

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of Consumers Energy Company for Authority to increase its rates for the distribution of natural gas and for other relief. MPSC Case No. U-20650

Attorney General's Reply Brief

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I. Introduction

On June 19, 2020, the Attorney General of Michigan filed an Initial Brief in this matter before the Michigan Public Service Commission (“the Commission”) responding to the Application filed by Consumer’s Energy Company seeking rate relief for its natural gas business. Other parties to this proceeding also filed their Initial Briefs on June 19, 2020 including, Consumers Energy Company (“Consumers Energy,” “Consumers,” “CECo,” or “the Company”), Michigan Public Service Commission Staff (MPSC Staff or Staff), the Association of Businesses Advocating Tariff Equity (ABATE), Energy Michigan, Inc., Lansing Board of Water and Lights, Retail Energy Supply Association, Michigan State University, Citizens Utility Board of Michigan, and the Residential Customer Group (RCG).

The Attorney General files this Reply Brief primarily to respond to or otherwise address arguments made by the other parties in their briefs. The Attorney General’s decision not to address certain issues in this Reply Brief is not a waiver of those issues. The Attorney General’s briefs and supporting testimony and exhibits should be considered in total in evaluating her position on the issues appearing in this case.

On December 16, 2019, Consumers Energy Company filed its application seeking \$245 million in rate relief for the 12-month period ending September 30, 2021 (“projected test year” or “test year”). In addition, the Company sought the continuation of a Revenue Decoupling Mechanism (RDM), approval of a Capital

Spending Deferral and Recovery mechanism. Since filing its application, Consumers Energy has made a downward adjustment to its test year revenue request and is now seeking approximately \$229 million which was reiterated in its Initial Brief.¹ The Company is still seeking a return on equity (“ROE”) of 10.50% and an overall rate or return of 6.09% (after tax)² for the projected test year.

The Attorney General participates in rate cases in general, as an advocate for ratepayers. Her goal is to represent the interest of the people paying the utility bills who might not have the ability to adequately voice their concerns in the proceedings. As always, it is the Company’s burden to prove that its requests are reasonable and prudent.³

This Reply Brief will address the following issues:

1. The Attorney General’s proposed adjustments to the Company’s capital expenditures are reasonable.
2. The Company’s equity balance proposal is unnecessary and unreasonable.
3. Consumers Energy’s failure to justify its request for an authorized return on equity of 10.50%.

¹ Initial Brief of Consumers Energy Company, p.4.

² See, Initial Brief of Consumers Energy Company, p. 169 and Appendix F, page 2.

³ See, Attorney General’s Initial Brief p. 11.

4. The Attorney General's proposed adjustments to industrial throughput are reasonable.
5. The Commission should adopt the Attorney General's proposed adjustments to the Company's O&M expenses because they are reasonable.

The Attorney General requests that the Commission make the adjustments proposed in this brief as well as her Initial Brief.

ARGUMENTS

II. Capital Expenditures

The Company disagreed with most of the Attorney General's proposed reductions to Capital Expenditures in its initial brief. The Attorney General stands by its proposed reductions as described in her initial brief and will only reply to a few issues addressed in the Company's initial brief in this reply brief.

First, the Attorney General will respond to a misstatement by the Company that "[b]ased on this pandemic, the Company carefully considered where to deploy its capital and continues to work hard to limit the costs requested to be included in customers rates."⁴ The Company filed its filing announcement on November 1, 2019, its filing summary on December 12, 2019 and its application in this case on December 16, 2019. In its filing summary, the Company recounted its previous gas

⁴ Initial Brief of Consumers Energy Company, p.3.

rate case U-20322 which was primarily driven by its infrastructure investment and then identified the driver for its rate increase in this case as its continued infrastructure investment. It also noted that despite its request for \$204 million in case U-20322, the Commission only authorized \$143.5 million annually with a Return on Equity of 9.9%.⁵ But, nowhere in the above referenced filings was there mention of the COVID-19 pandemic.

As noted in the Attorney General's Initial Brief, the Company's did not address COVID-19 on the record, until it responded to a request by the Attorney General's witness to reconsider and prioritize its capital expenditure requests in light of the COVID-19 outbreak. Instead of exercising some restraint, the Company co-opted the COVID-19 outbreak as a basis to reinforce its funding requests. The pandemic clearly did not play a role in the Company's determination of the amount its rate increase request contrary to the Company's representation.

