

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of)	
CONSUMERS ENERGY COMPANY for)	
accounting approval of depreciation rates for)	Case No. U-15629
gas utility plant.)	
_____)	

At the September 29, 2009 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. Orjiakor N. Isiogu, Chairman
Hon. Monica Martinez, Commissioner
Hon. Steven A. Transeth, Commissioner

OPINION AND ORDER

History of Proceedings

On July 31, 2008, Consumers Energy Company (Consumers) filed an application, with supporting testimony and exhibits, requesting approval of revised depreciation accrual rates for accounting and ratemaking purposes for the company’s gas utility plant. The company also requested a determination that it had substantially complied with the June 26, 2007 order in Case No. U-14292 (June 26 Order).

On November 26, 2008, a prehearing conference was conducted before Administrative Law Judge James N. Rigas (ALJ). The ALJ granted petitions to intervene filed by Attorney General Michael A. Cox (Attorney General) and the Association of Businesses Advocating Tariff Equity (ABATE). The Commission Staff (Staff) also participated in the proceeding.

On December 3, 2008, Consumers filed a partial settlement agreement in this docket in which all parties agreed that the Commission should authorize the company to implement a proposed depreciation schedule from the date that Consumers implemented the settled retail rates in Case No. U-15506 until the Commission issues a final order in this proceeding. The parties to the settlement noted that implementing the proposed depreciation rates would decrease Consumers' depreciation expense by \$19.6 million annually from the depreciation schedule authorized before the settlement. On December 23, 2008, the Commission approved the settlement agreement.

Evidentiary hearings were conducted on April 27 and 28, 2009. On May 15 and May 27, 2009, the parties filed briefs and reply briefs. On July 1, 2009, the ALJ issued his Proposal for Decision (PFD). On July 17, 2009, Consumers, the Staff, and ABATE filed exceptions. On July 31, 2009, Consumers, the Staff, the Attorney General, and ABATE filed replies to exceptions. The record in this case consists of 340 pages of testimony and 28 exhibits received into evidence.

Positions of the Parties

Dane A. Watson of Alliance Consulting Group performed a depreciation study for Consumers and also provided the alternative net salvage calculations required by the June 26 order.

Mr. Watson testified that he calculated cost of removal expense using the traditional method (i.e., the straight line average group life method), the five-year net salvage method, the Statement of Financial Accounting Standards (SFAS) No. 143 approach, and the inflation adjusted method. 2 Tr 48, 52. According to Mr. Watson, his analysis using the traditional approach supports a reduction in depreciation expense of approximately \$19.7 million per year. 2 Tr 52-54.

Mr. Watson testified that Consumers' depreciation expense is decreasing largely because of a reduction in realized removal cost over the past few years, which in turn has allowed the company to lower the projected cost of future removals.

Mr. Watson observed that net salvage rates for Consumers were last approved in Case Nos. U-12999 and U-13730 using the average five-year net salvage percent of retirements.

Mr. Watson testified that using this approach would result in a more negative net salvage rate and higher depreciation expense than the traditional approach. 2 Tr 58-59. Mr. Watson opined that the traditional approach is more appropriate than the five-year average percent of retirements method because the traditional approach allows for the reflection of trends in net salvage.

Mr. Watson explained that under the SFAS No. 143 method, the net present value (liability) and removal cost expense were calculated in the same manner that Consumers calculates its legal Asset Retirement Obligations (AROs) for reporting in financial statements. 2 Tr 62; Exhibit A-3. Mr. Watson testified that in the inflation adjusted approach, he adjusted the inflation for the remaining future years of the assets based on the difference between the 30-year average historical inflation rate and the 30-year average projected inflation rate. 2 Tr 63; Exhibit A-4. Mr. Watson contended that the SFAS No. 143 approach was not appropriate for regulatory accounting because: 1) it was created solely for financial reporting purposes; 2) the Federal Energy Regulatory Commission (FERC) has stated that there is no reason to change to this method; 3) SFAS No. 143 accounting defers depreciation expense to future customers; 4) depreciation expense for removal cost increases every year requiring annual filings to ensure appropriate cost recovery in rates; and 5) it is difficult to accurately calculate liabilities or accretion under the SFAS No. 143 approach for mass property. 2 Tr 64.

