STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of **INDIANA MICHIGAN POWER COMPANY** for a power supply cost recovery reconciliation proceeding for the 12-month period ended December 31, 2021.	U-20805

REPLY BRIEF

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I. REPLY TO I&M

A. The transfer price is not an appropriate market comparison for OVEC.

I&M[1] argues that the Commission should use the transfer price construct from renewable energy proceedings to determine how OVEC costs under the ICPA compare to market price.[2] The Attorney General anticipated this argument and addressed it at pages 31-34 of her initial brief. Staff also explains why the transfer price is not an appropriate benchmark at pages 7-8 of Staff's initial brief.

B. Consumers Energy's agreements with Michigan Power Limited Partnership and North American Natural Resources Inc. are not appropriate market comparisons for OVEC.

I&M next argues that the Commission should use costs incurred by Consumers Energy in 2021 under its agreements with Michigan Power Limited Partnership – a small natural gas-fired plant – and North American Natural Resources Inc. – a very small landfill gas plant – as market comparisons for OVEC costs under the ICPA.[3] The Attorney General anticipated this argument and addressed it at pages 34-35 of her initial brief.

C. The Lake Trout Purchase and Sale Agreement is not an appropriate market comparison for OVEC.

I&M next argues that the Commission should use the levelized cost of the Lake Trout Purchase and Sale Agreement as a market comparison for OVEC costs under

[1] Abbreviations used in this brief are the same as in the Attorney General's initial brief.

[2] I&M Initial Brief, pp. 21-23.

[3] I&M Initial Brief, p. 23.

the ICPA.[4] The Attorney General anticipated this argument and addressed it at pages 35-38 of her initial brief. Staff also explains why the Lake Trout PSA is not an appropriate benchmark at page 8 of Staff's initial brief.

D. I&M's characterization of Staff's position ignores Staff's rebuttal testimony.

I&M next claims that "Staff agrees that the Company's 2021 ICPA costs were reasonable and prudent in light of market pricing."[5] However, to support this claim I&M only discusses Staff witness Rashaun Bodiford's direct testimony and ignores his rebuttal testimony. The Attorney General explained in her initial brief that in his direct testimony, Mr. Bodiford reserved the right to change his recommendation; and then did in fact change his recommendation in rebuttal to a disallowance of OVEC costs.[6] Staff discusses its recommendation for a disallowance in detail at pages 10-12 of Staff's initial brief.

E. I&M's criticisms of Attorney General witness Devi Glick's comparisons are misplaced.

I&M next criticizes the market comparisons for OVEC costs offered by Devi Glick in her direct testimony. None of these criticisms have merit.

First, I&M argues that MPPA's agreements for power from Campbell 3 and Belle River are not PPAs and therefore I&M wonders if MPPA pays financing or

[4] I&M Initial Brief, p. 23.

[5] I&M Initial Brief, p. 24.

[6] Attorney General's Initial Brief, pp. 29-30, discussing Bodiford direct, 2 Tr 227-29 and Bodiford rebuttal, 2 Tr 233-35.

construction costs as part of these arrangements.[7] The Attorney General explained in her initial brief that Ms. Glick's corrected MPPA exhibits include references to construction and financing costs and resolve this question.[8]

Second, I&M asserts that in offering the Campbell 3 and Belle River agreements, witness Glick "appears to have simply picked agreements that she believed would fit her desired narrative without bothering to review the substance of the documents or determine whether they are legitimate comparators."[9] I&M fails to cite any record evidence in support of this statement, whose only purpose appears to be impugning Ms. Glick or her work without any basis. As noted in the discussion of prior Commission Orders in I&M's PSCR cases in the Attorney General's initial brief, the Commission has either accepted or endorsed Ms. Glick's testimony regarding appropriate market comparisons for OVEC in Case Nos. U-20804, U-20530, and U-21052.[10]

Third, I&M questions whether Campbell 3 and Belle River are similar to OVEC, given the different sizes of the units that make up the OVEC plants.[11] However, as noted in the Attorney General's initial brief, the Commission has already held that long-term power supply arrangements need not be "perfect apples-to-apples comparisons" to serve as benchmarks for the OVEC costs.[12] And certainly, as large

[7] I&M Initial Brief, pp. 24-25.

[8] Attorney General's Initial Brief, pp. 27-28, discussing Corrected Exhibits AG-7 and AG-8.

[9] I&M Initial Brief, p. 25.

[10] See Attorney General's Initial Brief, pp. 13-20.

[11] I&M Initial Brief, pp. 25-26.

[12] Attorney General's Initial Brief, p. 28, quoting Case No. U-21052, Order dated June 22, 2023, p. 20.

coal-fired power plants, Campbell 3 and Belle River were *far* more similar to OVEC in 2021 than MPLP's small natural gas plant, NANRI's tiny landfill gas facility, or the Lake Trout solar project which had not been constructed yet.

Fourth, I&M criticizes the use of CONE as a comparison. The Attorney General discussed the use of CONE at page 29 of her initial brief.

Fifth, I&M argues that witness Glick should not have relied on the results of the company's 2021 RFP but should have used the agreements resulting from its 2022 RFP instead.[13] But as the Attorney General explained in initial brief, Ms. Glick was comparing OVEC costs in 2021 to other long-term power supply arrangements, and therefore the 2021 RFP results are more appropriate than agreements negotiated following the 2022 RFP.[14]

Sixth, I&M argues that the Commission should not use the PJM energy and capacity market prices as market price comparisons for the Code of Conduct.[15] In initial brief, the Attorney General acknowledged the Commission's prior statements about using capacity auction prices as a market price comparison under the Code of Conduct, but explained that PJM market prices are still the proper way to evaluate the value of the ICPA in a given year.[16]

F. The Code of Conduct's price rule does not exceed the authority that the Legislature granted to the Commission.

[13] I&M Initial Brief, p. 26.

[14] Attorney General's Initial Brief, p. 29.

[15] I&M Initial Brief, p. 27.

[16] Attorney General's Initial Brief, pp. 24-25.

I&M next offers a slew of arguments as to why the Code of Conduct cannot be applied to the OVEC costs. I&M has made most of these same arguments in prior cases and the Commission has rejected them. The ALJ and Commission should reject them again in this case.

1. The Code of Conduct's market price rule does not conflict with the PSCR statute.

The first of I&M's arguments is that the Code of Conduct's market price rule exceeds the Legislature grant of authority to the Commission in the statute that directed promulgation of the Code.[17] I&M argues that applying the market price rule to PSCR costs conflicts with the PSCR statute, which evaluates PSCR costs based on whether they were reasonably and prudently incurred.[18]

I&M is wrong because the PSCR statute and the Code can easily be read in harmony, to require that the purchase of power from an affiliate meet the standards in the PSCR statute and the requirements of the Code of Conduct. The PFD in U-21052 stated: "This PFD does not perceive any conflict between the Code of Conduct and Act 304 regarding the PSCR process; instead, the Code of Conduct simply provides additional, stricter rules for a specific subset of transactions, *i.e.*, affiliate transactions."[19] The Commission in U-21052 found this issue "to be well-settled" and

[17] I&M Initial Brief, pp. 29-30.

[18] *Id*.

[19] Case No. U-21052, PFD dated March 29, 2023, pp. 25-26.

adopted the PFD's analysis, finding it "well-reasoned and aligned with the Commission's previous decisions on this issue."[20]

The cases I&M relies on are both distinguishable and not the authority most on point for this issue. In *Insurance Institute of Michigan*, the Office of Financial and Insurance Services issued rules that prohibited insurance scoring.[21] Because the Insurance Code allowed insurance scoring, the rules directly conflicted with the Code.[22] In the 42-year-old case of *Jackson v Secretary of State*, the Michigan Court of Appeals found that a historic version of the No-Fault Act – which provided the Secretary of State with authority to administer an assigned claims plan – did not implicitly provide the Secretary with quasi-judicial authority to adjudicate the validity of claims made under the plan.[23]

Both *Insurance Institute* and *Jackson* involved direct challenges to agency rules on the basis that they conflicted with the statute that authorized the rules. Neither *Insurance Institute* and *Jackson* involved claims that an agency decision under one statute conflicted with another statute, as I&M argues here. In two more recent cases that addressed challenges of the latter type, the Michigan Court of Appeals held that the electric utility statutes should be read *in pari materia* and harmonized to avoid conflicts, and upheld the MPSC's decisions in both cases.[24]

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[20] Case No. U-21052, Order dated June 22, 2023, p. 21.