Before COVID-19, the Company's ever-increasing capital expenditures were putting rate pressure on ratepayers, especially individuals with low or fixed income. Given the impact of COVID-19 on ratepayers, especially residential, affordability is even a bigger concern. The Attorney General recommends that every proposed increase in capital expenditure be subjected to scrutiny and that the Company be

⁵ Dkt. No. U-20650-002, pp 1 – 5.

strictly held to its burden to prove that such expenditures are not only reasonable and prudent, but necessary.

A. MAOP M&R Program

The Company disagrees with the Attorney General's proposal that the Commission approve a partial disallowance of the Company's projected expenditures for the MAOP M&R program in its initial brief.⁶ Although the Attorney General believes that a full disallowance is justified, she proposes a partial disallowance because the genesis of problems being addressed occurred many years ago. According to the Company, the Commission had previously decided against holding utility companies liable for old business decisions.⁷ However, Commission decisions are not strictly precedential and based on the facts in this case it would not be reasonable to hold ratepayers responsible for costs that could have been avoided by the Company.

The costs are being incurred because the Company failed to keep records that would document or verify things such as pressure records, pipe locations, missing pipe and fittings specifications, whether previous maximum allowable operating pressure for its transmission pipelines were commensurate with regulations, and pressure tests. These are not minor issues and the Company should have record of

⁶ Initial Brief of Consumers Energy Company, p. 30-31

⁷ Initial Brief of Consumers Energy Company, p. 30.

these items for safety reasons. The Attorney General does not know whether recordkeeping requirements were necessarily less stringent in the past, however she gave the Company the benefit of the doubt that they may have been in recommending shared responsibility of the cost.

The Company also referred to its argument in Section IV.A.2.e.ii.a of its Brief to support its contention.⁸ In that section, the Company refers to both a Court of Appeals and a Commission decisions. Neither decision should be used as a basis to reject the Attorney General's proposed disallowance.

The Company cites to *Detroit Edison Co v Public Service Commission*, 261 Mich App 448, 452 (2004) for the proposition that the utility does not have the benefit of hindsight in accruing costs, and the PSC must review the utility's expenditure in light of the knowledge that was available at the time the expenditures were made. This is not applicable to the instant case. The decision is being made now and the Company knows why the costs are being incurred, including its failure to maintain the necessary records. This situation is like all situations in which the Commission should evaluate whether cost being incurred is reasonable and prudent given the totality of the evidence and the Attorney General argues that it is not.

⁸ Initial Brief of Consumers Energy Company, pp. 62 – 63.

The DTE Gas order in U-18999 cited by the Company does not support its position. In that case, the Commission decided that it was “not appropriate to deny cost recovery for necessary safety upgrades based on design decisions made, in some instances, a generation ago, especially when the issue was not brought to light until the 2014 Staff audit. The Commission also notes that some of these costs, while not previously litigated, were included for recovery in Case No. U-17999. Therefore, the Commission finds that the Staff’s proposed \$5.826 million disallowance should be rejected.”⁹ However, context matters. According to the record in U-18999, Staff had audited DTE Gas’s safety standards between 1957 and 2014, but only identified DTE’s interpretation of the standard as wrong in 2014. In addition, recovery of similar costs had been recovered in a previous rate case. The Company has not alleged that these factors are present in this case. The cases are factually distinguishable. The Commission should approve the Attorney General’s proposed disallowance.

B. EIRP

The Company reiterated it plan to increase EIRP expenditures while implementing a grid approach for selecting projects under the guise that selecting projects based on the highest average risk concentration of pipe in a defined area, which will result in larger projects will improve productivity, costs, and ultimately

⁹ September 13, 2018 order, Case No. U-18999, p. 37.

reduce impact to customers.¹⁰ The Attorney General recommended adjustments to this program in her initial brief.¹¹

In response to her proposed adjustment of \$4.6 million due to the Company underspending the projected 2019 amount, the Company argued despite this underspend that the full amount should be approved. Its basis was that Mr. Coppola did not make adjustments when the Company spent more than it projected on other projects. First, the Attorney General's role in this case is as a ratepayer advocate, and she points out expenditures that it would be unreasonable to require ratepayers to pay because the Company fails to support the amount of the expenditure. It is unreasonable to charge ratepayers for costs that the Company previously identified as being necessary but did not actually incur. Second, it is the Company obligation to identify and support the amounts that it needs to invest in capital expenditures. In those other situations alluded to by the Company, it appears that it failed to do so.

