,905,000 for other customer operations O&M, an amount that exceeded the amount calculated by the Staff's estimate by $3,456,000. Consumers claims that the difference is a result of the method used by the Staff that ignores actual workload requirements.

The Staff based its analysis on actual 2003 figures and adjusted these figures for inflation increases of 2.2%-2.68%. The Staff's total for other customer operations O&M was $44,449,000. The Staff argued that Consumers misunderstood the nature of its O&M inflation adjustment, which serves as an overall allowance to defray expected cost increases, and not an increase that will exactly cover each component of O&M expense. According to the Staff, some O&M expenses will likely increase at a higher rate than the Staff's inflation allowance, and some O&M expenses will increase at a lower rate, or may even decrease due to productivity increases or cost reductions. According to the Staff, considering the offsetting effects of lower than average increases for some O&M expense components and productivity increases, there is no need to

provide additional revenues for every component of O&M expense that is expected to increase at a higher than average rate.

The Staff further argued that Consumers ignored the offsetting increase in revenues that would result from increased on-premises collection calls. The Staff observed that Consumers is currently allowed to charge customers $5 for each on-premises collection call and that the Staff has recommended that the on-premises collection call charge be increased to $10. Because the Staff has based its on-premises collection call revenue on the 2003 number of calls, then any increase in on-premises collection calls will generate additional revenues above the level of revenues assumed in the Staff's case, thereby offsetting any incurred increase in O&M expenses. Finally, regarding increases in O&M expenses for postage due to the increase in the numbers of customers, the Staff's case has not recognized the additional revenues that would be generated by new customers. Because, revenues from additional customers will be available to defray all of the cost increases caused by new customers, including increased costs of postage, the Staff recommended that the Commission deny Consumers' request for recovery of additional other customer operations expense in excess of inflationary increases.

One specific item that contributes significantly to the differences in the parties' positions is the variation in the methods used to calculate uncollectibles expenses. In its calculation, the Staff subtracted the uncollectibles expense from the 2003 starting point and then adjusted the remaining expense by inflation only. The Staff then used a three-year average (2001-2003) to determine the level of uncollectibles expense to include in the cost of service. The difference between Consumers' proposed inflation-adjusted uncollectibles amount and the three-year average recommended by the Staff is $563,000. Consumers maintains that the Staff's approach results in a significant understatement of the actual cost of uncollectibles.

The Staff responded that Consumers' view that the use of a three-year average materially understates the uncollectibles expense in 2006 is refuted by the record. The Staff pointed out that Consumers' booked uncollectibles expense for 2004 was $1,139,657 less than the uncollectibles expense booked for 2003. *See*, Exhibits S-28 and S-31. According to the Staff, the $563,000 difference between the company's proposed inflation-adjusted uncollectibles amount and the Staff's three-year average amount is dwarfed by the actual $1,139,657 decrease from 2003 to 2004 in its actual booked uncollectibles.

Furthermore, the Staff argued that the 2003 booked uncollectibles expense was an estimate of future exposure to uncollectible account write-offs. The Staff submits that Consumers' 2003 estimate appeared to have been overstated. According to the Staff, actual write-offs for 2003 and 2004 were $6,858,000 (Exhibit S-31) and $6,790,568 (Exhibit S-27), respectively. The Staff states that the actual amounts are far closer to the Staff's uncollectibles calculation of $6,586,000 than to Consumers' calculation of $9,038,963 plus inflation.

The ALJ agreed that the Staff's overall method for calculating other customer operations O&M expense was preferable to Consumers' approach. She further found that the Staff's evidence demonstrated that uncollectibles expenses were not understated, as Consumers maintained, and that therefore the Staff's method for calculating uncollectibles expense adjustment should be adopted.

In its exceptions, Consumers argues that the net effect of the Staff's calculation of the customer operations O&M expense increases the company's 2006 expense by only $210,000 over the 2003 base year. In addition to seriously underestimating uncollectibles, Consumers asserts that the Staff's approach fails to recognize the increased costs due to the performance standards, increased customer contacts, and increased theft/fraud/bad debt costs.

Consumers further argues that given the current state of the economy, it is unreasonable to rely on 2001-2003 data to develop 2006 costs. More importantly, Consumers claims that it is unlikely to be able to meet the new performance standards if it spends only the amounts recommended by the Staff. Consumers points to the fact that there has been a marked increase in the level of customer contacts inquiring about payment arrangements. Moreover, Consumers claims that in 2004, its Customer Service Department handled 13% more electric contacts than in 2003, and that by May 2005, there was already a 6% increase over the same period in 2004. Consumers concludes that the response-time feature of the performance standards requires more resources to handle the increased number of contacts as does the necessity to hire additional meter readers to assure compliance with the meter-read performance standards. Consumers urges the Commission to adopt its recommendation of $47,905,000 for other customer O&M expenses.

In its reply, the Staff reiterates that it disagrees with Consumers' argument that its 2006 O&M expense should be increased by $3,456,000 for increases to its Customer Operations Department in excess of inflationary increases. The Staff observes that Consumers simply repeats its previous arguments that were rejected by the ALJ, fails to address the conclusions reached by the ALJ, and fails to present any argument that demonstrates error by the ALJ on this issue.

The Commission likewise finds no error in the ALJ's findings. The Commission is particularly persuaded by the Staff's rationale for using, to the extent possible, actual revenue and expense values adjusted for inflation. As the Staff and the Commission recognize, some costs will increase above the rate of inflation but these costs will be offset by costs that increase below inflation, or even decrease due to increased productivity. As the Commission has consistently found, this approach provides the advantage of beginning with actual numbers, with no need to

speculate about the levels of revenues and expenses. Furthermore, the use of projected numbers, as Consumers proposes to do here, tends to be more speculative and difficult to verify.

Nevertheless, the Commission recognizes that for certain cost categories, the projected increases or decreases are substantial, reasonably expected to occur, and largely beyond the control of Consumers. For these few cost categories, the Staff and the ALJ recommended that estimated 2006 expenses be recognized. However, the Commission is not persuaded that Consumers has made the requisite showing that above-inflationary costs for other customer O&M are substantial, reasonably expected to occur, and beyond the control of the utility.

The Commission also finds that the Staff's method for calculating uncollectibles expenses, by using a three-year average, is reasonable. Consumers' evidence for 2003 and 2004 shows that uncollectible expenses can be extremely unpredictable, and the Commission has traditionally used an averaging method for volatile items. Although the Commission has typically used a five-year average for uncollectible expense, the Staff departed from this method in order to better reflect current economic conditions. Indeed, the Staff determined that the first two years of the traditional five-year average for uncollectible expense were not representative of current economic conditions because those two years had an unusually low allowance for uncollectible expense. Therefore, the Staff excluded those years from its average.

The Commission therefore adopts the recommendation of the Staff and the ALJ of $44,449,000 for other customer operations O&M expense.

xii. Electric Systems Operations O&M Expense

Forestry Expense

Consumers has exhibited a deteriorating trend with regard to customer outage minutes, which the company blames primarily on its poor performance with regard to tree trimming and line-

clearing activities. 2 Tr 92-93. Consumers offered evidence that "reliability has deteriorated over the past several years, is worse than national averages, and needs to be addressed." 2 Tr 112. Consumers indicates that it had allowed reliability to deteriorate because, during the rate freeze, the company could no longer afford to absorb the labor, materials, and other costs associated with maintaining the target 150 minute outage average. The evidence shows that Consumers cleared 5,531 miles of line in 2000, but only 1,618 miles of line in 2004. 7 Tr 2102; Exhibits AG-18, AG-19. Consumers proposes to spend approximately $46 million on forestry activities in 2006, which represents a substantial increase from prior years and exceeds 2003 adjusted levels. Exhibit A-49, p. 3, line 3.

The Staff supported this proposal, arguing that Consumers' line clearance expenditures, in recent years, have been below the level necessary for sustained reliability. The Staff contended that Consumers needs to commit to this level of expenditure in order to achieve its stated goal of an average annual outage duration of 150 minutes per customer (excluding catastrophic storms). Consumers indicates that outage minutes have "exceeded the 150-minute standard by significant amounts." 2 Tr 90. Consumers proposes to increase line-clearing in 2006 to 9,700 miles annually.

