STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of **MICHIGAN CONSOLIDATED GAS COMPANY** for approval of deferred accounting, deferred tax accounting, and rate recovery of environmental assessment and remediation costs.	)	Case No. U-10149
In the matter of the application of **MICHIGAN CONSOLIDATED GAS COMPANY** for authority to increase its rates and for other relief.	)	Case No. U-10150

At the October 28, 1993 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. John L. O'Donnell, Acting Chairman
Hon. Ronald E. Russell, Commissioner

OPINION AND ORDER

I.

HISTORY OF PROCEEDINGS

The existing rates for Michigan Consolidated Gas Company (Mich Con) were established by a settlement agreement approved in the Commission's April 12, 1990 order in Case No. U-9475. Paragraph 23 of that settlement agreement states:

"Mich Con shall file a general rate case on or before September 1, 1992 . . . to be effective no earlier than the first billing unit of January 1994 and utilizing a calendar year 1994 test year."

In accordance with paragraph 23, Mich Con filed an application on September 1, 1992, together with supporting testimony and exhibits, requesting authority to revise its rates for gas service so as to increase annual revenues by approximately $122 million. (However, as noted on page 132 of its replies to exceptions, the utility ultimately reduced its requested rate increase to $49.2 million.) Mich Con's application was conditionally accepted for filing pending receipt of additional documentation. On September 10, 1992, Mich Con satisfied these conditions by submitting a copy of the 1991 Annual Report for MCN Corporation (Mich Con's parent) and a revised version of Exhibit A-5, Schedule E-2, showing all accounts charged with affiliated company transactions.

Pursuant to due notice, a prehearing conference was held on September 30, 1992 before Administrative Law Judge Lana Shafer (ALJ). During and subsequent to the prehearing conference, the ALJ granted petitions to intervene submitted by: the Association of Businesses Advocating Tariff Equity (ABATE); the Residential Ratepayer Consortium (RRC); Attorney General Frank J. Kelley (Attorney General); Nancy Wood and Lason Systems, Inc. (whose party status was subsequently revoked for failure to respond to interrogatories); The Detroit Edison Company (Detroit Edison); Consumers Power Company (Consumers); ANR Pipeline Company (ANR); West Michigan Energy Users Group, et al. (West Michigan); Terra Energy, Ltd. (Terra); Oilfield Investments, Ltd. (who later withdrew from these proceedings); Antrim Development Corporation, Grace Petroleum Corporation, Muskegon Development Company, Ward Lake Drilling, Inc., d/b/a Ward Lake Energy, and Wolverine Gas and Oil

Company, Inc. (Antrim); and NOMECO Oil and Gas Company (NOMECO).[1] The Commission Staff (Staff) also participated in the proceedings.

On November 5, 1992, Mich Con's previously filed application for approval of deferred accounting, deferred tax accounting, and rate recovery of environmental assessment and remediation costs associated with manufactured gas plant sites owned or previously owned by Mich Con (Case No. U-10149) was consolidated with this general rate case (Case No. U-10150).

Cross-examination of all witnesses commenced on December 7, 1992 and concluded on April 2, 1993. The record consists of 4,765 pages of transcript and 191 exhibits that were received into evidence.[2] Briefs were filed on or before May 3, 1993 by Mich Con, the Staff, ABATE, the RRC, the Attorney General, NOMECO, Antrim, and Detroit Edison. Subsequently, all of these parties except Detroit Edison filed reply briefs. On July 9, 1993, the ALJ issued a Proposal for Decision (PFD) recommending a rate increase of $16,837,000. Exceptions were filed on July 30, 1993 by all parties except Consumers, ANR, and Terra. On August 13, 1993, Mich Con, ABATE, the Staff, the Attorney General, NOMECO, and Antrim filed replies to exceptions.

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[1]Antrim and NOMECO will also be referred to in this order as "the producer-intervenors."

[2]Exhibits I-100 and I-186 were denied admission by the ALJ, and Exhibits I-41 and A-108 were not offered into evidence.

II.

DESCRIPTION OF THE APPLICANT

Mich Con is an investor-owned public utility engaged in the transmission, distribution, and sale of natural gas. Its service territory includes Detroit, Grand Rapids, and Ann Arbor, as well as communities in the central and northern sections of the lower peninsula and the central and eastern sections of the upper peninsula. Mich Con serves 1,026,680 residential customers, 75,752 commercial and industrial sales customers, 811 transportation customers, and 135 school customers. As noted earlier, Mich Con is a subsidiary of MCN.

III.

TEST YEAR

In each rate case, a test year must be selected. In this proceeding, the parties agree that, pursuant to the settlement adopted in Case No. U-9475, calendar year 1994 must be used as the test year. However, a difference of opinion exists between Mich Con and the Staff over the methodology that should be utilized to forecast Mich Con's expenditures for that period.

The Staff asserts that the utility's 1994 test year revenue requirement should be "derived from the historical test year (13-month average test year ended May 31, 1992 as determined by the Applicant) adjusted for known and measurable changes." (Staff's reply brief, pp. 12-13.) According to the Staff, this is consistent with the position adopted by the Commission in its most recent gas utility rate case decisions, namely its December 7, 1989 order in Case No. U-8924 (involving Consumers) and its June 29, 1990 order in Case No. U-9323 (involving Michigan Gas Company). In contrast, Mich Con contends that those orders did not signal the adoption of a "hard and fast rule" requiring reliance solely upon known and measurable changes to the historic test year. (Mich Con's reply brief, p. 11.) Thus, Mich Con proposes that a fully-projected test year be adopted. Only in this manner, the utility contends, can the full cost of plant additions that it has proposed to make between May 31, 1992 and the mid-point of 1994 be recognized in rates.

Michigan does not have a statute that requires the use of any particular type of test year. Rather, the selection of a test year is within the Commission's broad ratemaking power and expertise. [Consumers Power Company v Michigan Public Service Commission, 181 Mich App 261 (1989).] The Commission is therefore free to select any reasonable methodology that is consistent with the objective of determining the level of investment on which the shareholders of the utility are entitled the opportunity to earn a fair rate of return, as well as the levels of expenditures that the utility is entitled the opportunity to recover. In making this selection, "[i]t is the overall objective of fairness, rather than devotion to a particular methodology, that is of paramount importance." (December 7, 1989 order in consolidated Cases Nos. U-8678, U-8924, and U-9197, p. 13.)

In the present consolidated proceedings, the Commission rejects the fully-projected test year sponsored by the utility. Mich Con's proposal includes several construction projects that, at the time of these proceedings, had not progressed beyond the planning stage.[3] The Commission therefore agrees with the conclusion reached by the Staff, and concurred in by the ALJ, that at least portions of Mich Con's projected test year figures constitute little more than

[3]Indeed, during the course of these proceedings, Mich Con withdrew its applications for approval to construct and operate the Belle River to Milford Loop and the Grand Rapids and Sparta Pipelines. (12 Tr. 2522-2525.) The total cost associated with these two proposed construction projects, $112.7 million, had been included in the utility's initial filing.

budget requests whose adoption would unfairly and unnecessarily inflate the utility's revenue requirement. The Staff's approach to the test year is thus more reasonable than Mich Con's proposal and should be adopted as the starting point for the calculation of the utility's revenue requirement. Finally, the Commission agrees with the Staff and the ALJ that those historical figures should be revised to reflect known and measurable changes occurring after May 31, 1992.

IV.

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. In this case, the Staff proposed that $1,025,416,000 be adopted as Mich Con's rate base, consisting of $951,051,000 in net utility plant and $74,365,000 in working capital. In contrast, Mich Con calculated its projected rate base to be $1,167,727,000, composed of $1,118,941,000 in net utility plant and $48,786,000 in working capital. The ALJ recommended adopting the Staff's figures.

Net Utility Plant

The parties agreed that the appropriate starting point for this analysis is Mich Con's December 31, 1991 net utility plant figure, namely $916,151,000. However, their respective analyses differed significantly from that point forward.

Susan Crimmins Devon, Supervisor of the Gas Audit Section of the Commission's Gas Division, offered the Staff's position regarding net utility plant. In keeping with the Staff's belief that only known and measurable changes should be added to Mich Con's December 31, 1991 net utility plant, she included (1) the cost of the Kalkaska Compressor Station, a project that was under construction in 1992 and will be placed in service sometime in 1993, (2) the additional cost of the Willow Run to Milford Loop, which was placed in service in early 1992, and (3) the capitalized costs of Statement of Financial Accounting Standards 106 (SFAS 106) postretirement benefits for 1993 and 1994, whose inclusion in utility rates was authorized by the Commission's December 8, 1992 order in Cases Nos. U-10040 and U-10040-A. (17 Tr. 3408.) This resulted in a figure of $958,604,000. She then reduced this figure by $59,000 to reflect the reclassification of a historical plant acquisition adjustment to non-utility operations and subtracted $7,494,000 for estimated contractors' liability and customer advances for construction. (Exhibit S-70, Schedule B-2, p. 1.) This resulted in a net utility plant for mid-1994 of $951,051,000. Although originally proposing a higher figure, ABATE supported the Staff's position.

In contrast to the Staff's inclusion of only known and measurable changes, Mark Cieslak, Mich Con's Director of Michigan Regulation and its lead witness on this issue, offered a fully-projected estimate of net utility plant. Specifically, he added $432,047,000 in projected construction for 1992 through 1994, subtracted $214,221,000 to cover projected depreciation and depletion, and made several small adjustments to arrive at a projected net utility plant of $1,126,471,000 for mid-1994. (Exhibit A-8, Schedule B-3.) Mich Con subsequently revised this figure to reflect--as proposed by the Staff and ABATE--the withdrawal of the utility's request to build the Belle River to Milford Pipeline and the Grand Rapids and Sparta Pipelines. It also agreed to the Staff's proposed adjustments regarding the capitalization of

SFAS 106 costs,[4] the reclassification of the acquisition adjustment, and the reduction for contractors' liability and customer advances. This left Mich Con's projected net utility plant at $1,011,978,000. (Mich Con's initial brief, pp. 8, 9, and 17.)

The remaining difference between the net utility plant proposed by the Staff and ABATE, on the one hand, and that proposed by Mich Con, on the other, arises primarily from one factor. Specifically, the parties disagree about the treatment of routine construction programs that the utility claims either were, or will be, undertaken between December 31, 1991 and mid-1994.

The Staff and ABATE assert that, consistent with past practice, Mich Con's spending on routine construction projects will be offset by its annual depreciation expense. Thus, they contend, Mich Con's net utility plant will not increase as a result of routine construction between December 31, 1991 and mid-1994. The Staff and ABATE go on to argue that Mich Con's evidentiary support for its projected routine construction expenditures is limited to "a brief description of the elements of the major categories of construction" and that "[n]o factual evidence has been provided upon which [these parties] can even identify the cause of, much less make a reasonable judgement concerning the need for, the proposed increases." (Staff's initial brief, p. 18; citing 17 Tr. 3412-3413.) They therefore contend that Mich Con "failed to prove that its proposed routine construction is reasonable and prudent or that significant additional construction dollars should be awarded for on-going, routine construction."

[4]As noted in Mich Con's initial brief, the Uniform System of Accounts classifies SFAS 106 costs as part of the utility's "Administrative and General Expense." The utility goes on to note that a portion of these expenses are routinely capitalized. The $4.5 million of SFAS 106 costs that the parties propose to capitalize in this case represent the part of Mich Con's "Administrative and General Expense" that should be allocated to plant construction and, ultimately, to utility plant in service. (Mich Con's initial brief, p. 9; citing 16 Tr. 3214 and Exhibit S-70, Schedule B-2, p. 2.)

(ABATE's initial brief, p. 13.) For these reasons, the Staff and ABATE request that the Commission adopt the $951,051,000 net utility plant proposed by Ms. Devon and recommended by the ALJ.

In excepting to the ALJ's recommendation, Mich Con argues that there is no support for the claim that routine construction expenditures for 1992 through 1994 will equal depreciation expense. According to the utility, no evidence was offered to show that the routine construction projects envisioned by Mich Con and accounted for in its direct case are unnecessary. Moreover, the utility asserts, neither the Staff nor ABATE claims that Mich Con's methodology for computing its new construction is incorrect. Mich Con goes on to assert that, even if the joint Staff/ABATE position is adopted, evidence provided in this case supports adding $19.3 million in specific plant additions[5] to the net utility plant proposed by Ms. Devon. Mich Con therefore claims that its proposed net utility plant of $1,011,978,000 should be adopted or, at the very least, $19.3 million should be added to the figure proposed by Ms. Devon, resulting in a new net utility plant of $970,351,000.

The Commission finds that the net utility plant figure supported by the Staff and ABATE, and recommended by the ALJ, should be adopted. It reaches this conclusion for the following three reasons.

First, as correctly noted by Ms. Devon, Mich Con "is proposing significant increases in its annual routine construction budgets for 1992, 1993, and 1994 over historical levels of

[5]As originally proposed by Mich Con, this figure was $24.1 million and encompassed 7 "known and ongoing" construction projects. However, in its exceptions, the utility acknowledged that one of those projects--the proposed construction of the Lynch Road facility adjacent to the Detroit City Airport--has been postponed indefinitely. (Mich Con's exceptions, pp. 11-12.) Thus, as shown on Appendix A-1 to its exceptions, the utility now contends that the joint Staff/ABATE figure must be increased by $19.3 million.

expenditures." (17 Tr. 3412.) Specifically, Mich Con's proposed 1992-1994 routine construction budgets are an average of 42% higher than its average construction expenditures for the five previous years. (Exhibit S-70, Schedule B-2, p. 3.) This represents a significant departure from the utility's past corporate operating objective, which limited annual construction expenditures to a level equal to its annual depreciation expense. This corporate objective was explained by Howard L. Dow, III, Mich Con's Vice President-Rates and Regulatory Affairs, as follows:

> "Since 1984, Mich Con has set an operating objective to limit its construction expenditures to no more than the annual depreciation expense. This overall cap has been an effective control technique which allows Mich Con to minimize its need for external financing and ultimately has reduced the need for more rate relief." (9 Tr. 3413; citing Mr. Dow's testimony in Case No. U-8812.)

Although the utility argues that the objective discussed by Mr. Dow "is obviously no longer the case" (Mich Con's initial brief, p. 13), it cites no testimony in support of its proposition that this corporate objective has, indeed, been abandoned. More important, Mich Con offered no evidence to show that some satisfactory reason exists for abandoning this previous corporate practice. These are important omissions in light of fact that the utility seeks a 42% increase in its annual routine construction budgets.

Second, the burden of proof rests with the applicant. (See the Commission's March 11, 1986 order in Case No. U-7976; its February 19, 1986 order in Cases Nos. U-7554, U-6107, and U-7917; its July 16, 1985 order in Case No. U-7660; its June 26, 1985 order in Case No. U-7985; its August 17, 1984 order in Case No. U-7650; and its October 9, 1983 order in Case No. U-7298.) However, as correctly noted by the ALJ, Mich Con's evidence regarding its projected increase in routine construction expenditures "is sketchy at best." (PFD, p. 10.) Specifically, its testimony consisted of nothing more than a rough breakdown depicting how much of the proposed routine expenditures for 1992, 1993, and 1994 would be allocated to each of 15 broad classes of costs.[6] No evidence was offered to show that these expenditures were intended for reasonable and prudent projects.

Third, problems similar to those discussed above plague Mich Con's alternative request. Although the utility identified several specific construction projects in its rebuttal testimony that it claims were "known and ongoing" (19 Tr. 4026), the record contains no evidence demonstrating the reasonableness of the proposed costs.[7] For these reasons, the Commission finds that the net utility plant proposed by the Staff and supported by ABATE, $951,051,000, should be adopted.

Working Capital

Working capital is the amount of funds required to bridge the gap between the time of payment of a utility's expenses and the receipt of revenues from its customers. In this case, Mich Con, ABATE, and the Staff proposed widely varying figures for the utility's working capital allowance. However, the parties later reached agreement on all issues except one, whether the utility's investment in Mich Con Trading Company (MTC), as well as that subsidiary's accounts payable and receivable, should be included in the computation of Mich Con's working capital.

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[6]As shown on Exhibit A-8, Schedule B-2, the 15 classes corresponding to routine construction expense consist of basic categories like "Overhead", "Mains", "Structures", "Production Plant", and "Other".

[7]Although Mich Con attempted to offer some testimony in this regard during rebuttal, it was stricken by the ALJ on the grounds that it constituted improper rebuttal. The propriety of the ALJ's ruling is discussed in detail in Section XI of this order.

The Staff asserts that, because the commonality of interests between Mich Con and MTC that was found by the Commission in its December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854 continues to exist, these amounts should be included. In contrast, Mich Con contends that all amounts relating to MTC should be considered non-jurisdictional. The parties therefore agree that if the Commission decides to consider MTC as part of Mich Con for ratemaking purposes, $74,365,000 should be adopted as the utility's working capital allowance. They further agree that if MTC is excluded from consideration, the appropriate figure to adopt would be $46,546,000.

As will be discussed at length in Section VII of this order, the Commission finds that MTC should be included in the calculation of Mich Con's revenue requirements. Therefore, based on the agreement of the parties, it adopts $74,365,000 as Mich Con's working capital allowance.

Conclusion

Based on the discussion and findings set forth above, the Commission finds that Mich Con's rate base is $1,025,416,000, computed as follows:

Mich Con's Net Utility Plant	$ 951,051,000
Working Capital Allowance	74,365,000
Rate Base	$1,025,416,000

V.

RATE OF RETURN

In order to calculate Mich Con's revenue requirement, it is necessary to select a rate of return to be applied to the utility's rate base. Establishing a rate of return requires a review of each element of Mich Con's capital structure, as well as the cost of each source of capital.

As this case developed, the parties were able to reach agreement with respect to many components of the utility's capital structure and the cost of various sources of capital. Specifically, the parties agreed that Mich Con's capital structure should include $93,114,000 of short-term debt, $10,509,000 of customer deposits, $979,000 of temporarily retained customer refunds, $5,720,000 of preferred stock, $2,782,000 of investment tax credits, $152,598,000 of deferred income taxes, and $36,445,000 of job development investment tax credits (JDITC). They further agreed that the cost of short-term debt should be 3.85%, the cost of long-term debt should be 8.89%, the cost of customer deposits should be 9%, the cost of retained customer refunds should be equal to the return on common equity authorized in this case, the cost of preferred stock should be 8.69%, the cost of JDITC should be equal to the weighted cost of permanent capital, and both investment tax credits and deferred income taxes should be cost-free. The ALJ recommended that the Commission adopt these undisputed cost rates and capital structure percentages, and none of the parties except. The Commission finds that these figures are reasonable and should be adopted.

Despite these areas of agreement, controversy still exists with regard to the amounts of long-term debt and common equity that should be included in the utility's capital structure. The parties also disagree about the utility's cost of common equity.

Capital Structure

Only Mich Con and the Staff presented evidence regarding an appropriate capital structure. These parties agreed that the Commission should adopt a capital structure that will allow the utility to maintain its current "A" bond rating and attract capital at reasonable terms. Likewise, they agreed that maintaining this bond rating requires that Mich Con's permanent capital structure include no more than 50% debt. Despite this agreement, Mich Con and the Staff have proposed slightly different capital structures.

Mich Con's proposal was based on the testimony of Glenn A. Hand, Jr., its Manager-Financial Analysis and Corporate Finance, and Peter L. Verardi, MCN's Vice President and Treasurer. According to these witnesses, the utility's proposed capital structure would allow it to maintain a debt-to-equity ratio of approximately 1:1 at the close of the test year (December 31, 1994), even after accounting for the effects of Mich Con's capital leases. To achieve this year-end ratio, they asserted, the 13-month average of Mich Con's long-term debt would need to be 47.39% and the 13-month average of its total equity--including preferred stock--would have to be 52.61%. These witnesses further noted that Mich Con's projected 13-month average capital structure closely resembled its actual capital structure for the 13 months ended May 31, 1992, which consisted of 46.32% long-term debt and 53.68% total equity. (Exhibit A-4, Schedule D-1.)

The Staff's position was presented by Brian L. Ballinger, a senior economist in the Commission's Technical Services Division. In contrast to Mich Con's witnesses, Mr. Ballinger advocated the use of a hypothetical capital structure that includes exactly 50% long-term debt when computed as a 12-month average. According to Mr. Ballinger, he developed the Staff's proposal regarding Mich Con's average projected 1994 capitalization by (1) reviewing data concerning the historical test year ended May 31, 1992, as well as the utility's proposed 1994 test year capitalization, (2) reviewing the capital structures of a comparable group of gas distribution companies, and (3) taking into consideration the fact that bond rating agencies usually want a utility's debt-to-equity ratio to be 1:1 before they will give it an "A" rating. (15 Tr. 3140-3141.)

The ALJ agreed with Mr. Ballinger's presentation and recommended that the Commission adopt the Staff's 12-month hypothetical capital structure instead of the projected 13-month average capital structure proposed by the utility. Mich Con excepts. According to the utility, its proposed capital structure is superior to the Staff's and should be adopted. It offers several reasons for this conclusion.

Mich Con first points out that, as is the case with any large gas utility that files a general rate case, it was required to submit a projected 13-month average capital structure for its test year. This information is required, Mich Con notes, under the filing requirements adopted by the Commission's January 17, 1992 order in Case No. U-10039. The Commission must believe that projected 13-month capital structures should be used in cases like this, the utility asserts, or it would not require their submission. Moreover, Mich Con contends, reliance upon its 13-month average capital structure is appropriate because the rate base information for the projected test year (information that the Staff used to compute the utility's total expected capital requirements) was compiled using 13-month average balances. According to Mich Con, it would be illogical to combine dissimilar methodologies when computing individual components of the utility's revenue requirements, which is what would result if the Commission adopts the Staff's proposed capital structure.

Mich Con goes on to assert that, as noted by Mr. Verardi, it is unlikely that the ratio of long-term debt to common equity will remain constant throughout the year. Due to "the seasonality of the gas heating business," he notes, the utility generally "earns a substantial part of its annual income in the January-March period, while paying out its annual income in the form of dividends over the balance of the year." (20 Tr. 4238-4239.) Thus, the utility contends, its debt to equity ratio would likely be lower than 1:1 early in the year and higher than 1:1 late in the year, assuming that Mich Con's capital structure began the year with equal amounts of long-term debt and total equity. Mich Con contends that this could result in long-term debt comprising more than 50% of the utility's capital structure at the close of each calendar year, thus precluding the utility from retaining its "A" bond rating. This situation can and should be avoided, the utility argues, by adopting a capital structure that includes 47.39% long-term debt and 52.61% total equity, as its proposal does.

Additionally, Mich Con argues, the Staff's proposal jeopardizes the utility's credit rating by (1) not adjusting for the effect that capital leases will likely have on rating agencies' decisions and (2) failing to take into account that, in the eyes of these rating agencies, there is a stigma associated with Detroit as a service territory. Specifically, the utility asserts, the equity component of the capital structure must be set at a level that is sufficiently above the debt component, so that the end result, as viewed by the rating agencies, will be a capital structure having at least 50% equity. It goes on to contend that, due to the perceived stigma mentioned above, Mich Con must maintain stronger financial ratios than other "A" rated utilities. For these reasons, Mich Con requests that the Commission reject the Staff's proposed capital structure as being unreasonable and adopt the structure initially proposed by the utility. Alternatively, Mich Con contends that if the Commission should somehow find the capital structures proposed by both the utility and the Staff to be unacceptable, it should simply adopt the utility's "actual historic test year capital structure for ratemaking purposes in this proceeding." (Mich Con's exceptions, p. 41.) According to the utility, this would result in a structure consisting of 53.68% equity and 46.32% debt, based on the average capital structure for the 13-month period ended May 31, 1992.

In response, the Staff claims that the utility's initial proposed capital structure and the arguments offered in support of it are flawed in three ways. First, the Staff contends that Mich Con's proposal was based on several unreasonable and unsupported assumptions. For example, the utility's projected 13-month capital structure is based on a constant return on equity of 13.5%. However, the Staff notes, its actual return will likely vary over time and, more important, the utility is no longer requesting that its rate of return be set that high. The Staff goes on to note that, although Mich Con's proposal assumes a normal quarterly dividend payout, the utility does not always make such regular distributions. For example, no dividends were paid in 1992 and it is possible that none will be paid in 1993. (6 Tr. 1086-1087.) Moreover, the Staff points out that Mich Con's proposed capital structure assumes construction levels greatly in excess of what the utility is now proposing in this case. Specifically, the utility's projected 13-month average capital structure includes additional amounts of debt and equity that, in light of its decision not to build the Belle River to Milford Loop and the Grand Rapids and Sparta Pipelines, will not be incurred. (6 Tr. 1071-1072.)

Second, the Staff notes that Mich Con's proposed capital structure improperly includes $12 million in long-term debt incurred on behalf of its subsidiary, Mich Con Development

Corporation.[8] Based on Mr. Hand's admission that these funds constitute non-utility investment (6 Tr. 1064-1065), the Staff contends that they must be excluded from the utility's capital structure.

Third, although it agrees with Mich Con that a debt-to-equity ratio of 1:1 is an appropriate goal, the Staff argues that it is inappropriate for ratepayers to contribute additional sums to cushion that ratio. It therefore contends that the utility's attempt to cushion its financial ratios to overcome the perceived anti-Detroit stigma and the rating agencies' potential consideration of capital leases should be rejected. This contention is based, in part, on the fact that although four separate agencies rate Mich Con's first mortgage bonds, only one (Standard and Poor's) is alleged to attach some sort of stigma to the utility's bond placements. The Staff goes on to assert that the Commission has consistently excluded all capital lease liabilities from utility capital structures and excluded all capital lease assets from rate base. Thus, the Staff notes, allowing Mich Con to build a cushion into its capital structure to offset rating agencies' potential recognition of its capital leases would simply allow the utility to do implicitly that which it is precluded from doing explicitly.

The Commission agrees with the ALJ that Mich Con's initial proposed capital structure should be rejected. The standard filing requirements imposed by the Commission's January 17, 1992 order in Case No. U-10039 necessitate submission of a capital structure based on the average of 13 monthly balances. Nevertheless, this fact does not, by itself, man-

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[8]The Staff concedes that it is often difficult to trace sources and uses of capital, particularly in the context of affiliate transactions. However, MCN's 1990 annual report states: "In May 1990, Mich Con issued $12 million of unsecured notes at 9.75 percent to June 1, 2000. The proceeds were used to permanently finance development of properties by a subsidiary of Mich Con." Mr. Hand identified that subsidiary as Mich Con Development. (6 Tr. 1064-1065.)

date the adoption of any particular capital structure. Although submission of information in a standardized format may facilitate consideration of ratemaking requests, the guiding factor must be whether it results in a reasonable capital structure.

In the present case, Mich Con's projected 13-month average capital structure was premised on several unjustified assumptions. Despite substantial evidence to the contrary, the utility assumed that (1) a constant return on equity of 13.5% would be experienced, (2) regular quarterly dividend payments would be used to distribute all of the utility's future net income, and (3) over $100 million of now-abandoned construction projects would be undertaken.[9] Therefore, the usefulness of the utility's proposal is in doubt. In addition, the Commission finds that it would be inappropriate to provide additional revenues due solely to some perceived anti-Detroit stigma. This is particularly true when, as here, only one of several bond rating agencies is alleged to hold that view. Furthermore, as correctly noted by the ALJ, "Mich Con's position with respect to capital leases is contrary to the Commission's practice respecting such items." (PFD, p. 22.) Because the Commission does not permit their explicit inclusion in the utility's rate base and capital structure, capital leases should not be implicitly included in a utility's capital structure as proposed by Mich Con.

It should also be noted that Mich Con's alternate proposal, the actual historical capital structure for the 13-month period ended May 31, 1992, suffers from several problems. For example, like the utility's initial proposal, this capital structure is based on a rate of return that

[9]Mich Con now asserts that during rebuttal it made certain adjustments to its proposed capital structure to reflect the decision not to build the Belle River to Milford Loop and the Grand Rapids and Sparta Pipelines. Nevertheless, the utility did not account for the fact that its revised figures continue to assume a significantly higher level of routine construction than adopted in this order. Thus, the Staff's argument regarding the utility's reliance on an excessive amount of construction continues to be valid.

is significantly higher than that proposed by any party to this proceeding. Likewise, the alternate capital structure proposed by Mich Con is skewed by the fact that no dividends were issued between January 1 and May 31, 1992, thus effectively overstating the amount of equity that would generally be found in the utility's capital structure. Finally, the use of a 13-month historical period ended May 31, 1992 would inflate the equity component of Mich Con's capital structure due to the fact that it would double-count a high equity month. Specifically, due to the "seasonality" of Mich Con's revenues, the amount of equity in its capital structure is higher during the months of March, April, and May than during other months. (Exhibit A-144.) Thus, because it includes figures for both May 1991 and May 1992, the alternate capital structure proposed by the utility is also unrealistic.

For all of these reasons, the Commission holds that the utility's initial and alternate proposals should both be rejected and that the Staff's proposed capital structure should be adopted, as recommended by the ALJ. That capital structure is adequate for Mich Con to maintain its "A" rating.

Cost of Common Equity

When a utility stands alone and its common stock is publicly traded, direct approaches can be applied to estimate a fair rate of return to be allowed on the utility's common equity. The process becomes more complicated when the utility is a subsidiary of a holding company, as is the case with Mich Con. Because the stock of a subsidiary is not publicly traded, expert witnesses are forced to resort to indirect or proxy approaches to estimate the utility's cost of common equity.