The Company also disagrees with certain alternative spending limits recommended by the Attorney General's witness in its initial brief.¹² Mr. Coppola recommended that the Company test year expenditure for the EIRP program be limited to \$97 million due to uncertainties about the likelihood that the Company

¹⁰ Initial Brief of Consumers Energy Company, pp 40 – 41.

¹¹ Attorney General's Initial Brief, pp. 41 – 49.

¹² Initial Brief of Consumers Energy Company, pp. 43 – 44.

will perform all of the proposed work in the test year. She also recommends that any amounts that the Company spends above its forecasted \$917,000 cost per mile be deferred in a regulatory asset account and reviewed for reasonableness and prudence in a subsequent rate case.

The Company's opposes the first recommendation asserting that the planned scope of construction for 2021 under the grid approach is expected to provide economies of scale and help reduce the costs per mile. Nothing in the Attorney General's proposal interferes with the Company achieving economies of scale, if anything she is asking that the Company be made to prove that its proposal will reduce costs to the benefits of ratepayers. The Company's proposal would increase the amount of work over what had been performed in prior years. And, this is a program that the Company has already overspent on. It is already questionable whether the Company will meet its 25-year target for completing the work.¹³ The Company is now asking ratepayers to trust that the grid approach along with increased spending will result in savings. The Attorney General's recommendation is a reasonable approach to hold the Company's feet to the proverbial fire to get the work done in a manner that will finally result in savings for ratepayers.

With regard to the second, per-mile proposal, the Company opposes being held to its projected cost per mile and having the overspent amount deferred to a

¹³ Initial Brief of Consumers Energy Company, p.40.

future rate case. The Company identifies several factors that it claims have impacted the EIRP costs over the years.¹⁴ The factors are either vague or are issues that should have been anticipated and addressed accordingly. The Company also claims other opportunities exist to review the costs – especially in future rate cases without the deferral method.¹⁵ However, the Commission is less likely to disallow costs that the Company has already incurred. And, the Company will likely argue that its unreasonable to deny recovery for costs already incurred – just as it has in this case. A deferral mechanism makes it clear to all the Company will still need to make the case that expenditures above its projected costs per mile are subject to a reasonableness and prudence review and there is no presumption in its favor.

III. Working Capital Adjustments

The Company disagreed with the Attorney General’s recommended reduction in working capital in its brief. Specifically, it disagreed with her proposed reduction in the amount of \$23.8 million to reflect an updated and lower cost of gas of \$2.335 Mcf.¹⁶ The Company’s brief does not provide analysis specific to the Attorney General’s recommendation and instead addresses a similar proposed reduction in the cost of gas by Staff. According to the Company, Staff’s proposal to rely on the NYMEX settlement prices from the first five business days of February 2020 to

¹⁴ Initial Brief of Consumers Energy Company, p.44.

¹⁵ *Id.*

¹⁶ Initial Brief of Consumers Energy Company, p. 159.

determine the average cost of gas is arbitrary and that the Commission should instead use its estimate based on forward NYMEX settlement prices from the first five business days of August 2019. It also claims that use of Staff's proposed cost of gas would understate the cost of gas.¹⁷ The record does not support the Company's claim.

First, the Company's argument that the Commission should approve the cost of gas calculated based on the forward NYMEX settlement prices from the first five business days of August 2019 should be used because it was consistent with methodology used in previous gas rate cases should be disregarded. Use of those particular forward NYMEX prices is not required. The information is now stale. The Company appears to be insisting on the use of the August 2019 date to keep the cost of gas higher. The August 2019 prices simply corresponds to the filing of this case, however since the case was filed more contemporary and lower forward NYMEX prices have occurred. And, it is not unusual for projections and costs to be adjusted during the pendency of a case based on new and better information. Approval of the Company's projected cost of gas will result in ratepayers incurring more costs than justified.

Second, the Company's claim that because the test year NYMEX prices as of April 2020 are significantly higher than Staff's proposal (\$2.306/MMBtu), that the

¹⁷ Initial Brief of Consumers Energy Company, p. 157 and 159.

Company's use of the August 2019 prices is a more reasonable estimate is untrue.¹⁸ As discussed above, the forward settlement price for the first five business days of February 2020 results in a lower projected cost of gas for the test years. Further, the average price of gas for the first five business days of April was only \$2.482/MMBtu, which occurred in the early and uncertain days of the COVID-19 pandemic.¹⁹ The Company's proposal is excessive.