The Staff supports recovery of the full amount, subject to refunding any portion that is not spent on line clearance, with an annual true-up. The Staff recommended adoption of a tracking/refunding mechanism, wherein Consumers shall agree to file an annual report, no later than 120 days after year-end, beginning with the 2006 calendar year, including for all distribution lines, at a minimum: (1) total line clearance expenditures in dollars; (2) length of line cleared to company specifications in miles; (3) number of line clearance crews used; (4) number of trees

removed; (5) number of trees trimmed; and (6) average annual outage duration per customer in minutes.[15]

The Attorney General objected to Consumers' proposal as a reward for Consumers' failure to spend the amounts previously authorized for this work. The Attorney General presented evidence supporting an allocation of approximately $28.3 million, and provided testimony indicating that the $46 million requested by Consumers is unrealistically high.

The ALJ, finding that the proposed amount is needed in this area to reverse the deteriorating trend in outage minutes, recommended that the full $46 million forestry expense be approved subject to the annual tracking/refunding mechanism proposed by the Staff.

In its exceptions, Consumers continues to request that it track these expenses every two years rather than annually. In response to the Attorney General's assertion that the Commission lacks the legal authority to order Consumers to track these costs in this way, Consumers offers, in its replies to exceptions, to waive any objections to such mechanisms based on their lawfulness.

The Commission agrees with the ALJ's finding that the company's tree trimming and line clearance programs have been unsatisfactory in recent years. As discussed previously, in the past few years, Consumers has sacrificed necessary expenditures for tree trimming and line maintenance so that the company could increase its cash flow and fund employee bonuses. Thus, the Commission further finds that funds for this program should be closely monitored through annual reporting. However, the Commission declines to authorize the total amount requested by Consumers for 2006. Exhibit A-49, p. 3, line 3, shows that Consumers spent approximately $16 million on forestry activities in 2003, $14.3 million in 2004 and 2005, and proposes to spend $46 million in 2006. This is an increase of approximately $31.7 million from 2005 to 2006. The

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[15]Consumers did not object to the Staff's proposal that this tracking mechanism be adopted, but requested that the report be filed every two years rather than annually.

Commission does not believe that Consumers can prudently spend in 2006 an amount that is more than triple[16] the amount that it spent in 2005 on forestry activities, nor does the Commission believe that Consumers can reliably direct an effort to clear 9,700 miles of line after clearing only 1,600 miles as recently as 2004. The Commission therefore approves $28.3 million for forestry activities in 2006. This amount, which was recommended by the Attorney General, represents approximately double the amount expended in 2005 of $14,324,000. With this allowance, the Commission expects to see an improvement in reliability, translated into fewer average annual outage minutes per customer.

The Commission also orders that this funding is subject to the annual reporting requirement proposed by the Staff and recommended by the ALJ and is subject to refund if not spent. Furthermore, the Commission's authorization of this amount for forestry expenses is conditioned upon a binding commitment from Consumers that the funds will be used solely for forestry and line clearing activities and an explicit waiver of its right to object to the refund provision on grounds of retroactive ratemaking. Forestry and tree-trimming expenditures will be reevaluated in the rate case Consumers is ordered to file in 2008.

Electric System O&M Expenses—Other Expenses

Consumers provided testimony concerning other O&M expenses for programs, in addition to tree-trimming, that it claimed were necessary to support the utility's efforts to ensure that customers receive reliable electric service. These programs address O&M of low voltage distribution and high voltage distribution lines and substations, the expenses needed for protective relays, and farm services programs. These programs also include expenses incurred in outage restoration

[16]Responses to discovery indicate that Consumers expected to spend a revised amount of about $22 million in 2005. Exhibit AG-20. Even if this is the case, the Commission declines to authorize Consumers to recover more than double that amount for forestry activities in 2006.

efforts and construction activities, engineering and operational support activities, and O&M expenses incurred to support new or enhanced computer hardware and software infrastructure needed to manage the Company's distribution system. Exhibit A-48 shows the O&M expense levels for the various programs that Consumers indicated were necessary in order to make progress on this goal. Consumers requested $55,194,000 for reliability, $47,478,000 for demand maintenance, $421,000 for O&M associated with construction, $1,4735,000 for distribution system services, and $1,543,000 IT projects.

The Staff disagreed with Consumers' above inflation increases for these items and proposed limiting other electric distribution O&M expenses to their 2003 levels adjusted for inflation. Accordingly, the Staff recommended $52,397,000 for reliability, $43,002,000 for demand maintenance, a decrease of $842,000 for O&M associated with construction, $13,638,000 for distribution systems services, and $106,000 for IT projects. Overall, the Staff's projection was approximately $11,000,000 less than that proposed by Consumers. *See*, Exhibit S-3, Schedule C-2 lines 16-21.

The Staff again argued that Consumers misunderstood the nature of its O&M inflation adjustment, which the Staff claimed serves as an overall allowance to defray expected cost increases, not as an increase that will exactly cover each component of O&M expense. According to the Staff, some O&M expenses will increase at a higher rate than the Staff's inflation allowance, and some O&M expenses will increase at a lower rate, or may even decrease due to productivity increases or cost reductions. The Staff concludes that with the offsetting effects of lower than average increases for some O&M expense components, and productivity increases, there is no need, nor would it be appropriate, to provide additional revenues for every component of O&M expense that is expected to increase at a higher than average rate.

The ALJ concurred with the Staff's position and recommended $108,301,000 for other electric systems operation expenses.

In its exceptions, Consumers argues that it will be impossible for it to meet the system availability interruption duration index (SAIDI)[17] if expenditures in these categories are held to the levels proposed by the Staff. Consumers particularly objects to the Staff's argument that Consumers needed to appropriately budget its costs to assure that necessary O&M expenditures are made, and that if costs are higher than anticipated, Consumers can request further rate increases in the future. Consumers argues that the Staff's position is "unlawful, unfair, and unreasonable"[18] on grounds that under *General Telephone Co* v *Public Service Comm*, 341 Mich 620; 67 NW2d 882 (1954), the Commission is required to consider factors that will affect utility operations in the future. Consumers maintains that the utility can only spend the resources it has available and cannot be expected to make expenditures and then request reimbursement in a future rate case. Consumers therefore requested that the Commission restore $10,922,000 of the funds that it requested for other electric system operations and maintenance.

In its replies, the Staff points out that the ALJ recommended that Consumers be provided with all of the distribution O&M expense that it incurred in 2003, with significantly higher inflation rates for 2004-2006 than were requested by Consumers. The Staff again observes that Consumers earned over its authorized return on equity in 2003, thereby proving that funds were available to ensure the safety and reliability of its system.

As discussed *supra*, the Commission has consistently expressed its preference for ratemaking based on an historic year with revenues and expenses adjusted for inflation, unless the utility can

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[17]SAIDI is a measurement of the average duration of outages experienced per customer per year.

[18]Consumers' exceptions, p. 4.

show that a particular expense is substantial, reasonably expected to occur, and largely beyond the utility's control. The Commission agrees with the ALJ and the Staff that Consumers has failed to make a sufficient showing to justify increasing these expense items beyond ordinary inflation. The Commission therefore adopts the ALJ's findings and approves $108,301,000 for other electric system O&M expenses.

xiii. Additional Fossil Fueled Plant O&M Expense

Consumers presented detailed testimony and exhibits addressing O&M expense for its fossil-fueled generating units, including a summary of the major factors affecting O&M expense and the planning efforts followed by Consumers to minimize O&M expenses. Consumers discussed the difference between "normal" and "major" maintenance projects, explaining that "normal" maintenance is generally associated with the typical ongoing activities necessary to keep its fossil-fueled generating unit operating between major overhauls. According to Consumers, these typically make up approximately 70% of total O&M expense. Consumers further explained that major maintenance costs are associated with generating unit overhauls, and are usually related to boiler or steam turbine generator refurbishment. Consumers claimed that it plans for a consistent level of major maintenance costs. Factors such as new environmental requirements, unforeseen equipment failure, and other initiatives (e.g., burning more western coal) can affect the scheduling and cost levels associated with major unit overhauls. Consumers also presented detailed discussion of the level of O&M expenses actually experienced in 2003, and anticipated for 2006, with an emphasis on certain major maintenance projects. Consumers calculated a total of $119,778,893 for 2006 for fossil-fueled plant O&M. *See*, Exhibit A-18.

The Staff supported incorporating Consumers' proposed spending levels into rates. The Staff maintained that, the expenditures were necessary to assure the continued high availability of the

company's fossil generating units, and to recognize the higher O&M costs associated with the more sophisticated environmental systems installed on the units. The Staff noted, however, that, because of the difficulty in accurately predicting the actual level of O&M expenses that will be incurred, a portion of the total ($9,688,000)[19] should be tracked annually and subject to refund if not spent.