In the present case, Mich Con, the Staff, and ABATE offered expert witnesses on this issue, each of whom used one or more indirect approaches for estimating a reasonable rate of return on common equity for Mich Con. Specifically, these witnesses performed discounted cash flow (DCF) analyses for both MCN and a group of comparable companies The witnesses then checked the results of their DCF analyses with other methods of estimation. Although relying on similar analyses, the parties' witnesses reached different results.

For example, Mich Con's witness, Charles E. Olson, concluded that the utility's cost of common equity was between 13.25% and 13.75%. (5 Tr. 638.) This led Mich Con to initially request that the midpoint of this range, 13.5%, be adopted. However, the utility later reduced its request to 12.75%. (Mich Con's initial brief, pp. 46-47.) In contrast, one of the Staff's witnesses, Mr. Ballinger, computed Mich Con's appropriate rate of return on common equity to be between 11.75% and 12.25%. (15 Tr. 3136.) Finally, ABATE's witness, Richard A. Baudino, concluded that a fair rate of return would be 10.9%. (15 Tr. 3078.)

The DCF approach used by these witnesses is based on the hypothesis that the required rate of return on an investment in Mich Con is equal to the current anticipated yield (the dividend) plus anticipated future growth (appreciation in price) of stock issued by a group of similar utilities. After reviewing the evidence, the ALJ agreed with the Staff that the appropriate anticipated yield is 6.22%. She went on to conclude that, as suggested by Mr. Ballinger, a growth rate of 5.25% should be adopted. These figures combine to create a basic rate of return figure of 11.47%. The ALJ then adjusted this figure to reflect the costs that a utility like Mich Con would likely incur in issuing additional stock, resulting in a return on common equity of 11.84%. The ALJ then compared this figure with the results of Mr. Ballinger's capital asset pricing model (CAPM) study[10], which had concluded that Mich Con's cost of common equity should be between 11.82% and 12%. Because the results of these two studies correspond closely, the ALJ recommended that the Commission adopt the mid-point Mr. Ballinger's 11.82% to 12% range, 11.91%, as the cost of common equity. (PFD, p. 31.)

a. Yield

None of the parties excepts to the ALJ's recommendation that the Commission adopt the yield component proposed by the Staff. Thus, because this figure is well supported by Mr. Ballinger's testimony, the Commission finds that the utility's yield should be set at 6.22%. This figure constitutes the best estimate of the utility's stand-alone historical dividend. However, as correctly noted by Mr. Olson, "[w]hen an investor buys common shares in a company, it is the future dividends that will be received, not the past dividends" that are relevant. (5 Tr. 663.) Therefore, the yield component must be adjusted to reflect the utility's estimated future payment of dividends. Although the yield adjustment is not specifically quantified in the PFD, the record indicates that it should be 0.15%. This is computed by multiplying the yield of 6.22% by one-half of the growth component of 4.7%, whose adoption is discussed below.

b. Growth

Although originally arguing in favor of a 5.75% growth component, Mich Con now agrees with the ALJ that the mid-point of the Staff's proposal, 5.25%, should be adopted. In

[10]The CAPM approach is based on the theory that a stock's expected rate of return consists of a risk-free rate plus a market premium that is proportional to the non-diversifiable, or systemic, risk of the security. The non-diversifiable risk is obtained by applying a factor designated as "beta," which indicates the relative risk of a security as compared to the market as a whole, to the market premium.

contrast, ABATE excepts to the ALJ's recommended adoption of this figure. According to it, the ALJ failed to "present any good reasons for rejecting ABATE's proposed growth rates," which Mr. Baudino estimated to be 4.56% for MCN and 4.01% for his comparison group of utilities. (ABATE's exceptions, p. 6.) Specifically, ABATE asserts, the ALJ simply stated that Mr. Baudino's proposed growth rate was "too conservative" in reaching her conclusion that the mid-point of the Staff's range of growth, 5.25%, was best supported by the record. (PFD, pp. 25-26.) ABATE argues that this conclusion was erroneous in light of the fact that "5.25% is not the mid-point of the Staff's range of growth rates." (ABATE's exceptions, p. 6.) The Commission agrees.

Mr. Ballinger testified that historical and projected 5-year dividend, earnings, and internal growth rates per share for his group of comparable companies range from 1.85% to 5.59%. He further testified that MCN's historical growth rates have ranged from 3% to 7.5%. (15 Tr. 3158-3161.) Thus, as correctly noted by ABATE, the mid-point of his growth rates would be approximately 4.7%, using 1.85% as the low end and 7.5% as the high end of this range. The Commission therefore finds that 4.7%, the mid-point of the Staff's range, is a more reasonable estimate of the growth component and should be adopted instead of the 5.25% growth recommended in the PFD.

c. Financing Cost Adjustment

Both Mr. Olson and Mr. Ballinger testified that, in computing Mich Con's cost of common equity, a financing cost adjustment should be used to reflect the cost of issuing additional shares of common stock. (5 Tr. 667-668; 15 Tr. 3154-3155.) However, they disagreed as to the appropriate level of the adjustment. Mr. Olson testified that a figure of 4.67% should be used to represent Mich Con's likely financing costs. (5 Tr. 668.)[11] Although acknowledging that MCN's actual costs for financing new shares of common stock during 1989 and 1991 were 4.95% and 3.77%, respectively, for an average of 4.36%, Mr. Ballinger proposed a financing cost adjustment of only 3.25%. According to Mr. Ballinger, use of this lower figure is appropriate because Mich Con does not receive 100% of the net proceeds of MCN's new stock issuances and, therefore, it should not be charged with 100% of the costs. (15 Tr. 3155.) As noted earlier, the ALJ recommended using Mr. Ballinger's proposed figure for the utility's financing cost adjustment.

Mich Con excepts to the ALJ's use of the Staff's proposed 3.25% figure and contends that MCN's uncontroverted average financing cost for its last two issuances of common stock, namely 4.36%, should be adopted. The utility offers two arguments in support of this contention. First, it claims that the reasonableness of MCN's 4.36% average financing cost is reflected by the fact that it is similar to, but even somewhat less than, the industry average of 4.67%. Second, it argues that the ALJ's reduction of the financing cost adjustment below the 4.36% arithmetic average of MCN's historical stock issuance costs is unreasonable. Specifically, Mich Con asserts:

> "Such a reduction is not necessary in order to 'share' the financing expenses between regulated and non-regulated businesses because the adjustment is expressed as a <u>percentage</u>. The rate of return which is derived from this percentage is <u>applied only to the equity component of Mich Con's rate base</u>. Consequently, the financing expenses are <u>already being shared</u> between MCN's regulated and non-regulated businesses, and it is not necessary to arbitrarily reduce the financing cost percentage below the arithmetic average of 4.36% in

[11]The utility's witness also proposed, at least initially, that an additional premium be included with the financing cost adjustment "to provide protection against down markets." (5 Tr. 668.) However, Mich Con subsequently adopted the Staff's position that the financing cost adjustment in this proceeding should be limited to financing costs themselves. (Mich Con's initial brief, p. 43.)

order to effect the sharing of these expenses between regulated and non-regulated businesses." (Mich Con's exceptions, p. 45.) [Emphasis in original.]

The Commission agrees with Mich Con that, because the financing cost adjustment is a percentage, use of a 4.36% factor will not result in the utility bearing all stock issuance costs incurred by MCN on behalf of both the utility and MCN's non-regulated subsidiaries. It therefore finds that the 3.25% financing cost adjustment factor recommended in the PFD should be rejected. However, that does not complete the Commission's analysis.

On page 28 of the PFD, the ALJ concluded that the financing cost adjustment proposed in this case "should only be allowed if new common stock is to be sold and infused into Mich Con." Disagreement has arisen regarding whether common stock will be issued during the period in which the rates established by this order remain in effect. For example, Mr. Ballinger noted that (1) during its September 24, 1992 meeting, MCN's Board of Directors authorized the sale of 2.2 million shares of common stock, and (2) an infusion of equity into Mich Con from MCN had been planned to occur by May 31, 1994. (15 Tr. 3154 and 3164.) In contrast, Mr. Baudino testified that it is not at all certain that MCN will issue stock for investment in Mich Con in the near future. (15 Tr. 3106 and 3119.) Disagreement has also arisen regarding whether the likelihood of such a stock issuance is relevant. Specifically, Mr. Olson testified that, just as the decision in Federal Power Commission v Hope Natural Gas Company, 320 U.S. 591 (1944), speaks in terms of "the ability to attract capital," the fact that a utility is unable to prove that it has an immediate and undeniable need for new capital "does not mean that it does not need to maintain a position of being able to attract capital on reasonable terms." (5 Tr. 669.)

Based on this conflicting testimony, ABATE contends that no financing cost adjustment should be made in this case, whereas Mich Con contends that the 4.36% adjustment should

should be adopted. (ABATE's exceptions, p. 9; Mich Con's exceptions, pp. 47-48.) Although any utility seeking a financing cost adjustment should bear the burden of proving that common stock will likely be issued for its benefit in the foreseeable future, the failure to include any financing cost adjustment in this case could unduly hinder Mich Con's ability to raise the capital necessary to deal with unforeseen circumstances. The Commission therefore finds that the most reasonable resolution of this issue is to allow Mich Con to include a financing cost adjustment equal to one-half of the average costs incurred in the course of MCN's two most recent stock issuances, or 2.18%.

d. Computing the Cost of Common Equity

Based on the above findings, the basic cost of common equity derived from a DCF analysis would be 11.07%. This represents the sum of a 6.22% yield, a 4.7% growth component, and a 0.15% expected yield adjustment. When this figure is increased by the 2.18% financing cost adjustment factor adopted in today's order, the result is 11.31%.

As has long been recognized in prior Commission orders, the determination of an appropriate return on common equity is never an exact matter and is always subject to some degree of judgment. This is particularly true when the utility is a wholly-owned subsidiary having no publicly-traded stock from which a more direct cost of common equity can be derived. Thus, although 11.31% could be adopted as a reasonable estimate of Mich Con's cost of common equity, the Commission finds that this figure should be increased slightly. The Commission's earlier adoption of the Staff's proposed capital structure resulted in a slightly higher debt-to-equity ratio. In addition, as discussed in Section VII of this order, the Commission has elected to limit the growth in Mich Con's authorized operating and maintenance expense (O&M expense) during 1993 and 1994 to 50% of the rate of inflation.

Because these two factors serve to increase the utility's perceived risk, the Commission finds that it should authorize Mich Con to earn a return on common equity of 11.5%.

Conclusion

Based on the discussion and findings set forth above, the Commission finds the overall rate of return for Mich Con to be 8.04%, computed as follows:

Description	Structure %	Cost Rate	Weighted Cost Rate
Long-Term Debt	35.53%	8.89%	3.16%
Short-Term Debt	9.09%	3.85%	0.35%
Customer Deposits/ Refunds	1.12%	9.22%	0.10%
Preferred Stock	0.56%	8.69%	0.05%
Common Equity	34.97%	11.50%	4.02%
Deferred Income Taxes	0.27%	0.00%	0.00%
Investment Tax Credits	14.90%	0.00%	0.00%
JDITC	3.56%	10.18%	0.36%
Total	100.00%	---	8.04%

VI.

THROUGHPUT

Mich Con prepared its projection of 1994 test year sales and transportation volumes through a combination of computer-generated trend analyses (which forecast the number of customers and their expected monthly gas usage in each of the utility's 17 districts) and a customer-by-customer analysis of its large-volume transportation customers, those having annual contract quantities of at least 100 million cubic feet (MMcf). Mich Con projected

207.368 billion cubic feet (Bcf) of sales and 108.867 Bcf of transportation (11.477 Bcf of which would come from coal displacement transportation customers), for a total throughput of 316.235 Bcf. (Exhibit A-11, Schedule F-2.)

The Staff's forecast, in contrast, was based on historic throughput levels for the year ended May 31, 1992, adjusted for known and measurable changes. These adjustments included the reclassification of 410 customers from sales to transportation rates to eliminate a double counting error by Mich Con and the removal of two customers, General Motors Corporation's Willow Run Assembly Plant (Willow Run) and McLouth Steel Company (McLouth), from the utility's T-2 rate. (12 Tr. 2432-2433.) According to the Staff, the closing of Willow Run has been greatly publicized since April 1992. The Staff further noted, as did Mich Con, that McLouth's past financial difficulties have been so widely publicized as to justify the exclusion of its historical usage from projected 1994 throughput levels. The Staff therefore projected 205.647 Bcf of sales and 119.904 Bcf of transportation (19.143 Bcf of which was assigned to Mich Con's coal-displacement customers), for a total throughput of 325.551 Bcf. (Exhibit S-73, Schedule F-2.)

Although not presenting a comprehensive throughput analysis of its own, ABATE did offer testimony in opposition to the joint Mich Con/Staff proposal to exclude McLouth's volumes. Specifically, Mr. George Davison, McLouth's Vice President of Purchasing, Transportation, and Raw Materials, testified that McLouth was "working diligently to assure continued operations in 1994 and future years." (22 Tr. 4710.) He further stated that the market for steel produced by McLouth bottomed-out in December 1992 and is starting to improve. (22 Tr. 4715.) ABATE therefore asserted that it would be unreasonable to exclude McLouth's historical transportation volumes from the computation of rates in this case.

Despite ABATE's assertion, the ALJ concluded that there was "sufficient evidence to demonstrate the uncertainty of McLouth's continued business operations." (PFD, p. 37.) She therefore recommended that McLouth's transportation volumes be excluded from projected 1994 throughput. The ALJ went on to adopt a joint Mich Con/Staff proposal that if the utility does receive revenue from McLouth in 1994 or any subsequent year, all such revenue should be refunded to sales and T-1 transportation rate customers--with interest at Mich Con's short-term borrowing rate--as part of the utility's annual gas cost recovery (GCR) reconciliation proceedings. Finally, she recommended that the Staff's throughput figures should be adopted with one modification. Specifically, the ALJ adopted a request by Mich Con to exclude 7.666 Bcf in coal displacement volumes from customers whose contracts expire prior to 1994. She therefore found that Mich Con's 1994 test year throughput should include sales of 205.647 Bcf, base transportation of 100.761 Bcf, and transportation for coal displacement customers of 11.477 Bcf, for a total of 317.885 Bcf. (PFD, p. 38.)

Three parties except to the ALJ's conclusions. First, ABATE points out that even the Staff's witnesses stated that McLouth would likely still be a customer of Mich Con during 1994 and would consume approximately the same volume of gas as it did during the historical period. ABATE asserts that this testimony, when coupled with that of Mr. Davison, requires the Commission to include McLouth's volumes in the utility's 1994 test year throughput. Second, Mich Con argues that the ALJ's recommended throughput must be adjusted to reflect customer losses. Although accepting the Staff's assertion that the incremental costs of adding new customers (namely, the return on investment, depreciation, and property taxes on the new distribution plant) will be recovered through the rates charged to those new customers, there are no new revenues to replace those lost from abandonments, demolitions, or other permanent customer losses. Thus, Mich Con contends that the ALJ's recommended sales volumes should be reduced by 1.617 Bcf. Third, the Staff argues that because it is as likely as not that coal displacement customers will renew their contracts with Mich Con upon expiration, exclusion of these volumes does not constitute a known and measurable change. (Staff's exceptions, pp. 10-13.) Thus, the Staff asserts, its original 19.143 Bcf coal displacement figure should be used in calculating Mich Con's 1994 test year throughput.

The Commission finds persuasive the arguments presented by Mich Con and the Staff. Specifically, the record indicates that, in Wayne County alone, Mich Con's actual demolitions average well over 4,000 per year.[12] (Exhibit A-155; Exhibit A-11, Schedule F-2.) Moreover, despite assertions that the loss of customers might lead to a corresponding reduction in Mich Con's cost of serving those customers, no evidence was introduced to support those claims. Rather, as noted by Mr. Dow, "since a large portion of the [utility's] operating expenses does not vary with changes in the level of throughput, these costs are also regarded as fixed in the short run." (11 Tr. 2334.) For these reasons, the Commission finds that the adjustment proposed by the utility should be adopted and that the sales volume recommended in the PFD should be reduced by 1.617 Bcf. This results in 1994 test year sales of 204.030 Bcf.

The Commission also agrees with the Staff that the exclusion of transportation volumes associated with expiring coal displacement contracts is not compelled by the known and measurable change standard. As correctly noted by the Staff, "[t]he contract expirations them-

[12]Although today's order adopts Mich Con's proposed adjustment, the Commission notes that the utility failed to clearly show whether inclusion in this demolition total was limited to situations where a structure actively received gas service during the historical test year. Mich Con is therefore put on notice that, in future rate cases, the utility's request for a similar adjustment must rest, at least in part, on a showing that gas service was supplied to the demolished structure during the test year.

selves do not constitute 'known and measurable' changes, since their impact on future test year volumes is neither known nor measurable." (Staff's exceptions, p. 10.) Specifically, those customers whose contracts expire prior to the start of the 1994 test year could negotiate roll-over contracts, sign new coal displacement contracts, or opt for service under Mich Con's T-1 or T-2 rates. A customer's selection of any of these options, as opposed to switching to coal as a fuel source, would allow Mich Con to retain that load. Moreover, even if gas prices rise relative to coal prices, other factors could persuade existing coal displacement customers to remain on natural gas. Thus, notwithstanding assertions by Joseph Roberts, Jr., Mich Con's Manager of Industrial Marketing, to the effect that recent increases in the price of natural gas may induce these customers to switch to coal, the Commission finds that the expiration of these coal displacement contracts does not constitute a known and measurable change and, therefore, the Staff's original coal displacement figure of 19.143 Bcf should be incorporated in the calculation of the utility's throughput.

In contrast to the exceptions raised by Mich Con and the Staff, the Commission is not persuaded by ABATE's argument that McLouth's volumes should be included in the computation of 1994 test year throughput. Although McLouth's economic fortunes appear to be improving, it is reasonable to exclude this customer's historical volumes from test year throughput levels and require that all net revenue received from McLouth should be refunded to Mich Con's sales and T-1 rate customers, with interest at the utility's short-term borrowing rate, in future GCR reconciliation proceedings. The Commission therefore adopts the ALJ's recommendation regarding this issue. To do otherwise would expose the utility to a potential $3.2 million reduction in the annual revenue figure used to set rates in this case.

Given these findings, the appropriate throughput for Mich Con's 1994 test year should include 204.030 Bcf of sales, 100.761 Bcf of base transportation, and 19.143 Bcf of coal displacement transportation, for a total of 323.934 Bcf.

VII.

ADJUSTED NET OPERATING INCOME

In order to establish whether a revenue deficiency exists, it is necessary to determine what Mich Con's net operating income will be in the future, based on its current rates. To make this calculation, allowable expenses, taxes, and depreciation must be subtracted from the utility's projected total operating revenues. In this proceeding, Mich Con and the Staff adopted $73,825,000 in adjusted net operating income for the 12-month period ended May 31, 1992 as the starting point. The utility then proposed net reductions totalling $15,255,000, and the Staff proposed adjustments that would increase the utility's net operating income by $11,267,000. These two parties subsequently reached agreement on several proposed adjustments,[13] as shown on Appendix A-4 of Mich Con's initial brief. Therefore, the disputed adjustments discussed below should be either added to or subtracted from the revised adjusted net operating income figure of $79,522,000 found on Exhibit S-71, Schedule C-1.

[13]Mich Con's acceptance of the Staff's proposed adjustment regarding SFAS 106 costs was contingent upon the Commission's acceptance of the utility's projected 1994 test year O&M expense level. If some other O&M expense level is adopted, Mich Con states, the gross amount of this item must be increased by $1,348,000 to $30,084,000. According to the utility, such an adjustment would be necessary to match the amount included by the Staff in "claims paid." (20 Tr. 4307-4310; Exhibit A-160.) Because today's order adopts the Staff's O&M figure instead of that offered by Mich Con, Mich Con's proposed $1,348,000 increase will be discussed later in the order.

Revenue and Cost of Gas Adjustment

The revenue and cost of gas adjustment is intended to represent the difference between pro forma revenues for 1994 based on Mich Con's existing rates and the utility's actual historical test year revenues. (17 Tr. 3545.) In this case, the difference between the Staff's position and Mich Con's arises solely from these parties' differences concerning projected 1994 throughput. Thus, using the Staff's proposed throughput volumes, adjusted for the 1.617 Bcf reduction in sales arising from the Commission's earlier adoption of Mich Con's position regarding abandonments, demolitions, and other permanent customer losses, the gross revenue and cost of gas adjustment should be $37,749,000[14] and the net adjustment should be $24,329,000. This results in a gross reduction of $3,358,000 in adjusted net operating income and a net reduction of $2,164,000.

Gas Storage Revenues

Mich Con projected that its 17.4 Bcf of excess storage would provide approximately $7,658,000 in gas storage revenues during its 1994 test year. This was based on the rates Mich Con currently charges for storage service. It therefore requested that only that amount of storage revenues be imputed to the utility when computing its net operating income.

In contrast, the Staff proposed that Mich Con begin offering market-based contract storage service under Rate Schedule CS-1 at a price "not to exceed $1.50 per Mcf." (Exhibit S-73, Schedule F-8-1, p. 13.) For purposes of computing Mich Con's revenue requirement, the Staff proposed imputing $13.9 million in gas storage revenues. This figure was based on the

[14]This figure is computed by taking the Staff's proposed $41,107,000 revenue and cost of gas adjustment (Exhibit S-71, Schedule C-2, line 1) and subtracting $3,358,000 in lost revenues (Mich Con's exceptions, Appendix A-3, p. 2, line 5) arising from abandonments, demolitions, and other permanent customer losses.

assumption that Mich Con could sell its 17.4 Bcf of excess storage at an average rate of 80¢ per thousand cubic feet (Mcf). In support of its proposed rate, the Staff noted that (1) ANR recently signed a long-term contract to purchase the entire storage capacity of the Blue Lake Storage Field at a maximum rate of 64¢ per Mcf, (2) the proposed storage rates included in the Federal Energy Regulatory Commission (FERC) Order No. 636 compliance filings recently submitted by ANR and Panhandle Eastern Pipeline Company (Panhandle) were 78.48¢ and 93.2¢ per Mcf, respectively, and (3) available storage in the Cold Springs 1 Storage Field was currently being marketed at 83¢ per Mcf.

Mich Con asserted that the 80¢ per Mcf rate was not adequately supported by the record. Specifically, the utility claimed that the type of service that the Blue Lake Storage Field can provide is more valuable to ANR than any storage available on Mich Con's system. It went on to note that the Staff's position is not supported by the ANR and Panhandle compliance filings because the figures cited by the Staff are merely maximum rates and because those rates have not yet been approved. Finally, Mich Con pointed out that although it is true that storage available in the Cold Springs 1 Storage Field is being offered at 83¢ per Mcf, that marketing effort has been unsuccessful. The utility therefore contended that the 48¢ per Mcf cost-based rate proposed by both Mr. Cieslak and Mich Con's former Senior Vice President of Gas Acquisition, Supply, and Storage, Stanley A. Surowiec, should be used instead to impute gas storage revenues. (Exhibit A-12, Schedule G-1; 19 Tr. 4018.) Finally, Mich Con argued that the existing 90/10 refund mechanism could be retained and used to distribute any gas storage revenues in excess of the amount imputed to the utility under the 48¢ per Mcf rate. (Mich Con's initial brief, pp. 58-59.)

The ALJ agreed with Mich Con that the more appropriate figure to apply in this case is the cost-based rate of 48¢ per Mcf. Moreover, because she also felt that this rate may prove to be too low in light of changes to the gas industry arising from FERC Order No. 636, the ALJ recommended that the current 90/10 refund mechanism be retained until a more rigorous analysis is undertaken regarding the market value of gas storage. Finally, she concluded that Mich Con should be required to include that type of market analysis in its next rate case filing. (PFD, pp. 42-43.)

Although conceding that the various storage rates offered in support of its 80¢ per Mcf rate "do not in and of themselves conclusively support" that figure, and further acknowledging that "due to the emerging nature of the competitive market for transportation and storage services, there are not any approved storage rates . . . that can be used as a benchmark in this case" (Staff's exceptions, p. 14), the Staff excepts to the recommended adoption of the utility's proposed rate. It argues that this figure was not sufficiently supported on the record. In addition, it expresses concern that unless the Staff's 80¢ per Mcf rate is used, Mich Con will lack the incentive to aggressively market this storage capacity at appropriate prices. ABATE also excepts to the ALJ's recommendation, but for a markedly different reason. Rather than claiming that 48¢ per Mcf is too little to ask for storage service, ABATE asserts that a much lower rate, based on cost of service, should be adopted. (ABATE's exceptions, pp. 92-95.)

The Commission does not find these arguments persuasive. Although the emerging nature of this market does make it difficult to establish market-based storage rates, the Commission finds that the figure proposed by the utility, 48¢ per Mcf, is supported by the record. As noted by Mr. Surowiec, a survey of potential gas storage customers indicates that there is little interest in contracting for storage in excess of the utility's proposed rate. (Exhibit A-130.)

Moreover, the results of this survey are bolstered by the fact that although Mich Con offered 3 Bcf of storage under terms like those proposed in this case and at a rate of 40¢ per Mcf in 1989, no purchasers were found for most of that storage. (19 Tr. 4016.) Finally, adoption of a cost-based rate like that proposed by ABATE would only serve to deprive Mich Con and its ratepayers of the value of this storage capacity and provide a windfall to any customers lucky enough to contract for underpriced storage service. The Commission therefore finds that $8,352,000 in gas storage revenues should be imputed to Mich Con, based on 17.4 Bcf of storage at a rate of 48¢ per Mcf. As correctly noted on page 97 of the PFD, this represents a $2,990,000 gross reduction from historical test year levels of $11,342,000, and a net reduction of $1,927,000.

Furthermore, because it agrees with the ALJ that this imputed cost may prove too low (at least once the competitive transportation and storage markets have had time to mature), the Commission holds that the current 90/10 refund mechanism should be retained. Under this mechanism, all annual storage revenues[15] in excess of $8,352,000--along with their associated transportation revenues--should be allocated to Mich Con's GCR sales customers and to the utility on a 90/10 basis, and the revenues allocated to these customers should be distributed in Mich Con's annual GCR proceedings. In addition, the Commission adopts the ALJ's recommendation that a comprehensive analysis of market-based storage rates be included in Mich Con's next rate case filing.

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[15]As discussed later in this order, Mich Con's transportation customers have storage capacity equal to 10% of their annual contract quantities (ACQs) included in their rates. However, because all gas held in storage for a transportation customer in excess of 10% of that customer's ACQ reduces the amount of contract storage available under Rate Schedule CS-1, all revenue received from this customer under the 25¢ per Mcf load-balancing charge discussed in Section X of this order should be covered by this 90/10 mechanism. (See 17 Tr. 3543-3544.)

As for the specific tariff language proposed by the Staff, Mr. Surowiec stated:

> "Mich Con's ability to meet its peak day requirement of 2.5 Bcf depends on its own system supply as well as on gas which third parties have in contract storage destined for delivery in the Mich Con service area. . . . In the event that a third party were to move storage gas off-system during a peak day period, Mich Con would either have to gamble that another third party would step in and supply equivalent volumes within the Mich Con service area or Mich Con, itself, would have to go out and acquire additional gas. That potential is unacceptable in terms of peak day planning. Consequently, our current contract storage agreements provide that service is interruptible for gas moving off-system." (19 Tr. 4019-4020.)

Thus, Mich Con requested that the Staff's proposed Rate Schedule CS-1 be revised to allow the utility to make storage service interruptible for gas moving off-system. None of the parties objected to this proposal. The Commission finds that such a change is reasonable and should be approved.

Off-System Transportation Revenues

Off-system transportation refers to transportation provided on Mich Con's "dry" system when the end-user of the gas is not on Mich Con's system. Mich Con proposed to establish two rate schedules, one for firm off-system transportation (Rate TOS-1) and the second for interruptible off-system transportation (Rate TOS-2). Mich Con and the Staff subsequently agreed that a rate "not to exceed" 15¢ per Mcf (Exhibit S-73, Schedule F-8-1, pp. 9 and 13) is reasonable for this type of transportation.

However, Mich Con and the Staff were unable to agree on how much off-system transportation revenue should be imputed to the utility in computing its net operating income. Mich Con asserted that, of the 30.9 Bcf in off-system transportation volumes arising during the historical test year, only 20.1 Bcf should be assumed to occur during the 1994 test year. Because the other 10.8 Bcf arose from an alleged "emergency" exchange of gas with Western

Gas Marketing, Ltd. (Western), and because Mich Con felt that this would not likely recur, the utility claimed that imputed off-system revenues should be based solely on the remaining 20.1 Bcf of gas.

In addition, Antrim was unable to agree with the Staff and Mich Con on the appropriate rate to use in this case. Specifically, Antrim alleged that their proposed rate understated the utility's total transmission volumes and that, when the proper figure is used, the utility's cost of service (and, thus, its off-system transportation rate) should be 12¢ per Mcf instead of 15¢ per Mcf.

The ALJ rejected Mich Con's argument and concluded that 30.9 Bcf was the appropriate volume to use in computing the amount of imputed off-system transportation revenues. She also rejected Antrim's assertion that the TOS-1 and TOS-2 rates must be reduced to 12¢ per Mcf, despite approving the Staff's proposal to use this lower figure in its computation of imputed off-system revenues. The ALJ therefore recommended that the Commission adopt the Staff's amended revenue figure of $3,709,000 and reject Antrim's request to revise Rates TOS-1 and TOS-2. Both Mich Con and Antrim except to the ALJ's recommendation.