The Attorney General recommends that the Commission use the updated GCR/GCC 13-month average cost of gas in underground storage of \$2.335/Mcf based on the average NYMEX prices for the first five business days of February 2020.²⁰ This results in a reduction of \$23.8 million to the cost of gas stored underground and a corresponding reduction in Working Capital.

IV. Capital Structure and Cost of Debt

Consumers Energy continues to propose a capital structure with 52.50% equity in its Initial Brief.²¹ While acknowledging the Commission's previous directive regarding moving to a more balanced debt-equity ratio and its own plan to move to a 50% equity ratio over several year, the Company indicates that it is

¹⁸ Initial Brief of Consumers Energy Company, p. 158.

¹⁹ Initial Brief of Consumers Energy Company, p. 158.

²⁰ Attorney General's Initial Brief, p. 90.

²¹ Initial Brief of Consumers Energy Company, p.170.

unable to make such a movement.²² According to the Company “events have occurred that would challenge a lock-step march toward a 50/50 equity ratio which imprudent at this time and into the foreseeable future.”²³ For the second rate case the Company reiterated its view that enactment of the Tax Cut and Jobs Act (TCJA) of 2017 has interrupted its move to a 50% equity ratio. It now adds the COVID-19 pandemic as an excuse for not moving toward a balanced debt/equity ratio.²⁴ The Company has not demonstrated that these events justify delaying its move to a completely balanced debt-equity ratio.

The Attorney General provided extensive analysis and reasons for moving to a balanced equity ratio and rejecting the Company’s proposal to stop its planned progression at a 52.5% equity ratio in her initial brief.²⁵ Therefore, this Reply Brief will provide very brief responses to some points raised by the Company in its Initial Brief.

The Company alleges that quantitative evidence and rationale support its claim that it cannot reasonably or prudently rebalance its equity ratio - “While the TCJA was, in itself, enough to cause concern over the impacts on the Company’s credit rating, the Company’s access to the financial markets, and implementation of its capital expenditure program, these concerns have been further exacerbated by

²² Initial Brief of Consumers Energy Company, p. 172.

²³ Initial Brief of Consumers Energy Company, p. 173

²⁴ *Id.*

²⁵ Attorney General’s Initial Brief, pp.90 – 101.

the COVID-19 pandemic”²⁶ - is based on generalities. While the credit ratings agencies have made general observations about the potential impact of the TCJA on the utility industry, their specific analysis and recommendations for Consumers Energy appeared to have taken the impact of the TCJA into consideration and they have either issued stable opinions or have otherwise not recommended a downgrade in the Company’s credit ratings because of it.²⁷

The Company argues that maintaining the current 52.05% equity ratio or lowering it further will result in a weakening of the Company’s FFO-to-Debt ratio and that on top of the TCJA and now COVID-19, would lead to a major deterioration of the quality of the credit available to the Company as assessed by the ratings agencies key financial metrics.²⁸ This is not true.

The Company’s senior secured debt is rated as “A” by S&P.²⁹ Furthermore, on page 3 of its January 29, 2020 report on Consumers Energy, S&P indicated that it would lower the Company’s rating if its stand-alone financial measures weaken such that its FFO to debt weakens and remains consistently below 15% or if it lowered the rating on its parent, CMS Energy.³⁰

²⁶Initial Brief of Consumers Energy Company, p. 173.

²⁷See *e.g.*, Exhibit AG-65.

²⁸ Initial Brief of Consumers Energy Company, p. 180.

²⁹ See, Exhibit A-23 (MRB-8).

³⁰ 3 TR 202.

In its June 19, 2019 report, Moody's stated that it would consider a downgrade if the regulatory environment in Michigan becomes less constructive and if financial metrics deteriorate "...such as CFO pre-W/C falling to below 20% or if parent [company] debt increases...."³¹ Page 9 of Moody's June 19, 2019 report shows the CFO Pre-W/C to Debt ratio at 22.3% for the 12 months ended March 2019, which was above the 20% coverage threshold more than a year after the TJCA went into effect.³²

In addition, Mr. Coppola calculated the Company's key cash flow to debt coverage ratios for 2017 adjusted for the TCJA, and the ROE and Common Equity ratio levels advocated by the Attorney General case. He used both the S&P and Moody's coverage ratio results for 2017 and adjusted them for the TCJA cash flow changes, the ROE rate of 9.50%, and a 50% common equity capital ratio. The result was that the cash flow coverage ratios dropped slightly to 18.3% for S&P and 21.1% for Moody's which would still have exceeded the minimum cash flow to debt coverage ratios of both rating agencies in 2017 by comfortable margins even after adjusting for the TCJA, a 9.5% ROE and a 50% common equity ratio.³³

³¹ See, Exhibit AG-65 - Moody's report (page 2) "Factors that could lead to a downgrade" provided by CECo in response to DR AG-CE-098 Attachment.