Mr. Watson testified that the inflation adjusted approach was likewise problematic because it is impossible to predict future inflation and because the average ages of retirements are generally much shorter than the average life of the accounts. Thus, more years of inflation will act upon the

assets in the future as the average age of retirements moves toward the average life of the account. This will move the net salvage percentages more negative than is reflected in the current analysis.

Mr. Watson added that the traditional method of estimating future salvage and removal costs is the approach authoritative sources generally support, citing the publication *Public Utility Depreciation Practices* published by the National Association of Regulatory Utility Commissioners (NARUC) and the 1994 treatise *Depreciation Systems*, by Wolf and Fitch. 2 Tr 66-67.

Jan C. Anderson, the Manager of Depreciation Studies and Regulatory Filings for Consumers, testified that Consumers reviewed its records and determined that a retrospective change in retirement units using the Staff's proposed Standard Retirement Units (SRUs) would be an administrative burden, if it was feasible at all. According to Ms. Anderson:

The Company has electronic files for the more recent years of 1999 through to present that could be electronically reviewed. But, prior to that time, manual work orders would need to be reviewed. Although we don't have an exact historical work order count, with 1.7 million gas services, 26,000 miles of gas distribution main, and 1,700 miles of gas transmission main, it is estimated that more than two million work orders were processed to record these assets. And if it is conservatively estimated that each order would take only five minutes to review and repost using the proposed Standard Retirement Units, it would require 80 full time employees each working for a full year on this and nothing else, to convert the historical information to the Staff's proposed Standard Retirement Units.

2 Tr 23-24.

Ms. Anderson added that despite the difficulty in converting past accounts, Consumers would support the use of the Staff's proposed SRUs on a going-forward basis. Ms. Anderson recommended that the changes in retirement units should be effective on the first day of the subsequent year, provided there is at least 90 days from the order date to the first day of the subsequent year. In addition, the change in retirement units should be effective concurrent with an order in a general rate case.

The Staff recommended that the Commission adopt Consumers' depreciation method and depreciation rates, noting that it agreed with Consumers' analysis of the shortcomings of the alternative methods and added that the traditional method produces reasonable results without being overly burdensome or overly reliant on analytical tools. The Staff also recommended that the Commission reject Consumers' failure to perform the depreciation study using the recommended SRUs as required by the June 26 Order. The Staff noted that no party addressed Consumers' failure to conduct this study, and added that this issue was contested by the parties to Case No. U-14292. The Staff recommended that the Commission direct Consumers to conduct the study and to file it at a date to be set at the Commission's discretion.

The Staff recommended that the traditional method should continue to be used for determining the net salvage for Consumers' gas plant depreciation, and that the company's net salvage calculations should be adopted in this case. The Staff recommended that the rates and service lives set forth by the company in this case should also be adopted and that Consumers' next gas depreciation study should be filed two years from the date of issuance of the order in this case. Following this, the Staff recommended that regular depreciation cases should be filed every three to four years. Finally, the Staff recommended that Consumers perform a study of its cost of removal and salvage practices as part of its next depreciation study for the purpose of keeping these costs under control.