In rebuttal, Consumers claimed that according to its updated estimates, it projected that the actual total level of fossil-fueled plant O&M spending in 2006 would be in excess of $119,778,893. Thus, Consumers' revised estimate for 2006 was increased to $130,219,000 for fossil-fueled plant O&M expenses.

Consumers indicated that although it was willing to accept the tracking mechanism proposed by the Staff, the expense level for O&M should nevertheless be calculated using the higher 2006 O&M expense level (i.e. $130,219,000) identified in its rebuttal testimony. Consumers proposed that the amount that would be "tracked" and subject to refund would, under this modified approach, be increased from $9,688,000 to $20,128,000 (i.e., the difference between $130,219,000 and $110,091,000).

As an alternative, Consumers proposed that if the lower expense level of $119,778,893 were used, then the tracker should be modified to permit rate adjustments for expenditures in excess of $119,778,893. Consumers argued that under this approach, if the utility spends less than this amount, it will refund the difference; if it spends more, it would be allowed to recover the excess in the succeeding year through an additional surcharge.

[19]The amount that the Staff proposed be subject to a tracker was the proposed expenditure in excess of the 2003 inflation adjusted amount of $110,091,000.

In reply, the Staff characterized Consumers' proposal as "a request for a signed blank check from the Commission."[20] The Staff also objected to Consumers' introduction of a revised position late in the proceedings when it was virtually impossible for the other parties to adequately address the issue. The Staff therefore requested that the ALJ reject Consumers' modification to the Staff's proposed tracking mechanism for fossil-fueled plant O&M expenses.

The ALJ found that the additional fossil-fueled plant O&M expense of $119,778,893 should be adopted, along with the Staff's proposed annual tracker mechanism, but that Consumers' proposal to surcharge customers for any amounts spent in excess of the approved amount should be rejected. The ALJ agreed with the Staff that Consumers offered its proposal too late in the case for the other parties to examine and address its new position.

In its exceptions, Consumers again urges the Commission to approve its proposal and argues that customers would be fully protected by the refund obligation covering the higher amount, and Consumers would be able to perform an increased amount of O&M work at its fossil generating units. Because, under the annual tracker, there would be a review of its expenditures, there would be an opportunity for the Commission to ensure that the additional funds were prudently spent.

The Commission agrees with the ALJ and the Staff that Consumers' revision to its fossil-fueled plant O&M expense was presented too late in the case to permit the other parties to assess the reasonableness of the proposal. The Commission therefore adopts the ALJ's recommendation and approves $119,778,893, subject to an annual tracker on the amount in excess of inflation, or $9,688,000.

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[20]Staff's reply brief at 15.

xiv. Hydro Expense

Consumers proposed O&M expenses for its hydro-electric facilities of $13,393,000. The Staff arrived at a 2006 test year figure of $12,468,000. Consumers accepted the Staff's adjustment and the ALJ recommended that the Staff's estimate be adopted. There were no exceptions. The Commission agrees and adopts the ALJ's estimate of $12,468,000 for hydro-electric expenses.

xv. Nuclear O&M Expense

Consumers presented its request for nuclear O&M expenses of $117,986,000. Consumers stated that part of this amount would cover additional Nuclear Regulatory Commission (NRC) required inspections and increased charges from Nuclear Management Company, which operates Consumers' Palisades nuclear generating facility. The Staff initially supported an amount slightly less than that proposed by Consumers. The difference was due to the Staff's lack of information to support the amounts for the increased inspections. On rebuttal, the company provided additional information including specific NRC references to support the additional $2,015,000 that Consumers initially proposed. The Staff then accepted the $117,986,000 expense as originally requested by Consumers, for nuclear O&M expense. The Staff also proposed that for nuclear O&M expenses that exceed the inflation-adjusted 2003 expense level, (i.e., the additional $2,015,000 of nuclear O & M expense) should be subject to an annual tracking mechanism. Any unspent amount of the additional allowance would be refunded to customers. The ALJ recommended that the Commission adopt the additional nuclear O&M expense, subject to an annual tracker and customer refunds. There were no exceptions filed. The Commission therefore adopts $117,986,000 for nuclear O&M, subject to an annual tracker to be applied to $2,015,000 of the expense, which, if not used shall be refunded to customers.

xvi. Broadband Over Power Lines

The Staff proposed a disallowance of $100,000 for the costs associated with a preliminary investigation of the feasibility of transmitting broadband communication signals over its power lines. In response to a Staff audit request, Consumers indicated that this was a pilot program for BPL. Consumers stated that the cost of its evaluation efforts were included in 2003 expenses but that the expenses had not been segregated and the total amount of expenditures was unknown. The Staff argued that it was premature to assess customers for any costs of the BPL program during the evaluation stage. Accordingly, the Staff proposed to disallow $100,000 in lieu of the actual amount, which could not otherwise be determined.

In response, Consumers argued that the Staff's disallowance of $100,000 represents a guess. Consumers asserts that the Staff's position is inconsistent, considering how supportive the Commission has been of BPL. Consumers claimed that any revenues produced by these efforts would ultimately flow to the customers. Thus, Consumers argued, if the expenses from BPL are not included in the rates, then neither should any BPL revenues be included in future rate cases.

The ALJ agreed with the Staff's disallowance on grounds that Consumers acknowledged that the costs of the preliminary investigation have not been segregated, thus it is impossible to identify any costs associated with these efforts.

In its exceptions, Consumers requests that the Commission defer action on this issue until there is more information available. The Staff replies that in support of its arguments in favor of allowing the BPL expenditure, Consumers asserted that it was impossible to specifically identify any costs that are associated with the BPL effort. The Staff claims that this statement was not supported on the record, and actually conflicts with the testimony of Steven L. Ray, Executive Manager of Consumers' Electric Systems Operations, at 2 Tr 114, where he stated that: "The

[BPL] activity has been absorbed by existing staff and minimal incremental expense has been incurred." The Staff argues that Mr. Ray's testimony contradicts Consumers' assertion that the costs cannot be identified and that Consumers simply refused to provide details on the costs incurred for BPL. The Staff asserts that because its estimated expense level of $100,000 is the only quantification of the expenses on the record, and because Consumers has not rebutted the Staff's estimate, the Commission should adopt the Staff's proposed $100,000 adjustment. The Staff further replies that it would be premature to make a determination that revenues, if any, that ultimately flow from BPL implementation should be excluded from rates in future cases.

The Commission fully agrees with the National Association of Regulatory Utility Commissioners (NARUC) BPL task force finding that:

> BPL is a synergistic technology used to deliver high-speed data to end users over existing electric power networks and lines. The technology holds promise for extending service to underserved areas, facilitating broadband competition, and enhancing both security and reliability through "smart grid." . . . On security, our review made clear that there is much to appreciate about BPL from a homeland security standpoint, as well as the reliability potential inherent the many "smart grid" opportunities presented by BPL for electric utilities.[21]

Thus, the integration of BPL potentially presents considerable prospects for electric utilities to provide better and more reliable service for the benefit of customers. For example, BPL may allow utilities to significantly improve their ability to monitor and control lines and may allow utilities to achieve more network automation thereby lowering the cost of system maintenance for ratepayers.

Mr. Ray characterized Consumers' BPL-related activities as a pilot program "in the early stages of development with only minimal activity" directed toward "reviewing the impacts to our system and our customers." 2 Tr 114-15. As noted in the NARUC report, a number of utilities are

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[21]NARUC Report of the Broadband over Power Lines Task Force, February, 2005.

looking at BPL as a means of enhancing their electric service applications (e.g., remote meter reading, enhanced monitoring, and control of distribution facilities) in addition to the potential to make broadband access available. There is no evidence in this case to suggest that deploying a minimal amount of employee time and resources toward studying the technological promise of BPL on a preliminary basis is imprudent. Given the potential benefits for ratepayers, the Commission is not persuaded that it should impose an estimated disallowance for undertaking exploratory activities.