Mich Con contends that the exchange of gas for Western was a one-time transaction. As such, the utility asserts, it constitutes a known and measurable change in Mich Con's test year figures. The utility therefore reasserts its contention that this 10.8 Bcf must be removed from the computation of Mich Con's imputed off-system revenues. In addition, the utility asserts that the 12¢ per Mcf rate used by the ALJ to impute off-system revenues to Mich Con is excessive. The Commission disagrees with both of these arguments.

First, the utility essentially argues that, because its transaction with Western was unusual, it should be considered a given that such transactions will not arise in the future. However, it offers no assurance that the factors leading to that exchange will not arise during the 1994 plan year and beyond. Moreover, it offers no evidence to establish that the remaining historical test year volumes attributable to Western are an accurate reflection of that customer's 1994 test year volumes. Thus, because no known and measurable change has been proven, the Commission finds that Mich Con's exception concerning the likely volume of future off-system movements should be rejected.

Second, Mich Con contends that competitive pressures in the off-system transportation market could make it difficult to find customers willing to pay 12¢ per Mcf. However, as correctly noted by the Staff, several of the utility's off-system transportation customers have been willing to pay, and have paid, effective rates that greatly exceed 12¢ per Mcf. Specifically, testimony provided by Mr. Surowiec indicates that the demand and commodity charges paid by Union Gas Company and GAZ Metropolitan during the historical test year resulted in effective rates of 80.74¢ per Mcf and 69.99¢ per Mcf, respectively. (19 Tr. 4075-4080; Staff's initial brief, pp. 151-152.) The Commission therefore finds that because 12¢ per Mcf represents a reasonable off-system transportation rate, the Staff's amended figure of $3,709,000 should be adopted, as recommended by the ALJ. This results in a gross revenue increase of $1,387,000 (computed by subtracting Mich Con's historical off-system transportation revenues of $2,322,000 from the $3,709,000 of revenues adopted in this order) and a net increase of $894,000.

In support of its exception, Antrim notes that the initial computation of a 15¢ per Mcf cost of service was based on transmission volumes that the Staff later conceded were understated. Because use of the appropriate transportation volumes results in a figure of 12¢ per

Mcf, Antrim contends, the ALJ erred in failing to recommend adoption of a 12¢ per Mcf off-system transportation rate. Again, the Commission disagrees.

As correctly noted by the ALJ, the 15¢ per Mcf rate included in Rates TOS-1 and TOS-2 represents the maximum rate that can be charged for any off-system transportation. (PFD, p. 45.) Thus, the only change that was necessitated by the use of corrected transportation volumes was the reduction in imputed revenues discussed above. The Commission therefore finds that the ALJ did not err by recommending that Rates TOS-1 and TOS-2 be adopted as originally proposed by the Staff.

Wet Header Transportation Revenues

Mich Con's Wet Header Pipeline (Wet Header) extends 191 miles across Michigan's northern lower peninsula. It is used to transport gas obtained from various gas-bearing formations to either of two processing plants near the city of Kalkaska. Although a majority of the gas is introduced directly into the main header system, a significant amount of the Wet Header's gas is collected in its extensive system of pipeline laterals.

In this case, Mich Con proposed a single, system-wide transportation rate of 11.1¢ per Mcf. This figure was based on volumes of 114.2 Bcf, which the utility claimed represented the 1994 projected volumes as filed in Mich Con's 1993 GCR plan case. The producer-intervenors introduced Exhibit I-37, which showed that Wet Header volumes for the 12-month period ended November 30, 1992 totalled 130.3 Bcf. Mich Con adopted this throughput figure on brief and also reduced its proposed price to 8¢ per Mcf. Despite relying on a single price, Mich Con planned to provide both firm and interruptible transportation service under proposed Rate Schedules TWH-1 and TWH-2, respectively.

In contrast, the Staff proposed a bifurcated rate structure with separate rates for use of the laterals (8¢ per Mcf) and the main header system (3¢ per Mcf). It further proposed that the Commission rely on a throughput level of 120.5 Bcf, which represented the amount of gas transported on the Wet Header during the historical test year ended May 31, 1992. The case filed by the producer-intervenors also proposed bifurcated rates, calling for 5.6¢ per Mcf for use of the lateral system and 1.2¢ per Mcf for the main header. Although originally proposing a volume of 130.3 Bcf, the producer-intervenors asserted that substantial drilling was continuing in the area surrounding the Wet Header, resulting in 1,189 new wells in 1992 alone. They therefore revised their throughput proposal to include anticipated volumes from these new wells, resulting in a figure of 145.5 Bcf.

The ALJ recommended that a bifurcated rate structure be adopted, as proposed by the Staff and the producer-intervenors. This was based on her belief that it is "inappropriate to establish a rate which charges producer-intervenors for services that they do not need." (PFD, p. 46.) She went on to recommend that the producer-intervenors' first proposed throughput figure be adopted, that being approximately 130.3 Bcf. This figure, the ALJ stated, represented a known and measurable change to Mich Con's historical test year Wet Header transportation levels. As for the producer-intervenors' higher figure, she concluded that it was too unreliable to be used in these proceedings. (PFD, pp. 47-48.) These recommendations spawned several exceptions.

First, Mich Con excepts to the ALJ's recommendation in favor of bifurcated rates. The utility contends that, although the Wet Header can be described in terms of lateral and main header components, it functions as a contiguous and integrated system whose rates should reflect that fact. Moreover, the utility asserts, use of a uniform rate follows the historical pattern of rate development reflected in Mich Con's retail sales and transportation rates. Finally, Mich Con claims, the adoption of bifurcated rates would require the adoption of a lower throughput figure in recognition of "the likelihood of transporters bypassing Mich Con's existing lateral system to avoid the separate lateral rates and instead opting to construct their own pipeline connections to the header." (Mich Con's exceptions, p. 60.)

These arguments are not persuasive. Although the rate proposed by Mich Con appears to be consistent with existing retail rates, such as the utility's unitary end-use transportation rates (Rate Schedules T-1 and T-2), there is one significant difference. Mich Con's T-1 and T-2 rates are unbundled rates that allow transportation customers to pay only for the services that they require from the utility. Mich Con's proposed unitary rate, in contrast, would charge transportation customers that do not use Mich Con's system of laterals for the cost of that system. This is despite the fact that those transportation customers may already be paying for the use of laterals owned by a third party. Furthermore, Mich Con's contention that the adoption of bifurcated rates requires the selection of a lower throughput figure is both speculative and unsupported by record evidence. The Commission therefore finds that bifurcated rates should be approved for the transmission of gas on Mich Con's Wet Header.

Second, both the Staff and Antrim except to the ALJ's recommendation that 130.3 Bcf be adopted as the appropriate throughput. The Staff, in arguing for the use of the historical test year figure of 120.5 Bcf, points out that the "known and measurable changes" standard does not envision the continual updating of all volumes, expenses, and revenues throughout the course of a rate case. If it did, the Staff's audit of the historical test year would become meaningless and the parties would be free to request updates that favor their position while ignoring all detrimental changes. Therefore, the Staff contends, only known and measurable changes that are "substantial and abrupt" should be accounted for and, thus, the higher throughput recommended by the ALJ should be rejected. (Staff's exceptions, p. 18.) In contrast, Antrim claims that the ALJ's proposed figure is too low. Rather than stopping with volumes transported during the 12-month period ended November 30, 1992, Antrim asserts that the ALJ should have adopted the more recent figure proposed by the producer-intervenors (145.5 Bcf), based on the expected output of the new wells drilled in the vicinity of the Wet Header.

The Commission agrees with the Staff that the limits of the historical test year should be preserved whenever reasonable. However, the recent surge in volumes of gas transported over the Wet Header constitutes a significant known and measurable change in throughput levels. Volumes transported on this system during the month of October increased 23.35% between 1991 and 1992. (Exhibit I-37.) Thus, it is reasonable to adopt a figure based on the most recent actual throughput data found in the record, which is what the ALJ did. The Commission further agrees with Antrim's assertion that wells constructed during 1992 can reasonably be expected to be on-line in 1994. However, it is unknown (1) when each of these wells will come on-line, (2) what their actual production levels will be, and (3) whether, and to what extent, existing wells will reduce their current levels of production, thus offsetting increases derived from these new wells. Thus, despite Antrim's assertion that its proposed increase is "conservative" (Antrim's exceptions, p. 5), these factors indicate that any throughput higher than 130.3 Bcf is too unreliable to use in this case. The Commission therefore rejects these parties' exceptions and finds that the ALJ's recommended throughput for the Wet Header should be adopted.

Several other issues have arisen concerning the Wet Header, most of which pertain to its cost of service and the rates required to recover this cost. These issues are discussed below.

a. <u>Plant Additions and Depreciation</u>

In computing the cost of service, the Staff relied on the historical test year figures for plant in service ($71,365,000) and accumulated depreciation ($59,172,000). This resulted in a proposed rate base of $12,193,000 for the Wet Header. (Exhibit S-119.) The ALJ adopted this proposal and Antrim excepts.

According to Antrim, the Staff's analysis improperly failed to include $313,000 of plant additions and $906,000 of additional depreciation that is expected between December 31, 1991 and the close of the projected 1994 test year. (Antrim's exceptions, pp. 5-6.) The Commission disagrees. It is far from certain whether the level of Wet Header plant additions envisioned by Antrim will actually occur, or whether some higher or lower amount of additions will be made. Thus, its request does not constitute a known and measurable change. The Commission therefore finds that the appropriate figure to adopt as the Wet Header's rate base is $12,193,000.

b. <u>Net Versus Gross Plant</u>

The Staff's cost of service analysis used gross plant values, rather than net plant values, to allocate a portion of Mich Con's $189 million in general plant expense to the Wet Header. The ALJ agreed with the Staff that this methodology was appropriate. She therefore recommended that the Commission include $7,517,000 of general plant expense, less $2,591,000 of accumulated depreciation, in the computation of the Wet Header's cost of service.

Antrim and NOMECO except to the ALJ's recommendation on the grounds that use of a gross plant ratio would allocate a disproportionate share of Mich Con's general plant costs to the Wet Header. Specifically, they point out, adoption of the allocation proposed by the Staff and recommended by the ALJ would result in a situation where general plant costs would make up over 40% of the Wet Header's rate base. A more reasonable allocation, they contend, would arise from use of a net plant ratio.

The Commission does not find this argument persuasive. Due to the utility's application of a somewhat unique form of depreciation, the net book value of the Wet Header has been reduced to an artificially low level. Specifically, as noted by William G. Aldrich, a Cost of Service Specialist in the Commission's Gas Division:

> "[T]he Wet Header system is almost totally depreciated, but the reason for that is not due to the system being old or antiquated . . . [but rather is due to] the fact that Mich Con has been using a unit of production depreciation for the Wet Header System.
>
> "And over the years, it's been almost fully depreciated from the standpoint of what assumed reserves were during the years, and the amount of production out of those assumed reserves." (17 Tr. 3592-3593.)

Thus, as correctly concluded by both the Staff and the ALJ, use of a gross plant ratio is much more reflective of the relative size and importance of the Wet Header to Mich Con's overall system. The Commission therefore adopts the ALJ's recommendation.

c. Receipt Point Expense

As proposed by both the Staff and Mich Con, the Wet Header's cost of service originally included nearly $2,668,000 of O&M expense. However, it was later discovered that O&M expense related to the operation of the system's purchase meter receipt points had mistakenly been included in that figure. Based on testimony offered by Mr. Cieslak, the ALJ therefore deducted approximately $482,000 from the original Wet Header O&M expense figure. (PFD, p. 49.) Antrim and NOMECO except to that adjustment, claiming that it is too small. Specifically, they contend that because all costs of the receipt point measurement program are already recovered through a separate $600 per month fee assessed on each of the producers' 207 receipt point meters, $1,490,400 should be deducted from the cost of service instead of the $482,000 recommended by the ALJ. (Antrim's exceptions, p. 12.) The Commission disagrees.

Although it is true that Mich Con's purchase meter receipt point expense totals $1,490,400 per year ($600 x 12 x 207), this total O&M expense is not the issue. Rather, the issue is how much of this total purchase meter receipt point expense was inadvertently included in the $2,668,000 Wet Header O&M expense initially proposed by the Staff and Mich Con. According to Mr. Cieslak, only two activities totalling approximately $482,000 of the proposed Wet Header O&M expense were identified as relating to the system's receipt points. (7 Tr. 1396.) No conflicting testimony was offered on this point. The Commission therefore finds that the $482,000 adjustment recommended by the ALJ should be adopted.

d. Property Tax

A dispute arose in this case regarding the amount of property tax that should be included in the computation of the Wet Header's cost of service. The Staff proposed allocating $1,913,000 to this expense category, which it derived by multiplying the utility's average property tax rate by the $12,193,000 rate base. In contrast, NOMECO proposed using a total figure for the Wet Header system of $1,127,415, which is the sum of the actual property taxes paid on the system during 1991 ($1,015,415) plus the estimated property tax on the general plant allocated to the main header ($112,000). Although not specifically discussing this dispute, the cost of service adopted in the PFD indicates that the Staff's proposed figures were used.

NOMECO and Antrim except to the apparent use of the Staff's figures. As correctly noted by these producer-intervenors, the Staff's witness on this issue concedes that the use of actual property tax figures is preferable in cases like this. (17 Tr. 3609.) The Commission therefore finds that the figures proposed by NOMECO should be adopted, with one correction. As shown on page 21 of NOMECO's initial brief, no property tax was included on the general plant allocated to the laterals. Thus, as pointed out by the Staff, $90,000 must be added to the computation of the actual property tax assigned to the Wet Header's laterals. (Staff's reply brief, p. 37.) This results in property taxes of $508,306 for the laterals and $709,109 for the main header, for a total property tax expense of $1,217,415.

e. Administrative Fee

Both Mich Con and the Staff proposed having users of the Wet Header pay an administrative fee of $300 per month. Although NOMECO and Antrim did not specifically object to payment of that fee, they asserted that users of the Wet Header should get credit for the revenue raised by it. This is due to the fact that the administrative and general expense components of the respective cost of service studies performed by the utility and the Staff already provided recovery of the administrative expense of operating the Wet Header. (7 Tr. 1414; 17 Tr. 3578.) The producer-intervenors therefore argued that Mich Con would be allowed to "double-dip" unless either (1) the revenue expected from this fee were deducted from each cost-of-service study, (2) the users of the Wet Header were given a 0.04¢ per Mcf credit, or (3) the $300 administrative fee were treated as a minimum fee.

The ALJ concluded that none of these adjustments were necessary. Her conclusion was based on the assertion that, due to competitive pressures, Mich Con would likely be forced to discount its lateral rate. Thus, she stated, the administrative fees would simply serve as "protection against the losses Mich Con could incur due to discounting." (PFD, p. 51.) NOMECO and Antrim except on the grounds that no evidence was offered to show that discounting of Wet Header lateral rates will actually occur.

The Commission agrees with the producer-intervenors. No evidence was offered to show that discounting has occurred in the past or that it will occur in the future. Furthermore, the best way to avoid having Mich Con recover twice for the same administrative costs is to reduce the utility's cost of service by the amount of its expected administrative fee revenue. As correctly noted on page 13 of Antrim's exceptions, the appropriate figure to subtract from the Wet Header's administrative and general expense for this purpose is $90,000. This represents the 12 monthly payments of $300 that Mich Con would likely receive from each of its expected 25 Wet Header customers.[16]

f. <u>Retainage</u>

Mich Con proposed to retain 0.9% of the gas transported on the Wet Header to compensate it for company use and lost and unaccounted for gas. Its reason for doing this was two-fold. First, expanded use of the Wet Header has increased the utility's system-wide

[16]The utility's witness concerning the number of expected Wet Header customers during the 1994 test year, Mr. Cieslak, testified that Mich Con planned to transport gas on the Wet Header for the 11 customers specifically named on Exhibit I-26, as well as 10 to 15 others that were simply designated as "other." (7 Tr. 1380-1381.) Mich Con therefore asserts that 25 customers should be assumed, which is near the upper end of Mr. Cieslak's range. The Commission finds this figure to be reasonable. Although Mr. Cieslak later stated that the total number of Wet Header customers would be 35 to 36 (7 Tr. 1404-1405), a review of the record as a whole indicates that this second statement was in error.

pressure drops, thus increasing system-wide fuel usage. Second, because a significant portion of the gas transported on the Wet Header never reaches Mich Con's dry pipelines, but rather flows into Consumers' system at Kalkaska, the failure to retain gas until a point further downstream would allow some producers to avoid compensating Mich Con for that increased system-wide fuel usage by simply moving their gas off the Mich Con system. Mich Con further proposed that, given operational and accounting complexities on the Wet Header, the most reasonable place for it to receive this replacement gas would be at the outlet of the gas processing plants at Kalkaska. The producer-intervenors objected to these proposals for several reasons. Specifically, they contended that (1) during the historical test year, there were more monthly gains than losses on the Wet Header; (2) Mich Con's "material balance program" already provides a means of compensating the utility for company use and lost and unaccounted for gas; (3) no study was offered in support of the 0.9% retainage figure; (4) Mich Con's proposal would impose the retainage twice on any Wet Header gas that moves into Mich Con's dry system; and (5) the current proposal would unfairly demand that producers pay the Kalkaska Intake Facility (KIF) processing fees on the company use and lost and unaccounted for volumes.

The ALJ agreed with the producer-intervenors' assertion regarding the potential for double payment and recommended that the Wet Header retainage fee be waived for any gas that moves into Mich Con's dry system. (PFD, p. 52.) However, she rejected their other arguments. Antrim and NOMECO except and reassert their initial claims regarding alleged inequities in the utility's proposed 0.9% retainage fee.

The Commission agrees with the ALJ that it would be unfair to expose gas delivered into Mich Con's dry system to two retainage charges. It therefore finds that the 0.9% Wet Header retainage fee should be waived for all gas that moves into the utility's dry system. However, like the ALJ, the Commission does not find persuasive the remaining arguments posed by Antrim and NOMECO. For example, forcing Mich Con to take its gas-in-kind from unprocessed gas on the upstream side of the KIF would give preferential treatment to Wet Header transportation customers in light of the fact that all other transportation customers are required to reimburse Mich Con with processed gas. In addition, as noted by the utility, the "material balance program" was neither designed nor can be operated to achieve the same purpose as the proposed retainage charge. (Mich Con's replies to exceptions, pp. 93-95.) Finally, Antrim and NOMECO are incorrect in asserting that no study was prepared to support the proposed retainage figure. Exhibit S-71, Schedule C-2-1, includes the results of the Staff's study and, as such, specifically shows how the 0.9% retainage figure was derived.

g. Computation of Wet Header Rates and Revenues

Based on the holdings discussed above, the Commission finds that the appropriate rates for transportation on the Wet Header are 2.2¢ per Mcf for use of the main header and 7.5¢ per Mcf for use of the lateral system. The computation of each of these bifurcated rates is attached as Exhibit A to this order. Based on the volumes of Wet Header transportation found on Exhibit I-37, these rates should produce approximately $5,024,000 of total revenue.[17] This results in a gross revenue increase of $2,049,000 and a net increase of $1,321,000.

Finally, because of its decision to waive the Wet Header retainage fee on any gas delivered into Mich Con's dry system, the Commission finds that the reduction to gas-in-kind

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[17]This figure is computed as follows: (2.2¢ per Mcf x 75,482,000 Mcf) + (7.5¢ per Mcf x 44,850,000 Mcf) = $1,660,604 + $3,363,750 = $5,024,354.

revenues proposed by the utility (and found on pages 96 and 97 of Mich Con's replies to exceptions) is reasonable. Thus, a gross figure of $840,000 and a net figure of $541,000 should be removed from the utility's 1994 test year gas-in-kind revenues when computing Mich Con's adjusted net operating income.

MTC Revenues

As discussed earlier, the Staff believed that the commonality of interests between Mich Con and MTC found by the Commission in its December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854 continues to exist. Therefore, in keeping with its request to include the utility's investment in MTC--as well as MTC's accounts payable and receivable--in the computation of Mich Con's working capital, the Staff asserted that this subsidiary's net revenue should be imputed to the utility. The Staff went on to assert that, because the $2.3 million loss experienced by MTC during the 13-month period ended May 31, 1992 was not representative of MTC's usual performance, the best figure to adopt was MTC's $4,590,000 calendar year 1991 profit. ABATE agreed with the Staff.

Mich Con conceded that, in its last fully litigated rate case, the Commission included MTC's net income in the computation of the utility's rates. However, Mich Con asserted, both the character of MTC's gas brokerage operations and its business environment changed dramatically since 1988. Mich Con therefore contended that the risks associated with MTC's operations had grown too high to be imposed on the utility's customers. In any event, Mich Con continued, it is never appropriate to regulate a business that, like MTC, does not maintain a monopoly. Finally, the utility argued that even if it were proper to impute MTC's investment, revenues, and expenses to Mich Con for ratemaking purposes, the Staff's proposed net revenue figure was excessive. According to Mich Con, the Commission should therefore impute either the $2.3 million loss experienced during the 13-month period ended May 31, 1992 or the $1.8 million average profit achieved by MTC during calendar years 1988 through 1992.

The ALJ agreed with the Staff and ABATE that MTC's net revenue should be imputed to Mich Con, as were the subsidiary's investment, accounts receivable, and accounts payable. She went on to conclude that, because MTC posted a significant profit during each of the last three calendar years, the loss experienced during the historical test period was an anomaly. The ALJ therefore recommended that the Commission adopt the figure proposed by the Staff and ABATE, $4,590,000, and include this net revenue in its calculation of Mich Con's rates.

Mich Con excepts to this recommendation and reasserts its arguments against imputing the MTC's net income. In addition, the utility contends that the decision in Michigan Bell Communications, Inc. v Michigan Public Service Commission, 155 Mich App 40 (1987), indicates that the Commission lacks authority to include MTC's net profits in the computation of Mich Con's revenue requirement. Specifically, Mich Con claims, Bell Communications stands for the proposition that companies like MTC cannot be "subjected to the regulations applicable to utilities" simply due to their status as an affiliate or subsidiary of a utility. (Mich Con's exceptions, p. 19.) Finally, Mich Con requests that the Commission take administrative notice of the fact that, on July 7, 1993, the utility filed Form 8-K with the Securities and Exchange Commission (SEC) advising the SEC that it is dissolving MTC and separating its gas brokering operations from Mich Con. Because terminating the parent/subsidiary relationship between Mich Con and MTC will provide the degree of separation sought by the Staff and ABATE, the utility argues, no valid reason exists for rejecting this request.

The Commission does not find these arguments persuasive for several reasons. First, as correctly noted by the Staff and ABATE, MTC's operations remain as closely intertwined with Mich Con's as when consolidated Cases Nos. U-8635, U-8812, and U-8854 were decided. This can be seen from the fact that (1) MTC has no employees of its own and, instead, relies on Mich Con's employees for all of its day-to-day operations, (2) MTC has few facilities of its own and therefore leases much of its gas storage space and all of its office facilities from Mich Con, (3) MTC does not use outside financing, relying instead on the Mich Con/MCN Inter-Company Credit Agreement, and (4) MTC's gas brokerage activities are limited to Michigan and 70% of its work is for former Mich Con sales customers who are now Mich Con transportation customers. (16 Tr. 3303-3308.) For these reasons, the Staff's witness on this issue, Robert C. Mogis, concluded that:

> "[T]here is no substance to [MTC] because it can not stand on its own feet (i.e., there is no tangible structure absent its relationship with Michigan Consolidated Gas Company). In reality it is an integral part of Michigan Consolidated Gas Company's operations." (16 Tr. 3307-3308.)

The Commission agrees with this conclusion and finds that MTC's net income should therefore continue to be imputed to Mich Con, as required by the December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854.

Second, the decision relied upon by the utility, Bell Communications, is not pertinent to the present case. In that decision, the Court held that the Commission could not regulate the sale of securities by Bell Communications because the securities statute, MCL 460.301, applies only to a utility or some entity that conducts an integral part of the utility's business. Nowhere in that decision does the Court of Appeals address the Commission's authority to consider the net income of a subsidiary when computing the utility's revenue requirement. Furthermore, the inclusion of MTC's net income in this calculation does not constitute regulation of MTC.

As correctly noted by the ALJ, "MTC remains free to engage in whatever activities it desires." (PFD, p. 57.) The Staff and ABATE do not propose, and the ALJ does not recommend, that the Commission establish or review the rates MTC charges its customers or that it set the terms and conditions of any service MTC offers.

Third, it would be inappropriate to take administrative notice of Mich Con's sale of MTC to another subsidiary of MCN. Because it took place after the close of the record, the parties had no opportunity to examine the consequences of this alleged sale, including its effect on Mich Con. Thus, as noted by ABATE, a multitude of questions remain unanswered, such as:

> "[D]oes the dissolution affect the number of employees Mich Con will have in the projected test year? If so, how will it affect estimated labor expenses, including health care, pension, and post-retirement benefits expenses? How does the dissolution affect the allocation of MCN [overhead] charges to Mich Con?" (ABATE's replies to exceptions, pp. 13-14.)

Without answers to these and other questions, it is impossible to accurately discern the effect of this purported sale.

Fourth, despite Mich Con's arguments to the contrary, the Commission agrees with the ALJ that the appropriate net income figure to impute in this case is $4,590,000. Although MTC experienced a $2.3 million loss during the 13-month period ended May 31, 1992, the Staff and ABATE showed that loss to be an anomaly. Specifically, Exhibit A-150 indicates that MTC earned a significant profit during each of the last three calendar years. Moreover, the five-year average touted by Mich Con as its back-up position includes a period during which MTC was still in its infancy. Because uncharacteristically small levels of profit or loss were experienced during that period, the five-year average is skewed downward by their inclusion. Having rejected Mich Con's alternatives as not being representative of the income level

MTC can expect to enjoy in the future, the Commission finds that the net income proposed by the Staff and ABATE, and recommended by the ALJ, should be imputed to the utility.

Encon Revenue

As with MTC, the Staff argued that the net income of Encon Engineering, Inc., (Encon) should also be imputed to Mich Con. This was based on the fact that Encon has no employees and facilities of its own, and that it relies on Mich Con for nearly every facet of its operation. (16 Tr. 3308-3309.) The Staff therefore asserted that $445,000, which represents Encon's historical test year net income, should be included in the computation of Mich Con's rates.

The ALJ agreed with the Staff and recommended that its proposal be adopted. None of the parties except to this recommendation. The Commission finds that the recommendation is supported by the record and, therefore, holds that Encon's $445,000 in net income should be imputed to its parent company, Mich Con.

Other O&M Expense

To determine the appropriate level of other O&M expense for the utility's 1994 test year, Mich Con, ABATE, and the Staff adopted a two-step process. First, each established what it felt was an appropriate level of other O&M expense for the historical test year ended May 31, 1992 (referred to as the base O&M expense). Second, each applied some type of inflation adjustment to its base O&M expense figure to arrive at a proposed 1994 test year other O&M expense level.

a. Establishing Base O&M Expense Levels

Numerous adjustments to Mich Con's historical test year O&M expense levels were proposed by the parties. However, as noted by the ALJ, they later reached agreement on nearly all of these proposals. Thus, the PFD identified only three remaining areas of dispute between Mich Con and the Staff concerning the appropriate level of base O&M expense to adopt in this case.

1. Executive Compensation

The utility's historical test year O&M expense included the cost of bonuses paid to executives of both MCN and Mich Con. The Staff proposed eliminating all recovery for bonuses paid to MCN's executives, as well as half of the recovery for bonuses paid to Mich Con's executives. This would result in a $523,000 decrease in base O&M expense. ABATE went one step further, recommending that the cost of all bonuses--for Mich Con and MCN executives alike--be removed from base O&M expense. Mich Con consented to the removal of all costs associated with bonuses paid to MCN's executives. However, it argued that those paid to Mich Con's executives were necessary to attract and retain qualified personnel. As such, the utility asserted, all bonuses paid to its own executives should be included in base O&M expense.

The ALJ agreed with ABATE and recommended that, in addition to those paid to MCN's employees, all of the bonuses granted to Mich Con's executives should be excluded. She further recommended that the Commission advise Mich Con that "in order for it to include such an incentive bonus plan in the future, it must demonstrate that its overall compensation package does not result in excessive costs to ratepayers." (PFD, p. 64.)

Although none of the parties object to the exclusion of MCN bonuses from base O&M expense, both the Staff and the utility except to the ALJ's recommendation to eliminate all of the cost of bonuses paid to Mich Con's executives. According to the Staff, a properly designed "pay-for-performance" plan can motivate utility executives to obtain objectives that, in turn, could lead to more efficient, higher quality service than might otherwise be rendered. (Staff's exceptions, p. 5.) Thus, based on its belief that the bonus plan adopted by Mich Con will likely provide some benefits to its ratepayers, the Staff continues to assert that a 50/50 sharing of the plan's costs should be allowed. Mich Con agrees with the Staff's assertion that ratepayers will likely benefit from the bonus plan. However, it disagrees with the Staff's implicit assumption that the benefits received by a utility's ratepayers and its shareholders are mutually exclusive. (Mich Con's exceptions, p. 66.) The utility therefore asserts that 100% of the bonuses paid to Mich Con's executives should be included in base O&M expense and collected from its ratepayers.