³² 3 TR 203 – 204.

³³ See, 3 TR 201 – 206 and Exhibit AG-39 for a complete analysis.

The Company has not demonstrated that it has suffered negative repercussions from a credit perspective for the Company because of the TCJA. It has not presented evidence of any negative credit actions against it because of the TCJA. In fact, it has viewed the TCJA as providing an opportunity to increase capital expenditures.³⁴

The Company's speculation about the impact of the COVID-19 pandemic does not provide a basis to further delay balancing the Company's debt/equity ratio and most certainly does not provide a basis for increasing the current equity ratio of 52.05% to 52.50%. The Company admits in its initial brief that the long-term impact of the pandemic is unknown.³⁵ While the Company refers to some general industry statements by the rating agencies or ratings outlooks for other utilities, it has not provided anything that indicates that the COVID-19 pandemic has led to a downgrade to the Company's credit ratings.³⁶ The Company does not provide evidence of any specific financial impacts to the Company that justifies a 52.5% equity ratio.

The Company misconstrues the Attorney General's arguments regarding the linkage between it and its parent, CMS Energy and impact of CMS using debt to

³⁴ Attorney General's Initial Brief, p. 93 – 94.

³⁵ Initial Brief of Consumers Energy Company, p.174.

³⁶ Initial Brief of Consumers Energy Company pp. 174-175.

fund equity infusions into Consumers Energy Company.³⁷ As noted in the Attorney General's initial brief, the relationship between Consumers Energy and CMS impacts the Company's proposed capital structure.³⁸ Their connection has an impact from a credit metric's standpoint. To the extent that the Company argues that potential negative credit ratings should influence its equity ratio, then the Commission should not ignore its relationship with CMS Energy because the ratings agencies are not ignoring it. As noted in the Attorney General's Initial Brief, the excessive debt and low common equity ratio (now approximately 29%) at CMS is a continuing concern for the rating agencies when assessing the debt rating of Consumers Energy. For example, in its June 19, 2019 credit update report on the Company, Moody's stated identified high leverage at the parent company as a credit challenge and an increase of parent debt as one of the factors that can lead to downgrade.³⁹ It is not clear how much the debt-laden capital structure of CMS has contributed to a lower debt rating than the Company could have achieved if CMS was capitalized with more equity capital. But, to the extent it negatively effects the Company rating, it can only result in higher interest costs for customers.⁴⁰

³⁷ Initial Brief of Consumers Energy Company pp. 191-192.

³⁸ Attorney General's Initial Brief, pp. 99-100.

³⁹Exhibit AG-65 page 2 of 9. *See also*, Exhibit AG-65 page 6 of 9.

⁴⁰ Attorney General's Initial Brief, pp.99-100.

The Company also argued that the Attorney General claim that Consumers Energy's equity ratio is higher than those of its peer group is inaccurate because the Attorney General relied on equity ratios at the parent holding company level and that the subsidiaries' actual ratios were higher than the ratio recommended by the Attorney General.⁴¹ This argument misses the point of Mr. Coppola's testimony on this issue.⁴² First, after removing the riskier non-utility operations from the peer group, the utility portion of the peer group's capital structure was lower than 50%.⁴³ Second, and more importantly, the peer group used by Mr. Coppola is the same peer group he used to determine the Company's cost of equity because the calculation of the ROE and the capital structure need to be synchronized by using the capital structure of the same publicly traded companies used to calculate the group proxy ROE.

Investors will look at the capital structure and debt leverage of the publicly traded company when determining what return on investment they should expect based on the financial risk of the Company as reflected in the capital structure. A higher equity ratio, and thus lower debt in the capital structure requires a lower return on equity given that there is less financial risk with the investment, and vice versa, a lower equity ratio requires a higher ROE. Mr. Coppola calculated a 9.5%

⁴¹ Initial Brief of Consumers Energy Company, pp. 192 – 193.

⁴² TR 196 – 197.

⁴³ See, Exhibit AG-44.