[21] *Insurance Institute of Michigan v Commissioner, Financial & Insurance Services*, 486 Mich 370 (2010).

[22] *Id*. at 398-400.

[23] *Jackson v Secretary of State*, 105 Mich App 132, 139 (1981).

[24] *Bauer v Saginaw County,* 332 Mich App 174, 199; 955 NW2d 553 (2020).

In *In re Consumers Energy Co,* the Court found that the statute authorizing a long-term industrial load retention rate (LTILRR) based on the cost of the Zeeland gas plant should be harmonized with the statute authorizing a securitization charge for the undepreciated book balance of the Karn coal plant, and held that Hemlock Semiconductor was required to pay both.[25] Similarly, in *In re Cloverland Electric Cooperative,* this Court held that Act 167, which authorizes member-regulated electric cooperatives to set their own rates, and MCL 460.6w, which requires the Commission to set a special "State Reliability Mechanism" charge for electric providers, should be read *in pari materia* and both given effect.[26] These two decisions use similar reasoning to the PFD in U-21052: that the market price rule applies a stricter standard to the subset of PSCR costs incurred via affiliate transactions.

Here, like in *Consumers* and *Cloverland,* there is no direct conflict between the PSCR statute and the enabling statute for the Code (or the Code itself). An electric utility that files a PSCR plan and reconciles PSCR costs must meet the standards of Act 304. If the utility seeks to recover among its PSCR costs any costs incurred to procure products or services from an affiliate, then the cost of those products or services must also meet the Code of Conduct. The fact that a utility must meet the standards of Act 304 for all of its PSCR costs, and must also meet the Code of Conduct for any of its PSCR costs incurred with affiliates, does not mean that the Code of Conduct conflicts with the PSCR statute.

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[25] *In re Consumers Energy,* 339 Mich App 346, 361 (2021).

[26] *In re Implementing Section 6w of 2016 PA 341 for Cloverland Electric Cooperative,* 329 Mich App 163, 178-81 (2019).

2. Applying the market price rule to recovery of OVEC costs is not arbitrary and capricious.

I&M next argues that comparing the costs it seeks to recover for purchases of affiliate OVEC power in a PSCR reconciliation case to other long-term power supply arrangements to determine whether the cost of the affiliate purchases exceeds market price is arbitrary and capricious.[27] I&M claims that applying the Code of Conduct market price rule in this way represents second-guessing based on hindsight and an unexplained change from prior Commission practice.[28] Neither claim is true.

I&M's argument about hindsight is incorrect for a few reasons. First, the principle against regulating based on hindsight is a general principle of utility regulation that has its origin in common law.[29] The Code of Conduct's market price cap is an administrative rule promulgated under a statutory mandate "to prevent cross-subsidization [and] preferential treatment…"[30] Neither the market price cap rule, nor the Code of Conduct generally, contain any exception for that allows a utility to recover more than market cost for purchases from an affiliate if the agreement may have been prudent when it was made.

Further, as the Commission has noted repeatedly, I&M never sought Commission approval of the ICPA or its amendments – despite having the right to do so. Therefore, the Commission has never held that the ICPA is a reasonable and prudent agreement. The Commission has found that "under the ICPA the contractual

[27] I&M Initial Brief, pp. 31-32.

[28] *Id*. at 32.

[29] See *ABATE v MPSC*, 208 Mich App 248, 256-57 (1994).

[30] MCL 460.10ee(1).

rates may vary from year to year, which is very different from a case involving a single set of construction costs included in rates…"[31] Further, "each PSCR case involves a new plan with appropriate PSCR factors."[32] The Commission "has the duty under statute to continuously evaluate the reasonableness of the PSCR plan and factors, including the cost arising under the ICPA and its amendments."[33] That is "particularly true for cases involving affiliate transactions that implicate the Code of Conduct," since those transactions have long been held to require special scrutiny.[34]

I&M's other argument is that disallowing recovery of PSCR costs incurred via purchase from an affiliate under the Code of Conduct is an "unexplained inconsistency in agency policy" and therefore an "arbitrary and capricious change from agency practice."[35]

I&M cites *Encino Motorcars, LLC v Navarro* in support of this argument.[36] In *Encino,* the Department of Labor revised a rule interpreting the term "salesman" in the Fair Labor Standards Act to change the status of service advisors with respect to overtime pay requirements. The Court held that the agency needed to explain the reasons for its change in policy with respect to the status of those employees.

Here, there has been no change in Commission policy. The Commission has repeatedly held that the Code of Conduct's market price rule caps recovery of PSCR

[31] Case No. U-20530, Order dated February 2, 2023, p. 13.
[32] *Id*.
[33] *Id*. at 14.
[34] *Id*.
[35] I&M Initial Brief, p. 32.
[36] *Encino Motorcars, LLC v Navarro*, 136 S Ct 2117, 2120 (2016).

costs incurred with an affiliate. The Attorney General's initial brief discussed the many I&M PSCR cases in which the Commission has already held that I&M must demonstrate in the PSCR that its recovery of OVEC costs complies with the market price under the Code of Conduct: Case Nos. U-20529, U-20224, U-20804, U-20530, and U-21052.[37]

The Commission has also applied the same approach in several DTE Electric Company's PSCR cases:

- In DTE Electric's 2019 PSCR plan case, which involved a contract between DTE Electric and the affiliate NEXUS gas pipeline, the Commission held that DTE had "an ongoing obligation to demonstrate compliance with the pricing provisions of the Code of Conduct in the reconciliation, which in turn will provide the Commission with the required information to determine the amount of affiliate transaction costs DTE Electric may recover."[38]
- In DTE Electric's 2018 PSCR reconciliation case, the Commission held that the TEAL amendment to the NEXUS contract "would trigger the market pricing test for an affiliate transaction pursuant to Rule 8(4) [of the Code of Conduct]."[39]
- In DTE Electric's 2020 PSCR plan case, the Commission reviewed the same TEAL amendment and found that "there is also heightened scrutiny that

[37] See Attorney General's Initial Brief, pp. 11-20.

[38] Case No. U-20221, Order dated May 8, 2020, p. 16.

[39] Case No. U-20203, Order dated December 9, 2020, p. 29.

applies to this affiliate transaction pursuant to the Code [of Conduct]."[40] The Commission found that "DTE Electric will also need to demonstrate compliance with the pricing provisions under Mich Admin Code, R 460.10108(4) (Rule 8(4))."[41] To evaluate compliance with the Code of Conduct, the Commission stated that it "expects to see evidence that the company has taken steps to renegotiate contracts in order to minimize the cost of gas, and will look to comparisons with other long-term supply options as informative as to whether this particular contract adheres to the requirements of the Code."[42]

- Finally, in the same 2020 DTE Electric PSCR plan case, the Commission also held that DTE would need to demonstrate that two contracts under which it purchased industrial waste gas from a different DTE affiliate "compl[y] with the pricing provisions under Rule 8(4)…"[43] The Commission held that DTE would need to demonstrate compliance in the reconciliation "particularly considering this expense issue being raised in this case and having not been previously adjudicated by the Commission on the merits under the Code or under Act 304, despite recovery of expense approval for both [waste gases] in the past."[44]

[40] Case No. U-20527, Order dated April 8, 2021, p. 22.

[41] *Id*.

[42] *Id*.

[43] *Id*. at 32-33.

[44] *Id*.

Requiring affiliate PSCR costs to comply with the Code of Conduct is longstanding Commission policy rather than a sudden change – let alone an unexplained one. Therefore, *Encino* does not apply and the Commission should reject I&M's argument.

G. Applying the Code of Conduct's market price rule to the OVEC costs does not unlawfully delegate legislative authority to the Commission.