William W. Dunkel, the principal of William Dunkel and Associates, testified on behalf of the Attorney General. Mr. Dunkel asserted that the traditional method for calculating future cost of removal overrecovers removal costs in general and that the overrecovery is more significant in the early years when removal costs are collected. 2 Tr 149, 156. Mr. Dunkel explained that under the traditional approach, the current removal cost for new plant is established, and this cost is then

inflated to the year of removal to determine the future cost of removal. This future removal cost is then divided by the number of years of service to derive the annual amount that must be collected to retire the plant. Mr. Dunkel provided an example of a current removal cost of \$50 for a pipeline expected to last 50 years. Applying inflation, the future cost of removal of the pipeline is calculated to be \$649. Under the traditional method, the company must collect \$12.98 per year ($\$649/50$) to cover the cost of removal. 2 Tr 153. According to Mr. Dunkel, the traditional approach fails to take into account the difference in purchasing power of current dollars compared to future dollars. Mr. Dunkel testified, “Calculating that \$12.98 in Year 2057 dollars is owed, but collecting \$12.98 in Year 2007 dollars is an overcharge, because Year 2007 dollars are worth much more than Year 2057 dollars.” 2 Tr 154.

Mr. Dunkel testified that the traditional approach was developed at a time when net salvage tended to be positive. Now, however, net salvage is more likely to be negative and, according to Mr. Dunkel, the theory on which the traditional approach is based was not designed to properly handle prepayments by customers.

Mr. Dunkel advocated that the Commission adopt a depreciation method that he called the “Present Value/SFAS 143/FERC Order 631” approach. Mr. Dunkel testified that under this approach, customers in 2007 are required to pay the present value of their share of the future removal cost. Thus, 2007 customers are responsible for paying \$12.89 in 2057 dollars, rather than 2007 dollars. In year 2007, customers would pay enough such that the money they paid, plus 50 years of interest on that money, would sum to the \$12.89 needed for their share of the removal cost in year 2057 in 2057 dollars. 2 Tr 164.

James T. Selecky, a consultant in the field of public utility regulation and a principal in the firm of Brubaker & Associates, Inc., testified on behalf of ABATE. According to Mr. Selecky,

Consumers' proposed depreciation rates are excessive because the cost of removal component of the depreciation rates reflects unreasonable amounts for future inflation. As a result, the cost of removal expense included in the depreciation rates greatly exceeds the actual net salvage expense currently incurred and the net salvage expense likely to be incurred in the near future.

Mr. Selecky testified that Consumers' proposed net salvage ratios produce an annual net salvage expense of \$52.92 million. However, according to Mr. Selecky, Consumers' average actual annual net salvage expense over the last five years was \$6.89 million, an amount that is 8 times lower than the company's proposed cost of removal expense. 3 Tr 298. Mr. Selecky testified that based on his analysis, Consumers has overstated the amount of net salvage that is included in depreciation rates and that this overstatement of net salvage places an unreasonable burden on today's ratepayers and provides a substantial benefit to future ratepayers. Mr. Selecky opined that the amount of net salvage included in Consumers' depreciation rates should be reduced to reflect a more accurate expectation of the level of net salvage expense that the company expects to incur over the next five to ten year period. Mr. Selecky testified that the disparity between net salvage expense included in Consumers' depreciation rates and actual net salvage costs is largely attributable to an overestimate of future inflation rates.

Mr. Selecky recommended that Consumers' net salvage expense should be based on the actual net salvage cost experience of the company over 15 years, the longest period for which data was available. Once the historical 15-year average was identified, this amount was then grossed-up for inflation over a period of 10 years to determine an average accrual of \$9.956 million for net salvage. 3 Tr 314-315; Exhibits AB-3 and AB-4. Mr. Selecky noted that periodic depreciation cases will allow for adjustments if cost of removal expense increases in the future.

Proposal for Decision

The ALJ noted that the parties did not disagree on Consumers' method for calculating depreciation expense and rates related to the recovery of original plant investment cost but did disagree on how the company should calculate depreciation expense and rates for recovery of net salvage costs. The ALJ prefaced his findings by observing that the June 26 order established the Commission's view that comparing removal costs in today's dollars with the original cost of the plant being retired is problematic because it assumes that high inflation rates from the past will continue into the future and fails to take into account the time value of money. The ALJ found that the traditional method for calculating future removal costs, as advocated by the Staff and Consumers, did not address the concerns in the June 26 order because the traditional method does not address the time value of money or significant depreciation expense accruals.