Executive bonuses have often been viewed as an appropriate cost of operating a utility. This is particularly true when the bonus plan is structured in a way that produces significant benefits for the utility's ratepayers. Thus, in light of the Staff's conclusion that ratepayers will likely benefit from Mich Con's bonus plan, the Commission finds that the ALJ's recommendation to exclude all of these costs should be rejected. However, as correctly noted by both ABATE and the ALJ, no evidence was offered in this case to indicate whether Mich Con's total executive compensation package is in line with packages offered by other utilities and other corporations. Thus, the reasonableness of Mich Con's executive bonuses cannot be evaluated as fully as the Commission would like. For these reasons, the Commission finds that the Staff's proposed 50/50 sharing of the bonus plan's costs should be adopted. It further finds that the utility should be placed on notice that future approval of an incentive bonus plan like this requires a showing that it will not result in excessive costs and that the benefits to the utility's ratepayers will be commensurate with those costs.

2. Allocation of Costs from MCN

MCN, as the parent company, provides numerous services to its subsidiaries.[18] Although some of these services result in costs that can be directly assigned to particular subsidiaries, others give rise to "common costs"--those that cannot be directly assigned. Therefore, a cost allocation formula is frequently used to allocate a parent company's common costs in an attempt to have each subsidiary bear its fair share of those expenses. In this case, MCN used three equally weighted determinants (plant, labor, and revenue) to produce an allocation that assigned 91.65% of its common costs to Mich Con.

Based on refinements to this allocation methodology that were suggested by the Staff, Mich Con proposed having itself assigned 87.35% of MCN's common costs. The Staff and ABATE objected to that proposed allocation. These parties point out that (1) due to MCN's failure to keep adequate records, it was impossible to determine how much time was devoted to work performed for a particular subsidiary, (2) because expense reports, travel vouchers, and dining bills consistently failed to describe the purpose of trips or meals, it was impossible to ascertain how much travel and dining expense was incurred on behalf of a particular subsidiary, and (3) because such a large percentage of MCN's total expenses were classified as common costs, its largest subsidiary in terms of plant, labor, and revenue, namely Mich Con, was likely assigned an excessive amount of its parent's costs. For these reasons, the Staff

[18]As shown on Exhibit A-5, Schedule E-1, MCN has 46 subsidiaries including Mich Con.

concluded that Mich Con's ratepayers were to some extent subsidizing the utility's unregulated affiliates. To counter this, the Staff recommended an allocation factor of 70%, instead of the 87.35% factor proposed by the utility. ABATE proposed a more severe remedy. Specifically, it argued that because Mich Con had the burden of proving that MCN's costs were fairly allocated, and because it failed to satisfy that burden, none of MCN's common costs should be allocated to the utility.

The ALJ agreed with the Staff and ABATE that the utility's proposed 87.35% allocation factor was excessive. However, despite concluding that MCN's "lax approach" to cost documentation should not be encouraged, she felt that removing all MCN billings from Mich Con's base O&M expense "would be a draconian measure." (PFD, p. 68.) Specifically, she noted that although MCN's recordkeeping was woefully inadequate, there was no dispute that MCN performs services that benefit Mich Con and for which the utility's customers should pay. The ALJ therefore recommended that the Commission adopt the 70% allocation factor proposed by the Staff. She further recommended that Mich Con be admonished for tolerating such imprecision and be warned that MCN's documentation must improve if the utility ever hopes to recover all costs for which it is billed by MCN.

Both Mich Con and ABATE except to these recommendations, albeit for different reasons. Mich Con contends that the ALJ's proposed reduction in the allocation factor "is based on pure conjecture and suspicion" and must therefore be rejected. (Mich Con's exceptions, p. 69.) Specifically, the utility argues, the Staff failed to show that expenses billed to Mich Con were for costs that should have been billed to a different MCN subsidiary. The utility goes on to assert that, despite the Staff's belief that detailed time logs should have been used to show how much work was being done for each of MCN's subsidiaries, it offered "absolutely no proof that such personalized time keeping practices resulted in any overcharges to Mich Con or that more refined time accounting would produce anything more than several hours being reallocated." (Mich Con's exceptions, p. 71.) Mich Con therefore contends that the ALJ's recommendation to reduce the allocation factor from 87.35% to 70% should be rejected, thus returning approximately $1.1 million of allocated common costs to the utility's base O&M expense. In contrast, ABATE reasserts that the Commission should disallow all MCN billings. (ABATE's exceptions, pp. 23-24.) The Commission does not find either of these parties' arguments persuasive.

Mich Con's arguments are premised on the faulty assumption that it is up to the Staff to affirmatively show that excessive costs were assigned to the utility. However, as noted earlier in this order, the burden of proof rests with the utility. Moreover, this is particularly important in situations where cross-subsidization of non-utility enterprises could arise.[19] Such a situation exists in this case with regard to the allocation of MCN's costs to Mich Con.

Despite being required to prove that the MCN costs assigned to base O&M expense were reasonable, Mich Con undertook no study to determine whether the services received from MCN are commensurate with the utility's allocated share of its parent's common costs. (11 Tr. 2344-2345.) Furthermore, the record indicates that the officers and employees of MCN

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[19]In examining the Commission's ability to deal with the allocation of costs from a non-utility enterprise to a utility affiliate, it was recently noted in <u>Midland Cogeneration Venture Limited Partnership</u> v <u>Public Service Commission</u>, 199 Mich App 286 (1993), that:

> "The PSC's regulatory function includes its power to set rates. That power is the tool with which the PSC can prevent cross-subsidization of non-utilities by ratepayers. The burden of proof is on the utility to justify the inclusion of affiliate-based costs in its rate base. The PSC need only apply an adverse inference whenever information it reasonably believes is relevant and within the control of an affiliate or other related entity has not been furnished." (199 Mich App at 324-325; dissent by Taylor, J.) [citations omitted.]

and Mich Con do not maintain accurate time logs and descriptions of the services that these entities provide to each other or to other Mich Con affiliates. For example, some employees had co-workers fill out their time reports for them. (21 Tr. 4464-4465.) Still others filled out their reports, from memory, only at the end of each week or month. (21 Tr. 4362-4366; Exhibit I-163.) Similarly, expense reports, travel vouchers, and meal records regularly contained no designation of the purpose of the trip or meal. (16 Tr. 3299.)

This lax approach to time and expense reporting apparently reduced the amount of costs that could be directly assigned to specific MCN subsidiaries, and thereby increased the amount of MCN's total costs that were deemed common costs. This can be seen from the fact that of the $7.5 million of billings from MCN to Mich Con during the historical test year, only $265,000 were in the form of direct billings. The remaining $7.2 million were assigned to the utility through the allocation formula. (10 Tr. 2044-2045.) The inequity inherent in this type of overreliance on a common cost allocation formula was explained as follows by ABATE's witness, James P. Cummings, a utility consultant and past utility holding company executive:

> "None of [MCN's] other subsidiaries are like Mich Con. They are all much smaller. Many require virtually no plant investment and none have payrolls or revenues comparable to Mich Con. Yet, there is a good chance that because of their small size, diverse nature, operation in competitive markets, lack of maturity and inexperienced managements, they require a far larger portion of [MCN's] attention than does Mich Con. On the other hand, Mich Con is a large, homogeneous company with an experienced management. It has its own chief executive, and with the exception of a few departments which have been transferred to [MCN], it is fully staffed to carry out its mission. In proportion to its size, it probably requires a relatively small amount of MCN's attention. When I reflected on my own experience in sharing my time among a holding company, a utility and several non-utility companies, I realized that I spent proportionally larger amounts of time on the non-utility companies and less on the utility than allocations under the [allocation formula] would have produced." (13 Tr. 2754.)

For these reasons, the Commission finds that the utility failed to prove that its proposed allocation of MCN costs was reasonable. It therefore rejects Mich Con's exception.

Turning to ABATE's request that an allocation factor of 0% be adopted, the Commission finds that MCN performs numerous services that benefit Mich Con. Specifically, certain tax, treasury, legal, financing, capital market access, planning, budgeting, and board of directors functions are undertaken for the utility by MCN. (11 Tr. 2344.) Even ABATE's witness, Mr. Cummings, acknowledged that Mich Con would have to bear the cost of performing these functions for itself were it not for MCN. (13 Tr. 2828-2829.) Thus, it would be inappropriate to bar all recovery of MCN's common costs from Mich Con's ratepayers, as suggested by ABATE.

For these reasons, the most reasonable proposal for allocating MCN's common costs to Mich Con is that offered by the Staff. The Commission therefore finds that the ALJ's recommendation to use an allocation factor of 70% should be adopted. It further agrees with the ALJ that Mich Con should be admonished for tolerating MCN's inadequate method of documenting its costs, and finds that the utility should be warned that MCN's documentation must improve if Mich Con hopes to recover all of the common costs MCN bills to it in the future.

3. Association Dues and Membership Fees

Mich Con requested $517,700 to pay for its annual association dues and membership fees. The Staff proposed eliminating $173,000 to reflect the fact that some of these dues and fees are paid to organizations that engage in lobbying. The ALJ agreed with the Staff. None of the parties except to the ALJ's conclusion, and the Commission finds that it is supported by the record and should be adopted.

Consistent with its findings regarding executive compensation, MCN costs, and association dues, the Commission agrees with the ALJ that the appropriate level of base O&M expense for the historical test year ended May 31, 1992 is $213,802,000.

b. <u>Inflation Adjustment/Incentive Proposals</u>

The parties agreed that the May 31, 1992 base O&M expense should be adjusted to reflect the 1992 year-end amount. They also agreed that this expense level should be determined by multiplying the May 31, 1992 figure by an inflation factor of 1.75%, which, based on the Commission's earlier findings, results in a December 31, 1992 base O&M expense of $217,544,000. However, the parties differed greatly on how this figure should be adjusted to recognize the effects of inflation during 1993 and 1994, as well as subsequent years. They also differed as to the need for, and structure of, incentive ratemaking plans.

Mich Con asserted that inflation factors of 3.2% and 3.8% should be adopted for 1993 and 1994, respectively. Thus, based on the utility's initial proposal to use a year-end 1992 base O&M expense of approximately $220 million, it asked that $235,423,000 be adopted as its adjusted year-end 1994 O&M expense. In addition, Mich Con proposed a comprehensive incentive package that it claimed "would serve the customers' interests and mitigate some of the problems encountered in the traditional rate of return mode of regulation." (Mich Con's initial brief, p. 91.)

The first component of this package, called the cost efficiency incentive mechanism (CEIM), would allow Mich Con to increase its rates between general rate cases to keep pace with inflation. Specifically, the utility could annually adjust the amount of recoverable O&M expense built into its rates by the same rate as increases in the Consumer Price Index - All Urban Consumers (CPIU). According to Mich Con, the CEIM would encourage cost control by the utility. This is because its shareholders would benefit if increases in O&M expense were held below the general rate of inflation, but would be penalized if the utility's management allowed cost increases to exceed the CPIU. (Mich Con's initial brief, pp. 91-92.) The second component of Mich Con's proposed package, referred to as the service level incentive mechanism (SLIM), would allow its authorized rate of return on common equity to be adjusted to reward or penalize the utility based on (1) customer satisfaction with telephone contacts with Mich Con, (2) customer satisfaction with business office contacts with the utility, and (3) Mich Con's use of actual, rather than estimated, meter readings. Specifically, if customer satisfaction with Mich Con exceeds that of other specified utilities, and if Mich Con reads a higher percentage of its customers' meters than it has in the past, the SLIM would add up to 2% to its authorized rate of return. However, if the utility did worse in these three categories, its rate of return could be reduced by up to 1%. (11 Tr. 2242-2244.)

The Staff proposed that rather than waiting until 1995 to institute a CEIM, as Mich Con would have the Commission do, any cost-containment program should be started immediately. Thus, instead of using inflation adjustments for 1993 and 1994 to establish a 1994 test year O&M expense level, the Staff suggested adopting a modified version of the utility's CEIM based on its year-end 1992 O&M figure. Under this modified version:

> "The O&M base will be increased each year by 80% of the increase in the CPIU. This adjusted O&M base then becomes the goal against which the company's actual performance will be measured to determine if a CEIM increase will be allowed. If a CEIM increase is achieved, the increase will be equal to the change in the O&M base for the period (80% of the CPIU). A CEIM increase will be permitted only if the company's actual base O&M expenses each year are equal to or less than the goal as defined above. If the company is unable to achieve the goal in any particular year, no rate increase will be allowed for that year and that year's inflation adjustment will be lost permanently." (17 Tr. 3439.) [Emphasis in original.]

In addition to keeping increases in O&M expense at or below 80% of future increases in the CPIU, the Staff's version of the CEIM would require the utility to achieve performance goals that parallel those found in Mich Con's SLIM proposal. Failure to achieve those goals would preclude any rate increase otherwise allowed under the modified CEIM. An alternative to its modified CEIM plan was also offered by the Staff. Under this alternative, the O&M expense inflation adjustment for 1993 and 1994 would be limited to 50% of the increase in the CPIU--thus providing the utility with a strong incentive for cost containment--and no CEIM or SLIM would be instituted. According to the Staff, establishing a strong incentive for cost containment is paramount in light of the fact that Mich Con allowed its base O&M expense to increase at approximately double the rate of inflation during 1991 and 1992.

ABATE asserted that the 1993 and 1994 inflation escalators proposed by the utility should be rejected on the grounds that they "excessively weighted the inflationary effect of medical expenses." (13 Tr. 2756.) ABATE also opposed all CEIM and SLIM proposals offered in this case. For example, it noted that Mich Con's CEIM makes no allowance for increases in productivity or improvements in cost control and could result in rate increases even when the utility is earning more than its authorized rate of return. As for Mich Con's proposed SLIM, Mr. Cummings stated that (1) increasing the utility's authorized rate of return would benefit only MCN and would thus have no effect on Mich Con's customer service representatives, (2) the program would likely prove unworkable, and (3) an incentive program should not be needed to ensure that utility employees do what they are already being paid for, namely providing prompt, courteous, and satisfactory service. (13 Tr. 2762-2763.) Finally, although it found the Staff's CEIM plan less offensive, ABATE pointed out that it would provide for annual rate increases without first requiring an audit of O&M expenses and, like Mich Con's proposal, would allow for rate increases even during periods of excess earnings.

The ALJ agreed with ABATE and recommended that all CEIM and SLIM programs proposed in these consolidated cases be rejected. She further found that despite the need for the utility to better restrain its O&M expenses, "Mich Con's proposal to incorporate all of the effect of 1993 and 1994 inflation would do nothing to encourage cost containment." (PFD, p. 79.) Thus, the ALJ also recommended that the Commission adopt the Staff's proposal to increase year-end 1992 base O&M expense by one-half of the anticipated rate of inflation for 1993 and 1994. As noted on pages 78 and 79 of the PFD, this would provide the utility with a base O&M expense increase of approximately $3,490,000 in 1993 and $4,210,000 in 1994, for a total of $7,700,000.

Mich Con excepts to both of these recommendations. It argues that the ALJ's proposal to adjust base O&M expense by only one-half of the predicted CPIU for 1993 and 1994 is based on the erroneous assumption that Mich Con has not been "diligent and aggressive in its cost containment efforts." (Mich Con's exceptions, p. 78.) Such an assumption, the utility contends, overlooks the fact that an early retirement program instituted in 1979 and substantial lay-offs during 1983, as well as other cost-cutting measures, succeeded in limiting its O&M cost increase over the last 10 years to approximately the rate of inflation. Mich Con goes on to argue that because many increases it will likely face in the next few years are in areas of uncontrollable expenses, like health care costs, it will be impossible for the utility to hold its overall O&M expense increases during 1993 and 1994 to levels below increases in the CPIU. As for its proposed CEIM and SLIM programs, Mich Con contends that the ALJ's rejection of these incentive proposals is based on the mistaken belief that they will provide guaranteed rate increases.

The Commission does not find these arguments persuasive. First, although cost containment efforts during the last 10 years may have held Mich Con's average increase in O&M expense to the rate of inflation during that period, costs have been allowed to rise at excessive rates during recent years. For example, the utility's base O&M expense increased by 7.5% during 1991 despite the fact that inflation was only 3.1%. (17 Tr. 3436.) The ALJ was therefore justified in concluding that, as of late, the utility's motivation concerning cost containment may have waned. Second, although some cost increases may be in areas where the utility has little control, such as employee health care costs, their effect can be offset by adjusting related expenses that are under management's control, such as wages, salaries, bonuses, and pension benefits. This type of adjustment could be justified, at least to some degree, due to the fact that Mich Con's wage and salary increases over the past several years have exceeded the rate of inflation. (11 Tr. 2358.) Third, despite the utility's assertions to the contrary, its CEIM proposal would effectively guarantee Mich Con an annual automatic rate increase equal to the increase in the CPIU. Moreover, as noted by the Staff, the utility's "SLIM proposal would allow minimum rate increases equal to $6,500,000 each year simply for maintaining the level of service provided to the ratepayers in 1991." (Staff's replies to exceptions, p. 54, fn. 5.)

For these reasons, the Commission finds that the ALJ's recommendations should be adopted, Mich Con's year-end 1992 base O&M expense should be adjusted by one-half of the increase in the CPIU for 1993 and 1994, and all CEIM and SLIM programs proposed in this case should be rejected. This results in a gross reduction in net adjusted operating income of $7,732,000 and a net reduction of $5,056,000.

Depreciation

Mich Con and the Staff agreed on all depreciation issues except one. Specifically, Mich Con asserted that the Staff erred in using a composite depreciation rate of 4.18% to remove the depreciation expense associated with the Belle River to Milford Pipeline and the Grand Rapids and Sparta Pipelines from the computation of its revenue deficiency. According to the utility, the depreciation rate for transmission plant, 2.26%, should have been used instead. Mich Con therefore claimed that over $2 million in wrongfully removed depreciation expense must be included in the computation of its rates.

The ALJ disagreed with the utility and concluded that the Staff's use of a composite depreciation rate was necessary in this case for two reasons. First, she indicated that Mich Con's proposed adjustment was apparently based on extra-record information. Second, she agreed with the Staff that even if use of the transmission plant depreciation rate was appropriate,

> "the impact of the transmission plant and its associated depreciation expense would have to be excluded from the calculation of the composite rate used by [the] Staff on the remaining plant. This turnaround will result in a larger exclusion for depreciation on the remaining plant than was reflected in [the] Staff's filing." (PFD, p. 80.)

The ALJ therefore recommended that the 4.18% composite depreciation rate be approved by the Commission.

Mich Con excepts to this recommendation. According to the utility, its proposal was sufficiently supported by evidence found in the record, such as Exhibits A-13 and I-68. Furthermore, although conceding that use of the depreciation rate for transmission plant would require an increase in the composite depreciation rate applied to the remaining gross plant, Mich Con argues that this would necessitate only a minor reduction in its proposed $2,168,000 adjustment. Specifically, as shown on Appendix A-3, page 6 of its exceptions, it asserted that its adjustment merely needs to be reduced by $59,000. Mich Con therefore claims that $2,109,000 in additional depreciation expense should be added to the computation of its revenue deficiency. The Commission agrees.

Much of the Staff's opposition to Mich Con's proposed adjustment stems not from the use of a different depreciation rate, but rather from the utility's failure to mention this proposal until after the close of the record. Had Mich Con offered testimony on this point during rebuttal, it is likely that the dispute could have been avoided. Nevertheless, the Commission finds that Mich Con's proposed adjustment is adequately supported by Exhibit A-13, Schedule H-3-2, and Exhibit I-68. Moreover, the utility's $59,000 revision to its initial proposal appears to be reasonable. The Commission therefore finds that Mich Con's depreciation adjustment should be adopted. This results in a gross reduction in adjusted net operating income of $2,109,000 and a net reduction of $1,392,000.

Company Use and Lost and Unaccounted For Gas Expense

The parties reached agreement on the projected cost of gas for 1994 ($2.81 per Mcf), the expected volume of company use (1,938 MMcf), and the appropriate lost and unaccounted for gas factor (0.3%) to be used in computing Mich Con's projected 1994 company use and lost and unaccounted for gas expense. The only point of contention was the volume of gas to use in making this computation.

Based on the sales, base transportation, and coal displacement volumes adopted earlier in this order, the Commission finds that this expense will total $5,161,000 during 1994. This represents a gross increase of $509,000 from the historical test year expense and a net increase of $328,000, the computation of which is attached as Exhibit B to this order. Therefore, the company use and lost and unaccounted for gas expense in the Staff's computation of adjusted net operating income must be increased by a gross amount of $29,000 and a net amount of $19,000.[20]

Provision for Uncollectibles

ABATE challenged the way Mich Con estimated its net charge-offs for the projected 1994 test year. According to ABATE's witness, Mr. Cummings, the utility's estimated charge-offs represented a 17.2% increase over actual net charge-offs for the 12-month period ended November 30, 1992. He believed that this figure was excessive in light of Mich Con's projection that its sales would rise by only 5.82% over the same period. In response, Mich Con asserted that using a "relatively simple throughput ratio" to adjust net charge-offs is not meaningful and should not be considered as a valid substitute for the testimony of its witness, Patrick J. Murray, who considered many variables when computing the reserve required for uncollectibles. (Mich Con's reply brief, p. 113.)

The ALJ agreed with the utility that one cannot appropriately estimate net charge-offs by simply using a percentage of sales. According to her, "[m]any other factors contribute to a determination of the proper level of uncollectibles." (PFD, p. 94.) She therefore concluded that, because Mich Con's witness considered these variables, his estimate of 1994 test year charge-offs was more meaningful than that proposed by Mr. Cummings. ABATE excepts to this conclusion and argues that, among other things, the ALJ failed to identify the variables that she believed were important to the determination of the proper level of uncollectibles.

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[20]These figures were computed by subtracting $509,000 from the Staff's proposed $538,000 gross adjustment and $328,000 from its $347,000 net adjustment, which were set forth on Exhibit S-71, Schedule C-1, line 2.

It therefore asserts that the analysis offered by Mr. Cummings should be adopted. The Commission disagrees.

As correctly noted by Mich Con, it is clear that the ALJ was referring to the numerous variables considered in Mr. Murray's analysis. The uncollectibles forecasting system used by Mr. Murray is based on a series of month-to-month relationships of account arrears to gas sales. Those relationships "are used to forecast the portion of revenues which will become arrears, the portion of arrears which will become final bills, the portion of final bills which will become gross charge-offs, and the anticipated recoveries of charged-off amounts." (5 Tr. 883.) Thus, based on its agreement with the ALJ that the comprehensive analysis performed by Mr. Murray will likely produce a more accurate estimation of Mich Con's 1994 test year uncollectibles than will the relatively simplistic approach used by Mr. Cummings, the Commission finds that ABATE's exception should be rejected.

In contrast to the dispute between the utility and ABATE, the only difference between Mich Con and the Staff regarding the 1994 test year uncollectibles was the level of rate increase proposed by each. Specifically, the utility's uncollectibles were based on an assumption that 1994 revenues will include a $53 million rate increase (Mich Con's initial request for a $122 million increase was reduced to this level in its initial brief) and the Staff's were based on its proposal for a $7.5 million increase. (17 Tr. 3445.) However, based on her conclusion that a $16.8 million rate increase should be adopted, the ALJ computed the appropriate provision for uncollectibles to be $27,049,000. This resulted in a gross reduction in the Staff's adjusted net operating income of $129,000 and a net reduction of $83,000.

Because neither of these parties except to the ALJ's computation, and because her proposed rate increase more closely matches that approved in this order, the Commission finds that the ALJ's figure should be adopted. Thus, her proposed gross and net adjustments will be included in the computation of net operating income.

City Income Tax

The Staff asserted that the utility's historical city income tax expense should be increased by $44,000 to obtain a reasonable 1994 test year expense. In contrast, Mich Con contended that the appropriate gross increase was $709,000. According to the utility, the Staff's proposed increase was greatly understated because it was based on revenues rather than income. Although the Staff subsequently agreed that this expense is more properly tied to taxable income than to revenue, it continued to maintain that its proposed figure constituted a reasonable estimate of the utility's 1994 test year city income tax expense. The ALJ disagreed with the Staff and recommended that Mich Con's proposed increase be adopted. (PFD, p. 81.)

The Staff excepts to this recommendation. According to it, the utility's proposal "grossly overstates" the projected test year's city income tax expense. (Staff's exceptions, p. 6.) This alleged overstatement can and should be avoided, the Staff argues, by using an income deficiency ratio. The Commission disagrees. As correctly noted by Mich Con, "[t]he income deficiency ratio that the Staff is proposing is simply Mich Con's revenue deficiency, net of federal and state taxes, and not Mich Con's authorized income." (Mich Con's replies to exceptions, p. 6.) Thus, despite conceding that net income is the appropriate factor to use when calculating city income tax expense, the Staff continues to propose an adjustment based on revenue, not income. The Commission therefore finds that the ALJ's recommendation should be adopted and that Mich Con's proposed expense, $709,000, should be used. This results in a gross adjustment of $665,000 to the Staff's net operating expense (which is the utility's

$709,000 figure minus the $44,000 previously included in the Staff's calculation) and a net adjustment of $439,000.

Amortization of Deferred Lost Gas

Since 1978, Mich Con has used and the Commission has adopted a lost and unaccounted for gas factor derived from the utility's actual lost gas percentages over the previous five years. As shown on Exhibit B attached to this order, that five-year average is then multiplied by the utility's projected sendout (throughput plus company use) to estimate the likely volume of lost and unaccounted for gas during the period in which the new rates will be in effect. During the mid-1980s, the percentage of Mich Con's actual lost gas decreased significantly from prior levels. In response to that decrease, Mich Con implemented an accounting procedure that, it contends, was designed to eliminate temporary income distortions by deferring the difference between a particular year's actual lost and unaccounted for gas volumes and the five-year average.

Both ABATE and the Staff have objected to the utility's unilateral adoption of this accounting procedure, arguing that the procedure required ratepayers to pay higher than necessary rates. They therefore proposed including the 1994 amortization of Mich Con's lost gas deferrals in the computation of its rates, thus increasing the utility's projected net income. They also requested that Mich Con be ordered to cease using this accounting procedure. The ALJ agreed with ABATE and the Staff that lost gas accounting is a valid rate-setting issue and, therefore, recommended that the utility's 1994 amortization of its lost gas deferrals be included in the computation of net income. She went on to recommend that the Commission order Mich Con to "discontinue the use of its current accounting methodology for deferred lost gas in the future." (PFD, p. 83.)

Mich Con excepts to these recommendations for two primary reasons. First, the utility argues that it is wrong to assume that Mich Con's accounting treatment for lost and unaccounted for gas forced customers to pay higher rates. Second, it asserts that the ALJ's recommendation to include the amortization of lost gas deferrals in the computation of net income constitutes retroactive ratemaking. The Commission disagrees.

As stated by Ms. Devon, Mich Con's accounting procedure resulted in its customers paying higher rates during the past two years under the operating incentive plan (OIP) and performance incentive plan (PIP) established in Case No. U-9475. Specifically, if the utility's net income had not been reduced due to the use of deferred lost gas accounting, its rates would have been lowered by over $2.3 million in 1991 and over $3.8 million in 1992 under the terms of the PIP. In addition, its 1991 OIP increase would have been reduced by nearly $8 million and no OIP increase would have been allowed in 1992. (17 Tr. 3420.) Instead, Mich Con obtained rate increases of $13.7 million in 1991 and $4.9 million in 1992. Thus, the utility's first argument must be rejected.

As for Mich Con's assertion regarding retroactive ratemaking, ABATE and the Staff correctly note that the ALJ did not propose any retroactive recapture of revenues collected under current rates. Neither refunds nor rebillings have been proposed to reflect a lower level of lost gas expense. Rather, as pointed out by ABATE:

> "The ALJ recommended that historical lost gas percentages should be used to estimate the lost gas expense for the projected test year, that Mich Con should discontinue its current lost gas accounting method, and that Mich Con's 1994 amortization of deferred lost gas expense should be included in setting rates in order to ensure that Mich Con does not continue to benefit from the methodology [that] it unilaterally implemented." (ABATE's replies to exceptions, p. 34.)

For this reason, the utility's second argument must also be rejected. Therefore, the Commission finds that the ALJ's recommendations concerning this issue should be adopted.

Finally, it should be noted that Mr. Aldrich discussed at length the history of the five-year average of lost and unaccounted for gas that the parties agreed to use in this case. (17 Tr. 3539-3543.) Mr. Aldrich testified to the superiority of the five-year average as compared to alternatives that have been proposed in other cases. Based on this uncontroverted testimony, the Staff requested that the Commission explicitly state in its order that the five-year average should be used in all gas general rate cases. None of the parties oppose this request, and the Commission finds that it should be accepted with respect to Mich Con. However, because circumstances may arise in which it would be unreasonable to apply this five-year average to some other Michigan gas utility, the Commission is not yet prepared to make its use an absolute requirement in all gas general rate cases. Rather, the Commission finds that it should go no further than to create a rebuttable presumption that the use of a five-year average of lost and unaccounted for gas is reasonable and should be adopted in future rate cases.

SFAS 106 Claims Paid Adjustment

In December 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards 106 (SFAS 106), which required companies to begin accounting for postretirement benefits other than pensions on an accrual basis, during the working lives of their employees, rather than on a cash or pay-as-you-go basis. The Commission subsequently adopted SFAS 106 for ratemaking purposes in its December 8, 1992 order in Cases Nos. U-10040 and U-10040-A. In light of that order, the parties addressed SFAS 106 costs in this general rate case.

Moreover, Mich Con and the Staff agreed to several adjustments to historical net operating income. One of those adjustments concerns SFAS 106 costs. However, as indicated in footnote 13, Mich Con's acceptance of the Staff's proposed $28,736,000 adjustment was contingent upon the Commission's approval of the utility's projected 1994 O&M expense. Because that approval did not occur, the Commission must address the parties' dispute over the proposed SFAS 106 claims paid adjustment.