I&M next argues that applying the market price rule to the OVEC costs would violate the nondelegation doctrine.[45] The nondelegation doctrine holds that the Legislature cannot constitutionally grant legislative power to an administrative agency.[46] Nondelegation is typically a challenge to the constitutionality of a statute.[47] Here, however, I&M does not clearly challenge the constitutionality of MCL 460.10ee, which required the Commission to establish the Code of Conduct. Rather, I&M at times appears to challenge the market price rule the Commission issued under the Code of Conduct; and at other times appears to challenge the application of the market price rule to limit recovery of affiliate PSCR costs. Neither challenge has any merit, and the question is not a close one.

[45] I&M Initial Brief, pp. 32-36.

[46] See for example, *North Michigan Land & Oil Corp v Public Service Commission*, 211 Mich App 424, 444–45 (1995).

[47] See for example, *Argo Oil Corp v Atwood,* 274 Mich 47 (1935).

To start, I&M relies principally on *State Conservation Dep't v Seaman,*[48] but fails to discuss all three principles that *Seaman* says must be used to evaluate a challenge under the nondelegation doctrine. Those principles are:

> First, the act in question must be read as a whole; the provision in question should not be isolated but must be construed with reference to the entire act.
>
> Second, the standard should be "as reasonably precise as the subject matter requires or permits."
>
> […]
>
> Third, if possible, the statute must be construed in such a way as to "render it valid, not invalid," as conferring "administrative, not legislative" power and as vesting "discretionary, not arbitrary, authority."[49]

Critically, I&M omits any mention of the third principle, which the Michigan Supreme Court in another case called "a presumption of constitutionality."[50] Consistent with that principle, *Seaman* upheld the statute in question against the nondelegation challenge in that case.

Here, MCL 460.10ee(1) provides in relevant part:

> The commission shall establish a code of conduct that applies to all utilities. The code of conduct shall include, but is not limited to, measures to prevent cross-subsidization, preferential treatment, and, except as otherwise provided under this section, information sharing, between a utility's regulated electric, steam, or natural gas services and unregulated programs and

[48] *State Conservation Dep't v Seaman,* 396 Mich 299 (1976).

[49] *Id*. at 309 (citations omitted).

[50] *Blue Cross & Blue Shield of Mich v Milliken*, 422 Mich 1, 51 (1985).

> services, whether those services are provided by the utility or the utility's affiliated entities.

This text clearly includes standards that are as reasonably precise as the subject matter requires or permits. And to the extent I&M is challenging the market price rule or the application of the market price rule under nondelegation, that rule is quite precise: "If an affiliate or other entity within the corporate structure provides services or products to a utility, and the cost of the service or product is not governed by section 10ee(8) of 2016 PA 341, MCL 460.10ee(8), compensation is at the lower of market price or 10% over fully allocated embedded cost."[51]

I&M also asserts that the statute does not "contemplate" the inclusion of a market price cap in the Code of Conduct.[52] I&M offers no authority or support for that assertion. The statute plainly requires the Code to include measure to prevent preferential treatment of affiliates, which is what the market price rule does. The statute plainly says that the Code of Conduct shall include certain types of measures but is not limited to those measures.

Further, the Code of Conduct is plainly based on 1998 guidelines for affiliate transactions published by the National Association of Regulatory Utility Commissioners (NARUC).[53] The NARUC guidelines include a market price cap

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[51] Mich Admin Code, R 460.10108(4). (MCL 460.10ee(8) is the section on value-added programs.)

[52] I&M Initial Brief, p. 34 ("subsection 10ee does not even contemplate a "price cap" on cost recovery associated with preexisting contracts…"); p. 35 ("although the Legislature generally authorized the Commission to develop a Code of Conduct, that authorization does not contemplate a "price cap" on Act 304 cost recovery…").

[53] NARUC, Guidelines for Cost Allocations and Affiliate Transactions (attached as Appendix 1) (see p 1 for date NARUC undertook the guidelines).

phrased in similar language: "Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices."[54] These issues are not unique to Michigan.

Moreover, the 2001 version of the Code of Conduct contained the same market price rule, and the appellate courts upheld it. The 2001 version of the Code stated that "[i]f an affiliate or other entity within the corporate structure provides services, products, or property to an electric utility or alternative electric supplier offering regulated service in Michigan, compensation for services and supplies shall be at the lower of market price or 10% over fully allocated embedded cost…"[55] In *Detroit Edison Co v Pub Serv Comm'n*, the Michigan Court of Appeals held that in enacting the Code, "the PSC was fulfilling its legislative mandate."[56] Later in the same case, the Michigan Supreme Court took issue with the process for adopting the Code of Conduct, but found that issue moot since the Legislature in 2004 "ratified the code of conduct established by the Public Service Commission."[57] If there was any reason to doubt that the Legislature contemplated a market price rule when it passed the first statute requiring the Commission to issue a Code of Conduct, there was no longer any such reason once the appellate courts upheld the Code and found that the Legislature ratified it.

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[54] *Id.*, p 4.

[55] Case No. U-12134, Order dated October 29, 2001, p. 3.

[56] *Detroit Edison Co v Mich Pub Serv Comm*, 261 Mich App 1, 9-10 (2004).

[57] *Detroit Edison Co v Pub Serv Comm'n*, 472 Mich 897 (2005)

I&M also relies on *Blue Cross & Blue Shield of Mich v Milliken* in support of its nondelegation challenge.[58] But that reliance is misplaced because the Court in *Blue Cross* "generally agree[d]" held that the statute at issue contained "absolutely no standards."[59] As just noted, the same is not true of the authorizing legislation for the Code of Conduct.

Finally, in Case No. U-21052, the PFD considered and rejected I&M's nondelegation argument. The ALJ found that the Code of Conduct and Act 304 are to be interpreted in harmony and therefore the Code does not supplant the PSCR standard; (2) the Code's authorizing statute did set a sufficient standard which the market price cap reasonably applies; and (3) the Legislature's ratification of the Code of Conduct essentially affirmed the Code.[60] The Commission in U-21052 adopted the PFD's legal analysis of this issue and other issues discussed below.[61]

H. Applying the Code of Conduct to 2021 OVEC costs is not impermissible retroactive application of statutes and rules.

Next, I&M argues disallowing recovery of OVEC costs under the Code of Conduct represents the impermissible retroactive application of a statute and/or rule.[62] Here again, I&M is unclear as to whether it is challenging the Code's authorizing statute, the market price rule, or just the application of the market price

[58] *Blue Cross & Blue Shield of Mich v Milliken*, 422 Mich 1 (1985).

[59] *Id*. at 53-55.

[60] Case No. U-21052, PFD dated March 29, 2023, pp. 27-28.

[61] Case No. U-21052, Order dated June 22, 2023, p. 21.

[62] I&M Initial Brief, pp. 36-40.

rule PSCR costs as impermissible retroactive action. In any event, I&M's argument fails, as described below.

I&M organizes its argument around the four factors set forth in *LaFontaine Saline, Inc v Chrysler Group, LLC*.[63] Those factors are: (1) "whether there is specific language providing for retroactive application;" (2) that "a statute is not regarded as operating retroactively merely because it relates to an antecedent event;" (3) in determining retroactivity, a court "must keep in mind that retroactive laws impair vested rights acquired under existing laws or create new obligations or duties with respect to transactions or considerations already past;" and (4) that "a remedial or procedural act not affecting vested rights may be given retroactive effect where the injury or claim is antecedent to the enactment of the statute."[64] Disallowing recovery of above-market OVEC costs in the PSCR is not impermissible retroactive application under *LaFontaine* for at least four reasons.

First, the market price rule precedes the current ICPA, not the other way around. The ICPA in effect today is the "Amended and Restated ICPA effective as of August 11, 2011."[65] As noted above, the authorizing statute for the original Code of Conduct was enacted in 2000, and the Commission first promulgated the market price cap rule in substantially identical form in 2001.[66] Because the market price rule

[63] *LaFontaine Saline, Inc v Chrysler Group, LLC*, 496 Mich 26 (2014).

[64] *Id*. at 38-39.

[65] Ex AG-2, OVEC Annual Report, p. 1.

[66] Case No. U-12134, Order dated December 4, 2000, p. 6. The Commission revised the Code on October 29, 2001. (U-12314-0223 (Oct. 29, 2001, Order on Rehearing). In *Detroit Edison Co v Pub Serv Comm'n*, 261 Mich App 1 (2004); *Detroit Edison Co v Pub Serv Comm'n*, 472 Mich 897 (2005), the Court of

precedes the current ICPA, it is not retroactive. While I&M claims that the *original* ICPA was executed in 1952, that agreement is not in evidence and its specific terms are unknown.