The ALJ agreed with ABATE that the traditional method does not provide reasonable or accurate results, and agreed with Consumers and the Staff that because the method proposed by ABATE uses a time span that is much shorter than the service life of the plant items being depreciated, this method will not permit the utility to recover its actual plant in service retirement costs.

The ALJ found that the record provides a choice between Consumers' SFAS No. 143 method and the Attorney General's proposed present value method. The ALJ determined that the method presented by the Attorney General was least problematic and recommended its adoption by the Commission. The ALJ added that periodically reviewing the present value calculations will provide the opportunity for refinement and will address the concerns about the accuracy of the results.

The ALJ agreed with the Staff's recommendation that consideration of SRU's should be deferred to the rulemaking proceeding in Case No. U-14812 and with the Attorney General's recommendation that Consumers should be required to file its cost of removal study and next depreciation case two years after the final order in this case.

Exceptions and Replies

Consumers takes exception to the ALJ's recommendation that the present value method should be adopted for calculating net salvage. According to Consumers, the present value method causes current customers to underpay and forces later customers to pay too much for removal costs. Consumers argues that in addition to this inequity, future customers will also face a higher rate base, which will cost them more for carrying the cost of the assets' net book value; they will pay more for maintenance expenses; and they will pay more for future assets that are capitalized at a higher cost. Consumers asserts that the ALJ failed to recognize that under regulated accounting, every dollar of removal cost recovered from customers is charged to the depreciation reserve, and every dollar added to the reserve decreases Consumers' rate base. Consumers claims that adoption of the present value approach would result in a 50% increase in both future value cost and current value cost over the traditional method's straight-line recovery of removal costs.

Consumers argues that the ALJ erred in finding that the traditional method does not provide reasonable or accurate results and erred by selectively applying language from the June 26 order. Consumers points to the Commission's concerns about the size of the company's cost of removal expense, noting that subsequent to the June 26 order the company reduced its cost of removal expense by over \$19 million per year. According to Consumers, this reduction, coupled with the company's commitment to file another depreciation study in two years, addresses this concern. Consumers adds that the ALJ ignored the language in the June 26 order characterizing the

Attorney General's proposed present value approach as "radical." Consumers adds that the Attorney General's proposed reduction of \$47.5 million from the levels set in Case No. U-12999 demonstrates that the Commission's concerns about the Attorney General's approach were sound. Consumers claims that such a substantial reduction could have a significant adverse effect on the company's cash flow. Consumers also asserts that, despite the Attorney General's opinion to the contrary, the company would have to file a depreciation case every year to assure full cost recovery.

Finally, Consumers argues that if the Commission determines that an SFAS No. 143 approach to cost of removal calculation is most appropriate, the Commission should adopt the SFAS No. 143 approach presented by Consumers. Consumers argues that the calculation presented by Mr. Dunkel violates a basic requirement of SFAS No. 143: that the calculation must use the future value of removal costs at the planned time of removal. Consumers notes that Mr. Dunkel used 22.8 years as the average age of asset retirements, rather than the projected asset retirement age of 40 years. The \$28 million difference between Consumers' SFAS No. 143 method and Mr. Dunkel's version is the result of Mr. Dunkel's exclusion of 17 years of inflation.

The Staff likewise takes exception to the ALJ's recommendation that the Attorney General's present value method should be adopted for calculating future cost of removal expense. The Staff claims that, contrary to the ALJ's finding, shifting costs to future ratepayers by implementing the present value method will create intergenerational inequities because these inequities are intrinsic to the method. The Staff adds that the intergenerational inequity created by the present value method would not necessarily be corrected by holding depreciation cases on a regular basis.