That being said, Consumers should have done a better job on this record of supporting and justifying their deployment of employees and resources. The Staff cannot do its job under the strict deadlines of a rate case unless it obtains the information necessary to evaluate the costs. Consumers is advised that obtaining favorable ratemaking treatment for BPL expenditures and other resources invested in innovative concepts and technologies in future cases will hinge on providing a timely and adequate accounting of the costs. Ultimately, adjudicating ratemaking consequences of a fully developed program will require full consideration of such matters as the potential for improvement in the reliability and quality of electric service, the potential risks to ratepayers of devoting material utility resources to a large-scale deployment, and the overall mix of benefits and costs implicit in a technology with multiple usages. The Commission therefore reverses the ALJ's disallowance of $100,000 for BPL.

xvii. Information Services and Technology

Consumers proposed $11,984,000 for information services and technology expense. The Staff recommended an increase to $12,118,000 based on updated inflation figures. Consumers accepted the Staff's adjustment, and the ALJ recommended that the Commission adopt the Staff's figure. There were no exceptions filed. The Commission therefore adopts the ALJ's recommendation.

xviii. Company Filed Adjustments

Exhibit S-3, Schedule C-6, lines 18-20, list three items that Consumers adjusted and the Staff did not oppose. These adjustments were for accounts receivable financing in the amount of $2,168,000, maritime transportation security in the amount of $231,000, and the removal of transmission O&M expense in the amount of $87,214,000. The ALJ recommended that the Commission adopt these adjustments and there were no exceptions to this recommendation. The Commission therefore adopts the ALJ's recommendation for these adjustments.

xix. Ludington Trust Fund

Consumers explained that it entered into a settlement agreement with various state and federal agencies at the Federal Energy Regulatory Commission (FERC) regarding fish mortality issues at the Ludington pump storage plant site. Consumers was required to perform a Ludington End State Study and file it at the FERC. As part of the settlement, in its first general rate case following completion of the study, Consumers was to "include costs related to the establishment of trust funds to collect from ratepayers the costs of: (1) permanent non-power operation, or (2) partial project removal, or (3) complete project removal." (3 Tr. 695-96.) The intent of the parties to the settlement was to establish a trust fund that would ensure that funds are available for proper future management of Ludington upon its retirement from power production.

The issue here is whether an external trust should be established for the cost of the Ludington removal at this time. The End State Study calculated that the cost of decommissioning Ludington under the above three scenarios in 2003 dollars was $2,900,000, $345,000,000, and $411,900,000, respectively. Consumers currently internally funds the Ludington cost of removal, which is recovered from retail rate customers. When general rates are determined, customers receive the benefit for the amounts they have previously collected through a reduction in rate base.

Consumers argued that it would be premature to start a Ludington external trust at this time and requests that the Commission defer any decision on funding such an external fund. According to Consumers, the revenue requirement would increase in this case if an external fund is established.

The Staff agreed with Consumers that this issue should be deferred to Consumers' next general rate case. The Staff believes that Consumers' current ratemaking treatment for the Ludington cost of removal is reasonable, and that an external fund does not have to be established in this rate proceeding

The ALJ agreed with the Staff and Consumers and recommended that any decision on the Ludington trust should be deferred to Consumers' next general rate case. There were no exceptions filed. The Commission therefore adopts the ALJ's recommendation and defers consideration of the Ludington trust until Consumers' next general rate case.

xx. Depreciation, Taxes and AFUDC

The Staff made adjustments to record depreciation, property and other taxes, and AFUDC for the 2006 test year, which are found in Exhibit S-3, Schedule C-1. The Staff made these adjustments to reflect 2003 historical amounts adjusted for inflation. These items are directly related to the company's plant levels, which the Staff accepted. Specifically, the Staff's adjustments were $31,412,000 for depreciation, $11,625,000 for property tax, negative $437,000 for other taxes, $1,846,000 for AFUDC, negative $2,444,000 for Michigan Single Business Tax, and negative $23,643,000 for federal income tax.

Because there were no material differences between Consumers and the Staff on these items, the ALJ recommended that the Commission accept the Staff's adjustments. There were no excep-

tions to this recommendation. The Commission therefore adopts the ALJ's recommendation for company filed adjustments.

xxi. Pro Forma Income Tax Savings

This adjustment recognizes a reduction of *pro forma* income tax savings. The purpose of this adjustment is to calculate the change in income taxes due to the change in interest expense allowed to Consumers in this case. The Staff explains that because projected interest expense is less than the 2003 interest expense, income taxes should be decreased by $6,613,000. *See*, Exhibit S-3, Schedule C-1, line 25. Consumers did not dispute this amount. Therefore, the ALJ recommended that the Commission adopt the Staff's adjustments. There were no exceptions filed. The Commission therefore adopts the Staff's adjustment for pro-forma income tax savings.

5. Net Adjusted Operating Income

Based on the modifications to the PFD discussed above, Consumers' adjusted net operating income for the year ended December 31, 2006 is calculated as follows:

Description	Adjustment	Jurisdictional Amount	Net of Tax @63.765%	Amount
Recommended NOI (PFD)				$258,427,00
Employee Savings Plan	$ 6,260,000	$ 6,217,000	$3,964,000	
Forestry Expense	$17,707,000	$17,585,000	$11,213,000	
Misc. Service Charges	($ 479,000)	($476,000)	($ 303,000)	
BPL	($ 100,000)	($99,000)	($ 63,000)	
Net Operating Income				$273,238,000

6. Revenue Deficiency

Based on the foregoing findings, Consumers' revenue deficiency for the year ended December 31, 2006 is computed as follows:

Rate Base	$4,838,297,000
Rate of Return	6.78%
Income Required	$ 328,170,000
Adjusted Net Operating Income	$ 273,238,000
Income Deficiency	$ 54,933,000
Revenue Multiplier	1.5683
Revenue Deficiency	$ 86,149,000

6. Cost of Service and Rate Design

This is Consumers' first rate case since the May 16, 2002 order in Case No. U-12970, in which the Commission adopted, pursuant to Section 10b(2) of Act 141, the company's proposed unbundling of its rates into the functional categories of generation, transmission, distribution, customer costs, and the regulatory adjustment charge (RAC). In that order, p. 2, the Commission explained that the RAC "represents the difference between the costs allocated to a rate class and the costs recovered through the rates charged for that class." The RAC is based on the amount of rate skewing.

Consumers' current full service rates reflect the Commission's long-standing policy of having commercial and industrial (C&I) customers provide residential customers with an inter-class subsidy. Recently, this inter-class subsidy has been exacerbated by the additional ROA (choice) rate subsidies included in the retail access service tariff (RAST). These inter- and intra-class

subsidies result in skewed rates, which particularly affect full service C&I customers. In general, C&I full service customers are paying both the skewing subsidy for residential and choice customers, and their full distribution cost. C&I choice customers do not currently participate in paying the residential subsidy; nor do they pay their full distribution cost.

a. Rate Design

Consumers proposes to eliminate skewing over a five-year time period, by imposing a single RAC on each rate class. The RAC represents the difference between the revenue currently generated by that class and the actual cost to serve that class. The RAC, as proposed by the company, would begin on January 1, 2006, and would be phased out by 20% per year beginning January 1, 2007, until the RAC is eliminated on January 1, 2011.

The Staff and Consumers propose that a single RAC should be calculated for each rate class and should be applied equally to both choice and full service customers within that class. The intervenors (with the exception of the Attorney General) charge that the RAC, as proposed, must necessarily have both a generation and distribution component, and that it is unfair to burden any choice customer with a RAC that contains a generation component. These intervenors agree that the present subsidization of choice customers by full service customers with respect to distribution charges should cease, but argue that the proposed RAC simply imposes a new subsidy flowing in the other direction. The intervenors advocate a RAC for choice customers that includes only a distribution component, with the entire generation-related RAC borne by full service customers.

The ALJ found that there is no way to associate a specific part of the skewing with any of the functionally unbundled costs allocated to any class. The ALJ pointed to the testimony of the Staff's expert to the effect that the amount of revenue skewing in the present rates for each class cannot possibly be associated with specific unbundled cost components because the skewing is

not associated with any costs; it is simply a result of long-standing Commission policy. The ALJ found that adoption of a single, uniform RAC will provide the alternative electric suppliers (AESs) a level playing field from an economic standpoint.

In its exceptions, Energy Michigan argues that the last few years have seen an unbroken series of rate increases for choice customers, and states that the addition of a RAC containing a generation charge will kill the choice program. This, in turn, Energy Michigan argues, will cause substantial rate increases for full service customers, because Consumers will have to make unanticipated additional capacity purchases at higher prices to serve the migrating choice customers.

Energy Michigan contends that setting a uniform allocation across the board will also produce inaccurate rates for larger customers. Energy Michigan insists that separate choice distribution RACs should be calculated for each rate by multiplying the total generation and distribution RAC by a percentage based on the portion that distribution costs comprise of total power and distribution costs for each rate class. For example, distribution costs are a greater percentage of rates for residential customers than they are for large C&I customers, and Energy Michigan contends that this difference should be taken into account in designing each bifurcated RAC. Energy Michigan argues that any other calculation unfairly penalizes large customers.[22]

In their replies to exceptions, Kroger, Wal-Mart, ABATE, and NewEnergy support Energy Michigan's recommended bifurcated RAC calculation.