Second, the Commission has already found that applying the Code of Conduct to ICPA costs is not retroactive application at all. In Case No. U-20804, the Commission noted that "decisions made in a PSCR plan case are applied prospectively to inform reconciliations and not retroactively to PSCR factors set in earlier plan years, and as such it is appropriate to apply the Code of Conduct to the case at hand."[67] The PFD in U-21052 relied on this language in rejecting the same argument from I&M.[68]

Third, this case is distinguishable from *LaFontaine* as to factors (3) and (4) because the Code of Conduct does not strip I&M of vested rights. In *LaFontaine,* an automobile dealer entered into an agreement with Chrysler in 2007, when the Motor Vehicle Dealer Act (MVDA) defined the dealer's "relevant market area" as a six-mile radius.[69] When a 2010 amendment of the MVDA expanded the relevant market area to nine miles, the Michigan Supreme Court held that the new market area did not apply retroactively to void the market area expectation that the dealer had in its agreement with Chrysler.[70]

Appeals upheld the Code and the Supreme Court found that the Legislature ratified the Code in 2004. *Detroit Edison*, 472 Mich at 897.

[67] *See* Case No. U-20804, Order dated November 18, 2021, p. 17.

[68] Case No. U-21052, PFD dated March 29, 2023, p. 28.

[69] *LaFontaine Saline, Inc v Chrysler Group, LLC*, 496 Mich 26, 39; 852 NW2d 78 (2014).

[70] *Id*. at 42. More recently, the Michigan Supreme Court held in *Andary v USAA Casualty Insurance Co* that amendments to the Michigan No-Fault Act limiting lifetime benefits to persons who suffered

Here, by contrast, I&M did not have a vested right to charge customers above-market costs for power from its affiliate, nor did I&M have a reasonable expectation that it should be able to do so. Regulated utilities know that their costs and decisions will be scrutinized in PSCR cases. The law of utility regulation has required special scrutiny of affiliate transactions in one way or another for nearly a century. The U.S. Supreme Court recognized in 1932 that "[t]here is an absence of arms' length bargaining between the two corporate entities involved, and of all the elements which ordinarily go to fix market value."[71] For the 70 years that it was in effect, the Public Utility Holding Company Act of 1935 required registered utility holding company systems to price "at cost" the sale of goods and services between affiliate companies.[72] The U.S. Supreme Court held again in 1937 that "any relationship between the buyer and seller which tends to prevent arm's length dealing may have an important bearing on the reasonableness of the selling price."[73]

Likewise, the Michigan Court of Appeals has maintained for decades that affiliate transactions require special scrutiny:

> It is well recognized that expenses incurred in transactions between utilities and their affiliates deserve special scrutiny, given the potential lack of arms-length bargaining and improper subsidization of the affiliate's

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traumatic injuries in automobile accidents did not apply retroactively. *Andary v USAA Casualty Insurance Co,* __ Mich __; __ NW2d __; 2023 WL 4873660, *slip op* (July 31, 2023, Docket No. 164772). I&M does not discuss *Andary* in its initial brief but the same arguments regarding *LaFontaine* apply to *Andary*.

[71] *Western Distributing Co v Public Service Comm*, 285 US 119, 124; 52 S Ct 283, 284; 76 L Ed 655 (1932).

[72] Public Utility Holding Company Act of 1935, 15 USC § 79m(b), repealed by the Energy Policy Act of 2005, PL 109-58; 119 Stat 594.

[73] *Natural Gas Pipeline Co of America v Slattery*, 302 US 300, 307; 58 S Ct 199 (1937).

> unregulated operations through the utility's rates. The PSC need not assume that the fees charged to a utility by its affiliate are fair, and the utility has the burden of proving the reasonableness of its transaction with its affiliates.[74]

Unlike the change in the dealer's contracted market area, a statute or rule that codifies longstanding case law on affiliate transactions does not impair vested rights acquired under existing laws or create new obligations or duties. I&M never had a vested right or settled expectation that it could charge its customers more than market price for power from its affiliate.

Finally, the PFD in U-21052 rejected this same argument from I&M. It noted the Commission's holding in U-20804 that decisions in a PSCR plan case "are applied prospectively to inform reconciliations and not retroactively to PSCR factors set in earlier plan years, and as such it is appropriate to apply the Code of Conduct to the case at hand."[75] The Commission adopted this part of the PFD's analysis in its Order in U-21052 as well.

I. Applying the Code of Conduct to the 2021 OVEC costs does not violate the Contract Clause.

Next, I&M claims that applying the Code of Conduct would violate the Contract Clause by "prospectively impairing I&M's rights with regard to the

[74] *Midland Cogeneration Venture Ltd Partnership v Public Service Comm'n*, 199 Mich App 286, 313-14 (1993) (citations omitted); see also *Mich Bell Tel Co v Public Service Comm'n*, 85 Mich App 163, 168-69 (1978).

[75] Case No. U-21052, PFD, p. 28, quoting Case No. U-20804, Order dated November 18, 2021, p. 17.

ICPA..."[76] I&M the Michigan Supreme Court's three-step Contract Clause analysis from *Romein v General Motors Corp:*

a. Does the state law operate as a substantial impairment of a contractual relationship?

b. Is there a significant and legitimate purpose behind the regulation?

c. If there is a legitimate public purpose, are the means adopted to implement the legislation reasonably related to the public purpose?[77]

The Contract Clause requires a balancing approach:

> The modern United States Supreme Court has construed the Contract Clause as not prohibiting a state from exercising its police power to abrogate private or public contracts if reasonably related to remedying a social or economic need of the community. Under modern Contract Clause analysis, a balancing approach has been adopted by the courts, weighing the degree of the impairment of the contractual rights and obligations of the parties against the justification for the impairment as an act of the state's police power to implement legislation for a legitimate public purpose.[78]

Further, the governmental interest is given the greater weight in the balancing exercise: "Although the language of the Contract Clause is facially absolute, its prohibition must be accommodated to the inherent police power of the State to safeguard the vital interests of its people."[79] Applying the Code of Conduct to ICPA

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[76] I&M Initial Brief, pp. 40-41.

[77] *Romein v General Motors Corp*, 436 Mich 515, 534-36 (1990).

[78] *Blue Cross & Blue Shield of Michigan v Milliken*, 422 Mich 1, 20 (1985), quoted in Case No. U-17929, Order dated September 8, 2016, pp. 30-31.

[79] *Energy Reserves Group, Inc, v Kansas Power & Light Co*, 459 US 400, 410 (1983).)

costs does not breach any of the steps in the *Romein* analysis or run afoul of the balancing approach, for the reasons that follow.

As to the first step, I&M – like Consumers in U-17929 – "operates in a pervasively regulated industry, as was particularly noted in *Energy Reserves*, and parties to contracts in these types of industries must anticipate that regulations may change over the course of a contract."[80]

Further, the recommended disallowances of ICPA costs in this case are not substantial relative to the total PSCR or ICPA costs that I&M seeks to recover. I&M incurred a total of about $465.5 million in actual PSCR costs in 2021, including about $52.2 million of ICPA costs.[81] Staff recommends disallowing $803,809 of those costs.[82] The Attorney General recommends disallowing $2,613,485 or $1,556,993 at a minimum.[83] While these are substantial sums in an absolute sense, they are small fractions of I&M's OVEC costs in 2021 and miniscule fractions of I&M's total PSCR costs that year. Because there is no substantial impairment of a contractual relationship under the U.S. Supreme Court, Michigan Supreme Court, or MPSC precedents just discussed, there is no need to proceed any further with the Contract Clause analysis.

Just for the sake of argument, however, even if there was a substantial impairment, there would still be no Contract Clause violation. Under the second step,

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[80] Case No. U-17929, Order dated September 8, 2016, pp. 32-33, citing *Blue Cross*, *supra*, 422 Mich at 22 and *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400, 411–13 (1983).

[81] Ex IM-4, p. 3, lines 19 and 13, respectively.