ROE (which is higher than the true cost of equity of 8.59%⁴⁴) based on a peer group equity ratio of 50% for the group. The Company's calculation of a 10.50% ROE based on a 52.5% equity ratio is inconsistent with this basic investment analysis as it seeks to maximize both its equity ratio and its ROE. In addition, the Company's proposed equity ratio is not based on the publicly traded peer group used by the Company in calculating the proxy ROE for the peer group and is therefore unsupported and disconnected from the calculation of the ROE rate.⁴⁵

The Company prefers to use the equity ratios of non-publicly traded subsidiaries of the companies in the peer group, which do not reflect the risk profiles of the companies in which investors will be investing. The Company's proposed equity ratios have no relationship to the equity ratios that investors rely on to make investment decisions.

The Company's plan to put the move to a 50% equity ratio on hold indefinitely is not supported by the record. Enactment of the TCJA, does not require this result. Nor does the recent COVID-19 pandemic. Interestingly, the Company claims that its common equity ratio is balanced from a GAAP financial and ratings agency basis at just over 50%.⁴⁶ However that claim is misleading,

⁴⁴ See, 3 TR 237. See also, Exhibit AG-40.

⁴⁵Initial Brief of Consumers Energy Company, p 207. See also, 3 TR 1306 and Exhibit A-14 (SM-1), Schedule D-5.

⁴⁶ Initial Brief of Consumers Energy Company, pp. 175 and 194.

because the Company goes on to state that certain adjustments require an equity ratio of 52.50% for regulatory purposes.⁴⁷ Other than to provide a general explanation of the items included and excluded between the two presentations, the Company provides no quantitative information to assess this claim (dollar amounts).⁴⁸ There is no reason for the financial and regulatory capital structure to diverge by 2.5%. The reality is that the Company had given lip service to a balanced equity ratio for years before the Commission forced it to address the issue directly. It only briefly committed to working towards a balanced ratio. For the last two rate cases, the Company has used the TCJA as a basis for retreating from the commitment it made to move to a balanced equity ratio. And, it has now added the COVID-19 pandemic as an excuse for not move to a balanced debt/equity ratio.

The Company has not made a persuasive case for delaying a move to a balanced equity ratio in this proceeding and the Attorney General sees no need to even delay such a move to 2023. The Attorney General recommends that the Commission approve a 50-50 balanced debt to equity ratio thus saving ratepayers approximately \$15.2 million annually.⁴⁹

⁴⁷ Initial Brief of Consumers Energy Company pp. 185 – 186.

⁴⁸ See, Exhibit AG-69 (AG-CE-485).

⁴⁹ 3 TR 211 – 212.

V. The Company's proposed return on equity is excessive.

The Company continues to seek an excessive return on equity (ROE). In its Initial Brief, the Company reiterated its request for an authorized ROE of 10.50%.⁵⁰ The proposed ROE is 60 basis points higher than the Company's most recently authorized rate of return in Consumer Energy's natural gas rate case, No. U-20322. The Company cites to the state of the economy and capital markets, its need to make capital investments, its risk profile, established principles for setting a fair ROE, and the results of various economic models as the basis for its proposed cost of equity.⁵¹ The Company also cites to the impacts to its financial strength, the TCJA and COVID-19 as a basis for its proposed ROE. None of the factors identified by the Company support such an excessive ROE.

A. The Company's claims are based on vague or general business and economic factors should be rejected.

Much of the support offered by the Company for its proposed ROE is based on arguments about business or economic conditions that are vague and generalized. The Company has not presented any credible evidence that its gas operations has a risk profile supporting a 10.50% ROE. The Company has and continues to meet its obligations and earn at or above its ROE. The United States is still experiencing low interest rates. And, while there has been some recent turbulence in the

⁵⁰ Initial Brief of Consumers Energy Company, p.169.

⁵¹ Initial Brief of Consumers Energy Company, p. 196.

markets, as discussed in the Attorney General’s Initial Brief, that turbulence does not require the kind of ROE requested by Consumers Energy.⁵²

The Company argues that an attractive ROE is important because it results in equity and therefore financial resources and capital *being provided by utility shareholders* to support debt financing raised by the utility, procure contracts with suppliers and fund unplanned and unexpected expenses.⁵³ In other words to access capital markets. Of course, Consumers Energy does not sell its stock on the market to raise capital. Its parent holding company, CMS Energy, which consists primarily of Consumers Energy Company, can sell its stock on the market. To the extent that Consumers Energy’s performance impacts the value of CMS’s stock the Company continues to be a low risk investment alternative with above average earnings potential. However, as discussed in the Attorney General’s Initial Brief and above, CMS has its own financial weaknesses that if not managed, can impact its stock performance.⁵⁴

The Company also posits that in addition to competing for external private capital investment, “Internally, the management team, as fiduciaries, must weigh whether investment in the utility provides sufficient risk-adjusted returns relative to other options including natural gas utility investments, investments in other

⁵² Attorney General’s Initial Brief, pp. 103 – 104.