Energy Michigan further recommends, in its exceptions, that choice customers are entitled to the same start date (2007) for phase in of this new RAC increase and the same duration of phase in (five years) as full service customers. Energy Michigan asserts that choice customers cannot

[22]*See,* Energy Michigan's replies to exceptions, p. 4, table.

afford to pay 100% of the distribution RAC plus 100% of the distribution rate increase caused by bringing distribution rates between choice and full service customers for comparable service into parity. Therefore, Energy Michigan contends that choice customers should be charged only a distribution RAC, and that the choice distribution RAC should be phased in, in the same manner that it is phased in/phased out for other customers. Energy Michigan further contends that, even if this recommendation is followed, rate imbalances between choice and full service customers will follow shortly. Energy Michigan suggests that the Commission address this potential problem by looking at rates again in 2008. The other intervenors (with the exception of the Attorney General) support this proposal.

Currently, choice customers do not pay into the subsidy for residential customers that causes skewing (that is, choice customers pay no RAC); and choice customers do not pay the actual cost of distribution services (that is, they pay the cost for distribution that is included in the RAST, which is a subsidized amount). The Commission is not convinced that all customers should eventually pay rates that are based solely on the cost to serve them. Other factors need to be weighed when setting rates. The current rates are the product of numerous prior Commission decisions that should not be undone too quickly. Certain rate classes such as senior citizens may continue to receive a subsidy as needed to keep the service affordable. The Commission is persuaded that ROA customers should be brought to parity with full service customers by having their distribution rates based on cost of service. However, the Commission is not persuaded that the RAC, as proposed by Consumers, should be instituted at this time. The responsibility for the residential subsidy will remain with C&I full service customers; however, the Commission finds that the subsidy should be reflected only in distribution rates for C&I full service customers and not in their generation rates. While this may result in an increase in distribution rates for C&I full

service customers, those increases will be mitigated as a result of bringing all choice customers up to cost-based distribution rates. Any additional movement towards cost-of-service-based rates must be undertaken in a cautious and deliberate manner. This will result in more reasonable and prudent ratemaking, and will ease the transition for residential and choice customers. The Commission does not, by this order, change any of the terms and conditions of the choice program. However, this case represents a significant movement towards addressing Consumers' concern that ROA customers have historically enjoyed a rate advantage over bundled customers.

The Commission rejects Wal-Mart's proposal that choice customers' distribution charges be brought up to cost-based amounts over a three-year phase in period. The Commission finds that, given the unanimous agreement among the parties that this subsidy should cease, and the fact that no party other than Wal-Mart believes that a phase in period is required, the choice and full service distribution charges for comparable service, excluding inter-class subsidies, should be brought into parity with the implementation of the new rates approved by this order. Finally, the Commission notes that all parties agree that the RAST distribution rates should be moved from the RAST tariffs and into the full service tariff. The Commission adopts this recommendation.

b. Cost of Service Study Method

In its May 10, 1976 order in Case No. U-4771, the Commission adopted a method for allocating costs to be used in preparing cost of service studies, which became the standard filing requirement. The filing requirements rely upon a 12CP 75/25 allocation of production (generation) plant costs. This method is based on the 12 one-hour monthly coincident peaks (12CP), with 75% allocated on a demand basis, and 25% allocated on an energy basis, or 12CP 75/25. In this case, Consumers relied upon its 2003 historical test year COSS, which was adjusted

to reflect 2006 test year cost level changes incorporating the 12CP 75/25 allocation method. The result is the updated 2006 COSS entered as Exhibit A-132.

The Staff proposes a change to the 12CP 75/25 production plant allocation method that would shift 50% of generation plant costs away from the system peak demands, and reclassify them as related to on-peak energy or average demand. The Staff proposes to use a multi-hour approach, which looks at a seven-hour time period, from 1:00 p.m. to 8:00 p.m., on the peak day of each summer month, June through September, or MH4CP. The Staff's proposal of the MH4CP 25/50/25 method is intended to refine the allocation of production plant costs in the COSS, by recognizing that more of the demand that Consumers is responding to is constant demand, rather than peak demand.[23] The Staff's proposed new method effectively shifts some cost responsibility from low load factor residential customers to higher load factor C&I customers.

The Staff's approach looks at the peak day on the four peak months of the year, June through September, and identifies a seven-hour period, from 1:00 p.m. to 8:00 p.m., as encompassing the high-demand part of the day. The Staff contends that these 28 hours better reflect the basis for establishing the coincident maximum demand responsibility of each customer than the 12 hours encompassed by looking only at the peak hour in each of the 12 months of the year. The Attorney General supports the Staff's method. ABATE proposes a 4CP 75/25 method, which it argues is more reflective of current cost causation. The other parties, including Consumers, oppose the Staff's proposal to change the COSS cost allocation method, primarily on the basis that the old

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[23]Some parties expressed concern that if transmission costs are included as part of the PSCR expenses those costs will be allocated on the basis of energy rather than the traditional 12CP 75/25 method prescribed in the standard filing requirements. The Commission is not adopting a change in the allocation of transmission costs at this time. Therefore, transmission costs should be allocated on the 12CP 75/25 method in this case.

method is tried-and-true, and that the Staff has failed to make the case for the necessity of the new method.

The ALJ found that the Staff's proposed method results in a COSS that more accurately reflects the design and operation of Consumers' system, which leads to a more accurate determination of the subsidies among the classes. The ALJ pointed to the testimony of the Staff's expert, Mr. Miller, where he explained that, of the full per kilowatt (kW) cost of all of Consumers' generating plants, only 25% of that cost relates to the loads that are experienced on hot summer afternoons, because the cost of capacity per kW built to serve those peak loads is only approximately one-fourth of the actual cost of the generating capacity that Consumers has built to serve loads all year round. 6 Tr 1874-1875. The ALJ found that the Staff demonstrated that 12 hours (or 4 hours as proposed by ABATE) is an extremely narrow basis upon which to allocate hundreds of millions of dollars, and that the Staff's proposed 28-hour method provided greater accuracy. The ALJ recommended that the Commission adopt the Staff's COSS contained in Exhibit S-23 to establish class revenue responsibility and rate design.

The Commission agrees with the ALJ and the Staff. The Commission finds that, while the standard filing requirements have worked well in the past, that does not preclude the possibility of improvement. Based upon the evidence and analysis presented by the Staff, the Commission finds that it is appropriate to initiate this change at this time. While the total amount of generation capacity needed by Consumers is based on peak demand, the greatest amount of investment is incurred to serve base load and intermediate load. For the purposes of this case, the Commission is persuaded that it is appropriate to increase the weight given to average demand in the allocation of the production plant costs relative to peak demand, and to expand the number of hours used for

this calculation. The Commission directs Consumers to file a class cost of service study in its next rate case utilizing the MH4CP 25/50/25 method.[24]

c. Securitization and Nuclear Decommissioning Costs

The Commission agrees with the ALJ, and rejects the recommendations of ABATE and Energy Michigan to change the manner in which securitization and nuclear decommissioning costs are allocated to the various rate classes. These two intervenors argue that these charges are unfairly imposed on choice customers and should be allocated using the same method used to allocate generation plant costs. This argument has been previously addressed, and the Commission sees no reason to deviate from its previous rulings. Act 142 provides that securitization charges are nonbypassable, and, thus, must be imposed on all customers. MCL 460.10(f), 460.10h(i), and 460.10i(4). *See, also,* October 24, 2000 order in Case No. U-12505; and November 2, 2000 order in Case No. U-12478. The Commission has likewise had a long-standing policy that nuclear decommissioning charges should be paid by all customers. *See,* January 14, 1998 order in Case No. U-11290; and December 16, 1999 order in Case No. U-11662.