[82] Staff Initial Brief, p. 12.

[83] Attorney General's Initial Brief, p. 39.

there is a legitimate public purpose underlying the Commission's requirements.[84] And under the third step, the Code of Conduct's market price rule is reasonably related to that public purpose – as the Commission enacted it under a statutory directive and in a manner consistent with longstanding case law and a NARUC model code, as discussed above.

The PFD in U-21052 addressed this issue too. After reciting the three-prong test for the Contract Clause, the PFD first found that any disallowance "does not impair – let alone substantially impair – the ICPA because I&M's rights and obligations under the ICPA remain the same; the only change would be the amount of money related to the ICPA that I&M can recover through the PSCR process."[85] Second, the PFD found that "even if there were a substantial impairment, the Code of Conduct serves a legitimate public purpose because it prevents preferential treatment among utilities and their affiliates."[86] Third, the PFD found that "the Code of Conduct's price cap is reasonably related to the proffered public purpose because it effectively prevents a utility from collecting excessive amounts under an affiliate contract."[87] As with the other legal issues, the Commission in U-21052 adopted the PFD's analysis.[88]

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[84] *See Energy Reserves*, 459 US at 411–13 ("One legitimate state interest is the elimination of unforeseen windfall profits" and "Courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.") (Internal citations and quotations omitted).

[85] Case No. U-21052, PFD, p. 29.

[86] *Id*.

[87] *Id*.

[88] Case No. U-21052, Order dated June 22, 2023, p. 21.

J. Applying the Code of Conduct to the 2021 OVEC costs is not a taking.

Next, I&M argues that a disallowance of OVEC costs would be an unconstitutional taking of its property under the Takings Clause.[89] I&M's argument is counter to U.S. Supreme Court precedent regarding takings claims by regulated utilities. "[T]he guiding principle has been that the Constitution [only] protects utilities from being limited to a charge for their property serving the public which is so unjust as to be confiscatory."[90] A rate is "confiscatory" if it is "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired," and thereby "practically deprive[s] the owner of property without due process of law."[91] A Takings Claim will fail where the "overall impact" of the utility commission's order is not confiscatory.[92]

I&M fails to argue that the disallowances recommended by Staff or the Attorney General meet the "confiscatory" standard. Piecemeal application of the Takings Clause, coupled with vague assertions of economic impact, do not establish a Takings violation.

The PFD in U-21052 addressed a similar argument by I&M, and found that the claim failed under the *Duquesne* standard. The PFD found that I&M did not argue that "any potential disallowance under the Code of Conduct would render the overall

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[89] I&M Initial Brief, pp. 43-47.

[90] *See Duquesne Light Co v Barasch*, 488 US 299, 307 (1989) (internal quotations and citations omitted).

[91] *Id.*; see also *Covington & Lexington Turnpike Rd Co v Sandford,* 164 US 578, 597 (1896).

[92] *Duquesne Light Co*, 488 US at 312.

PSCR plan or factors so low as to be confiscatory, and the utility thereby fails to provide an argument that addresses the pertinent analysis."[93] The Commission Order adopted the PFD's analysis.[94]

K. Due Process Clause.

I&M also argues that a disallowance of OVEC costs would violate the Due Process Clauses of the Michigan and United States Constitutions.[95] I&M offers two reasons for this claim: first, that a disallowance would violate the principle against regulating based on hindsight; and second, that a disallowance would represent an "unexplained inconsistency" in prior MPSC policy that "has engendered serious reliance interests…"[96]

I&M's arguments under the heading of the Due Process Clause are essentially identical to its arguments on pages 31-32 of its initial brief that a disallowance of OVEC costs would be arbitrary and capricious. There, I&M makes the same claims about regulating based on hindsight and an unexplained inconsistency in agency policy, and even asserts that such actions violate its due process rights. The Attorney General adopts by reference the same responses here.[97]

L. The Commission has repeatedly rejected I&M's argument that the Code of Conduct does not apply to the ICPA because it is a federally regulated wholesale service.

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[93] Case No. U-21052, PFD dated March 29, 2023, pp. 30-31.

[94] Case No. U-21052, Order dated June 22, 2023, p. 21.

[95] I&M Initial Brief, pp. 47-49

[96] *Id*.

[97] See Section II.F.2 of this Reply Brief.

I&M next argues that "[t]he Commission has established that wholesale purchase power agreements, such as the ICPA, do not give rise to an affiliate transaction subject to the Commission's Code of Conduct."[98] I&M bases its argument on a passing comment in a 2018 Commission Order that "the Code of Conduct does not apply to federally regulated wholesale services."[99] The Commission's comment concerned a different issue than the one raised here, and is inapplicable to the question of whether the Code applies to a regulated utility seeking recovery of power supply costs from an affiliate. I&M has made this same argument in several prior cases, and the Commission has rejected it each time.

The order cited by I&M, in Case No. U-18361, approved the current Code of Conduct administrative rules.[100] In that docket, Wolverine Power Supply Cooperative asked in a comment that the definition of "utility" in the Code be amended to clarify that the Commission was not asserting jurisdiction "over a federally regulated electric cooperative such as Wolverine which provides *only* wholesale service."[101] Wolverine explained that it "makes wholesale sales to its members and does not make any retail sales to end-use customers."[102] Therefore, Wolverine explained, it "is not subject to the Commission's regulation and should not be subject to the Proposed Rules."[103] Wolverine specifically requested:

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[98] I&M Initial Brief, p. 49.

[99] *Id*., citing Case No. U-18361, Order dated August 28, 2018.

[100] Case No. U-18361, Order dated August 28, 2018.

[101] *Id*. at 7 (emphasis added).

[102] Case No. U-18361, Comments of Wolverine Power Supply Cooperative dated June 29, 2018 ("Wolverine comments"), p 2.

[103] *Id*.

> In order to avoid unintentionally expanding its jurisdictional reach by applying the Proposed Rules to FERC-regulated electric cooperatives such as Wolverine, the Commission should include clarifying language in the Proposed Rule that reflects the statutory mandate limiting applicability of Section 10ee to utilities regulated by the Commission.[104]

The Commission granted Wolverine's request for clarification. The Commission added the underlined text to the definition of a utility under the Code:

> (f) "Utility" means an electric, steam, or natural gas utility regulated by the public service commission, and an electric or natural gas cooperative <u>that is subject to regulation pursuant to the Electric Cooperative Member-Regulation Act, 2008 PA 167, MCL 460.31 to 460.39</u>.[105]

Thus, the Order cited by I&M relates to the *types of entities* subject to the Code of Conduct, and not the *types of contracts* subject to the Code of Conduct. I&M is an electric utility regulated by the Commission and subject to the Code of Conduct under the first clause in the definition of "utility." The clarification requested by Wolverine had nothing to do with the types of contracts subject to the Code or regulated utilities like I&M. The Code contains no exemption for affiliate contracts for wholesale services nor for affiliate contracts approved by FERC.

I&M cites PFDs in Case Nos. U-20529 and U-20224 to support its argument, but the Commission overruled the PFDs in both of those cases on this point. In Case No. U-20529, the Commission held:

> The language relied upon by the company and the ALJ in determining that the ICPA is not subject to the Code of

[104] *Id.* at 3.

[105] Case No. U-18361, Order dated August 28, 2018, Exhibit B, p. 2.

> Conduct was clarifying language with respect to the definition of "utility" under Rule 2(1)(e). In the present case, however, I&M purchases power through the ICPA to serve its retail customers. Expanding the conclusions of the August 28 order to include any and all transactions—even between affiliates—that flow through regional wholesale markets or involve a contract approved by FERC would render meaningless the provisions of the Code of Conduct. That the Commission cannot do. As such, the Commission distinguishes this case and finds the phrase "the Code of Conduct does not apply to federally regulated wholesale services" is inapplicable to the ICPA and amendments at issue here.[106]

The Commission reiterated this same holding in Case No. U-20224.[107] The PFD in Case No. U-21052 also rejected I&M's argument that wholesale power agreements with affiliates are exempt from the Code, and the Commission adopted the PFD's analysis.[108]

As part of its argument that the Commission exempted wholesale power contracts from the Code of Conduct, I&M also argues that the Commission is required to exempt them on account of federal preemption.[109] That argument duplicates I&M's next argument regarding FERC preemption, and the Attorney General address it in the next section.