This dispute arose from the fact that a significant difference exists between the costs the Staff included in base O&M expense for SFAS 106 claims paid and the amount the Staff deducted from total SFAS 106 costs for this same item. Specifically, although the Staff used $11,208,000 to represent SFAS 106 claims paid when developing its base O&M expense, it reduced the utility's total SFAS 106 costs for 1994 by $12,690,000. Despite its agreement with the theory underlying the Staff's adjustment, Mich Con asserted that the amount of the adjustment must be equal to the figure used to compute base O&M expense. To achieve this consistency, the utility recomputed the 1994 SFAS 106 accrual using $11,208,000 to represent both the 1993 and 1994 claims paid. This resulted in a 1994 SFAS 106 accrual of $30,084,000 instead of the $28,736,000 used by the Staff, a difference of $1,348,000. (20 Tr. 4309; Exhibit A-160.) The ALJ agreed with Mich Con that these numbers should be consistent and recommended that the Commission adopt the utility's proposed 1994 SFAS 106 accrual of $30,084,000.

The Staff and ABATE except to this recommendation, albeit for different reasons. The Staff contends that, despite Mich Con's apparent belief to the contrary, its use of two different numbers was intentional. Specifically, a smaller figure was included in base O&M expense for 1994 SFAS 106 claims paid than was subtracted from total SFAS 106 costs in recognition of the Staff's proposal to limit inflation adjustments to 50% of the increase in the CPIU. (17 Tr. 3517-3518.) If the ALJ's recommendation to use identical figures is adopted, the Staff asserts, its plan to limit base O&M increases to 50% of the inflation rate for 1993 and 1994 would be "effectively undermined," and the utility "would be allowed to recover a higher inflation allowance than anticipated in [the] Staff's proposal." (Staff's exceptions, p. 8.) It therefore contends that the Staff's proposed accrual, $28,736,000, should be adopted. As for ABATE, it contends that the figure proposed by Mich Con and recommended by the ALJ is unreasonably high due, in great part, to its reliance on an outdated actuarial study. ABATE contends that a proper accrual figure can arise only from use of the December 1992 actuarial study performed by Hewitt Associates. (ABATE's exceptions, pp. 49-52.) The Commission agrees with both of these parties' arguments.

As discussed earlier in this order, restricting Mich Con's inflation adjustment for 1993 and 1994 to 50% of the increase in the CPIU is necessary to encourage the utility to contain its ever-increasing O&M expense. Thus, because the 1994 SFAS 106 claims paid expense must be included in test year O&M expense, it was appropriate for the Staff to use a smaller figure than that deducted from total SFAS 106 costs. Doing otherwise would undermine the O&M cost containment measures adopted in today's order. Moreover, the record indicates that the Staff's proposed SFAS 106 accrual was based on the December 1992 actuarial study supported by ABATE. (16 Tr. 3213.) The Commission therefore finds that the Staff's figure, $28,736,000, should be adopted.

Additional Adjustments Proposed by ABATE

In addition to those addressed above, ABATE proposed five other adjustments to net operating income. Each of these proposed adjustments will be discussed separately.

a. <u>The "Power of You" Program</u>

Included in Mich Con's projected 1994 test year O&M expense was the cost of its Power of You - Build the Future program (Power of You program). According to the utility, this employee training project--initiated in 1990--was designed to "shift the corporate culture" and alter the way its workers view their jobs through the use of team building initiatives, leadership training initiatives, personal development system initiatives, and a quality effort focused on business processes. (4 Tr. 541-543.) Based on its belief that the Power of You program will simultaneously improve the utility's quality of service and strengthen its cost containment efforts, Mich Con claimed that the project's costs belong in rates. In contrast, ABATE asserted that it would be unreasonable for ratepayers to pay for a program that was primarily designed to make the utility's employees feel better about their jobs. ABATE therefore requested that all Power of You program costs be removed from rates through a $4.6 million reduction in Mich Con's projected 1994 test year O&M expense.

The ALJ rejected ABATE's request and recommended that Mich Con be allowed to recover the cost of its Power of You program through its rates. This was based on her "expectation that some benefit will flow through to ratepayers in the form of reduced levels of O&M expense increases." (PFD, p. 87.)

ABATE excepts to this recommendation for several reasons. First, it asserts that no evidence was offered regarding the effectiveness of the Power of You program. Instead, ABATE points out, Mich Con's lead witness on this issue, Mary Jo Braun, testified that no analysis has been performed regarding the program's anticipated effect on O&M expenses and that she has no idea if or when the program's benefits can be quantified. (4 Tr. 554-557; 5 Tr. 856.) Second, ABATE notes that, although Mich Con's affiliates and MCN are allowed to enroll their employees in the Power of You program, the utility was unable to explain how costs are allocated among these various entities. Third, it contends that, although improved quality of service is an appropriate goal, ratepayers "should not be expected to pay millions of dollars to enable Mich Con to train its employees to do what they should have been doing all along." (ABATE's reply brief, p. 9.) ABATE therefore asserts that the Commission should reduce the utility's projected 1994 O&M expense by $4.6 million.

The Commission agrees in substantial part with these assertions. As correctly noted by ABATE, Mich Con has undertaken no analysis of the program's effect on future expenses or quality of service. Without proof regarding whether, and to what degree, the Power of You program will reduce O&M expenses and improve customer service, the Commission cannot justify requiring ratepayers to continue paying for it. All costs of this program must therefore be removed from projected 1994 O&M expense. However, it appears that ABATE's proposed disallowance, namely $4.6 million, is excessive. As stated by John E. VonRosen, Mich Con's Senior Vice President for Customer Operations, only $2.5 million in Power of You program costs was included in Mich Con's 1994 O&M expense. (19 Tr. 3973.) The Commission therefore finds that this lower figure should be disallowed. This results in a gross increase of $2.5 million in adjusted net operating income and a net increase of $1,611,000.

MCNCSI Profit

Mich Con sought recovery of the expected cost of computer services received from one of its unregulated affiliates, MCN Computer Services, Inc. (MCNCSI). This was done by including the cost of these services in the utility's projected 1994 O&M expense. According to Mich Con, this included data center, terminal, and time sharing costs totalling $13.7 million.

ABATE disagreed with Mich Con's proposed recovery. Instead, it estimated MCNCSI's annual profit from its contract with the utility to be approximately $1.4 million and requested the elimination of this profit from projected O&M expense. In making this request, ABATE (1) pointed out that, prior to selling its data center to MCNCSI in 1988, the utility performed all of these computer services for itself, (2) noted that Mich Con did not solicit competitive bids for these services, and (3) concluded that MCNCSI earned excessive profits from its contract with Mich Con.

The ALJ concluded that it would be inappropriate to eliminate MCNCSI's estimated profit from Mich Con's projected 1994 O&M expense. According to her, if the utility obtained these computer services from some other entity, that entity's price would include a return on the assets used to serve Mich Con. "It is likewise only reasonable," the ALJ stated, "that MCNCSI would be expected and allowed to secure a return also as long as that return is reasonable." (PFD, pp. 89-90.) She therefore recommended that, because ABATE failed to prove that MCNCSI was receiving an excessive profit under its contract with Mich Con, the entire $13.7 million should be included in rates. ABATE excepts to this recommendation and renews its assertion that all profit derived from providing computer services to the utility should be disallowed.

The Commission again agrees in substantial part with ABATE's exception. As noted earlier, it is the utility's responsibility to prove that its costs are reasonable. It could easily have done so by requesting competitive bids for its computer services contract and showing that MCNCSI's bid was preferable to all others. However, Mich Con failed to make such a showing. Moreover, the record supports ABATE's assertion that MCNCSI is receiving excessive profits from its contract with the utility. This is based on the fact that MCNCSI's historical rate of return is 19.5% and that nearly one-half of its gross revenue comes from Mich Con. (10 Tr. 1996-1999.)

However, because the ALJ is correct in noting that some of MCNCSI's profit should be recovered in rates, it would not be appropriate to disallow the entire $1.4 million. The Commission therefore finds that, in the present case, a more reasonable result is to disallow one-half of MCNCSI's estimated profit from work performed for Mich Con. This results in a gross increase in net operating income of $700,000 and a net increase of $451,000.

It should be noted that the Commission is very concerned by evidence that Mich Con has transferred an otherwise routine utility operation--the performance of its day-to-day computer services--to a highly profitable unregulated affiliate. As stated in the Commission's December 7, 1989 order in Cases Nos. U-8678, U-8924, and U-9197, the transfer of a utility operation like this to an unregulated affiliate or a third party is appropriate only when "the utility can establish both a good business reason to transfer the activity to another entity and that the cost of doing so is reasonable." (December 7, 1989 order, p. 98.) The Commission therefore places Mich Con on notice that, in future rate cases, it will have to prove that its annual payments to MCNCSI do not exceed the lesser of (1) the utility's cost of providing this service in-house or (2) the market price for this service. Any excess costs will be disallowed.

Employee Termination Payments

Mich Con proposed including in the computation of its adjusted net income $4,403,000 of injuries and damages expense. According to Ms. Braun, this represented the five-year historical average of cash payments made by Mich Con for workers' compensation claims, lawsuits, and other damage claims against the utility. (4 Tr. 512.) The five-year average included payments to several terminated employees who filed suit after the utility instituted its work-force reduction program in 1983. However, Ms. Braun noted, payments resulting from the 1983 workforce reduction were completed in 1990 or 1991. (5 Tr. 801.)

Due to Ms. Braun's admission that no further employee termination payments will likely arise from the utility's 1983 workforce reduction, ABATE proposed the elimination of one-fifth of the utility's suggested $4.4 million in injuries and damages expense, or $880,000. According to ABATE, employee termination payments were unusual, non-recurring costs and therefore should not have been included in the computation of the five-year average. The ALJ disagreed and recommended that Mich Con's proposed figure should be adopted. ABATE excepts to this recommendation.

The Commission finds that Mich Con's five-year average, without the adjustment proposed by ABATE, is reasonable and should be adopted. It reaches this conclusion for two reasons. First, using a five-year average of actual expenditures to estimate a utility's future injuries and damages expense is a long-standing practice. (4 Tr. 512.) This practice has consistently been approved by the Commission, as can be seen from the December 22, 1988 order in consolidated Cases Nos. U-8653, U-8812, and U-8854, as well as the December 7, 1989 order in consolidated Cases Nos. U-8678, U-8924, and U-9197. Second, as correctly noted by the utility, "the provision for Injuries and Damages uses a five-year average of actual costs precisely because (i) the costs can be extremely volatile, and (ii) the nature of these costs is that they all are essentially non-recurring, unusual costs." (Mich Con's replies to exceptions, p. 61.) For these reasons, the Commission adopts the ALJ's recommendation and rejects ABATE's request to reduce the utility's proposed injuries and damages expense by $880,000.

Office Rent Expense

In developing its projected 1994 O&M expense figure, Mich Con added $418,000 to its historical test year office rent expense. This increase corresponded to the utility's decision to move its Grand Rapids office to the newly constructed Bridgewater Office Building. According to Ms. Braun, Mich Con decided to change offices because (1) its old office was severely overcrowded, (2) no additional space was available at that location, (3) negotiations with its previous landlord resulted in an offer for even less space than the utility originally occupied, (4) its previous landlord had recently increased its rent from $16 per square foot to $19.50 per square foot, and (5) the utility was offered all of the space it needed at the Bridgewater facility. (4 Tr. 515.) Over ABATE's objection, the ALJ recommended increasing office rent expense by the full amount that Mich Con had requested.

ABATE excepts to this recommendation for two reasons. First, in accordance with testimony submitted by its witness, Mr. Cummings, it argues that $318,000 must be eliminated from the utility's proposed increase. This is based on his belief that Ms. Braun erred in her calculations by including the full rental for the new space rather than the differential between the old and new rentals. Second, ABATE argues that even if Ms. Braun's computation was correct, the utility "failed to prove that a $418,000 increase in rental expenses for relocation to a building owned in part by its affiliate is reasonable and prudent." (ABATE's exceptions, p. 45.) The Commission does not find these arguments persuasive.

Mr. Cummings' proposed adjustment to office rent expense is mistakenly based on the assumption that $5 per square foot is the only incremental difference between the old office rent and that charged at the new location. (Exhibit A-79.) In contrast, the correct expense adjustment consists of two components: (1) the $5 per square foot increase in rent for the equivalent, existing floor space and (2) the additional square footage required at the new rate of $21 per square foot. Because Ms. Braun correctly included both of these costs in her calculation, ABATE's first argument must be rejected. As for its second argument, Ms. Braun's uncontroverted testimony concerning the need for additional space, the previous landlord's inability to provide this added space, and the rent increase recently imposed by that landlord is sufficient to justify the requested $418,000 cost increase. The Commission therefore finds that ABATE's exception should be rejected and that the ALJ's recommendation should be adopted.

<u>Amortization of SFAS 106 Transition Obligation</u>

The FASB recognized that upon implementing SFAS 106 requirements, companies would be forced to recognize a transition obligation, which consists of the unfunded and unrecognized accumulated postretirement benefit obligation for all plan participants. This transition obligation makes up a significant portion of the SFAS 106 annual accrual expense discussed earlier. Moreover, in ruling that large Michigan utilities should begin using SFAS 106, the Commission stated that "[p]arties to cases involving recovery of SFAS 106 costs should present evidence and arguments concerning an appropriate amortization period [for this transition obligation of] between 20 and 40 years." (December 8, 1992 order in Cases Nos. U-10040 and U-10040-A, p. 11.) In the present case, Mich Con and the Staff proposed using a 20-year amortization period. In contrast, ABATE proposed using a 40-year period. The ALJ agreed with Mich Con and the Staff.

ABATE excepts to the ALJ's recommendation. As it did in Cases Nos. U-10040 and U-10040-A, ABATE contends that because the SFAS 106 transition obligation arises from postretirement benefit costs related to a prior period, it is not fair to require current or future customers to bear these costs in addition to the current service costs that make up the annual accrual expense. However, because the Commission's December 8, 1992 order in those cases authorizes recovery of the transition obligation through current rates, ABATE asserts that a 40-year amortization period should be used to "spread the obligation over as large a group of customers as possible." (ABATE's exceptions, p. 52.) ABATE goes on to assert that, although a 20-year amortization period more closely corresponds to commonly accepted accounting practices, the Commission has long recognized that accounting standards do not govern ratemaking.

The Commission agrees with ABATE that neither accounting standards nor the accounting treatment adopted by a utility are controlling in ratemaking determinations. However, as correctly noted by the ALJ, "when those accounting standards are reasonable under the circumstances presented, there is a benefit from utilizing the same treatment for accounting and ratemaking." (PFD, p. 96.) In this case, the Commission finds, circumstances are such that use of the 20-year amortization period adopted by FASB's Emerging Issues Task Force is appropriate. The Commission reaches this conclusion for two reasons. First, this shorter amortization period results in more money going into the retirement fund during the first few years. This should increase the amount of interest earned on fund assets and, therefore, result in a lower overall ratepayer contribution to retirement benefits. Second, as noted by Mr. Dow, the 40-year amortization period would result in a poor matching of revenues and expenses, thereby producing "a material adverse impact on the Company." (11 Tr. 2264.) Specifically, Mich Con's earnings would be reduced by $5.6 million annually for the next 20 years. (11 Tr. 2263.) The Commission therefore finds that Mich Con's SFAS 106 transition liability should be amortized over 20 years.

Remaining Issues

Three additional adjustments are required when computing adjusted net operating income. The first concerns the allowance for funds used during construction (AFUDC). In this case, the only parties to submit a projection of AFUDC for 1994, Mich Con and the Staff, used the same methodology to arrive at their respective projections. As shown on Exhibit C attached to this order, when the Commission's findings regarding plant balances, cost of debt, and overall rate of return are included in the computation, the gross reduction in AFUDC and the net AFUDC adjustment are $649,000 and $553,000, respectively. This results in a gross increase of $5,000 in adjusted net operating income and a net increase of $8,000.

The second adjustment reflects the tax effect of the interest implicit in the capital structure. This adjustment, which results in an income tax savings of $951,000 and an increase in adjusted net operating income of $78,000, is computed as follows:

Rate Base	$1,025,416,000
Weighted Cost of Debt	x 3.61%
Required Interest Expense for 1994	$ 37,018,000
Historical Interest Expense	- 34,221,000
Increased Interest Deduction	$ 2,797,000
Federal Income Tax Rate	x 34%
Income Tax Savings	$ 951,000

The third adjustment reflects the effect of the JDITC contained in the capital structure. This adjustment, which recognizes the tax consequences of interest synchronization, results in a net tax savings of approximately $21,000 and is computed as follows:

Rate Base	$1,025,416,000
JDITC Portion of Capital Structure	x 3.56%
Portion of Rate Base Funded by JDITC	$ 36,505,000
Weighted Cost of Debt in JDITC Return	x 4.45%
Interest Amount	$ 1,624,000
Less: Historical Interest Synchronization	- 1,561,000
Increased Interest Deduction	$ 63,000
Federal Tax Rate	x 34%
Additional Tax Savings	$ 21,000

The tax savings arising from the interest synchronization adjustment results in a $5,000 increase in adjusted net operating income.

Conclusion

Based upon the discussion and findings set forth above, the Commission finds the utility's adjusted net operating income to be $72,307,000. This figure is computed as follows:

	Gross ($000)	Net ($000)
Staff's Adjusted Net Operating Income: (per Exhibit S-71, Schedule C-1)		79,522
Revenue and Cost of Gas Adjustments	(3,358)	(2,164)
Storage Revenue	(2,990)	(1,927)
Off-System Transportation Revenue	1,387	894
Wet Header Revenue	2,049	1,321
Additional Adjustment to Gas-In-Kind Revenue	(840)	(541)
O&M Inflation Adjustment	(7,732)	(5,056)
Depreciation Expense Revision	(2,109)	(1,392)
Lost and Unaccounted for Gas	29	19
Provision for Uncollectibles	(129)	(83)
City Income Tax	(665)	(439)
Power of You Program	2,500	1,611
MCNCSI Profit	700	451
AFUDC	5	8
Interest Implicit in Capital Structure	78	78
Interest Synchronization	5	5
Adjusted Net Operating Income:		$72,307

VIII.

REVENUE DEFICIENCY

Once Mich Con's rate base, overall rate of return, and adjusted net operating income have been determined, the computation of the utility's revenue deficiency, $15,727,000, is relatively straight-forward. The computation is set forth below:

	Amount
Rate Base	$1,025,416,000
Overall Rate of Return	x 8.04%
Required Income	$ 82,443,000
Less: Adjusted Net Operating Income	- 72,307,000
Income Deficiency	$ 10,136,000
Revenue Multiplier	x 1.5516
Revenue Deficiency	$ 15,727,000

IX.

COST ALLOCATION

Having established Mich Con's revenue deficiency, the Commission must now allocate costs and design rates to eliminate the deficiency. Testimony and exhibits concerning the first step in this process, namely cost allocation, were submitted by Mich Con, ABATE, the Attorney General, and the Staff. What follows is a discussion of the pertinent issues that remain in dispute among these parties.

Allocation of Storage Costs

In consolidated Cases Nos. U-8635, U-8812, and U-8854, Mich Con's last contested rate case, storage costs were allocated between sales and transportation customers by using peak day consumption as a means of estimating peak day storage withdrawals. Although continuing to support the peak day consumption method, Daniel J. Wozniak, the utility's witness concerning storage cost allocation, indicated that the derivation of peak day storage withdrawals should be altered to better assign to sales and transportation customers their fair share of storage costs. According to Mr. Wozniak, this change was necessary because (1) more information has become available concerning transportation customers' actual storage withdrawals, (2) Mich Con's recent gas supply realignment has made its GCR sales customers more dependent on storage to meet peak day demand, and (3) Mich Con has proposed, in the context of this case, to establish restrictions on transportation customers' use of storage. (6 Tr. 1190.)

Mr. Wozniak prepared two storage cost allocation analyses. The first, which included no limitation on transportation customers' injections into and withdrawals from storage, indicated that 21.1% of Mich Con's storage costs should be allocated to transportation customers. (6 Tr. 1192.) The second analysis, which assumed that each transportation customer would be prohibited from (1) placing more than 10% of its annual contract quantity (ACQ) in Mich Con's storage facilities, (2) withdrawing more than 3% of its ACQ during any month from November through March, and (3) injecting more than 1.43% of its ACQ during the months of September and October, led to a proposed cost allocation of 5.8%. (6 Tr. 1193.) Based on its intention to impose these three limitations, Mich Con supported--at least initially--adoption of this 5.8% allocation factor.

ABATE accepted this allocation factor, but asserted that other storage options should be provided for transportation customers that cannot operate under Mich Con's proposed injection and withdrawal restrictions. The first of these options, called "enhanced transportation service," would entitle a customer to store up to 25% of its ACQ, limit monthly storage withdrawals from November through March to 7% of its ACQ, restrict the customer's injection of gas to 2.5% of its ACQ during September and October, and limit gas injections to 5% during the months of April through August. According to ABATE, transportation customers would pay an additional 5.02¢ per Mcf for this service. The second option would allow customers to receive transportation service completely unbundled from storage and load balancing service, and would reduce the base transportation rate for these customers by 1.9¢ per Mcf.

In contrast to the utility, the Staff proposed allocating storage costs to transportation customers based on the percentage of total storage capacity set aside for their use. According to the Staff's witness, Mr. Aldrich, this capacity-based allocation assigned 10.4% of Mich Con's storage costs to its transportation customers. (17 Tr. 3546-3547.) After reviewing Mr. Aldrich's proposal, the utility concluded that the Staff's allocation factor was reasonable and should be adopted instead of Mich Con's factor. (Mich Con's initial brief, p. 124.)

The Attorney General's witness, Ralph E. Miller, originally proposed that storage costs be allocated on the basis of peak day storage withdrawals. This allocation methodology, which was based on deliverability, assigned 21.1% of the utility's storage costs to transportation customers. However, Mr. Miller subsequently testified that the Staff's proposed use of a capacity-based allocation factor was equally appropriate. (21 Tr. 4479.) The Attorney General therefore concluded that the most reasonable way to allocate storage costs to transportation customers would be by combining these two approaches. Specifically, he recommended that one-half of the utility's storage costs be allocated based on deliverability (with an allocation factor of 21.1%) and that the other half be allocated based on capacity (with an allocation factor of 10.4%). This 50/50 allocation recommended by the Attorney

General assigned 15.7% of Mich Con's total storage costs to its transportation customers. (21 Tr. 4480.) The Staff subsequently agreed that this allocation should be adopted, thus "recognizing the importance of both peak day usage and total capacity available to each rate class." (Staff's initial brief, p. 167.)

The ALJ agreed with the Attorney General and the Staff that the 50/50 allocation was the most appropriate option. She therefore recommended that the Commission adopt a 15.7% allocation factor. In making this recommendation, the ALJ noted that Mich Con had abandoned its initial request to use a 5.8% allocation factor. She went on to conclude that ABATE's proposals for enhanced transportation service and fully unbundled storage service must be rejected because they were based on the utility's discarded 5.8% cost allocation and "have not been demonstrated to be cost-based when coupled with the 15.7% allocation adopted by the [ALJ]." (PFD, p. 101.)

ABATE excepts to the ALJ's conclusions and recommendations for two reasons. First, it argues that, notwithstanding the ALJ's belief to the contrary, adoption of the 5.8% allocation factor is reasonable in light of the utility's proposed withdrawal and injection limits. Second, ABATE argues that the 15.7% allocation factor should be adopted only if its proposals for enhanced transportation service and unbundled storage service are also approved. The Commission disagrees.

The 5.8% allocation factor initially proposed by the utility was based on the assumption that, on a design peak day, transportation customers would utilize no more than 1/30 of their monthly load-balancing capacity. However, Mich Con's proposed injection and withdrawal limitations do not restrict transportation customers' use of load-balancing on a daily basis. Rather, they establish monthly restrictions. As correctly noted by Mr. Miller, this means that "transportation customers would be free to take as much of their gas out of storage on any one day as they desire." (14 Tr. 2923.) Because Mich Con's abandoned 5.8% allocation factor was based on an erroneous assumption, and thus greatly understates the amount of storage costs that should be assigned to transportation customers, its rejection by the ALJ was proper.

Furthermore, the ALJ's rejection of ABATE's enhanced transportation service and unbundled storage service proposals is fully justified despite her adoption of the 15.7% allocation factor. As noted by one of the utility's witnesses, Mr. Cieslak, restricting transportation customers' injection and withdrawal activities will achieve the following two benefits:

> "First, it will improve the overall operational planning and supply purchasing functions of Mich Con, thereby maximizing the flexibility Mich Con requires in filling storage [during the summer months to meet] GCR customers' winter requirements. Second, it will provide additional control to Mich Con during the peak winter period by assuring better Mich Con management of its storage withdrawals to meet GCR customer demands." (7 Tr. 1326.)

Thus, although ABATE's proposed enhanced transportation service might prove advantageous for certain transportation customers, these advantages would likely be provided at the expense of GCR customers' rights to reliable service. ABATE's proposed unbundled storage service could also jeopardize service to Mich Con's GCR customers. As conceded by Mr. Wozniak, daily metering of Mich Con's storage volumes is not currently available. (6 Tr. 1191.) Thus, it is impossible for the utility to know "whether its transportation customers are in fact achieving a daily balancing of their usage with the quantities of gas that their suppliers are delivering to Mich Con's system." (21 Tr. 4483.) If, without the utility's knowledge, a customer that opts for unbundled service continues to use Mich Con's storage facilities for purposes of load balancing, operational difficulties could arise that adversely affect GCR customers' service. Moreover, Mich Con correctly points out that even if operational difficulties do not occur, GCR customers and any transportation customers that are not paying the lower unbundled rate would effectively subsidize the unbundled transportation customers that make unauthorized use of storage facilities. (Mich Con's reply brief, p. 135.)

For these reasons, the Commission finds that the ALJ's recommendations to adopt a storage allocation factor of 15.7%, reject ABATE's proposed enhanced transportation service, and reject ABATE's proposed unbundled storage service are proper.

Administrative Costs of the Transportation Program

In its December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854, the Commission allocated the administrative costs of running Mich Con's transportation program to its transportation customers. This resulted in the assignment of costs totalling $300 per month for each customer. Based on an estimate of 653 transportation customers, $2,350,800 was included in the cost-of-service study to reflect the annual expense of administering the utility's transportation program. (December 22, 1988 order, pp. 39-40.) Despite the cost allocation methodology adopted in those consolidated cases, Mich Con neglected to assign its transportation customers an equivalent share of administrative costs in the present case. Concluding that this omission was simply an oversight, the Staff added an annualized figure of $2,919,000 to the cost of service assigned by Mich Con to its transportation customers. According to Mr. Aldrich, this figure was derived by assigning the same level of administrative costs, $300 per month, to each of the utility's 811 existing transportation customers. (17 Tr. 3549.)

In its reply brief, Mich Con indicated--for the first time--that the failure to include this cost allocation in its cost-of-service study was not an oversight. Rather, the utility contended, it was based on the belief that the cost of administering the transportation program should be borne by sales and transportation customers alike. To do otherwise, the utility asserted, would allocate an unnecessarily high percentage of costs to transportation customers. Mich Con therefore asked that the Commission reject the Staff's proposal to assign all of these costs to the utility's transportation customers. The PFD did not adopt Mich Con's request, and the utility excepts.

Since Mich Con is proposing a change in the established procedure for allocating these transportation-related costs, it has the burden of proof on this issue. However, as correctly noted by the Staff, the utility has failed to provide "any record support whatsoever for its assertion that this allocation results in an overallocation of costs to transportation customers." (Staff's replies to exceptions, p. 68.) The Commission therefore finds that Mich Con's requested change should be rejected and that the administrative cost allocation approved in consolidated Cases Nos. U-8635, U-8812, and U-8854 should be retained.

Capacity Cost Allocation

In assigning capacity-related costs, the methodology can have a significant effect on the costs assigned to a particular customer class. In the present case, ABATE proposed using the average and excess demand (AED) method. This method allocates costs based on the average use of the distribution system (system average demand) and the excess use of the system (which is the difference between each rate class's peak demand and average demand). The system average demand component is allocated to each customer class in proportion to its average demand. The excess use component is allocated to each customer class in proportion to the amount that the class's peak demand exceeds its average demand. Use of the AED method would therefore generally benefit members of customer classes that use gas at a steady rate (high load factor customers), like large industrial customers. In contrast to

ABATE's proposal, Mich Con, the Staff, and the Attorney General support use of the average and peak (A&P) method. The A&P method apportions capacity costs based on the average demand and the peak demand. A weighted average is therefore derived from a capacity (peak) allocation factor and a commodity (average use) factor. Thus, unlike the AED method, the A&P method gives partial weight to each customer class's annual throughput.

In keeping with long-standing Commission practice, the ALJ recommended using the A&P methodology. Based on its belief that the A&P method allocates an excessive amount of capacity costs to Mich Con's large-volume transportation customers, ABATE excepts to this recommendation. ABATE offers several arguments in support of its exception, including the following.