ABATE argues that the ALJ erred in rejecting its approach for calculating net salvage. According to ABATE, the ALJ summarized the advantages of using the 15-year average historical

net salvage expense inflated for 10 years, but then rejected it on grounds that it uses a much shorter period than the service life of the plant being depreciated and resulted in a significant reduction in cost of removal expense. ABATE argues that it is unreasonable to find a method that uses future predictions of net salvage expense preferable to one that uses the best available historical information coupled with a future estimate of inflation. ABATE observes that all of the advantages associated with the SFAS No. 143 method are true of ABATE's proposed approach; however, the approach advocated by ABATE has the additional advantage of a basis in actual historical data.

Findings of Fact and Conclusions of Law

On October 14, 2004, the Commission issued an order in Case No. U-14292 requesting comments regarding “[the] future treatment of FAS No. 143-related issues, proper future ratemaking policy regarding those issues, necessary uniform system of accounts revisions, and other matters that are related to the retirement of tangible long-lived assets and the associated asset retirement costs.” After reviewing the comments, the Commission issued a final order on June 26, 2007. In the June 26 order, the Commission observed, among other things, that, “an SFAS No. 143 approach applied to required [asset retirement obligations] ARO and other ARO accounts would be informative, even if the Commission determines that SFAS No. 143 should not be used for ratemaking.” The Commission then directed the large utilities to:

[F]ile new depreciation cases in 2008, using 2007 cost of removal expenses as a basis, and to calculate cost of removal depreciation under: 1) the current method for calculating cost of removal; 2) the current method for calculating cost of removal using the standard retirement units proposed by the Staff; 3) the method proposed by Mr. Czech and using the standard retirement units proposed by the Staff; and 4) an SFAS No. 143 approach that considers the time value of money applied to required AROs and other AROs, with and without the standard retirement units proposed by the Staff. This additional information will allow the

Commission to assess the propriety of the different proposals and the efficacy of implementing them for each individual utility.

June 26 order, p. 33.

The Commission agrees with Consumers and the Staff that continued use of the traditional, straight-line depreciation method, coupled with the use of the Staff's proposed SRUs on a going-forward basis, is the most appropriate means of addressing future removal costs. As discussed by Mr. Watson in his rebuttal testimony, the net present value approach proposed by the Attorney General has been consistently rejected by most Commissions and does not comport with depreciation methods recommended by authoritative sources on depreciation accounting. The accrual for net salvage must be based on estimates of the future cost that will be incurred, not the removal cost at today's price level. Therefore, it is appropriate to ask current customers to pay for future costs of removal at inflated price levels, and, as Mr. Watson pointed out, the rate base offset compensates rate payers for the prior payment for the costs incurred by the utility. Finally, the Commission finds that the Attorney General's proposed method significantly decreases the cash flows available to utilities to meet their infrastructure and other public service obligations. This, in turn, has a negative financial effect on both the utility and its customers by requiring that such obligations be met with more expensive sources of external financing and by driving up the cost generally of obtaining money in the capital markets. The Commission finds that the Attorney General has not shown that the adoption of the net present value method would justify these increased costs for utility consumers.

The Commission disagrees with the Staff's recommendation that Consumers should be required to perform a depreciation study using the Staff's recommended SRUs as required by the June 26 order. While it is true that there was some dispute over the effects of changing to SRUs, the amount of effort required to update older, non-electronic records was not contemplated by the

Commission or the utilities. The Commission therefore agrees with Consumers that the Staff's recommended SRUs should only apply on a going-forward basis.

THEREFORE, IT IS ORDERED that:

A. Consumers Energy Company shall continue the depreciation rates authorized by the December 23, 2008 order approving a partial settlement agreement in this case.

B. Consumers Energy Company shall file a new depreciation case and an updated depreciation study by September 15, 2011.

C. Consumers Energy Company shall use standard retirement units proposed by the Commission Staff in Case No. U-14292 for new gas plant effective January 1, 2010.

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

Orjiakor N. Isiogu, Chairman

By its action of September 29, 2009.

Monica Martinez, Commissioner

Mary Jo Kunkle, Executive Secretary

Steven A. Transeth, Commissioner