M. The Commission has repeatedly rejected I&M's argument that a disallowance of OVEC costs would violate the FERC filed rate doctrine.

[106] Case No. U-20529, Order dated May 13, 2021, p. 16.

[107] Case No. U-20224, Order dated June 23, 2021, p. 11.

[108] Case No. U-21052, PFD, pp. 30-31 and Order, p. 21.

[109] I&M Initial Brief, pp. 49 and 51.

As I&M next argues that the FERC filed rate doctrine bars the Commission from disallowing any of the costs I&M paid to OVEC.[110] The FERC filed rate doctrine prohibits a state utility commission from holding a FERC-approved wholesale rate to be unreasonable.[111] The Commission has rejected I&M's argument several times before. The Commission should reject it again here, for two reasons.

First, the Commission has found several times that FERC did not approve any rate associated with the ICPA. In I&M's 2020 PSCR plan, the Commission stated:

> FERC did not directly approve a rate or an allocation like that in *Nantahala*. In accepting the 2004 and 2010 amendments to the ICPA, FERC expressly noted that:
>
> > This action does not constitute approval of any service, rate, charge, classification, or any rule, regulation, contract, or practice affecting such rate or service provided for in the filed documents; nor shall such action be deemed as recognition of any claimed contractual right or obligation affecting or relating to such service or rate; and such action is without prejudice to any findings or orders which have been or may hereafter be made by the Commission in any proceeding now pending or hereafter instituted by or against any of the applicant(s).[112]

The Commission reaffirmed this finding in I&M's 2019 PSCR reconciliation and 2021 PSCR plan cases.[113]

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[110] I&M Initial Brief, pp. 49-53.

[111] *Nantahala Power & Light Co v Thornburg*, 476 US 953 (1986).

[112] Case No. U-20529, Order dated May 13, 2021. p. 20, citing December 13, 2004 FERC letter in Docket Nos. ER04-1026-000 and ER04-1026-001.

[113] Case No. U-20224, Order dated June 23, 2021, p. 13; Case No. U-20804, Order dated November 18, 2021, pp. 18-19.

Even if FERC had approved a rate, charge, or contract in the filing acceptance letters for the ICPA, that approval still would not bar the MPSC from disallowing a portion of the OVEC costs under the Code of Conduct. The Federal Power Act recognizes the MPSC's exclusive jurisdiction over retail rates charged to Michigan customers.[114] While preemption under the filed-rate doctrine precludes an entity from challenging a wholesale rate approved by FERC, a state utility commission is permitted to address the reasonableness of including those costs in retail customers' rates. As the Federal Third Circuit Court of Appeals explained in *Kentucky West Virginia Gas Co v Pennsylvania Public Utility Commission*:

> Although *Nantahala* underscores that a state cannot independently pass upon the reasonableness of a wholesale rate on file with FERC, it in no way undermines the long-standing notion that a state commission may legitimately inquire into whether the retailer prudently chose to pay the FERC-approved wholesale rate of one source, as opposed to the lower rate of another source.[115]

FERC has held that "while the state cannot review the reasonableness of the wholesale rate set by the Commission, it may determine whether it is in the public interest for the wholesale purchaser whose retail rates it regulates to pay a particular price in light of its alternatives."[116]

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[114] 16 USC § 824(b); *see FERC v Electric Power Supply Ass'n*, 136 S Ct 760, 776 (2016); *Hughes v Talen Energy Marketing, LLC*, 136 S Ct 1288, 1292 (2016) (FPA gives FERC exclusive authority to regulate wholesale sales but "leaves to the States alone, the regulation of 'any other sale'—most notably, any retail sale—of electricity.").

[115] *Kentucky West Virginia Gas Co v Pennsylvania Public Utility Commission*, 837 F.2d 600, 609 (3rd Cir. 1988).

[116] *Central Vermont Public Service Corporation*, 84 FERC ¶ 61,194, 61,973 (August 21, 1998).

Pike County Light & Power Co v Pennsylvania Public Utility Comm'n is quite similar to this case.[117] In *Pike County,* the retail utility, Pike, had a power supply agreement with its parent company, Orange & Rockland, that was filed with FERC. An ALJ for the Pennsylvania Public Utility Commission (PUC) found that the utility's reliance on its parent company "as a source of power represented an abuse of management discretion in consideration of available, alternative, more economical, supplies of electricity."[118] The PUC adopted the ALJ's recommended disallowance based on a comparison of the cost of power from Pike's parent company with the cost of power purchases from an unaffiliated power company – Pennsylvania Power & Light (PP&L) – which were estimated based on publicly available data.[119] The court rejected Pike's argument that the disallowance was barred by the filed rate doctrine:

> [W]hile the FERC determines whether it is against the public interest for Orange & Rockland to charge a particular rate in light of its costs, the PUC determines whether it is against the public interest for Pike to pay a particular price in light of its alternatives. The regulatory functions of the FERC and the PUC thus do not overlap, and there is nothing in the federal legislation which preempts the PUC's authority to determine the reasonableness of a utility company's claimed expenses. In fact, we read the Federal Power Act to expressly preserve that important state authority.[120]

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[117] *Pike County Light & Power Co. v. Pennsylvania Public Utility Comm'n*, 77 PA Cmwlth 268; 465 A2d 735 (1983).

[118] 465 A2d at 736.

[119] *Id*. at 738.

[120] *Id*.

When Pike argued that there was no evidence it could have actually obtained a power supply contract with PP&L on the terms used to estimate the disallowance, the court found that "there is no evidence indicating why, in view of the cost advantages apparent in power purchases from PP&L, Pike failed to even explore this alternative to the more costly purchases from its parent company."[121]

The MPSC has twice held that even if FERC had approved the ICPA's wholesale rates, the filed rate doctrine would still not prevent the MPSC from disallowing I&M's recovery of a portion of the OVEC costs in retail rates. In Case No. U-20529, the Commission held:

> Through the application of the Code of Conduct discussed above, the Commission is not determining the reasonableness of a FERC-approved rate. Rather, the Commission will evaluate the reasonableness and prudence of I&M's decision to purchase from OVEC, an affiliate, as opposed to another source at a lower rate or market price. See, *id*. Therefore, the Commission finds that it is not preempted from applying Rule 8(4) to this case as it is within its authority to establish the cost of retail service through considering the reasonableness and prudence of I&M's decision.[122]

The Commission reiterated this same holding in Case No. U-20224: "In evaluating the ICPA, the Commission is not determining the reasonableness of a FERC-approved rate, but rather is evaluating the reasonableness and prudence of I&M's decision to purchase from OVEC pursuant to requirements under Act 304."[123]

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[121] *Id*.

[122] Case No. U-20529, Order dated May 13, 2021, p. 21.

[123] Case No. U-20224, Order dated June 23, 2021, p. 13.

I&M also cites the unpublished Michigan Court of Appeals decision in *Wabash Valley Power Ass'n v Pub Serv Comm*, to argue that FERC has exclusive authority to determine the reasonableness of wholesale rates and that any MPSC decision in conflict with FERC's authority "must fail."[124] However, *Wabash* is distinguishable.

In *Wabash,* the Wabash Valley Power Association paid off its loans to the Rural Utilities Service and became subject to FERC's exclusive jurisdiction during the pendency of Wabash's PSCR reconciliation case. Wabash sought to withdraw its PSCR application because the MPSC no longer had jurisdiction over Wabash and FERC had issued an order in its proceeding that addressed the same costs that were at issue in the PSCR case. The Court of Appeals found that "FERC expressly determined that it would exercise exclusive jurisdiction over all rates, terms and conditions of wholesale electric service and transmission in interstate commerce provided by Wabash, including any existing contracts and addressed the 2003 cost recovery issue."[125] Because FERC had expressly assumed exclusive jurisdiction, the MPSC had no authority to review Wabash's costs in the PSCR reconciliation.

Nothing similar to *Wabash* has occurred in this case. I&M is still fully subject to the jurisdiction of the MPSC. There is no pending FERC proceeding over the ICPA costs. FERC has not issued any orders assuming exclusive jurisdiction over I&M's recovery of costs paid to OVEC in 2021. Therefore, *Wabash* has no application here.