Further, regarding Energy Michigan's stranded cost calculation and alternative proposal, the Commission agrees with the ALJ's finding that the proposal does not serve any purpose, because stranded costs will be accounted for by bundled sales customers once rates have been reset to recognize choice sales at current levels.

d. Cost of Service Study Collaborative

The Staff requests that the Commission open a collaborative for the purpose of modernizing the rate case process for major electric utilities by developing a standardized COSS model that will

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[24]Because there was no consensus on this issue, the Commission reserves the right to revisit this issue in the future when more information is available.

not be proprietary, and will take advantage of the electronic data processing capabilities of all parties, in order to allow COSS data to be submitted and analyzed on a desktop personal computer. The Commission is persuaded that it has become vital for the parties to major rate cases to be able to exchange information electronically. The Staff is directed to work with Consumers, Detroit Edison, and other interested parties to develop a standardized COSS model that can be exchanged electronically and provides sufficient flexibility to allow all parties to understand the bases for the data underlying the COSS.

e. The Next Rate Case

The Commission directs Consumers to file a general rate case, including a COSS and a rate design proposal consistent with the Staff's methodology, no later than July 1, 2008, based on 2007 actual operating results. This will give Consumers sufficient time to collect and analyze the data that will be made available at the conclusion of 2007, and will allow further rate decisions to be based on more current data than the 2003 data that provides the basis for the projected 2006 numbers that underlie this order. A rate case proceeding will allow the Commission and others to review issues that are changing more rapidly than in the past, while balancing that need with the need of customers to a degree of certainty regarding both the reasonableness of rates and the stability of the rate structure that allows customers to make informed choices over a reasonable planning horizon. The Commission declines to initiate an economic development forum at this time.

f. Rate E

The Commission agrees with the ALJ and the Staff, and approves Rate E as proposed by the Staff. Rate E will apply to new load of one MW and greater from either existing or new customers

who would otherwise be on the company's Rate D, F, J, J-1, or R-3, commenced after January 1, 2006. The Commission finds that the negotiation of the amount of energy or demand usage under Rate E is reasonable for those situations where it may be cost prohibitive to separately meter the new load. The Commission also finds that Rate E should be made available to choice customers. The Staff's proposed Rate E tariff shall be revised to eliminate the references to the RAC and will instead refer to the rate differential between the full service and ROA distribution charges.

g. The Transitional Primary Rate Tariff

Consumers proposed a transitional primary rate (TPR) tariff that will provide discounts to customers currently taking service under Commission-approved special contracts that are scheduled to expire on December 31, 2005. Upon expiration of those contracts, these customers will face a significant rate increase as they return to full service. The TPR tariff is intended to facilitate this transition by mitigating the rate shock that these customers would otherwise experience.

In the November 23, 2004 order in Case No. U-13808 (Detroit Edison's rate case), p. 76, the Commission authorized a similar discount to these special manufacturing contract customers, which amounted to a 50% reduction. The Staff supports Consumers' proposal for the TPR rate, and both the Staff and Consumers agree that the rates in this proceeding should be calculated differently from the Detroit Edison rates, because there are varying degrees of discounts for Consumers' special contract holders that were not present in the other case. The Staff further recommended a one-year commitment period, which Consumers proposed to extend to three years.

ABATE supports these proposals. Dow supports these proposals with some modifications. The Attorney General and Energy Michigan oppose the TPR proposal, arguing that the proposal involves an unwarranted discount, or is inherently discriminatory. Energy Michigan recommends

that the Commission instead adopt its proposal that rate discounts apply only to generation costs and that Consumers' shareholders pay for those discounts.

The ALJ found the proposed TPR tariff to be reasonable and recommended its adoption at the Staff's proposed rate, with a one-year commitment period as proposed by the Staff and a 30-day window of opportunity for acceptance of the new rate. The Commission agrees and approves the TPR tariff as adopted by the ALJ. The Commission further adopts Dow's recommendation that the rate be calculated using 12 months of data. The average rate used to determine the level of the discount will be based on a customer's actual energy usage during the 12 months ending April 30, 2005. The Commission finds that the TPR tariff provides a cushion against rate shock for special contract customers while not depriving Consumers of revenue that it needs. The TPR tariff also mitigates the harm that other customers might endure should the special contract customers leave the system entirely when the new rate sets in. A one-year commitment requirement maintains the status quo, and matches the requirements placed on other customers choosing new service or returning to full service from choice.

h. The Timing of Return to Service Decisions

Regarding the timing of the annual return to service deadline for this case, this issue was recently addressed in the October 18, 2005 order in Case No. U-14662 (Detroit Edison), in which the Commission approved a temporary waiver of the deadline in that company's tariff provision[25] until 60 days after issuance of an order addressing unbundling or March 1, 2006, whichever comes first. The Commission adopts the March 1, 2006 deadline for this case.

[25]Ordinarily, pursuant to the RAST, a choice customer that wants to return to full service for the summer months at regulated rates must give notice by December 1 of the prior year and make a commitment to remain a full service customer for 12 months.

i. Allocation of Revenue Deficiency, Rate Design, and Rate Implementation

The Commission adopts Consumers' recommendation to allocate the revenue deficiency to all classes on the basis of an equal percentage of each class' present revenue, but with choice sales included in their native rate classes. Consumers is directed to file redesigned rates and modified tariff sheets by January 10, 2006 that conform to the Commission's findings in this order. The rates shall be designed with power supply charges and distribution charges unbundled. The full service and choice distribution charges shall be based on the cost of service except that the bundled service distribution charges shall be adjusted to include the inter-class subsidy, to bring the revenues for the class to the level approved by this order. The redesigned rates should not separately identify the RAC; instead there will be separate distribution charges for full service and choice customers. The RAC charges to be incorporated into the full service distribution charges shall be calculated by comparing the approved revenue requirement for each rate class to its cost of service. The COSS should be based on the methodology in the Staff's study, shown on Exhibit S-23, adjusted to allocate transmission costs using the 12CP 75/25 methodology. The redesigned rates should also incorporate the new PSCR base as previously discussed.

Consumers shall revise its tariff sheets to show power supply charges, full service distribution charges, and the choice distribution charges on the same rate schedule so that customers may more easily compare the full-service and choice rates. The Commission will issue an order indicating the effective date of the redesigned rates following a review and acceptance of the rate schedules and revised tariffs.

7. Other Tariff Issues

Regarding other tariff issues, the ALJ recommended that the Commission: 1) make the Residential Time-of-Day Service Rate available to more customers; 2) direct Consumers, the Staff,

and others to collaborate regarding a potential PAYS® Tariff program for those customers who purchase and install money-saving energy efficient products and services and establish a collaborative to address administrative burdens if the tariff is implemented; 3) establish a collaborative to consider the de-averaged distribution system credits pilot program; 4) approve ROA tariff changes that are not disputed; 5) eliminate the aggregator requirement under the ROA for residential customers and those small customers using less than 1000 kW demand of service by striking Service Standard F2.3B and removing the aggregator requirement from the ROA-R residential tariff F-23.00 and the ROA-S secondary tariff sheet F-26.00; 6) reject the Staff's proposed tariff change to Rule F3.7 and find that Consumers continues to have the authority to curtail service if an AES fails to deliver; 7) approve Consumers proposed language for a 10-business day requirement for delivery of customer sales and demand data, which will be inserted into the retailer handbook under the heading "Release of Customer Information;" 8) approve Consumers' language regarding slamming to be added to Tariff Sheet No. F-6.00, F. 2; 9) approve a $5.00 switching charge to all ROA customers returning to utility full service; 10) no longer consider proposed language changes in the indemnity provision of Rule B-10 because Consumers withdrew this proposal; and 11) commence a collaborative proceeding to address line extension rule changes. There were no exceptions filed to any of these recommendations, therefore the Commission adopts the ALJ's recommendations, with the exception of the Staff's proposed tariff change to Rule F3.7. Upon reviewing this issue, the Commission is persuaded that Rule F3.7 (1) and (2) of Consumers' tariffs should be changed to read: "Retail Open Access Customers will be subject to the relevant curtailment procedure contained in Consumers Energy's electric procedures. Consumers Energy shall give Retail Open Access Customers the same priorities in curtailment situations as it gives to full service customers."

There were, however, exceptions to the ALJ's recommendations to 1) approve return to service tariff changes like those that were approved in Case No. U-13808;[26] 2) eliminate the profile management service charge because Consumers offered no cost of service basis to justify its current load profiling charges and establish a collaborative to address Energy Michigan's proposals; 3) commence a collaborative proceeding to address the extraordinary facilities charge for all electric utilities; and 4) approve the tariff provisions attached as Appendix A to the PFD. These issues will be discussed below.

a. Profile Management Service Charge

Consumers excepts to the ALJ's recommendation to eliminate the profile management service charge because it did not have a cost of service basis to justify its current load-profiling charges. The load-profiling program, it explains, was offered as a means to promote customer choice for smaller customers and allows customers with energy demands below 20 kW to avoid installing a time-of-use meter. It is impossible, Consumers alleges, for an AES to supply power to ROA customers each hour in a manner that matches perfectly with the customer's hourly usage. Therefore, Consumers says, it must have sufficient generation resources available to meet these hourly imbalances.