⁵³ Initial Brief of Consumers Energy, p.199.

⁵⁴ Attorney General’s Initial Brief, p. 99.

jurisdictions, non-regulated investments, or simply returning capital to shareowners in the form of dividends and/or share repurchases.”⁵⁵ This testimony illuminates the kind of regard that the Company holds for ratepayers. In addition to funding the operation of the Company’s natural gas business in its service territory, ratepayer also provide a reasonable return to the benefit of its “shareholders” which consists solely of CMS. Any use of those funds outside of the Company’s jurisdiction and for non-regulated investments should be considered unreasonable and imprudent.

B. The Company has not demonstrated that a ROE of 10.50% is needed for Michigan’s regulatory environment to be conducive to investments.

The Company’s reliance on an investor expectation argument and analysts’ opinions as a basis for its proposed excessive rate is misplaced. The Company’s witness alludes to the view that Michigan’s regulatory environment has historically been viewed as constructive and that the positive view has shifted to one of cautious optimism.⁵⁶ In addition, the Company is also alleging that a fear of “ROE creep” and the continued supportiveness of the regulatory environment in Michigan has

⁵⁵ Initial Brief of Consumers Energy Company, p. 199, citing Maddipati testimony, 3 TR 1280.

⁵⁶ Initial Brief of Consumers Energy Company, p. 200.

been voiced by some “investment analyst sources” as a basis for not only keeping its artificially high ROE but pushing it even higher.⁵⁷

First, the Company has not provided a clear definition for how it defines a “constructive regulatory environment.” In Case No. U-18124, it alluded to it involving issues beyond just ROEs. However, implicit in the Company’s discussion of the term is the notion that constructive regulatory environments include higher than average authorized ROEs.

Second, the Company also implies that decreasing ROEs amount to ROE creep.⁵⁸ The concept of ROE creep is based on a false narrative. The higher ROEs that Michigan experienced were a product of the perception that Michigan was a higher risk place to invest and the overall economic downturn during the “great” recession. However, Michigan’s economy has rebounded economically from that period. While the COVID-19 issue continues to unfold, it is pure speculation that the Company needs a 10.50% ROE to attract investors. As discussed in the Attorney General’s initial brief and her witness’s testimony, the true cost of equity is even much lower than the current 9.9% ROE.

Third, the Company has not demonstrated that a 10.50% ROE is needed to maintain the Company’s ability to access capital at reasonable rates. In fact, the

⁵⁷ Initial Brief of Consumers Energy, pp. 201.

⁵⁸ Initial Brief of Consumers Energy Company, p. 200

record shows that the Company has had no problem with accessing capital at its current ROE. Under the guiding principles of *Bluefield* and *Hope*,⁵⁹ a utility is only entitled to a reasonable ROE to attract investment, not an exorbitant return.

The Company's proposed ROE is not based on reality. It continues to inflate its ROEs with the hopes of keeping its authorized returns artificially high. It is evident from Mr. Maddipati's testimony in support of the ROE – that the Company constructed its analysis using unconventional inputs and methods that are not widely accepted to reach a certain ROE range, instead of using realistic inputs and sound analysis to determine the ROE.

C. The Attorney General's recommended ROE meets the requirements of *Bluefield* and *Hope*.

As discussed in the Attorney General's Initial Brief, the Supreme Court addressed the standard for the recovery of rate in the *Bluefield* case and it was reinforced in the *Hope* case. The Company summarized the standard in its brief as: (i) compensation for risk, which is comparable to certain other companies of like risk; (ii) adequate return to ensure the financial soundness of the business; and (iii) sufficient return to maintain credit and attract capital.⁶⁰ The Supreme Court's standard also involves consideration and balancing of interest to arrive at a

⁵⁹ *Bluefield Water Works and Improvement Company v Public Service Commission of West Virginia* 262 U.S. 679 (1923) (emphasis added) and *FPC v Hope Natural Gas Company*, 320 U.S. 591 (1944).