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[124] I&M Initial Brief, pp. 51 and 49, quoting and citing *Wabash Valley Power Ass'n v Pub Serv Comm*, unpublished per curiam opinion of the Court of Appeals, issued December 15, 2005 (Docket No. 260773).

[125] *Id*. at *2.

For these reasons, the FERC filed rate doctrine does not preempt the MPSC from disallowing I&M's recovery in retail rates of a portion of the OVEC costs.

N. Disallowing above-market OVEC costs under the Code of Conduct does not contravene *Union Carbide* because the Commission's authority to disallow cost recovery does not interfere with utility management decisions.

In addition to the FERC preemption argument, I&M also argues that the Commission cannot disallow ICPA costs under *Union Carbide.*[126] I&M's argument is misplaced. While *Union Carbide* does say that the Commission may not usurp a utility's power to make management decisions, *Union Carbide* also upholds the Commission's broad authority to disallow costs in order protect ratepayers from the negative economic consequences of those management decisions.

In *Union Carbide Corp v Public Service Comm,* the Michigan Supreme Court held that while the Commission could not prevent a utility from operating certain electric generating units uneconomically, the Commission could prevent the utility from passing the costs on to customers:

> The commission acted properly in preventing Consumers from passing on to ratepayers any additional fuel expenses incurred while operating the Karn units out of economic order. This portion of the commission's order related directly to its power to regulate rates and charges; Consumers was passing through to the consuming public increased charges due to its noneconomic operation.[127]

[126] I&M Initial Brief, pp. 53-55, citing *Union Carbide Corp v Public Service Comm,* 431 Mich 135, 149 (1988).

[127] *Union Carbide Corp v Public Service Comm,* 431 Mich 135, 149; 428 NW2d 322 (1988).

Likewise, in *Consumers Power v Public Service Comm,* Consumers sought to recover from customers $38.5 million to settle a breach of contract suit with Union Carbide arising from Consumers' failure to take minimum amounts of oil required by contracts between the two. The Commission declined to allow Consumers to recover any of the settlement payment because it found that Consumers imprudently renegotiated the contracts. The Court of Appeals affirmed.[128]

In this case, the Commission would not be attempting to make management decisions for I&M regarding OVEC and the ICPA. Rather, the Commission would be disallowing the portion of the cost of I&M's power purchase from its affiliate that was above market price. That decision falls squarely within the Commission's authority under *Union Carbide* and *Consumers.*

O. The Commission should apply the Code of Conduct to the above market costs I&M paid for power from AEG's portion of Rockport under the UPA.

Finally, I&M argues that the high costs I&M paid its affiliate AEG under the UPA for AEG's share of power from the Rockport plant were reasonable and prudent, and that the Commission should not apply the Code of Conduct to these purchases.[129] The Attorney General largely anticipated I&M's arguments regarding the evidence on this issue in her initial brief.[130]

[128] *Consumers Power v Public Service Comm,* 196 Mich App 687, 691 (1992).

[129] I&M Initial Brief, p. 55.

[130] Attorney General's Initial Brief, pp. 39-45.

I&M also includes the AEG costs and the UPA in a number of its legal arguments against applying the Code of Conduct to the OVEC costs and the ICPA. The Attorney General addressed those arguments in the reply to I&M's legal arguments about OVEC costs. The Attorney General replies to those arguments in summary fashion as follows:

I&M argues that applying the Code to the UPA costs violates the nondelegation doctrine.[131] The Attorney General's reply in Section I.G, above, applies equally to the UPA.

I&M also argues that applying the Code to the UPA would constitute impermissible retroactive ratemaking.[132] To the contrary, the Commission's statement in Case No. U-20804 that "decisions made in a PSCR plan case are applied prospectively to inform reconciliations and not retroactively to PSCR factors set in earlier plan years, and as such it is appropriate to apply the Code of Conduct to the case at hand" applies with equal force to the UPA costs.[133] Further, the UPA costs are distinguishable as to factors (3) and (4) of the *LaFontaine* analysis because the Code of Conduct does not strip I&M of vested rights. All of the discussion in Section I.H, above, regarding the nature of regulated utilities and the longstanding law regarding affiliate transactions applies equally to the UPA.

I&M also argues that applying the Code of Conduct to the UPA violates the contract clause.[134] The Attorney General's reply regarding ICPA and the Contract

[131] I&M Initial Brief, p. 35.
[132] I&M's Initial Brief, p. 37.
[133] *See* Case No. U-20804, Order dated November 18, 2021, p. 17.
[134] I&M Initial Brief, pp. 40-41.

Clause applies similarly to the UPA.[135] As to the first step in the Contract Clause analysis, the impairment is not substantial because the Attorney General's proposed disallowances range from $18.3 million to $20.6 million out of $218 million that I&M paid its affiliate AEG under the UPA in 2021.[136] The public purpose and relationship to public purpose considerations are the same as discussed in Section I.I, above.

I&M also argues that applying the Code of Conduct to the UPA is an unlawful taking.[137] The Attorney General's response is the same as in Section I.J, above – substituting the dollar figures for total UPA costs and proposed disallowances just mentioned.

I&M does not mention the UPA in its arguments about the claimed exemption of wholesale power contracts from the Code of Conduct, the FERC filed rate doctrine, or *Union Carbide*. In case I&M brings up any of these issues in reply, the Attorney General relies on the same arguments. It is worth specifically pointing out that when it comes to the UPA and the FERC filed rate doctrine, FERC's acceptance letter for the most recent version of the UPA contained very similar language to the ICPA letters:

> This acceptance for filing shall not be construed as constituting approval of the referenced filing or of any rate, charge, classification, or any rule, regulation, or practice affecting such rate or service contained in your filing; nor shall such acceptance be deemed as recognition of any claimed contractual right or obligation associated therewith; and such acceptance is without prejudice to any

[135] See Section I.I of this reply brief, above.
[136] Attorney General's Initial Brief, pp. 44-45 (disallowances) Ex IM-4, p. 3, line 12 (total AEG purchases).
[137] I&M Initial Brief, p. 44.

> findings or orders which have been or may hereafter be made by the Commission in any proceeding now pending or hereafter instituted by or against AEG.[138]

Finally, it is worth noting again that I&M also has chosen for the past few years to disregard the Commission's directive in Case No. U-18404 to address the inflated return on equity that I&M pays its affiliate AEG under the UPA. The Attorney General discussed this point in her initial brief.[139]

II. REPLY IN SUPPORT OF STAFF REGARDING I&M'S FAILURE TO COMPLY WITH THE EWR STATUTE

In its initial brief, Staff explains that in 2020 I&M failed to meet the statutory requirement to achieve energy savings levels of at least 1.0% of its retail electricity sales.[140] Staff explained that I&M's failure in this regard is unprecedented.[141] In Case No. U-20867, the Commission required I&M to evaluate the impact of the company's failure to achieve the statutory minimum savings level on its PSCR costs and needs.[142] I&M submitted such an analysis in this case, arguing that the failure to meet the minimum EWR savings level provided financial savings to customers in the PSCR. Staff witness Karen Gould testified that the Commission should reject I&M's conclusion, and presented a number of options for the Commission to consider in addressing the cost of customers of I&M's failure. The Attorney General supports Staff's recommendations concerning this issue.

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[138] Docket No. ER19-717-000, FERC letter dated February 14, 2019, p. 2.

[139] Attorney General's Initial Brief, pp. 9-10.

[140] Staff Initial Brief, p. 13.

[141] *Id*. at 14-15.

[142] Case No. U-20867, Order dated March 17, 2022, p. 10.

Respectfully submitted,

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Appendix 1

Guidelines for Cost Allocations and Affiliate Transactions:

The following Guidelines for Cost Allocations and Affiliate Transactions (Guidelines) are intended to provide guidance to jurisdictional regulatory authorities and regulated utilities and their affiliates in the development of procedures and recording of transactions for services and products between a regulated entity and affiliates. The prevailing premise of these Guidelines is that allocation methods should not result in subsidization of non-regulated services or products by regulated entities unless authorized by the jurisdictional regulatory authority. These Guidelines are not intended to be rules or regulations prescribing how cost allocations and affiliate transactions are to be handled. They are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocations and affiliated transactions. Variation in regulatory environment may justify different cost allocation methods than those embodied in the Guidelines.