The profile management service charge, it asserts, recovers the cost of maintaining the generation resources necessary to accommodate those differences and, absent this charge, full service customers will incur these costs that the ROA customer avoids, creating a subsidy for ROA customers and their retailers. Consumers notes that Jack Mason, a statistician for the Commission,

[26]Specifically, ROA customers must give 30 days notice of return to Consumers' service or 60 days notice if greater than 10% of the customer load is under ROA. However, all customers must initially give 60 days notice after the release of the order approving the changes. Returning ROA customers are not required to commit to a 12-month term.

acknowledged that if the profile management service charge is eliminated from the ROA tariff, costs are "theoretically" shifted to the bundled service customers. 7 Tr 1908.

Consumers claims that it offered the load profiling management program in good faith during the development of Act 141 to effectuate choice and the profiling charge is not an impediment to ROA. Consumers argues that the primary drivers for the historical absence of residential customers pursuing ROA via load profiling are rate skewing and a rate cap. Finally, Consumers points out that a load profile management service charge is found in Detroit Edison's tariffs, as approved in Case No. U-13385 and modified in Case No. U-13808. Consumers concludes that to eliminate the charge at the expense of its bundled customers is unwarranted and ill-advised and urges the Commission to reject the ALJ's recommendation to eliminate the profile management service charge.

Energy Michigan concurs with the ALJ's finding and says that Consumers provided no evidence that there are significant costs associated with choice customer profile management service. Energy Michigan argues that Consumers admitted that such costs, if any, were relatively minor. Therefore, Energy Michigan urges the Commission to reject Consumers' exception and eliminate the profile management service charge.

The Attorney General neither supports nor opposes Consumers' exception to the elimination of the profile management service charge.

The Commission agrees with the ALJ and Energy Michigan that Consumers has failed to justify the profile management service charge with specific cost study data and, therefore, concurs with the ALJ finding to eliminate this charge.

b. One Year Commitment for Returning ROA Customers

Consumers excepts to the ALJ's recommendation that returning ROA customers should not be required to commit to a 12-month term. The ALJ found that a 12-month commitment was inconsistent with the Commission's June 30, 2005 order in Case No. U-13808 (June 30 order), where it clarified its November 23, 2004 order in Detroit Edison's rate case that allowed ROA customers the option to return to full service without a 12-month commitment (albeit without the attendant cost savings).

Consumers opines that full service customers have a longstanding Rule B13.2, Choice of Rates, that requires customers to stay on a rate for 12 months in order to allow adequate resource planning. This tariff, Consumers says, is consistent with the tariffs of nine cooperatives. Similarly, Consumers notes, a returning gas choice customer must follow the longstanding Choice of Rates provision and remain on the full service rate for 12 months. A level playing field puts returning ROA electric customers in the same position, Consumers concludes, as other full service electric customers and is consistent with accepted gas program provisions. Finally, Consumers argues that a 12-month commitment greatly reduces the administrative burden imposed by tracking customers for shorter periods (before 12 months expire), with the attendant calculation of the retroactive market-based rate plus 10% treatment.

Energy Michigan responds by offering three reasons for the Commission to reject Consumers' request to require returning choice customers to stay on bundled service for a minimum of 12 months. First, Energy Michigan says, Consumers is fairly compensated for risks of returning choice customers who stay for less than one year because such customers must pay the greater of market rates or bundled tariff rates. Consumers cannot lose money, Energy Michigan concludes,

because the utility can always charge the returning customers a price that covers cost of service whether from native resources or through purchases.

Secondly, Energy Michigan argues, Consumers' current tariff language is very similar to that of Detroit Edison's regarding return to service. Energy Michigan points out that Detroit Edison requested that the Commission impose a 12-month minimum term and the Commission rejected this request. Finally, Energy Michigan concludes that Consumers request would render much of the current language of F2.5C meaningless. If the Commission had meant to require all customers to commit to a minimum term, Energy Michigan points out, then it would not have provided alternative pricing mechanisms for those customers that stay less than 12 months.

The Attorney General neither supports nor opposes Consumers' request to require ROA customers to commit to a 12-month term.

As the Commission explained in its June 30 order, "If a customer returns to bundled utility service with the required notice and 12-month commitment, but does not remain on that service for the required minimum time period, it will be back-billed the appropriate higher rate for service during the period that it received bundled utility service, as if it had not made the 12-month commitment." Order, p. 8. The Commission agrees with the ALJ and Energy Michigan and finds that ROA customers returning to full service are not required to make a 12-month commitment.

c. Extraordinary Facilities Requirements and Charges (Rule B10.4)

Consumers' tariff Rule B10.4 sets forth the charges for "extraordinary facilities" and allows the customer the choice to either pay a monthly facilities charge equal to 2% of Consumers' total investment in those facilities or make special contractual arrangements with the company. Consumers initially proposed to modify the language wherein the utility would choose the payment option the customer was required to pay. The Staff originally supported Consumers'

request; however, based upon strong opposition from other parties, the Staff recommended that the Commission defer this issue to the line extension collaborative proceeding. In the alternative, the Staff proposed that the Commission approve the company's changes but reduce the monthly facilities charge from 2% to 1.5% as calculated by Mr. Kurin in Exhibit DDC-1.

Consumers agreed to withdraw its proposal, so the ALJ deferred this issue to the line extension collaborative. Dow excepts to the ALJ's recommendation, because it proposed changing Rule B10.4 and did not withdraw its proposal. Dow proposed that the 2% charge is excessive and that the correct percentage set forth in Rule B10.4 should be 1.5% rather than 2%. In discovery response 14347-DOW/HSC-CE-141 (see, Exhibit DCC-1), Consumers admitted that the correct percentage based on a 2003 test year would be 1.5%, and the discovery response was verified on the record by Consumers' Senior Rate Analyst, Antonette D. Noakes. 2 Tr, pp 236-237. Consumers explained the specific calculations underlying its admission that the old 2% number should be updated to 1.5% to reflect current costs. 2 Tr, pp 237-238 and 260-261.

Based upon Consumers' admission, Dow says, the billing option in Rule B10.4 should be changed from 2% to 1.5%. Although it agrees that contested issues should be deferred to the line extension collaboration, it would be illogical and unfair to defer decision on this issue. Dow argues that its proposal is uncontested and should be approved. ABATE supports reducing the monthly extraordinary facilities charge from 2% to 1.5% and agrees this proposal is uncontested and should be adopted by the Commission

Dow also requested that Appendix A be changed to reflect that the Staff did not accept Consumers' proposed Rule B10.4 change. Specifically, point 2, on page 1 of Appendix A related to rule B10 and Dow says the Staff accepted the company's withdrawn proposal to modify the

extraordinary facilities rule (item iii). Dow requests that the Commission strike the words "allocation of resources through the extraordinary facilities rule (item iii)" from Appendix A.

The Commission agrees and finds that Dow's proposal, as supported by the Staff, to change Rule B10.4, to require a 1.5% rather than 2% charge, should be made. Further, the Commission approves adoption of Appendix A to the PFD except that "allocation of resources through the extraordinary facilities rule (item iii)," found in item 2 on page 1 of Appendix A, is deleted. The Commission adopts the ALJ's recommendations in the PFD as modified above and would like to commend all the parties for their cooperation and willingness to work together to collegially resolve most of the tariff issues in this case.

d. Miscellaneous

The Commission further finds that, with the issuance of this final order, Consumers' production fixed costs that had been stranded when customers moved to choice service have now been reallocated to customers in the bundled service rate classes. This reallocation of production fixed costs in this rate case now allows Consumers full recovery of its production fixed costs on a going forward basis. Therefore, production fixed costs cease to be stranded. Because this rate case now allows Consumers to recover its production fixed costs on a going forward basis from its bundled service rate customers, and the Commission is allowing Consumers to recover, in its annual stranded costs cases, its production fixed costs from choice customers from the enactment of the Act 141 rate freeze, the Commission finds that it has provided for full recovery of Consumers' net stranded costs, as required by Act 141.

Finally, Consumers is directed to participate in a collaborative on a potential PAYS® tariff, which would seek to establish a program to encourage the purchase and installation of money-saving, energy efficient products and services.