First, ABATE contends that although the A&P method allocates part of capacity-related costs on the basis of throughput, "annual throughput is not a true cost-causative consideration" in the design or installation of capacity- or demand-related plant. (ABATE's exceptions, p. 57.) Second, it asserts that the overallocation of costs to large-volume transportation customers by Mich Con's existing A&P-based rates can be seen from the fact that its transportation rates are higher than those of six other Midwest gas utilities. Third, ABATE contends that continued reliance on the A&P method is unreasonable because it would result in rates for Rouge Steel Company that would be 36% higher than that customer's estimated cost of service. For these reasons, ABATE claims that the Commission must abandon its long-standing reliance on the A&P method and adopt the AED method. The Commission disagrees.

As for ABATE's first argument, the record indicates that any reasonable cost allocation methodology, such as the A&P method, recognizes that some portion of capacity must be allocated on the basis of non-peak usage. As correctly noted by Mr. Aldrich:

> "A gas distribution system is in some ways similar to a plant that produces two products. One product, peak day service, requires the entire capacity of the 'plant'. The other product, off-peak service, requires only a portion of the 'plant'. The plant has to produce both products to be economically viable; peak day load alone is insufficient to pay for the cost of building the plant, and off-peak service alone is not sufficiently desirable to many customers to allow for rates sufficient to recover the costs of building the plant. ABATE would have the Commission allocate the entire cost of the 'plant' to users of the peak day service product, because the whole plant is needed to produce that product. ABATE ignores the original cost causation question, i.e. would the plant have ever been built to produce only peak day service? The answer to that question is a resounding no." (22 Tr. 4475-4476.) [Emphasis in original.]

The Commission therefore finds that, because at least part of Mich Con's capacity costs should be allocated on the basis of throughput, ABATE's first argument must be rejected.

ABATE's second argument is also flawed, as pointed out by Mr. Miller, because its comparison of Mich Con's transportation rates to those of six other utilities fails to account for significant differences in the service offered by each utility. Specifically, the transportation rates charged by five of ABATE's six comparison utilities are stated in therms, rather than cubic feet, thus biasing the comparison against Mich Con. (21 Tr. 4487.) This comparison is further skewed against Mich Con by its failure to include the effect of these utilities' respective gas-in-kind retention requirements. (21 Tr. 4488.) More important, it fails to account for the fact that ABATE's comparison utilities are much less generous than Mich Con in how they allow large-volume transportation customers to use storage and load balancing. (21 Tr. 4489-4490.) This argument must therefore also be rejected.

As for ABATE's third argument, the Commission agrees with the ALJ that it is not meaningful to use a single customer's cost of service as a proxy for all other members of the customer class. This is particularly true with Rouge Steel, whose size, location, and load factor make it "an extraordinary case." (PFD, p. 104.)

For these reasons, the Commission finds that ABATE's proposed use of the AED method should be rejected and that the A&P method should be used to allocate Mich Con's capacity costs, as recommended by the ALJ. However, two other issues regarding the A&P method must be addressed.

For example, ABATE claimed that the Staff made several minor computational errors in calculating the costs assigned to the peak component of the A&P method. Upon further review, the Staff agreed with ABATE's proposed revisions, and their adoption was subsequently recommended by the ALJ. None of the parties except to this recommendation and the Commission finds that ABATE's proposed revisions should be adopted.

Finally, a dispute arose regarding the respective weights to be assigned to the average usage and the peak usage components of the A&P method. Mich Con and ABATE supported a 35/65 weighting of average daily use to design peak day use. In contrast, the Staff suggested using a 40/60 weighting, as was adopted in Mich Con's last contested rate case. The ALJ agreed with the utility and ABATE, and recommended that the 35/65 ratio be adopted.

The Staff excepts on the grounds that the 35/65 ratio is based on an abnormally high peak day figure. According to it, Mich Con should have computed and applied normal peak day usage instead of the design peak day usage included in the utility's allocation ratio. Its failure to do so, the Staff contends, could lead to an overallocation of capacity costs to Mich Con's low load factor customers. The Staff therefore argues that a 40/60 ratio should be adopted.

In response, Mich Con and ABATE contend that use of the higher figure is justified because (1) weather experienced during the historical test year peak month was warmer than normal, (2) use of a design peak day figure better reflects the costs of the system as constructed, (3) actual peak day usage is "randomly based" on the weather experienced on a single day during the historical test year, and thus may not be reflective of future peak day usage, and (4) use of a design peak day figure better reflects the utility's need to ensure uninterrupted service even on the coldest day of the year. (Mich Con's reply to exceptions, p. 24.) Further, they assert that the ALJ's recommendation is consistent with the Staff's earlier adoption of design day peak usage when allocating storage costs.

The Commission finds the arguments of Mich Con and ABATE more persuasive than those offered by the Staff. It therefore agrees with the ALJ that the 35/65 weighting of average daily use to design peak day use is appropriate and should be adopted for allocating capacity costs in this case.

Coal Displacement Customer Discounts

Mich Con initially recommended that the cost of offering transportation service to coal displacement customers at a discounted rate should be accounted for in the manner approved in prior Commission orders. In contrast, ABATE proposed that this cost be spread over all rate classes, rather than requiring only other transportation customers to continue bearing this expense. ABATE supported this proposal by pointing out that all utility customers benefit from load retention arising from this discount. In light of this argument, Mich Con withdrew its initial suggestion and adopted ABATE's proposal. The ALJ agreed with these parties, noting that "everybody benefits from the contribution to fixed costs received from coal displacement customers." (PFD, p. 108.) Therefore, over the objections of the Staff and the Attorney General, she recommended that all customer classes be assigned a portion of this cost.

The Staff and the Attorney General except. According to them, expenses arising from this rate discount should not be assigned beyond the transportation customer class for three reasons. First, it would conflict with the Commission's preference for cost-of-service rates. Second, it would be inconsistent with the practice of requiring the cost of a discounted rate to be borne by members of the same rate class. Third, it would eliminate any incentive on the part of the utility to make sure that all discounts are justified. The Staff and the Attorney General therefore contend that all costs arising from these discounts should continue to be borne by the utility's transportation customers. The Commission agrees.

The Commission has long stressed the need to move utilities toward the establishment of cost-of-service rates for each customer class. However, because it would shift costs from transportation customers to members of other rate classes, the proposal offered by ABATE and supported by Mich Con conflicts with this goal. Moreover, as correctly noted by the Staff and the Attorney General, it is inconsistent with prior orders regarding the assignment of costs resulting from rate discounting. For example, in Case No. U-7895, Mich Con proposed offering low income senior citizens a discounted rate, Rate 3A. ABATE strenuously opposed spreading the cost of that subsidy beyond the residential customer class on the grounds that, because the customers ABATE represents would not be allowed to take advantage of the discounted rate, they should not be forced to pay the subsidy. (22 Tr. 4753.) The Commission agreed with ABATE's argument in that case, finding that "the costs of the Rate 3A program should be recovered only from the residential class as only residential customers may become eligible for the Rate 3A program." (June 26, 1985 order, p. 63.) Thus, because the coal displacement rate is open only to transportation customers, it would be inconsistent with Case No. U-7895 to make members of other rate classes subsidize that discount. Finally, adherence to the existing requirement that all costs of the coal displacement rate discount be recovered from other transportation customers forces Mich Con to be careful not to discount unnecessarily. Should it fail to offer these discounts sparingly, it could face the loss of its other transportation customers. Thus, the adoption of ABATE's proposal could remove a powerful constraint on the excessive use of rate discounts.

For these reasons, the Commission finds that the ALJ's recommendation should be rejected, ABATE's request to spread the cost of Mich Con's coal displacement rate discount beyond other transportation customers should be denied, and the existing cost allocation methodology should be retained.

Distribution Mains

Although conceding that the Commission has consistently rejected all requests to allocate a portion of Mich Con's distribution mains on a customer basis, ABATE asked that it reconsider. This request is based on an assertion by ABATE's witness, Alan Rosenberg, that a strong correlation exists between the linear feet of distribution mains included in Mich Con's system and its number of customers. Specifically, Mr. Rosenberg claimed that his study of this issue produced a correlation coefficient of 0.97. (13 Tr. 2679.) ABATE claims that this finding, when coupled with the fact that at least two authoritative utility references indicate that it is not patently improper to allocate a portion of distribution main costs on a customer basis, justifies granting its request.

The Attorney General, Mich Con, and the Staff all oppose this request. For example, the Attorney General's witness, Mr. Miller, testified that Mr. Rosenberg's study was seriously flawed. When his errors were corrected, it was alleged, the correlation coefficient dropped to 0.47. (21 Tr. 4509.) Furthermore, Mich Con and the Staff pointed out that ABATE's requested allocation cannot properly be applied to this utility. Because Mich Con has previously recovered the cost of building distribution mains through its main extension rules and area extension program, they contended, adoption of ABATE's proposal could result in customers being charged twice for the same gas line.

The ALJ concluded that ABATE did not adequately address the fact that its proposal "would disregard previously paid amounts and would double charge customers who paid main extension deposits in the past." (PFD, p. 110.) She therefore recommended that the Commission reject ABATE's request to include a customer component in the allocation of distribution main costs. ABATE excepts to this recommendation, raising many of the same arguments originally offered in support of its proposal. However, it also asserts that Mich Con's main extension rules are not pertinent to the issue of allocating distribution plant costs. Specifically, ABATE argues that "[t]he method of paying for distribution costs, including customer payments for main extensions, is a rate design matter, and not a cost allocation matter." (ABATE's exceptions, p. 71.) [Emphasis omitted.]

The Commission finds ABATE's arguments unpersuasive for two reasons. First, as correctly noted by Mich Con, ABATE's assertion that the utility's main extension rules are not pertinent is in error. The utility's rules require customers to pay for main extensions if the annual revenues from those customers do not recoup the entire cost of those gas lines. Thus, because annual revenues are derived from annual throughput, the costs are associated with adding volumes to the system, not customers.

Second, as stated in the Commission's December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854, as well as in its December 7, 1989 order in consolidated Cases Nos. U-8678, U-8924, and U-9197, any allocation methodology is imprecise. In the final judgment, the question is not whether a more exact methodology can be constructed. Rather, the question is whether the method and result are reasonable. In this case, the Commission finds that the method proposed by the Attorney General, Mich Con, and the Staff--which includes no allocation of distribution main costs on a customer basis--is reasonable.

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TARIFF AND RATE DESIGN ISSUES

Much of the controversy concerning the specific tariff language included in Mich Con's rate schedules has either been resolved by the parties or through the Commission's earlier rulings in this order regarding cost allocation. However, several tariff and rate design issues require further discussion.

Sales Rate Schedules

In its initial brief, Mich Con stated that it was willing to accept several of the Staff's proposed changes to its sales rate schedules. These proposals include (1) eliminating Rate Schedules 7 and 9, (2) retaining Rate Schedule 6 and allowing it to apply to all commercial heating and industrial customers, and (3) closing Rate Schedule 8 to new customers and terminating that rate when the eligibility of its 15 remaining customers expires. None of the other parties object to the Staff's proposals. The Commission finds that these proposals should be adopted.

Transportation Rate Schedules

Mich Con, ABATE, and the Staff recommended a number of modifications to the terms and conditions of transportation service offered under Rate Schedules T-1 and T-2. Although many of these proposed modifications were approved by all parties to this case, others generated significant disagreement.

a. <u>Basic T-1 and T-2 Tariff Issues</u>

Mich Con proposed that several aspects of its current transportation program remain unchanged. Specifically, it requested that its T-1 and T-2 tariffs continue to be offered, that the T-1 rate be cost-based, that the T-2 rate be based on a negotiated charge, and that the average transportation rate negotiated for Mich Con's T-2 customers be required to equal the cost-based T-1 rate. None of the parties opposed these requests, and the Commission finds that they should be granted.

b. <u>Disaggregation of Transportation Customers</u>

Mich Con's existing rate schedules treat all transportation customers alike, regardless of size. However, ABATE asserted that this uniform rate treatment was unfair to large-volume transportation customers. Specifically, it noted that, on average, Mich Con's large-volume transportation customers use gas at a much more even pace than the utility's other transportation customers. This results in a lower per Mcf cost of service for these relatively high load factor customers.

For this reason, ABATE requested that Mich Con's existing transportation customers be disaggregated into small- and large-volume transportation classes, and that each class be assigned a rate based on its own cost of service. Relying on the Staff's cost-of-service study and the utility's requested rate increase, ABATE's witness, Mr. Rosenberg, concluded that small-volume transportation customers should pay a customer charge of $1,300 per month and a volumetric charge of 62.5¢ per Mcf, and that large-volume transportation customers should pay a customer charge of $2,682 per month and a volumetric charge of 45.91¢ per Mcf. (Exhibit I-187, Schedule 2A.) According to Mr. Rosenberg, his proposed rate structure would produce a break-even point of approximately 100,000 Mcf.[21] He further recommended that all customers taking service under his proposed large-volume transportation rate be required to pay for a minimum of 100,000 Mcf of gas annually.

The Staff objected to ABATE's proposal to disaggregate Mich Con's transportation customers. Its objection was based primarily on three factors. First, the Staff pointed out that not all large-volume transportation customers have high load factors. For example, it noted that although Steelcase, Incorporated, uses approximately 900,000 Mcf of gas per year, its load factor was lower than that of Mich Con's average transportation customer. (20 Tr. 4126; Exhibits S-73 and S-134.) Second, the Staff asserted that the record lacks sufficient detail to accurately establish the type of small- and large-volume transportation tariffs requested by ABATE. Third, it feared that the resulting increase in the overall transportation rate assessed to small-volume transportation customers could prove excessive. For these reasons, the Staff recommended that Mich Con be ordered to (1) provide electronic remote metering to all transportation customers using more than 100,000 Mcf per year and any other transportation customers that request that form of metering, and (2) conduct a load study, prior to the filing of its next rate case, on which future transportation rates can more accurately be based. Pending completion of these tasks, the Staff urged, disaggregation of the transportation customer class should be postponed.

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[21]Apparently due to errors in both his assumptions and computations, these proposed rates produce a break-even point significantly below the 100,000 Mcf level deemed proper by Mr. Rosenberg. Thus, the parties agree that if the Commission adopt's ABATE's proposal to disaggregate Mich Con's transportation customers, his proposed rates for large- and small-volume customers must be revised accordingly.

Mich Con supported ABATE's proposed disaggregation of transportation customers. Although admitting that ABATE's proposal was not perfect, the utility asserted that its adoption would further the move toward cost-of-service-based rates. The utility went on to express confidence in the Commission's ability to develop specific tariff language that would satisfy this goal despite the record's lack of detail on this issue. Mich Con therefore suggested that disaggregated transportation rates be adopted in this case and that, when additional data regarding load factors and consumption patterns become available, the rates be fine-tuned in a future rate case. Finally, Mich Con objected to the Staff's suggestion that electronic remote metering be installed (and a cost-of-service study be prepared based on information derived from these meters) prior to filing its next rate case. According to the utility, this could unreasonably delay the filing of such a case.

The ALJ agreed with ABATE and Mich Con that although the load study and metering recommended by the Staff "may be helpful in refining the transportation program in a future case, there is no good reason to delay cost-based rates for large- and small-volume transportation customers until a future case." (PFD, p. 112.) She therefore recommended that the Commission adopt ABATE's request to disaggregate Mich Con's transportation customers based on whether they use 100,000 Mcf or more of gas annually, and establish rates reflecting the fact that large-volume transportation customers generally have higher load factors than small-volume customers. The Staff excepts to this recommendation and reasserts its previously-noted arguments.

The Commission agrees with the ALJ. Although an occasional large-volume transportation customer like Steelcase may have a lower than expected load factor, this appears to be an exception to the rule. Specifically, evidence indicates that the average monthly load factor for Mich Con's large-volume transportation customers exceeds that of its average small-volume customers. (13 Tr. 2667; Exhibit I-75, Schedule 4.) This should result in a lower cost of service for the average large-volume customer. Such a result should be recognized in the rates established by this order. Moreover, this can be accomplished by re-running the Staff's cost-of-service study after separating out the transportation volumes assigned to customers having an ACQ of 100,000 Mcf or more.[22] The Commission therefore finds that the ALJ's recommendation regarding disaggregation of transportation customers should be adopted.[23]

Moreover, a few small-volume transportation customers may conclude that, due to disaggregation, they would be better off as sales customers. However, because they are currently barred from rejoining Mich Con's sales rates until five years after signing as transportation customers, they may find themselves locked into a rate class that they would not have selected had disaggregation been in place from the outset. The Commission therefore finds that small-volume transportation customers should be given the opportunity to switch to sales rates by notifying the utility, in writing and within 60 days following issuance of this order, of their intention to resume sales service. To ensure that these customers have a reasonable oppor-

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[22]Consistent with the proposal described by ABATE's witness, which included a customer charge for large-volume transportation customers that was approximately twice that of small-volume transportation customers, it will be assumed that customer-related costs are higher for large-volume transportation customers.

[23]The Commission acknowledges that, due to the absence of daily usage data that can only be obtained through use of electronic remote meters, the results of any cost-of-service study used to set the rates for large- and small-volume transportation customers found in the tariff sheets attached to this order will not be precise. However, in an effort to ensure that small-volume transportation customers, the utility, and its sales customers are not harmed by disaggregating Mich Con's transportation customers, the Commission has directed that the Staff's cost-of-service study be re-run in a manner that yields what ABATE may consider a somewhat conservative result. The only reasonable alternative, which has been rejected for reasons stated earlier, would be to delay disaggregation indefinitely.

tunity to make this switch, the Commission also finds that Mich Con should, within 30 days of issuance of this order, notify all small-volume transportation customers of this option.

Furthermore, the Commission agrees in part with the Staff's request to expand Mich Con's use of electronic remote meters. However, it also agrees with the utility that the installation of these meters and their use in a cost-of-service study should not be made a condition precedent to the filing of Mich Con's next rate case. The Commission therefore finds that, regardless of when Mich Con elects to file its next rate case, the following steps should be taken. First, the utility should be given until the start of the 1994-1995 heating season to install electronic remote meters for all transportation customers having ACQs of at least 100,000 Mcf, as well as for all other transportation customers that request remote meters. Second, a cost-of-service study should be undertaken based on the daily usage patterns revealed through the use of those meters. Third, that study should be filed with the Commission, with the underlying data, no later than January 15, 1996.

Finally, the Commission notes that although Mich Con supports disaggregation of its transportation customers and "is not averse to the gathering of more metering information," it expresses two additional concerns regarding the installation and use of electronic remote meters. (Mich Con's reply brief, p. 149.) First, the utility seeks assurance that it will be compensated for installing these meters. Second, it states that the installation and use of these meters may necessitate tariff changes and billing procedure revisions. The Commission finds that these issues can be adequately addressed in subsequent proceedings[24] and, there-

[24]For example, any arguments regarding the reasonableness and prudence of the remote meters' installation costs, as well as the appropriate method of cost recovery, should be addressed in a future rate case.

fore, do not constitute a valid basis for postponing the installation of these devices beyond the schedule established above.

c. Load-Balancing Charge

The Staff proposed that a contract storage tariff be approved having a maximum rate of $1.50 per Mcf. It went on to propose that a monthly storage rate, otherwise known as a load-balancing charge, of 25¢ per Mcf be established. This load-balancing charge, which would be applied to all gas held in storage for a transportation customer in excess of 10% of that customer's ACQ, was equivalent to the monthly rate that the customer would have to pay to store the gas for six months at the maximum contract storage rate of $1.50 per Mcf. (18 Tr. 3799.) The ALJ recommended adoption of the Staff's proposed load-balancing charge.

ABATE excepts to this recommendation and asserts that the Staff's proposed rate must be rejected because it is market-based. It argues that a cost-based rate of 4¢ per Mcf should be adopted instead. To do otherwise, ABATE implies, would unjustifiably establish an excessive load-balancing rate. The Commission disagrees.

As stated in the discussion of gas storage revenues, adoption of a cost-based rate like that proposed by ABATE would deprive Mich Con and its ratepayers of the true value of the utility's excess storage capacity. It is for this reason that the Commission earlier acknowledged that Mich Con's storage rates should be market-based. Furthermore, it must be noted that transportation customers already have storage capacity equal to 10% of their ACQ included in their transportation rates. Thus, adoption of the Staff's proposal will provide these customers with the necessary incentive to closely monitor their injection and withdrawal activities to ensure that they do not exceed their allotted capacity. For these reasons, the Commission finds that the ALJ's recommendation should be adopted and a rate of 25¢ per Mcf should be established for Mich Con's load-balancing service.

d. Transportation Customer Charge

Mich Con initially proposed to combine the monthly transportation charge with the administrative fee and to raise the total charge from $1,300 to $1,800. Although the Staff supported combining these two items into a single customer charge, it suggested retaining the existing rate of $1,300. Mich Con subsequently accepted the Staff's position and the ALJ recommended adopting a combined transportation customer charge of $1,300 per month.

ABATE excepts to this recommendation. Although conceding that this is the appropriate charge to impose upon small-volume transportation customers, ABATE contends that its proposal to disaggregate the transportation customer class requires that a higher customer charge be established for large-volume transportation customers. The Commission agrees.

In light of its decision to disaggregate this customer class, the Commission finds that the $1,300 monthly customer charge recommended by the ALJ should apply only to transportation customers that select the small-volume rate (which is designed for those having ACQs of less than 100,000 Mcf). All other transportation customers should have a higher customer charge that, when coupled with the new transportation rates established in this case, should continue to create an economic break-even point of 100,000 Mcf.

e. Elimination of SSEC, EPC, and Authorized Gas Usage Charges

Mich Con proposed eliminating its system supply entitlement charge (SSEC), its excess pipeline charge (EPC), and its authorized gas usage charge. The preferred method for accomplishing this, the utility asserted, would be to (1) immediately drop the EPC and the authorized gas usage charge in their entirety, and (2) close the SSEC to any new customers and "grandfather" the existing provision for customers currently paying the SSEC until the expiration of their existing transportation contracts. (7 Tr. 1321-1323.) The Staff generally agreed with this proposal. However, it did propose the use of different language to recognize that some SSEC customers would be allowed to continue using that mechanism until their contracts expire.

The ALJ agreed with the utility's proposal, as modified by the Staff, and recommended its approval. No parties except and the Commission finds that the ALJ's recommendation should be adopted.

f. Restrictions on Rate Switching

A majority of Mich Con's contracts with its transportation customers include a provision that prohibits these customers from returning to sales service for five years. The utility has therefore proposed to formalize this restriction by including it in its transportation tariffs. Similarly, Mich Con proposed adding a restriction requiring that any transportation customer that switches to sales service must remain on sales service for five years.

The Staff concluded that the utility's proposal was overly broad. It therefore asserted that the following provision should be inserted in place of the utility's proposed language:

> "A customer that selects transportation service under Rate Schedules Nos. T-1 or T-2 is prohibited from applying for sales service for a period of five years from the date of the initial transportation service, subject to the provisions of Rule B3, controlled service." (18 Tr. 3802.)

The Staff also asserted that Rate T-1 customers should be allowed to apply for service under Rate T-2 at any time during that five-year period. (18 Tr. 3787.) Mich Con consented to these changes and the ALJ recommended that these provisions, as amended by the Staff, be adopted. None of the parties except to the ALJ's recommendation, and the Commission finds that it is supported by the record and should be adopted.

g. Storage, Withdrawal, and Injection Limits

As discussed in Section IX of this order, Mich Con proposed prohibiting each transportation customer from placing more than 10% of its ACQ in the utility's storage facilities, withdrawing more than 3% of its ACQ during any month from November through March, and injecting more than 1.43% of its ACQ during the months of September and October. As noted earlier, these restrictions are intended to improve Mich Con's operational planning and supply purchasing functions, "thereby maximizing the flexibility Mich Con requires in filling storage for GCR customers' winter requirements," and provide the utility with additional control over its storage facilities during the peak winter period, thus allowing it to better manage the storage withdrawals necessary to meet GCR customers' demands. (7 Tr. 1326.) The Staff and the Attorney General agreed with the utility's proposal. In doing so, they noted that although these limits would result in improved utility operations, transportation customers would still be able to use Mich Con's storage system for daily load balancing and some load peaking.

The ALJ found that these storage, withdrawal, and injection limits were "essential to safeguarding service to GCR customers while providing transportation customers with some flexibility." (PFD, p. 117.) Therefore, over ABATE's objection, she recommended that the Commission adopt Mich Con's proposal. ABATE excepts to this recommendation. It contends that it would be unfair to allocate 15.7% of the utility's storage costs to transportation customers and, at the same time, adopt Mich Con's proposed restrictions on storage injections and withdrawals.

The Commission does not find ABATE's argument persuasive. The 15.7% figure recommended by the ALJ and adopted earlier in this order simply reflects the portion of Mich Con's total storage costs that should be allocated to its transportation customers. This allocation recognizes that Mich Con's proposed injection and withdrawal limits are based on monthly figures and, therefore, do not constrain transportation customers' daily storage activities. Thus, as correctly noted by the ALJ, "it does not follow that because the allocation factor is greater [than the 5.8% figure proposed by ABATE], withdrawal limitations should be lessened." (PFD, p. 117.) The Commission therefore finds that the storage, withdrawal, and injection limits proposed by Mich Con and recommended by the ALJ should be adopted.

h. Appropriateness of a Transition Period

The Staff concluded that implementation of the utility's proposed restrictions on storage withdrawals could impose a hardship on some transportation customers unless the Commission provides for a transition period. Specifically, it pointed out that Mich Con's new rates and tariffs are slated to take effect on January 1, 1994. As of that date, transportation customers would have to comply with these withdrawal restrictions, or pay unauthorized usage charges, without a reasonable opportunity to modify their purchase and usage patterns. The Staff therefore proposed that a transition period be established to allow transportation customers to make necessary changes in their gas acquisition programs to comply with these new restrictions. According to the Staff, this should "pose no hardship for either Mich Con or [its] transportation customers." (Staff's replies to exceptions, p. 82.)

The Commission finds that a transition period should be established for the storage withdrawal limits proposed by Mich Con and adopted in this order. Specifically, it finds that the monthly withdrawal limits should not take effect until November 1, 1994.

i. Diversion of Customer-Owned Gas

ABATE's witness stated that, although remote, a possibility exists that, during a future gas shortage, transportation customers' gas may be seized by Mich Con to supply its other customers. Given this possibility, ABATE proposed that a tariff be established requiring the utility to pay the transportation customer "the higher of (a) the price of the gas that the transportation customer paid in that month, or (b) the price of the customer's alternate fuel" for any gas diverted to the use of Mich Con's other customers. (13 Tr. 2686.) Although a similar suggestion was rejected in Mich Con's last fully contested rate case, the other parties did not specifically oppose ABATE's position. Rather, the utility indicated a willingness to frame a tariff provision consistent with ABATE's proposal, should the Commission so desire. Furthermore, the Staff stated that, if the time is right to establish a tariff regarding diversion of customer-owned gas, Mich Con should be ordered to file specific tariff language and all parties should be given an opportunity to submit arguments regarding the proposed wording.

The ALJ concluded that ABATE's proposal should be adopted. However, she went on to note that no proposed language was offered that could have been evaluated or contested by the other parties. She therefore recommended that Mich Con be instructed to file specific tariff language concerning the diversion of customer-owned gas and that interested parties be offered an opportunity to prepare arguments for the Commission's consideration.

None of the parties except to these recommendations. The Commission finds that, within 30 days of this order's issuance, Mich Con should file proposed tariff language concerning diversion of customer-owned gas, providing copies of that proposal to all parties, and the parties should, within 21 days of that filing, submit for the Commission's consideration arguments regarding the proposed tariff language.

j. Miscellaneous Transportation Rate Issues

Several other issues regarding transportation rates and tariffs that were hotly contested prior to issuance of the PFD are no longer in dispute. Specifically, the ALJ recommended that: (1) consistent with her recommendation regarding retainage of the Wet Header, a gas-in-kind factor of 0.9% should be applied to end-user transportation customers' volumes; (2) the unauthorized gas usage provision should be modified as proposed by Mich Con and the Staff; (3) all transportation customers should be designated as Sales Rate Schedule No. 1 customers for purposes of applying load balancing and unauthorized gas usage charges; (4) the utility's proposed gas purchase settlement rate, as qualified by both the Staff and Mich Con, should be adopted; and (5) Detroit Edison's request to allow permissive storage, as clarified by the utility, should be granted. None of the parties except to these recommendations, and the Commission finds that they are reasonable and should be adopted.

Wet Header Transportation Conditions and Terms

Mich Con proposed that both firm and interruptible transportation be provided on the Wet Header. Exhibit A-12, Schedules G-2-2 and G-2-3, set forth the utility's proposed tariff provisions regarding service eligibility; definitions; types of available service; terms and conditions, including a proposed standard contract; imbalances; gas-in-kind reimbursement; and rates. The Staff found all of these provisions acceptable, except for their failure to establish bifurcated rates for the main header and the lateral system at the levels approved in this order. In contrast, the producer-intervenors object to a number of the provisions found in Mich Con's proposed tariffs and its standard contract. In addition, they propose that Mich Con be required to retain existing accounting practices regarding the Wet Header.

The Commission has already decided that bifurcated rates should be established for use of the main header and the lateral system. The remaining Wet Header transportation issues are addressed below.

a. Increasing the Maximum Daily Quantity

The first of these issues concerns the producer-intervenors' claim that Paragraph 1.3 of the proposed standard contract, concerning forced increases in the transportation customer's maximum daily quantity (MDQ), should be stricken. This provision provides:

> "If, in any consecutive three-month period, Shipper delivers an average daily volume of gas which exceeds [the] MDQ by 10 percent, then Mich Con shall have the right, after providing written notice to the shipper, to increase [the] MDQ under this Agreement to an average of the daily volumes of gas delivered over the three-month period." (Exhibits I-30 and I-34, p. 2.)