The Guidelines acknowledge and reference the use of several different practices and methods. It is intended that there be latitude in the application of these guidelines, subject to regulatory oversight. The implementation and compliance with these cost allocations and affiliate transaction guidelines, by regulated utilities under the authority of jurisdictional regulatory commissions, is subject to Federal and state law. Each state or Federal regulatory commission may have unique situations and circumstances that govern affiliate transactions, cost allocations, and/or service or product pricing standards. For example, The Public Utility Holding Company Act of 1935 requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies.

The Guidelines were developed by the NARUC Staff Subcommittee on Accounts in compliance with the Resolution passed on March 3, 1998 entitled "Resolution Regarding Cost Allocation for the Energy Industry" which directed the Staff Subcommittee on Accounts together with the Staff Subcommittees on Strategic Issues and Gas to prepare for NARUC's consideration, "Guidelines for Energy Cost Allocations." In addition, input was requested from other industry parties. Various levels of input were obtained in the development of the Guidelines from the Edison Electric Institute, American Gas Association, Securities and Exchange Commission, the Federal Energy Regulatory Commission, Rural Utilities Service and the National Rural Electric Cooperatives Association as well as staff of various state public utility commissions.

In some instances, non-structural safeguards as contained in these guidelines may not be sufficient to prevent market power problems in strategic markets such as the generation market. Problems arise when a firm has the ability to raise prices above market for a sustained period and/or impede output of a product or service. Such concerns have led some states to develop codes of conduct to govern relationships between the regulated utility and its non-regulated affiliates. Consideration should be given to any "unique" advantages an incumbent utility would have over competitors in an emerging market such as the retail energy market. A code of conduct should be used in conjunction with guidelines on cost allocations and affiliate transactions.

A. DEFINITIONS

1. Affiliates - companies that are related to each other due to common ownership or control.

2. Attestation Engagement - one in which a certified public accountant who is in the practice of public accounting is contracted to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

3. Cost Allocation Manual (CAM) - an indexed compilation and documentation of a company's cost allocation policies and related procedures.

4. Cost Allocations - the methods or ratios used to apportion costs. A cost allocator can be based on the origin of costs, as in the case of cost drivers; cost-causative linkage of an indirect nature; or one or more overall factors (also known as general allocators).

5. Common Costs - costs associated with services or products that are of joint benefit between regulated and non-regulated business units.

6. Cost Driver - a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.

7. Direct Costs - costs which can be specifically identified with a particular service or product.

8. Fully Allocated costs - the sum of the direct costs plus an appropriate share of indirect costs.

9. Incremental pricing - pricing services or products on a basis of only the additional costs added by their operations while one or more pre-existing services or products support the fixed costs.

10. Indirect Costs - costs that cannot be identified with a particular service or product. This includes but not limited to overhead costs, administrative and general, and taxes.

11. Non-regulated - that which is not subject to regulation by regulatory authorities.

12. Prevailing Market Pricing - a generally accepted market value that can be substantiated by clearly comparable transactions, auction or appraisal.

13. Regulated - that which is subject to regulation by regulatory authorities.

14. Subsidization - the recovery of costs from one class of customers or business unit that are attributable to another.

B. COST ALLOCATION PRINCIPLES

The following allocation principles should be used whenever products or services are provided between a regulated utility and its non-regulated affiliate or division.

1. To the maximum extent practicable, in consideration of administrative costs, costs should be collected and classified on a direct basis for each asset, service or product provided.

2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, regulatory authorities may consider incremental cost, prevailing market pricing or other methods for allocating costs and pricing transactions among affiliates.

3. To the extent possible, all direct and allocated costs between regulated and non-regulated services and products should be traceable on the books of the applicable regulated utility to the applicable Uniform System of Accounts. Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.

4. The allocation methods should apply to the regulated entity's affiliates in order to prevent

subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates, and vice versa.

5. All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.

6. The primary cost driver of common costs, or a relevant proxy in the absence of a primary cost driver, should be identified and used to allocate the cost between regulated and non-regulated services or products.

7. The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they relate using relevant cost allocators.

C. COST ALLOCATION MANUAL (NOT TARIFFED)

Each entity that provides both regulated and non-regulated services or products should maintain a cost allocation manual (CAM) or its equivalent and notify the jurisdictional regulatory authorities of the CAM's existence. The determination of what, if any, information should be held confidential should be based on the statutes and rules of the regulatory agency that requires the information. Any entity required to provide notification of a CAM(s) should make arrangements as necessary and appropriate to ensure competitively sensitive information derived therefrom be kept confidential by the regulator. At a minimum, the CAM should contain the following:

1. An organization chart of the holding company, depicting all affiliates, and regulated entities.

2. A description of all assets, services and products provided to and from the regulated entity and each of its affiliates.

3. A description of all assets, services and products provided by the regulated entity to non-affiliates.

4. A description of the cost allocators and methods used by the regulated entity and the cost allocators and methods used by its affiliates related to the regulated services and products provided to the regulated entity.

D. AFFILIATE TRANSACTIONS (NOT TARIFFED)

The affiliate transactions pricing guidelines are based on two assumptions. First, affiliate transactions raise the concern of self-dealing where market forces do not necessarily drive prices. Second, utilities have a natural business incentive to shift costs from non-regulated competitive operations to regulated monopoly operations since recovery is more certain with captive ratepayers. Too much flexibility will lead to subsidization. However, if the affiliate transaction pricing guidelines are too rigid, economic transactions may be discouraged.

The objective of the affiliate transactions' guidelines is to lessen the possibility of subsidization in order to protect monopoly ratepayers and to help establish and preserve competition in the electric generation and the electric and gas supply markets. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility, its ratepayers and competition. As with any transactions, the burden of proof for any exception from

the general rule rests with the proponent of the exception.

1. Generally, the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.

2. Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.

3. Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of prevailing market price or net book value, except as otherwise required by law or regulation. Generally, transfer of assets from an affiliate to the utility should be at the lower of prevailing market price or net book value, except as otherwise required by law or regulation. To determine prevailing market value, an appraisal should be required at certain value thresholds as determined by regulators.

4. Entities should maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation.

E. AUDIT REQUIREMENTS

1. An audit trail should exist with respect to all transactions between the regulated entity and its affiliates that relate to regulated services and products. The regulator should have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with the guidelines. Regulators should have complete access to affiliate records, consistent with state statutes, to ensure that the regulator has access to all relevant information necessary to evaluate whether subsidization exists. The auditors, not the audited utilities, should determine what information is relevant for a particular audit objective. Limitations on access would compromise the audit process and impair audit independence.

2. Each regulated entity's cost allocation documentation should be made available to the company's internal auditors for periodic review of the allocation policy and process and to any jurisdictional regulatory authority when appropriate and upon request.

3. Any jurisdictional regulatory authority may request an independent attestation engagement of the CAM. The cost of any independent attestation engagement associated with the CAM, should be shared between regulated and non-regulated operations consistent with the allocation of similar common costs.

4. Any audit of the CAM should not otherwise limit or restrict the authority of state regulatory authorities to have access to the books and records of and audit the operations of jurisdictional utilities.

5. Any entity required to provide access to its books and records should make arrangements as necessary and appropriate to ensure that competitively sensitive information derived therefrom be kept confidential by the regulator.

F. REPORTING REQUIREMENTS

1. The regulated entity should report annually the dollar amount of non-tariffed transactions

associated with the provision of each service or product and the use or sale of each asset for the following:

a. Those provided to each non-regulated affiliate.

b. Those received from each non-regulated affiliate.

c. Those provided to non-affiliated entities.

2. Any additional information needed to assure compliance with these Guidelines, such as cost of service data necessary to evaluate subsidization issues, should be provided.

PROOF OF SERVICE - U-20805

The undersigned certifies that a copy of the ***Attorney General's Reply Brief*** was served upon the parties listed below by e-mailing the same to them at their respective e-mail addresses on the 16th day of October 2023.

Michael E. Moody Digitally signed by Michael E. Moody Date: 2023.10.16 14:04:41 -04'00'

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