The Commission FINDS that:

a. Jurisdiction is pursuant to 1909 PA 300, as amended, MCL 462.2 *et seq*.; 1919 PA 419, as amended, MCL 460.51 *et seq*.; 1939 PA 3, as amended, MCL 460.1 *et seq*.; 1969 PA 306, as amended, MCL 24.201 *et seq*.; and the Commission's Rules of Practice and Procedure, as amended, 1999 AC, R 460.17101 *et seq*.

b. Consumers is experiencing a revenue deficiency in the annual amount of $86,149,000 and, according to the terms of this order, an increase in its annual revenues is warranted. The Commission's decision is based on Consumers' 2006 test year rate base of $4,838, 297,000 and its adjusted NOI of $273,238,000, a return on common equity of 11.15%, and an overall rate of return of 6.78%.

c. Consumers' recommendation to allocate the revenue deficiency to all classes on the basis of an equal percentage of each class' present revenue should be adopted, but with choice sales included in their native rate classes. Consumers should file redesigned rates and modified tariff sheets by January 10, 2006 that conform to the Commission's findings in this order. At the same time, the company should serve a copy of its new rates and tariff sheets on all parties to this proceeding. The rates should be designed with power supply charges and distribution charges unbundled. The full service and choice distribution charges should be based on the cost of service except that the bundled service distribution charges should be adjusted to include the inter-class subsidy, to bring the revenues for the class to the level approved by this order. The redesigned rates should not separately identify the RAC; instead there should be separate distribution charges for full service and choice customers. The RAC charges to be incorporated into the full service distribution charges should be calculated by comparing the approved revenue requirement for each rate class to its cost of service. The COSS should be based on the methodology in the Staff's

study, shown on Exhibit S-23, adjusted to allocate transmission costs using the 12CP 75/25 methodology. The redesigned rates should also incorporate the new PSCR base as previously discussed.

Consumers should revise its tariff sheets to show power supply charges, full service distribution charges, and the choice distribution charges on the same rate schedule so that customers may more easily compare the full-service and choice rates. The Commission will issue an order indicating the effective date of the redesigned rates following a review and acceptance of the rate schedules and revised tariffs.

e. The proposal by ABATE and Energy Michigan to change the method for allocating Consumers' securitization and nuclear decommissioning costs should be rejected.

f. The proposal to require Consumers to immediately begin to deskew the rates paid by the utility's full service customers should not be adopted at this time.

g. The Staff should be directed to commence separate collaborative discussions with all interested persons to develop a standardized COSS model and uniform line extension policies. The Staff should also establish a collaborative to consider a de-averaged distribution system credits pilot program.

h. Consumers should be directed to file a full rate case proceeding no later than July 1, 2008, based on operating data from calendar year 2007.

i. The Staff's proposal for adoption of a new Rate E should be approved.

j. Consumers' proposal to adopt a TPR tariff provision to provide discounts to customers already taking service from the utility pursuant to a Commission-approved special contract should be approved with a one-year commitment period and a 30-day window of opportunity for

acceptance of the new rate. The 30-day period should not commence until after implementation of the new rates.

k. Consumers should be directed to make contributions to the LIEEF in the annual amount of $26,536,000.

l. Consumers should be authorized to implement pension and OPEB equalization mechanisms.

m. Consumers should be directed to submit a letter, signed by the Chairman of Consumers on behalf of the company, which agrees to make the additional forestry expenditures as well as the additional fossil and nuclear operations expenses or to refund any unexpended amounts to its customers. The letter should also contain a waiver of Consumers' right to object to the refund provisions on grounds of retroactive ratemaking and an agreement to submit annual tracking reports regarding forestry and tree-trimming to the Staff.

n. Consumers should be directed to meet with interested parties to discuss the implementation of a program containing the essential elements of the PAYS® concept. The company should also be directed to file a report with the Commission no later than April 17, 2006 on the progress of this matter.

o. Consumers' production fixed costs that had been stranded when customers moved to choice service have now been reallocated to customers in the bundled service rate classes. This reallocation of production fixed costs in this rate case now allows Consumers full recovery of its production fixed costs on a going forward basis. Therefore, production fixed costs cease to be stranded. Because this rate case now allows Consumers to recover its production fixed costs on a going forward basis from its bundled service rate customers, and the Commission is allowing Consumers to recover, in its annual stranded costs cases, its production fixed costs from choice

customers from the enactment of the Act 141 rate freeze, the Commission finds that it has provided for full recovery of Consumers' net stranded costs, as required by Act 141.

THEREFORE, IT IS ORDERED that:

A. Consumers Energy Company is authorized to increase its annual electric revenues by $86,149,000 as directed by this order.

B. Consumers' recommendation to allocate the revenue deficiency to all classes on the basis of an equal percentage of each class' present revenue is adopted, but with choice sales included in their native rate classes. Consumers shall file redesigned rates and modified tariff sheets by January 10, 2006 that conform to the Commission's findings in this order. At the same time, the company shall serve a copy of its new rates and tariff sheets on all parties to this proceeding. The rates shall be designed with power supply charges and distribution charges unbundled. The full service and choice distribution charges shall be based on the cost of service except that the bundled service distribution charges shall be adjusted to include the inter-class subsidy, to bring the revenues for the class to the level approved by this order. The redesigned rates shall not separately identify the RAC; instead there should be separate distribution charges for full service and choice customers. The RAC charges to be incorporated into the full service distribution charges shall be calculated by comparing the approved revenue requirement for each rate class to its cost of service. The COSS shall be based on the methodology in the Staff's study, shown on Exhibit S-23, adjusted to allocate transmission costs using the 12CP 75/25 methodology. The redesigned rates shall also incorporate the new PSCR base as previously discussed.

Consumers shall revise its tariff sheets to show power supply charges, full service distribution charges, and the choice distribution charges on the same rate schedule so that customers may more easily compare the full-service and choice rates. The Commission will issue an order indicating

the effective date of the redesigned rates following a review and acceptance of the rate schedules and revised tariffs.

C. The proposal by the Association of Businesses Advocating Tariff Equity and Energy Michigan to change Consumers Energy Company's method for allocating securitization and nuclear decommissioning costs is rejected.

D. The proposal to require Consumers Energy Company to immediately begin to deskew the rates paid by the utility's full service customers shall not be adopted at this time.

E. The Commission Staff is directed to commence separate collaborative discussions with all interested persons to develop a standardized cost of service study model and uniform line extension policies. The Staff shall also establish a collaborative to consider a de-averaged distribution system credits pilot program.

F. Consumers Energy Company is directed to file a full rate case proceeding no later than July 1, 2008, based on operating data from calendar year 2007.

G. The Commission Staff's proposal for adoption of a new Rate E is approved.

H. Consumers Energy Company's proposal to adopt a transitional primary rate tariff provision to provide discounts to customers already taking service from the utility pursuant to a Commission-approved special contract is approved with a one-year commitment period and a 30-day window of opportunity for acceptance of the new rate. The 30-day period shall not commence until after implementation of the new rates.

I. Consumers Energy Company shall make contributions to the Low Income and Energy Efficiency Fund in the annual amount of $26,536,000.

J. Consumers Energy Company shall immediately convene collaborative meetings with interested parties and the Commission Staff to discuss the implementation of a program containing

the essential elements of the PAYS® concept. The company shall file reports of the agreed resolutions on this matter with the Commission as soon as any resolutions are reached, but no later than April 17, 2006.

K. Consumers' production fixed costs that had been stranded when customers moved to choice service have now been reallocated to customers in the bundled service rate classes. This reallocation of production fixed costs in this rate case now allows Consumers full recovery of its production fixed costs on a going forward basis. Therefore, production fixed costs cease to be stranded. Because this rate case now allows Consumers to recover its production fixed costs on a going forward basis from its bundled service rate customers, and the Commission is allowing Consumers to recover, in its annual stranded costs cases, its production fixed costs from choice customers from the enactment of the Act 141 rate freeze, the Commission finds that it has provided for full recovery of Consumers' net stranded costs, as required by Act 141.

L. Consumers is directed to submit a letter, signed by the Chairman of Consumers on behalf of the company, which agrees to make the additional forestry expenditures as well as the additional fossil and nuclear operations expenses or to refund any unexpended amounts to its customers. The letter shall also contain a waiver of Consumers' right to object to the refund provisions on grounds of retroactive ratemaking and an agreement to submit annual tracking reports regarding forestry and tree-trimming to the Staff.

M. Consumers is authorized to implement pension and OPEB equalization mechanisms.

The Commission reserves jurisdiction and may issue further orders as necessary.

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, pursuant to MCL 462.26.

MICHIGAN PUBLIC SERVICE COMMISSION

/s/ J. Peter Lark
Chairman

(S E A L)

/s/ Laura Chappelle
Commissioner

/s/ Monica Martinez
Commissioner

By its action of December 22, 2005.

/s/ Mary Jo Kunkle
Its Executive Secretary

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, pursuant to MCL 462.26.

MICHIGAN PUBLIC SERVICE COMMISSION

____
Chairman

____
Commissioner

____
Commissioner

By its action of December 22, 2005.

____
Its Executive Secretary