Based on testimony provided by Antrim's witness, Richard A. Metz, the producer-intervenors argued that this provision could result in increasing a customer's MDQ "whenever the transporter has a short-term peak in volume." (15 Tr. 2992.) This would be a particularly unconscionable, they asserted, in light of the fact that other provisions in the standard contract limit any downward adjustment in a customer's MDQ to twice per year.

In response, the utility pointed out that, rather than being triggered by a short-term peak, an increase in a customer's MDQ would only occur when its daily volumes average 110% of its MDQ for three consecutive months. Mich Con further contended that because a transporter's excessive use of the Wet Header cannot be detected until after-the-fact, and because capacity constraints caused by this overutilization can prevent other firm transportation customers from injecting their allotted volumes of gas into the system, this provision is necessary to provide the utility a reasonable level of control over the Wet Header.

The ALJ agreed with Mich Con and Antrim excepts.

The Commission finds Mich Con's arguments persuasive. The disputed provision is necessary to prevent transporters from signing up for low MDQ levels and then ignoring them. This is particularly true in light of the possibility that overutilization of the Wet Header by one transporter may prevent another transporter from making full use of its allocated capacity. As correctly noted by the ALJ, if a producer transports in excess of its MDQ for three consecutive months, it is reasonable to expect that the same level of transportation will continue in the future. Moreover, such an assumption is necessary in order for the utility to undertake reasonable planning with regard to the use of its system. The Commission therefore finds that Paragraph 1.3 of the standard contract should not be deleted.

b. Force Majeure

Paragraph D-14.1 of the standard contract contains a clause relieving Mich Con and its firm transportation customers of their duties to each other in the event of force majeure on the Wet Header. According to this clause, the utility is not obligated to transport gas and firm customers are not required to pay demand charges if the Wet Header is unable to operate due to certain occurrences including acts of God, strikes, wars, riots, lightning, earthquakes, fires, storms, floods, washouts, explosions, and breakdowns in the pipeline or its appurtenant machinery that are beyond the parties' control. (Exhibits I-30 and I-34, p. 22.)

The producer-intervenors proposed amending this clause to include force majeure on the transporters' production facilities. Specifically, they requested that transporters be relieved of their obligation to pay demand charges in the event of "insufficient delivery pressure, well freeze-ups, the necessity to make repairs, tests or alterations to wells, [and the] partial or entire failure of the gas supply." (15 Tr. 2994.) This change is necessary, they argued, because it would be unfair for Mich Con to be excused for force majeure on the Wet Header while transporters are not excused for force majeure on their facilities. Moreover, the producer-intervenors asserted, it is justified by the fact that, by definition, force majeure can only be claimed when the occurrence is beyond the party's control.

Mich Con opposed the amendment and argued that its adoption would significantly harm the utility's ability to control and operate the Wet Header. It further argued that the proposed language would cover interruptions for occurrences over which producers have at least partial control, such as well tests and alterations.

The ALJ found Mich Con's arguments persuasive and recommended that the Commission reject the producer-intervenors' proposed amendment. Both Antrim and NOMECO except to that recommendation, reasserting that fairness dictates that the force majeure clause should cover problems experienced by both the utility and these transporters. The Commission disagrees.

Mich Con reserves capacity on the Wet Header in return for the demand charges called for in its contracts with firm transportation customers. Thus, as correctly noted by the utility, the potential production-related difficulties that these customers "may experience, for whatever reason, would significantly upset the Company's operation of the Wet Header system." (Mich Con's replies to exceptions, pp. 104-105.) Furthermore, allowing these difficulties to serve as the basis for a claim of force majeure would unfairly shift the usual production-related risks from these customers to the utility and its other ratepayers. The Commission therefore finds that the proposed revisions to the force majeure clause should be rejected.

c. <u>Interruption, Curtailment, and Mandatory Service</u>

The producer-intervenors raised three interrelated concerns regarding Mich Con's proposed interruptible service. First, they pointed out that Paragraph D-1.12 of the standard contract states that service to interruptible customers on the Wet Header may be interrupted when, "in Mich Con's sole judgement, interruption is necessary due to operating conditions, unavailability of sufficient capacity on Mich Con's system, or the needs of Mich Con's sales customers." (Exhibits I-30 and I-34, p. 11.) Arguing that this language is overly broad and grants Mich Con too much discretion, they proposed that the utility be ordered to interrupt service on the Wet Header only if "required to meet the needs of its sales or GCR customers who rely on Mich Con for gas supply." (Antrim's exceptions, p. 22.) Second, the producer-intervenors noted that Paragraph D-4.1 of the contract states that, in the event of curtailment, local distribution companies (LDCs) shall have first priority, firm customers shall have second, and interruptible customers shall have last priority. They claimed that this system was neither logical nor fair because all customers pay the same rate for Wet Header service. They therefore asserted that either this provision should be stricken or that interruptible customers should be charged a lower rate for use of the system. Third, the producer-intervenors questioned whether Mich Con is serious about offering interruptible service and asserted that the utility may be withholding available capacity from willing interruptible customers in an attempt to force them to sign up for firm service instead. They therefore asked that Mich Con be specifically ordered to offer additional interruptible service.

Mich Con objected to these characterizations and requests. According to it, interruptible service has simply been structured in a manner that protects the rights of LDCs' sales customers and firm transportation customers. The utility therefore asked that the Commission reject the producer-intervenors' requests regarding interruption, curtailment, and mandatory service.

The ALJ agreed with Mich Con and recommended that those three requests be denied. Antrim and NOMECO except to this recommendation.

As did the ALJ, the Commission finds that the producer-intervenors' requests should be denied. Their first request, if granted, could potentially eliminate Mich Con's ability to interrupt service to protect either the integrity of the Wet Header system or the rights of its firm transportation customers. Regarding the producer-intervenors' second request, the Commission finds the curtailment priority established by Paragraph D-4.1 to be both logical and fair. As noted by Mr. Cieslak:

> "Mich Con has tariffs that say, when curtailing service, the priority of service is residential, core customers types first, and we work our way down through the industrial and non-heat type loads last.
>
> "What this does, this provision in the [standard transportation] contract identifies that the local distribution companies, that being Consumers and Mich Con, [which] are purchasing gas for jurisdictional sales customers, which would predominantly be residential heating type customers . . ., would have first call to the gas.
>
> "That would be followed by firm transportation customers because they do have firm contracts, but the bulk of those contracts would be for industrial, manufacturing, and commercial [customers], which would be lower priority on Mich Con's system, and then interruptible transportation customers would be last, because they're paying interruptible rates . . . ." (9 Tr. 1760-1761.)

Thus, because this curtailment system corresponds with that established for the utility's sales customers, and because it recognizes that interruptible Wet Header transportation customers pay no demand or reservation charges,[25] the producer-intervenors' second request should be rejected. Finally, the Commission finds it highly unlikely that Mich Con would have

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[25]In contrast, contracts signed by firm Wet Header transportation customers (although not imposing a separately-priced demand charge) contain a take-or-pay clause. Specifically, firm transportation customers are obligated to pay the Wet Header commodity rate for all volumes that they nominate, regardless of whether these volumes are actually tendered to Mich Con for transportation on the Wet Header.

proposed an interruptible transportation rate if it did not intend to offer interruptible transportation service. Thus, pending proof that the utility is unreasonably rejecting producers' requests for interruptible service, the Commission will refrain from ordering Mich Con to offer more interruptible service than it sees fit.

d. Evidence of Downstream Agreements

Paragraph D-2.2 of the standard contract requires each transportation customer to "demonstrate to Mich Con's satisfaction that it has downstream processing agreements, transportation agreements, and/or any other necessary agreements with a third party sufficient to handle the volumes of gas proposed to be transported" on the Wet Header. (Exhibits I-30 and I-34, p. 12.) The producer-intervenors were concerned that this provision could allow the utility's marketing affiliate, MTC, to obtain confidential information about the transporters' markets that could lead to unfair competition. They therefore recommended that an affidavit that does not disclose the nature of, nor the parties to, these downstream agreements be deemed sufficient to satisfy this provision.

Mich Con did not oppose this alternative method for proving the existence of downstream agreements. However, it suggested that the affidavit state the period during which any downstream pipeline agrees to accept a transporter's gas and "any other necessary information requested by Mich Con." (Mich Con's initial brief, p. 137.)

The ALJ agreed with the producer-intervenors and recommended that Paragraph D-2.2 be modified to allow for the use of an affidavit like that proposed by these parties. She further recommended that the affidavit should be required to state the period during which a downstream pipeline has agreed to accept the transporter's gas. However, she found that the utility's additional request, concerning "any other necessary information," was overly broad and would not provide sufficient protection against unfair competition. The ALJ therefore recommended that this language not be included.

None of the parties except to the ALJ's recommendations, and the Commission finds that they should be adopted.

e. Prepayment

Paragraph D-10.1 of the standard contract allows Mich Con to require a transporter to prepay up to three months of its anticipated monthly charges if it has become insolvent or is unable to demonstrate its creditworthiness when requested by the utility. (Exhibits I-30 and I-34, p. 19.) The producer-intervenors argued that, although it may be reasonable to provide the utility with some measure of protection against uncollectible accounts, no logical basis exists for requiring such a large advance payment. They therefore suggested revising this provision to require prepayment of one month's charges.

Mich Con conceded that it would be reasonable in most cases to require only a one-month advance payment. However, the utility went on to assert that if a transporter has previously been delinquent in its payment of Wet Header charges or has become insolvent, the three-month prepayment requirement is necessary to protect the utility and its ratepayers from a potentially significant level of uncollectibles.

The ALJ recognized that, in many cases, Mich Con faces little risk if prepayment is limited to 100% of a customer's expected monthly Wet Header charges. However, she agreed with Mich Con that situations arise where a much higher level of risk may exist, like when a customer is insolvent or has a history of delinquencies. In those situations, she concluded, the utility must be able to impose the prepayment conditions found in Paragraph D-10.1. She therefore recommended that the producer-intervenors' request to revise this provision be rejected.

Antrim excepts to this recommendation, and asserts that if a transportation customer has previously been delinquent in its payments, Mich Con has a right to insist upon full payment for these prior delinquencies. Once the outstanding balance has been recovered, Antrim asserts, it would be "unreasonable to require the transporter to then prepay for three months in advance." (Antrim's exceptions, p. 25.) According to it, Mich Con would be fully protected if prepayment of a single month's charges were required. The Commission disagrees.

As correctly noted by Mich Con, limiting all prepayments to a one-month estimate of a customer's Wet Header transportation charges would not fully protect the utility. For example, if a customer makes a prepayment of its estimated transportation bill for the month of July, the actual volume of gas transported during that month will not be known until August 1. Furthermore, it would likely be mid-August before the estimated and actual usage figures are reconciled and any rebillings are received by the customer. Thus, non-payment of the rebilled amount would not become evident until perhaps late September, at which time August and September deliveries would be at or near completion. When viewed in this light, the use of a three-month advance payment--covering July, August, and September--is not unreasonable. The Commission therefore finds that the producer-intervenors' proposal to revise this provision should be rejected.

f. Wet Header Accounting

Mich Con's method of accounting for the Wet Header was established to satisfy the requirements of its Joint Use Agreement with Consumers. (7 Tr. 1394-1395.) Because the agreement provided for a sharing of certain costs between these two, Wet Header costs were assigned on the basis of areas and functions. Because this agreement has expired, Mich Con is no longer required to adhere to its earlier, highly detailed accounting methodology.

NOMECO asserts that due to Mich Con's maintenance of separate plant records and depreciation balances, the parties were able to assign many costs directly to the main header and to the lateral system. According to NOMECO, this allowed for the accurate computation of bifurcated rates for use of the main header and the laterals. However, it now fears that the utility will cease to use this accounting methodology, thus making it much more difficult to accurately compute Wet Header rates on a bifurcated basis. NOMECO therefore argues that Mich Con should be ordered to continue this accounting practice indefinitely.

Mich Con objects to NOMECO's request. It argues that although the Uniform System of Accounts (USOA) requires the utility to use specific accounts to track production and gathering expenses (as well as distribution, transmission, storage, administrative, and general expenses), neither the USOA nor any statute or rule requires Mich Con to track its costs by area and function. Furthermore, the utility asserts that cost-of-service studies prepared in future rate cases should provide an adequate means to measure and allocate system costs assigned to its Wet Header transportation customers. Mich Con therefore asserts that it should not be ordered to continue these "expensive and time-consuming" accounting practices. (Mich Con's replies to exceptions, p. 106.)

The Commission finds Mich Con's arguments persuasive. However, this finding is based, in large part, on the utility's assertion that it will be able to provide sufficient documentation from which the Wet Header's bifurcated rates can be accurately computed in future rate cases. Thus, although it is not being ordered to continue its present accounting, the utility should note that the responsibility for providing adequate information from which Wet Header transportation rates can be derived continues to reside with the utility.

XI.

MISCELLANEOUS RATE CASE ISSUES

Numerous other rate case issues were raised by the parties. These can be divided into nine areas, each of will be discussed seriatim.

Off-System Transportation Conditions and Terms

As noted earlier in this order, Mich Con proposed offering firm and interruptible off-system transportation service under Rates TOS-1 and TOS-2, respectively. These proposed rates include provisions covering service eligibility; definitions; type of service offered; terms and conditions, including a standard contract identical to that used for Wet Header transportation; imbalances; gas-in-kind reimbursement; and rates.

The ALJ noted that, notwithstanding the requests of the Staff and Antrim to reduce the maximum rates found in each of these tariffs, none of the parties specifically opposed these provisions as they applied to off-system transportation. She therefore recommended that, after reducing the maximum off-system transportation rate to the Staff's suggested level of 15¢ per Mcf, all other provisions be adopted. (PFD, p. 126.)

Antrim excepts to this recommendation. Because the standard agreement covering Wet Header transportation also applies to off-system transportation, Antrim contends that its arguments regarding the proposed 0.9% retainage factor, increases in the MDQ, the definition of force majeure, and other transportation-related issues apply with equal force to proposed

Rates TOS-1 and TOS-2. Antrim therefore requests that the Commission adopt its position on these issues for both off-system and Wet Header transportation.

The Commission agrees with Antrim regarding the need for consistency and finds that the decisions reached on these issues should apply equally to off-system and Wet Header transportation. However, the Commission's earlier rulings on these issues require only one change to the provisions proposed by Mich Con. Specifically, as discussed in Section VII of this order, a "not to exceed" rate of 15¢ per Mcf should be included in both Rates TOS-1 and TOS-2. All other off-system transportation provisions proposed by Mich Con should be adopted.

Guidelines for Affiliate Transactions

The Staff proposed the adoption of seven conditions designed to ensure that the Commission can effectively safeguard the public interest while Mich Con's parent company, MCN, pursues corporate diversification. These conditions, which were adopted by the Commission's December 7, 1989 order in consolidated Cases Nos. U-8678, U-8924, and U-9197 (concerning Consumers' Gas Division), its June 19, 1990 order in Case No. U-9323 (concerning Michigan Gas Company), and its May 7, 1991 order in Case No. U-9346 (concerning Consumers' Electric Division), are as follows:

> "1. That the utility ensure that the Commission has access to books and records of the holding company and each of its affiliates and their joint ventures. Any objections to not providing all books and records must be raised before the Commission and the burden of showing that the request is unreasonable or unrelated to the proceeding is on the respondents.
>
> "2. Each utility, holding company, and each of its subsidiaries and the joint ventures of the holding company and/or its subsidiaries shall employ accounting and other procedures and controls related to cost allocations and transfer pricing to ensure and facilitate full review by the Commission

and to protect against cross-subsidization of non-utility activities by the utility's customers.

"3. The holding company and each of its subsidiaries and the joint ventures of the holding company and/or its subsidiaries shall keep their books in a manner consistent with general accounting principles and, where applicable, consistent with the Uniform System of Accounts.

"4. The utility shall furnish the Commission with:

a. The quarterly and annual financial statements of the consolidated utility and/or its parent holding company;

b. Annual statements concerning the nature of intercompany transactions concerning the utility and a description of the basis upon which cost allocations and transfer pricing have been established in these transactions;

c. Annual balance sheets and income statements of the non-regulated subsidiaries of the utility and/or the non-consolidated subsidiaries of the holding company;

d. As a separate exhibit in its next general rate case, an audit report of its transactions between the utility and its non-utility affiliates;

e. Federal income tax on a consolidated or non-consolidated basis depending on filing.

"5. The utility shall avoid a diversion of management talent that would adversely affect the utility. An annual report identifying personnel transferred from the utility to non-utility subsidiaries is required.

"6. The utility shall notify the Commission in writing within thirty days prior to any transfer to non-utility affiliates of any utility assets or property exceeding a fair market value of $100,000. Asset transfers from regulated to non-regulated shall be at the higher of cost or fair market value and non-regulated to regulated shall be at the lower of cost or fair market value. All services and supplies provided by non-regulated enterprises shall be at market price or 10% over fully allocated cost, whichever is less.

"7. Market, technological, or similar data transferred, directly or indirectly, from the utility to a non-utility affiliate shall be transferred at the higher of cost or fair market value." (Exhibit S-72, Schedule D-5, pp. 14-15.)

Mich Con stated that, although it did not feel that they were necessary, it was willing to follow the Staff's proposed guidelines as they have been construed, and partially revised, by the Court of Appeals in Midland Cogeneration Venture Limited Partnership v Public Service Commission, 199 Mich App 286 (1993). The utility therefore requested that the Commission recognize the Court's interpretations and modifications if it elects to impose these seven conditions on Mich Con. It further requested delaying implementation of these guidelines for six months. The utility asserted that it needs this time to establish new recordkeeping and reporting procedures. (Mich Con's reply brief, p. 146.)

Based on the utility's arguments, the ALJ recommended adopting the Staff's proposed guidelines, but only as interpreted and modified by the Court of Appeals. However, she disagreed with Mich Con's assertion regarding the need to delay their implementation. According to the ALJ, the utility (1) had been advised of the Staff's proposal throughout the course of these proceedings, (2) was aware that identical conditions have been imposed on other Michigan utilities, and (3) had notice of the Court of Appeals' decision since April 1993. (PFD, p. 131.) She therefore recommended that the Commission reject Mich Con's proposed delay.

None of the parties except to these recommendations. The Commission finds that the Staff's guidelines should be approved, as interpreted and revised by the Court of Appeals. It also finds that, although application of these conditions should be prospective, there is insufficient reason to delay their implementation. Thus, Mich Con's request for a six-month delay should be rejected.

ABATE's witness, Mr. Cummings, also made several recommendations regarding affiliate transactions. Specifically, he proposed that:

"1. MCN should immediately require its officers and employees to maintain daily time logs and descriptions of services which they provide for each subsidiary, and MCN should charge these subsidiaries directly for these services;

"2. MCN's non-labor costs should be charged directly to subsidiary companies which caused the cost to be incurred. Non-labor costs which cannot be directly charged should be reflected in overheads and distributed among the subsidiaries on the basis of direct labor as reflected in daily time logs;

"3. Competitive bidding should be required for all goods and services which Mich Con can purchase from affiliates or independent suppliers;

"4. The Commission should prohibit loans by Mich Con to its affiliates, and should require prompt payment for all transactions with affiliates to avoid loans by non-payment;

"5. All services and facilities provided by Mich Con to its affiliates should be billed at costs which include full allocation of indirect costs, overheads and return on investment;

"6. All calculations and records associated with any transaction between Mich Con and its affiliates should be subject to Staff audit and audit by parties of record in any Commission proceeding;

"7. The transfer of any assets from Mich Con to its affiliates should be subject to prior Commission approval; and

"8. The acquisition of any assets by Mich Con from its affiliates should be subject to prior Commission approval." (13 Tr. 2773-2774.)

According to ABATE, these eight restrictions are necessary to combat what it described as "MCN's cavalier attitude" about the relationship between Mich Con, its parent company, and its affiliates. (ABATE's initial brief, p. 171.) In support of this argument, ABATE cited numerous examples of how closely the utility was tied to these other companies.

Mich Con offered several arguments in opposition to ABATE's proposed restrictions. First, it pointed out that several of these restrictions duplicate conditions already found in the Staff's guidelines. Second, the utility noted that others would require the Commission to oversee entities that, according to Midland Cogeneration Venture Limited Partnership, supra, it has no authority to regulate. Third, Mich Con asserted that no support was offered regarding ABATE's request to ban inter-company loans and require competitive bidding for an unspecified number of goods and services. It therefore requested that ABATE's proposed restrictions be rejected.

Based on the Court's ruling in Midland Cogeneration Venture Limited Partnership, the ALJ found ABATE's additional restrictions to be too intrusive. She therefore recommended that they be rejected. However, the ALJ stated that she shared ABATE's concerns regarding the potential for cross-subsidization of Mich Con's non-regulated affiliates. Thus, she went on to recommend that "unless Mich Con chooses to adequately demonstrate that the costs allocable to it [from MCN and its affiliates] are proper and verifiable, those costs should be denied recovery" in future rate cases. (PFD, p. 130.)

ABATE excepts to the first of these recommendations, and requests that the Commission adopt the eight restrictions proposed by Mr. Cummings. In support of this exception, ABATE reasserts its arguments. No exceptions were filed regarding the ALJ's second recommendation.

The Commission finds that, because they are either duplicative of the Staff's guidelines or contrary to the Court's ruling in Midland Cogeneration Venture Limited Partnership, ABATE's proposed restrictions should be rejected. However, because the utility has done a relatively poor job of justifying the costs assigned to it by MCN and incurred through Mich Con's dealings with affiliated companies, the Commission finds that the ALJ's warning is warranted.

Additional Filing Requirements

The Staff requested that Mich Con be required to file, on a monthly basis and in the format shown on Exhibit S-73, a summary of the rates it intends to charge its rate schedule sales and transportation customers. Neither Mich Con nor any other party opposed this request. The Commission finds that this proposal is reasonable and should be adopted.

ABATE offered a proposal regarding changes to Mich Con's required filings. Specifically, it asked the Commission to order that all actual and projected data in the utility's rate filings be classified according to the USOA, and that the same type of information required in the annual report to the Commission be supplied for any historical test period that does not coincide with the fiscal year covered by the report. In support of this proposal, ABATE contended that Mich Con's assignment of historical test year expenses to various accounts on the basis of area and function made it difficult to analyze the utility's expenses. This was particularly true, ABATE claimed, when trying to compare historical and projected cost levels.

Mich Con offered two arguments in opposition to ABATE's proposals. First, it pointed out that the Commission recently adopted a comprehensive set of standard filing requirements and that no compelling reasons have been given for adding ABATE's requirements. Second, it argued that ABATE's alleged difficulty in analyzing data submitted in this case is suspect because none of the other parties claimed to have trouble with it.

The ALJ agreed with the utility and recommended that ABATE's additional filing requirements be rejected. ABATE excepts.

The Commission finds that the ALJ's recommendation should be adopted. As correctly noted by Mich Con, the Commission recently examined the issue of standardized filing requirements and made the changes it deemed appropriate. Absent a compelling reason to again revise these requirements, the Commission agrees with the ALJ that "it is more appropriate to afford the parties experience with these new requirements." (PFD, p. 132.) Therefore, ABATE's proposed changes should be rejected.

The RRC's Low Income Heating Assistance Proposal

The RRC recommended that the Commission order Mich Con to use unrefunded balances (unclaimed refunds from GCR reconciliations and other refund proceedings) to provide energy assistance to low income families in Michigan. In making this recommendation, the RRC noted that both state and federal funding for low income energy assistance has been cut dramatically over the last few years, and will likely continue to decline. Furthermore, it pointed out that the federal government recently adopted "a leveraging incentive fund" allocation methodology, under which the amount of federal money given to a state for low income energy assistance is based on the amount of money raised from public and private sources within the state. (13 Tr. 2886-2887.) By adopting its proposal, the RRC asserted, more matching funds would be provided to the State of Michigan. In further support of its proposed use of these funds, the RRC claimed that the majority of the residential unrefunded refunds are likely to have derived from accounts of low income families. (13 Tr. 2891.)

Mich Con and the Staff opposed the RRC's plan. Although acknowledging that the RRC's purpose is laudable, they contended that it would be inappropriate for the Commission to endorse the direct, additional funding by ratepayers of social programs that, under Michigan's statutory structure, are primarily within the domain of a separate governmental body. These parties went on to assert that there was no support for the RRC's assumption that unrefunded balances derive primarily from low income customers. Moreover, they pointed out that because no specific program has been proposed for handling either the unrefunded balances or the matching funds they would generate, the RRC's proposal could benefit customers of other utilities or even those who rely on propane or fuel oil for heat.

The ALJ agreed with Mich Con and the Staff, and recommended that the Commission reject the RRC's proposal.

The RRC excepts to this recommendation for three reasons. First, it asserts that the Commission has previously approved programs to benefit low income utility customers. For example, it notes that the Commission previously approved positive billing heating assistance programs for Mich Con in Cases Nos. U-9475 and U-10018, and points out that over $14 million will be allocated in the present case to cover the cost of heating assistance programs for Mich Con's customers. Second, it states that whether unrefunded balances derive from low income customers is irrelevant. What matters, says the RRC, is that there is a genuine need for the proposed assistance program and that the funds in question are not the property of identifiable Mich Con customers. Third, it expresses confidence that a program could be designed that would restrict all benefits from the use of these unrefunded balances to Mich Con's customers. For these reasons, the RRC renewed its request to have these unrefunded balances designated for use in a low income heating assistance program.

Based on the record as it now stands, the Commission is not prepared to either approve or reject the RRC's request. Although the Commission has previously authorized low income heating assistance programs for Mich Con, this approval has consistently followed a review of the specific programs' reasonableness. In contrast, no specific program has been proposed in the case at hand. Rather, the RRC has requested that the Commission establish a source of funds for a program whose parameters will, by that party's own admission, not be established until the interested parties have completed discussions regarding program design.

The Commission therefore finds that it should defer ruling on the RRC's request until after the interested parties (including representatives of the Michigan Department of Social Services) have had an opportunity to discuss this issue and develop one or more specific proposals.

The Commission further finds that the RRC should take the lead in coordinating these discussions and developing at least one such proposal. In order to avoid having this process continue indefinitely, the first discussion should occur within 30 days of this order's issuance and at least one fully-developed proposal should be submitted to the Commission within 120 days of the order's issuance. Any proposal filed should address, among other things, (1) what percentage of the funds derived from unrefunded balances would be matched with federal dollars, (2) what percentage of the funds would go toward the purchase of gas, rather than being used for conservation programs or some other purpose, and (3) whether all of the leveraged funds would go to Mich Con's customers, as opposed to low income families that obtain their heating fuel elsewhere.

West Michigan's Proposed Aggregation of Accounts

West Michigan proposed that each transportation customer having multiple, but non-contiguous, locations be allowed to consolidate its monthly bills into a single account. This aggregation of accounts, and reduction in the number of monthly customers charges, would reduce the financial burden on a customer with operations scattered throughout the state by allowing it to avoid paying monthly transportation service charges on all but one of its non-contiguous sites. West Michigan also proposed that the utility be required to implement computerized bulletin boards, imbalance trading procedures, and interruptible utility supply back-up. These steps are necessary, West Michigan asserted, because Mich Con's proposed storage injection and withdrawal limits make it necessary for transportation customers to

(1) obtain detailed information regarding their gas supply and consumption patterns, (2) receive this information as expeditiously as possible, and (3) have access to a back-up source of fuel should its receipt of transportation volumes be interrupted.

Mich Con opposed West Michigan's proposals and the ALJ agreed with its reasoning. Specifically, the ALJ pointed out that these proposals would increase the utility's administrative expenses while reducing its overall revenue. Despite this fact, the ALJ noted, West Michigan failed to provide testimony regarding the magnitude of these cost increases and revenue reductions. Furthermore, it neglected to propose a mechanism for recovering these added expenses and replacing this lost revenue. For these reasons, the ALJ recommended that the Commission reject West Michigan's proposals.

West Michigan excepts to this recommendation. In addition to its initial arguments, it adds the following. First, West Michigan asserts that it is unfair to allow a customer with contiguous facilities to consolidate its monthly bills--as Mich Con's tariffs currently do--while refusing to provide the same opportunity to a customer with non-contiguous facilities. Second, it implies that concerns regarding increased expenses and lost revenue are overstated because few customers are in a position to take advantage of West Michigan's proposed aggregation of accounts.

The Commission does not find these arguments persuasive. There is nothing arbitrary about allowing aggregation of accounts for contiguous facilities but not for non-contiguous ones. Certain fixed costs, such as those arising from meter reading, customer service, and field service, are closely tied to the location of meters and therefore increase with the distance between a customer's various meters. Thus, as Mich Con correctly notes, these costs are higher for customers with non-contiguous facilities. Furthermore, in contrast to West

Michigan's second argument, it appears that many entities having more than one facility could take advantage of the proposal. Even West Michigan's witness conceded that all members of a restaurant or grocery chain could band together and request that they collectively pay a single monthly bill for transportation service. (12 Tr. 2510.) If every eligible customer took advantage of this proposal, the revenue effect could be dramatic. For these reasons, the Commission finds that the ALJ's recommendation should be adopted and that West Michigan's proposals should be rejected.

SFAS 106 Cost Reconciliation Mechanism

Although requesting that all of its estimated SFAS 106 costs be recovered in rates, Mich Con asserted that the nature of these costs makes them extremely volatile. Thus, it claimed that the amount of SFAS 106 costs actually incurred in a particular year could differ significantly from the amount recovered in rates. The utility therefore requested that any difference between its actual booked SFAS 106 expenses and the amount included in rates be deferred for amortization in future cases. Specifically, Mich Con proposed that each year's difference be accumulated, with interest at the utility's overall rate of return, until its next rate case. At that time, the total amount would be amortized over a five-year period through the rates established in that case. The Staff opposed Mich Con's proposal for several reasons.

The ALJ agreed with the Staff and recommended that Mich Con's proposed SFAS 106 cost reconciliation mechanism be rejected. None of the parties except to the ALJ's recommendation, and the Commission finds that it is supported by the record and should be adopted.

Exclusion of Rebuttal

As discussed in Section IV of this order, the ALJ's recommendation regarding the appropriate level of net utility plant was based in part on the Mich Con's failure to show that its projected increases in routine construction expenditures for 1992, 1993, and 1994 were intended for reasonable and prudent projects. The utility asserts that this lack of evidence regarding reasonableness and prudence arose, in great part, from the ALJ's March 20, 1993 ruling that struck a portion of Mr. Surowiec's testimony on the grounds that it constituted improper rebuttal and should have been offered as part of Mich Con's direct case. The utility argues that this ruling was erroneous.

Mich Con contends that the issue of whether its anticipated construction projects were reasonable and prudent did not arise until the Staff challenged its proposed projects in the course of its own direct case. Because its first realistic opportunity to offer testimony on this issue was during rebuttal, the utility asserts, it was improper for the ALJ to expect that the stricken testimony could have been offered as part of its initial filing. This could only have occurred, Mich Con claims, "had the Company's skill bordered on clairvoyance and had it perfectly anticipated [the] Staff's direct case." (Mich Con's exceptions, p. 6.) It therefore requests that the Commission reverse the ALJ's March 20, 1993 ruling and consider Mr. Surowiec's stricken testimony when selecting an appropriate figure for net utility plant.

The Commission does not find Mich Con's arguments persuasive. As repeatedly stated in this order, it is the utility's responsibility to prove that its requested rates are justified. However, in this proceeding, the testimony and exhibits offered in support of the utility's proposed rate increase simply included $277 million in "routine construction projects" without showing which projects this money would finance and whether those projects were reasonable.

Because Mich Con is well aware of the fact that net utility plant includes only facilities that are found to be used and useful, evidence showing that these projects are reasonable and prudent should have been included in its direct case, as correctly noted by the ALJ. Furthermore, allowing the utility to place Mr. Surowiec's stricken testimony on the record at this juncture would deprive the other parties of their right to conduct discovery and cross-examination regarding the issue of reasonableness. For these reasons, the Commission finds that Mich Con's request to overturn the ALJ's March 20, 1993 ruling should be denied.

Mich Con's Requests for Clarification

Mich Con requested clarification of several issues in this case. Although some of its requests have been dealt with in earlier sections of this order, three others have not been specifically addressed. These concern the timing of its analysis regarding market-based storage rates, the treatment of certain regulatory assets, and the effect of proposed changes regarding property and income taxes.

a. Timing of the Market Study

The utility noted that, on page 43 of the PFD, the ALJ recommended that a comprehensive analysis of market-based storage rates be included in Mich Con's next rate case filing. Although not disputing the need for this analysis, it asserted that--depending on the outcome of this proceeding--it may be compelled to file another rate case in the near future. It therefore objects to conditioning the filing of a subsequent rate case upon completion of this analysis. Thus, the utility asks that it simply be ordered to prepare the study within the next six months, submit it to the Staff for comment, and then file the amended version (if any) "within a reasonable time thereafter." (Mich Con's exceptions, p. 108.)

In Section VII of this order, the Commission adopts the ALJ's recommendation regarding this analysis of market-based storage rates. The Commission's decision is based on its belief that this type of analysis should take considerably less time than the six to nine months envisioned by the utility. Specifically, much of the information Mich Con will need to conduct its study can be obtained by simply contacting utilities, transporters, and storage field operators to determine what rates they are paying for various types of storage service, what steps have been taken to market these services, and how successful these steps have been. It does not appear that an elaborate or highly technical procedure must be developed. If diligently pursued, the utility should be able to complete this task and prepare a comprehensive analysis of market-based storage prices within weeks. Because this should not significantly delay any future rate filing from Mich Con, the Commission finds that the utility's request should be denied.

b. Treatment of Regulatory Assets

In the course of this proceeding, Mich Con requested assurance of continuing recovery of regulatory assets that are recorded in Accounts 191 and 192. According to the utility, explicit approval of this long-standing practice is necessary to comply with the Security and Exchange Commission's position regarding proof of compliance with the "probability criterion" contained in SFAS 71. (6 Tr. 987-988.) Noting that the ALJ failed to specifically mention this request in the PFD, Mich Con asks the Commission to include this assurance in its order.

None of the parties have voiced an objection to this request, and the Commission finds that the utility's proposal is supported by the record and should be adopted.

c. Proposed Tax Revisions

Mich Con asserts that, due to the Michigan Legislature's recent action regarding property taxes and the Federal government's recent revisions to the corporate income tax, the Commission should address the likelihood of future proceedings to reflect the effect of those changes on utility rates. Although noting that the net effect of these tax law revisions cannot currently be computed, the utility asserts that some change in its overall tax liability is "a virtual certainty in the near future." (Mich Con's exceptions, p. 109.) It therefore argues that the Commission should, as part of this order, authorize Mich Con to institute a limited purpose proceeding to address any State and Federal tax law changes, their effect on the utility's rates, and the appropriate rate relief necessitated by those changes.

The Commission finds that authorization to institute a limited purpose rate proceeding is, at the very least, premature. The nature and magnitude of many of these changes, as well as their net effect on this utility, cannot be discerned at this time. It is therefore impossible for the Commission to determine whether, and in what form, subsequent ratemaking proceedings should be initiated. The Commission therefore defers ruling on this issue until more certainty exists regarding the net effect of these proposed tax law changes.

Staff's Proposal Regarding G-Tec

Mich Con Investment Corporation (one of Mich Con's affiliates) has a subsidiary, G-Tec, which is marketing a gas torch and related equipment. The G-Tec torch was initially developed by Mich Con with the use of ratepayer-supplied funds before being transferred to this affiliate for further design work and marketing. The Staff notes that the Commission's December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854 ordered Mich Con to include in its next rate case "a specific proposal on how G-Tec's profits will be determined and how the ratepayers' profit interest will be applied" in the future. (Order, p. 22.) However, it further notes that no such proposal has been forthcoming. The Staff therefore requests the Commission to explicitly remind Mich Con of its obligation and direct the utility to include its proposal in its next rate case filing. No opposition was expressed concerning this request.

The Commission finds that the Staff's request should be adopted. Mich Con is therefore directed to include its proposed computation and sharing of G-Tec profits in its next rate case filing. Furthermore, in light of the utility's disregard for the Commission's earlier directive, whether intentional or accidental, Mich Con is placed on notice that continued failure to follow this directive will result in appropriate sanctions.

XII.

ENVIRONMENTAL ASSESSMENT AND REMEDIATION

In Case No. U-10149, Mich Con requested accounting and ratemaking authority to defer future costs that it expects to incur for environmental assessment and remediation activities at 16 former manufactured gas plant (MGP) sites. According to Mr. Dow, gas was manufactured from coal at these locations from the 1800s until the mid-1950s, when the increasingly widespread use of natural gas led to the expanded construction of interstate pipelines and, in turn, to the closing of these MGPs. The extraction of gas from coal during that earlier period resulted in by-products, such as coal tar, that are now recognized as environmentally harmful. Mr. Dow testified that Mich Con has been evaluating these MGP sites for the past decade and has discovered some soil contamination at each location. (11 Tr. 2252.)

Shortly after it first became aware of this problem in 1984, the utility established a reserve of $11.7 million to cover future costs for assessment and remediation activities. However, Mich Con failed to request deferral and amortization of those costs prior to establishing that reserve. Consequently, in its December 22, 1988 order in consolidated Cases Nos. U-8635, U-8812, and U-8854, the Commission declined to approve retroactive deferral of these costs. The Commission went on to note, however, that the utility could properly request deferral and amortization of costs like these if it did so in advance.

Following issuance of the Commission's order, Mich Con has become increasingly aware that the costs of environmental assessment and remediation at its MGP sites will significantly exceed the $11.7 million previously set aside. According to the utility, these costs are now expected to run anywhere from $15 million to $220 million. (10 Tr. 2132.) Thus, although not seeking rate recovery of its MGP assessment and remediation costs in this rate case, Mich Con has requested advance approval of a deferral mechanism for recovery of the costs in excess of the $11.7 million previously charged to this reserve. Mr. Dow described the utility's proposal as follows:

> "In recognition of the potentially large [size] and unpredictable timing of costs that may be incurred in connection with Mich Con's remediation of the MGP sites, Mich Con is proposing that all cumulative costs incurred in excess of the $11.7 million of previously reserved amounts be deferred for accounting purposes and be subject to a five-year amortization in future rates. Carrying charges at Mich Con's most recent MPSC authorized overall pre-tax rate of return would be added to those costs deferred in excess of the $11.7 million reserve." (11 Tr. 2255.)

Each of the parties that addressed this issue agreed that deferral of the utility's MGP assessment and remediation costs is appropriate. The Staff also agreed that deferred tax accounting should be used to compensate for the book/tax timing differences that may arise from these deferrals. In addition, Mich Con agreed with several refinements to its proposed deferral mechanism that were proposed by the Staff. However, the parties differed, at least initially, on the following issues.

Carrying Costs/The Appropriate Cost Rate

With respect to carrying charges arising from these deferred costs, the parties agreed that some level of carrying charges should be recognized. However, they differed regarding what level is appropriate. Mich Con and the Staff asserted that these charges should be accrued at the utility's pre-tax authorized rate of return. In contrast, ABATE claimed that Mich Con's short-term borrowing rate should be used. In support of this claim, ABATE pointed out that assessment and remediation costs are expenses, rather than investments in utility plant. It therefore contended that, because the utility would likely not be selling stock and mortgage bonds to finance these expenses, use of the short-term borrowing rate is justified.

The ALJ agreed with Mich Con and the Staff that the rate at which carrying charges are accrued should be Mich Con's pre-tax authorized rate of return. ABATE excepts, raising the arguments discussed above.

The Commission does not find ABATE's arguments persuasive. As shown on Exhibit S-22, page 35, Mich Con's financing policy is to use short-term borrowing to meet its seasonal and short-term cash requirements. For example, during the Fall and Winter of each year, the utility borrows funds on a short-term basis to finance increases in natural gas inventories and customer accounts receivable. This debt is then repaid as cash is received from winter heating sales. Because these deferred costs will be long-term in nature, the use of some type of long-term financing will be required. Furthermore, it is reasonable to conclude that this long-term financing will consist of equal amounts of debt and equity. This is due to the previously-expressed goal of maintaining an equal weighting of debt and equity in Mich Con's capital structure. For these reasons, the Commission finds that use of the utility's pre-tax authorized rate of return is appropriate.

Carrying Costs/Timing

Mich Con proposed that carrying charges should begin when the deferrals are accrued. This means that they would be applied as soon as the utility incurred environmental assessment and remediation costs in excess of the existing $11.7 million reserve. In contrast, the Staff recommended that carrying charges should not be recognized until after these costs have been reviewed and found to be prudently incurred in a rate case. According to the Staff, delaying recognition of these carrying charges would create incentive for Mich Con to contain its assessment and remediation costs.

The ALJ agreed with the Staff and recommended that carrying costs not be recognized until after the utility's expenses are reviewed in a rate case. Mich Con excepts to this recommendation, arguing that this purported incentive is unnecessary. Specifically, the utility asserts that "subjecting the clean-up costs to a prudence review prior to rate recovery already provides Mich Con [with] incentive to keep those costs in check." (Mich Con's exceptions, p. 103.) It therefore requests that the Commission reject the ALJ's recommendation and approve the accrual of carrying costs on the deferrals in the year that the costs are first deferred.

The Commission finds that the utility's request should be rejected. Absent the accounting authority sought in this proceeding, the utility would be required to expense all assessment and remediation costs on an annual basis as incurred. This requirement would have provided Mich Con with a strong incentive to minimize its costs in an attempt to protect its shareholders. However, the potential harm to the utility's shareholders, as well as the incentive arising from it, is effectively eliminated by authorizing the utility to use deferred accounting for these costs. Thus, the Staff's proposal is an attempt to reestablish that incentive, at least in part, by precluding carrying charges from accruing on each vintage year's accounts between rate cases. The Commission finds that the Staff's proposal is reasonable, that the ALJ's recommendation should be adopted, and that carrying charges should not accrue until after the utility's assessment and remediation costs are reviewed in subsequent rate cases. This will be accomplished through the inclusion of the vintage year account balances in Mich Con's rate base during those future rate cases.

Legal Standard for Future Prudence Reviews

ABATE requested that the Commission clarify two points concerning the review of environmental assessment and remediation costs that were not discussed in the PFD. First, it asked that the Commission specifically state that all deferred costs for which the utility seeks recovery will be subject to a reasonableness and prudence review, "including a review of Mich Con's efforts to minimize [its] exposure and any actions taken to obtain reimbursement costs from other sources." (ABATE's exceptions, p. 112.) Second, it asked that the Commission reject the utility's request to expressly acknowledge that prudence will be evaluated on the basis of laws, rules, and regulations in effect at the time the costs are incurred.

None of the parties object to ABATE's first request, and the Commission finds that all deferred costs for which Mich Con seeks recovery will be subject to a prudence review (including a review of the utility's attempts to minimize its exposure and obtain reimbursement from others). As for the second request, the Commission finds that it would be inappropriate at this time to establish a uniform standard to be applied in all future prudence reviews.

Rather, the decision regarding what standard should be applied should be decided in the context of these prudence reviews.

Effect of Taxes on Deferrals

ABATE's witness, Mr. Cummings, proposed that Mich Con be ordered to defer its environmental assessment and remediation costs on a net-of-tax basis. The ALJ rejected this proposal on the grounds that this witness (1) offered no testimony regarding what tax effects would arise, (2) failed to explain why it would be desirable to defer only the after-tax portion of these costs, (3) provided no examples of comparable treatment, and (4) cited no rate-making or accounting authority in support of this proposal. (PFD, pp. 141-142.)

ABATE excepts to the ALJ's conclusion on the grounds that she failed to recognize the parties' agreement to use deferred tax accounting in this case. Thus, it asserts, Mich Con's assessment and remediation costs will be deductible as soon as they are incurred. ABATE goes on to contend that the normalization of taxes will therefore "require that the tax effect of that deduction be deferred for financial reporting purposes." (ABATE's exceptions, p. 111.)

Again, the Commission does not find these arguments persuasive. As correctly noted by Mich Con, there is no support for ABATE's underlying assertion that these costs will immediately become deductible for federal tax purposes. Furthermore, pursuant to the Commission's February 8, 1993 order in Case No. U-10083, the utility was given authority to use deferred tax accounting for all book/tax temporary differences arising since January 1, 1993. Because all tax benefits associated with assessment and remediation costs will be recognized during the periods in which the costs are expensed for financial statement purposes, deferred taxes will be recorded for the book/tax differences. Therefore, in future rate cases, the tax benefits and deferred taxes will appropriately be treated as an offset to rate base in the same manner as other tax benefits and deferred taxes. This is a reasonable outcome. For these reasons, the Commission finds that ABATE's exception should be rejected.

Amortization of Deferrals

Mich Con and the Staff differed regarding when the amortization of deferred environmental assessment and remediation costs should begin. Mich Con proposed delaying any amortization until after the costs giving rise to it have been included in rates. In contrast, the Staff suggested that amortization of each vintage year account, which contains the environmental assessment and remediation costs incurred during that year, should begin with the start of the next calendar year. The ALJ agreed with the Staff that amortization should be delayed only until the following January and, therefore, recommended that the Commission adopt its proposal.

Mich Con excepts to the ALJ's recommendation. It argues that the Staff's proposal would automatically deny the utility an opportunity to recover all assessment and remediation costs because it is based on the mistaken premise that all of Mich Con's costs are presently being recovered in rates. Such a denial, the utility contends, would be "unprecedented." (Mich Con's exceptions, p. 104.) According to Mr. Dow, no regulatory body has, to his knowledge, denied full recovery of a utility's environmental remediation costs. Mich Con therefore asserts that the Commission must adopt its proposal instead.

The Commission disagrees with the utility's assertion. As noted on page 143 of the PFD, the Staff's proposal is supported by the following testimony from Ms. Devon:

> "[Mich Con's] rates are set in order to provide the company with a fair opportunity to earn its authorized rate of return. By providing the deferral and amortization of [its environmental remediation] expenses, it is anticipated that

> a normalized level of cost will be included in the company's income each year. This cost then becomes an ongoing operating expense and as such should not require any further deferral until the company's next rate case. If the change in expenses resulting from the amortization of remediation costs, when combined with all other changes in the company's revenue and expense levels, results in the need for a rate increase, the company always has the opportunity to file a rate case. If the company does not file a rate case, it can be assumed that the expenses are covered in current rates. (17 Tr. 3451-3452.)

Moreover, notwithstanding the utility's assertion that no environmental assessment and remediation costs are currently included in its rates, adoption of the Staff's proposal will not necessarily deny Mich Con recovery of all such costs. Instead, due to regulatory lag, it is as likely that additional amounts will be recovered in the time between the end of the amortization period and the next rate case The Commission therefore finds that the Staff's proposal is reasonable and should be adopted.

Length of the Amortization Period

The Staff proposed that these deferred costs be amortized over a ten-year period. It further proposed that the use of this period, if adopted, should be reviewed in the future when experience with the actual level of assessment and remediation costs can provide further guidance. Specifically, if the actual costs are near the low end of the $15 million to $220 million range, a shorter amortization period may be warranted. In contrast, costs near the high end of that range could justify a longer amortization period.

Mich Con did not dispute the reasonableness of the Staff's initial proposal. Like the Staff, it believed that a ten-year[26] amortization period should be adopted in this order. Furthermore, it did not oppose the idea of reviewing, and potentially revising, the amortization period

[26]Although initially proposing a 5-year amortization period, Mich Con subsequently concluded that "the Staff's 10-year period is appropriate." (Mich Con's initial brief, p. 154.)

in the future. However, it requested that the Commission specifically note that any change in the amortization period should only be made on a prospective basis.

The ALJ agreed with the proposals offered by these two parties.[27] She therefore recommended that (1) a ten-year amortization period be adopted at this time, (2) the reasonableness of this period be reviewed from time to time, and (3) any revision to this amortization period be prospective in nature. None of the parties except to the ALJ's recommendations, and the Commission finds that they are supported by the record and should be adopted.

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, R 460.17101 et seq.

b. A working capital requirement of $74,365,000, net utility plant of $951,051,000, and rate base of $1,025,416,000 are reasonable and appropriate.

c. An overall rate of return of 8.04% and a return on common equity of 11.5% are reasonable and appropriate.

d. A sales level of 204,030,000 Mcf, a base transportation volume of 100,761,000 Mcf, a coal displacement volume of 19,143,000 Mcf, and a combined throughput volume of 323,934,000 Mcf are reasonable and appropriate.

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[27]In reaching her conclusion regarding Mich Con's request to make any future changes in the amortization period prospective only, the ALJ stated that "she based her determination not on the arguments set forth by Mich Con but [rather] on the issue of fairness." (PFD, p. 144.) Likewise, the Commission's decision regarding the prospective nature of any future change is based solely on fairness.

e. Mich Con's adjusted net operating income is $72,307,000, resulting in an income deficiency of $10,136,000 and a revenue deficiency of $15,727,000.

f. Transportation customers should reimburse Mich Con for company use and lost and unaccounted for gas through a 0.9% gas-in-kind factor.

g. Mich Con should establish a bifurcated rate structure for use of the Wet Header, with rates of 2.2¢ per Mcf for use of the main header and 7.5¢ per Mcf for use of its lateral system.

h. Transportation customers receiving service under Rate Schedules T-1 and T-2 should be disaggregated into small-volume and large-volume classes.

i. Within 30 days of issuance of this order, Mich Con should advise its small-volume transportation customers of their limited right to switch to sales service.

j. Small-volume transportation customers should have 60 days from issuance of this order to advise Mich Con in writing of their decision to switch to sales service. Failure to request this change within the period established by this order should result in the small-volume transportation customer being served under Rate Schedule T-1 or T-2.

k. A comprehensive analysis of market-based storage rates should be included in Mich Con's next rate case filing.

l. Mich Con should, before the start of the 1994-1995 heating season, install electronic remote meters for all transportation customers having ACQs of at least 100,000 Mcf and for all other transportation customers that request these meters. It should then undertake a cost-of-service study based on the daily usage patterns revealed by use of these meters and file this study, with the underlying data, no later than January 15, 1996.

m. Mich Con's proposed storage, withdrawal, and injection limits concerning its transportation customers should be adopted, but the proposed monthly withdrawal limit should not take effect until November 1, 1994.

n. Mich Con should include in its next rate case filing its proposed computation and sharing of G-Tec profits.

o. Mich Con should file, within 30 days of issuance of this order, proposed tariff language concerning the diversion of customer-owned gas. All other parties should have 21 days from the date of that filing to submit arguments regarding the utility's proposed language.

p. Mich Con's proposal to defer future environmental assessment and remediation costs, use deferred tax accounting, and amortize these costs and their attendant carrying charges over a number of years, as amended by this order, should be approved.

q. Mich Con should make the revisions to its rules, regulations, and rate schedules approved in this order.

r. Mich Con should file, within 30 days of issuance of this order, all tariff sheets necessary and appropriate to comply with this order.

s. The Commission should defer ruling on the RRC's proposal to use unrefunded balances to fund low income energy assistance programs until the interested parties have had an opportunity to discuss this issue and file a fully-developed program for Commission review.

t. All contentions of the parties inconsistent with this order and not specifically determined should be rejected.

THEREFORE, IT IS ORDERED that:

A. Michigan Consolidated Gas Company is authorized to increase its rates and charges for gas service by $15,727,000 annually for service rendered on and after January 3, 1994, which is the billing date of the first billing unit of January 1994, as provided in this order.

B. Michigan Consolidated Gas Company's rules and regulations shall be revised as provided in this order, to be consistent with the rules and regulations attached to the original order contained in the Commission's file.

C. Michigan Consolidated Gas Company shall file, within 30 days of issuance of this order, all tariff sheets necessary and appropriate to comply with this order.

D. Within 30 days of issuance of this order, Michigan Consolidated Gas Company shall advise all small-volume transportation customers currently receiving service under Rate Schedules T-1 and T-2 of their limited right to switch to sales service.

E. Michigan Consolidated Gas Company shall include in its next rate case filing a comprehensive analysis of market-based storage rates.

F. Michigan Consolidated Gas Company shall, before the start of the 1994-1995 heating season, install electronic remote meters for all transportation customers having annual contract quantities of at least 100,000 thousand cubic feet and for all other transportation customers that request those meters. It shall then conduct a cost-of-service study based on the daily usage patterns revealed by use of those meters and file the study, along with its underlying data, no later than January 15, 1996.

G. Michigan Consolidated Gas Company shall include in its next rate case filing its proposed computation and sharing of G-Tec profits.

H. Michigan Consolidated Gas Company shall file, within 30 days of issuance of this order, proposed tariff language concerning the diversion of customer-owned gas. All other parties to these consolidated cases shall have 21 days from the date of that filing to submit arguments on the proposed language.

I. Michigan Consolidated Gas Company's proposal to defer future environmental assessment and remediation costs, use deferred tax accounting, and amortize these costs and their attendant carrying charges over a number of years, as amended by this order, is approved.

J. The Residential Ratepayer Consortium shall, within 30 days of issuance of this order, coordinate a meeting among interested parties for the purpose of establishing a fully-developed proposal to use unrefunded balances to fund low income energy assistance programs. Any such proposal shall be filed with the Commission within 120 days of this order's issuance.

K. All contentions of the parties inconsistent with this order and not specifically determined are rejected.

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/ John L. O'Donnell
Acting Chairman

(S E A L)

I join in all aspects of the Commission's order and file a separate concurring opinion.

/s/ Ronald E. Russell
Commissioner

By its action of October 28, 1993.

/s/ Dorothy Wideman
Its Executive Secretary

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

* * * * *

In the matter of the application of **MICHIGAN CONSOLIDATED GAS COMPANY** for approval of deferred accounting, deferred tax accounting, and rate recovery of environmental assessment and remediation costs.	)	Case No. U-10149
In the matter of the application of **MICHIGAN CONSOLIDATED GAS COMPANY** for authority to increase its rates and for other relief.	)	Case No. U-10150

SEPARATE CONCURRING OPINION OF
COMMISSIONER RONALD E. RUSSELL

Due to their nature, rate cases require the Commission to balance a multitude of competing interests. Among these are the need to (1) protect the economic viability of the utility, (2) allocate the cost of providing service in a fair and reasonable manner, and (3) establish rates that are no higher than necessary to ensure safe and reliable service. The Commission order does that, and I therefore concur with all of the findings expressed in today's order. However, my review of the record leads to the conclusion that the Commission should provide the utility with further direction regarding the issue of executive bonuses.

In addition to disallowing 50% of the costs arising from Michigan Consolidated Gas Company's (Mich Con's) executive bonus plan, today's order warns Mich Con that future rate recovery of bonus plan expenses will require a showing that the plan will not result in excessive costs and that the utility's ratepayers will derive benefits from the plan that are commensurate with its costs. I believe that Mich Con should further be placed on notice that any executive bonus plan for which cost recovery is sought in future rate cases should provide incentives that are directly tied to the overall operation of the utility. The best method for achieving this end appears to be through the reduction or elimination of monetary bonuses and their replacement with stock options or shares of stock.

Switching to a stock-based executive bonus system has three potentially important benefits. First, it creates an incentive program that is largely self-enforcing. If the utility is well-managed, the value of the stock held by its executives will likely increase. Second, it allows the market, rather than the utility's ratepayers, to pay for most--if not all--of the bonus plan's cost. Third, it produces a system that responds both positively and negatively to executives' actions. Good management practices should improve the stock's value and poor practices should reduce its value.

For these reasons, I feel that this additional warning should be given.

Ronald E. Russell
Commissioner

October 28, 1993

EXHIBIT A

COMPUTATION OF WET HEADER TRANSPORTATION RATES

	Total Amount	Main Header	Lateral System
Rate Base (per Exhibit S-119)	$12,193,000	$5,199,000	$6,994,000
Pre-Tax Return on Investment[1]	1,308,000	558,000	750,000
Depreciation	2,829,000	938,000	1,891,000
O&M Expense	2,186,000	305,000	1,881,000
Administrative and General Expense[2]	2,407,000	335,000	2,072,000
Property Taxes	1,217,000	709,000	508,000
Payroll Taxes	200,000	28,000	172,000
Total Cost of Service	$10,147,000	$2,873,000	$7,274,000
Volumes of Gas (MMcf)[3]		130,261	97,038
Cost of Service Rates (per Mcf)[4]		$ 0.022	$ 0.075

1. Rate base x 10.73% (pre-tax rate of return per Exhibit S-119, line 8).
2. $90,000 reduction in administrative fees (allocated $13,000 to main header and $77,000 to laterals, using ratios from Exhibit S-119, line 11).
3. Exhibit I-37 (totals for 12 months ended November 1992).
4. Computed as follows: $2,873,000 ÷ 130,361 MMcf = $0.0220388 per Mcf.
   $7,274,000 ÷ 97,038 MMcf = $0.0749603 per Mcf.

COMPUTATION OF COMPANY USE AND LOST AND UNACCOUNTED FOR GAS EXPENSE

Total Throughput (Per Order)	323,934 MMcf
Estimated Company Use Volumes	+ 1,938 MMcf
Total Sendout	325,872 MMcf
Lost and Unaccounted For Gas Factor	x .003
Total Lost and Unaccounted For Gas Volumes	978 MMcf

Company Use and Lost and Unaccounted For Gas Volumes[1]	2,916 MMcf
Percentage Assigned to Sales[2]	x .6299
Company Use and Lost and Unaccounted for Gas Assigned to Sales	1,837 MMcf
Estimated 1994 Cost of Gas (per Mcf)	x $2.81
Revenue Requirement for 1994	$ 5,161,000
Historical Test Year Revenue Requirement[3]	- 4,652,000
Revised Gross Adjustment	$ 509,000
Tax Conversion Factor	x .6445
Revised Net Adjustment	$ 328,000

1. Company Use Volume (1,938 MMcf) + Lost and Unaccounted For Gas Volume (978 MMcf).

2. 204,030 MMcf of Sales ÷ 323,934 MMcf of Total Throughput.

3. Taken from Exhibit A-11, Schedule F-3-1.

EXHIBIT C

COMPUTATION OF AFUDC

Qualifying Construction Work in Progress	$ 4,670,000
Overall Rate of Return	x 8.04%
Projected 1994 Test Year AFUDC	$ 376,000
Historical AFUDC	- 1,025,000
Gross Reduction in AFUDC	$ (649,000)

Qualifying Construction Work In Progress	$ 4,670,000
Weighted Cost of Debt	x 3.61%
Interest on Debt Portion of AFUDC	$ 169,000
Historical AFUDC Interest Expense	- 452,000
Change in AFUDC Interest Expense	$ (283,000)
Tax Factor	x 34%
Impact of Tax on AFUDC	$ (96,000)

Gross Reduction in AFUDC	$ (649,000)
Less: Impact of Tax on AFUDC	- (96,000)
Net Reduction in AFUDC	$ (553,000)