⁶⁰ Initial Brief of Consumers Energy Company, p. 197.

reasonable return: “The return should be *reasonably sufficient* to assure confidence in the financial soundness of the utility and should be adequate, *under efficient and economical management*, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties...”⁶¹ It is not a blank check to investors or the Company. It requires the Company to efficiently and effectively manage its business including presumably the type and timing and investments it makes.

As noted in her initial brief, the Attorney considered the effect of risk on a utility’s required return on equity. Generally, utilities are not as risky as many other businesses due to the regulatory scheme which provides for rate increases if reasonable and prudent and authorized rates of return. As a result, a utility’s return should be lower than other riskier businesses. The Attorney General also considered that a utility’s return should be comparable to other businesses with similar degree of risk in order to maintain its financial soundness including maintain its credit standing and attract capital for investment.⁶² As discussed below and in her Initial Brief, with regard to the application of the various ROE

⁶¹ *Bluefield Water Works and Improvement Company v Public Service Commission of West Virginia* 262 U.S. 679 (1923) (emphasis added) and *FPC v Hope Natural Gas Company*, 320 U.S. 591 (1944) (emphasis added).

⁶² Attorney General’s Initial Brief, p. 103.

models that also consider these issues, the Attorney General recommended an appropriate ROE.

The Attorney General also considered the ability of the Company to attract credit. The Company argues that an authorized ROE as proposed by the other parties to the case will impair the Company's ability to access capital markets.⁶³ The Attorney General addressed the impact of a lower ROE on the Company, including the impact on its FFO/debt ratio in her Initial Brief and determined that even if there was an impact the Company should still be able to access credit. In addition, a review of ROE decisions from some other jurisdictions contradict the Company's argument that a lower ROE would be detrimental to it. In exhibit AG-46, the Attorney General provides a list of 56 gas utilities that have received ROEs below 10% in the last two years. On page 2 of that exhibit, it lists several utilities that have had access to capital markets while having ROEs below 10%.⁶⁴

In response to evidence that other utilities have thrived with lower ROEs, the Company asserts that "Staff and intervenor analysis seek to "average down" the Company's ROE by comparing Consumers Energy to companies that have poor performance with their customers and operate in unconstructive regulatory environments."⁶⁵ However, the Company does not provide any evidence that the

⁶³ Initial Brief of Consumers Energy, pp. 201.

⁶⁴ 3 TR 233. *See also*, Exhibit AG-46.

⁶⁵ Initial Brief of Consumers Energy Company, p. 219.

companies used by Staff or the intervenors have poor performance with customers. The Company's argument is based on nothing more than unsubstantiated accusations.

As discussed below, and in her Initial Briefs, the Attorney General's proposed ROE is based on the principled application of commonly accepted and used quantitative models. However, reference to lower ROEs in other jurisdictions should help alleviate any concerns that the Commission may have regarding the financial impact of a lower ROE on the utility. This information should also dispel the notion that a ROE rate below 10% and in line with the 9.5% proposed by the Attorney General would impair the Company's ability to raise capital.

D. The Company overstates the impact of the TCJA and the COVID-19 pandemic.

According to the Company "[e]ach of the other ROE witnesses in this case either disregarded the impacts of the TCJA and COVID-19 or they discussed its significance without any meaningful analysis of the impact."⁶⁶ This statement is not accurate because Mr. Coppola did give due consideration to the TCJA both in this case and the previous gas rate case U-20322, in which the Company first raised this argument.⁶⁷ He evaluated potential changes to the Company's credit metrics,

⁶⁶ Initial Brief of Consumers Energy Company, p.205.

⁶⁷ Mr. Coppola was involved in all of Consumers Energy's TCJA cases: U-20102 For Consumers Energy's electric Credit A; U-20103 for Consumers Energy's (gas) credit A; U-20286, U-20287 for Consumers Energy's Credit B cases, and U-20309, for

capital structure, working capital, and reviewed analysts' evaluations of Consumers Energy. Mr. Coppola concluded that the Company still had a positive or stable outlook even with the TCJA. More importantly, while the Company argues that its credit metrics have been weakened, it has demonstrated actual harm from the TCJA. And, making an adjustment for the TCJA just for the sake of an adjustment is not warranted.

The Company argues that S&P, Moody's and Fitches lowered the North American utilities sector outlook to negative due to COVID-19 and emphasized the need for sufficient liquidity to weather a prolonged period of financial volatility and turbulent capital market.⁶⁸ The Attorney General addressed this issue in her Initial Brief and volatility in the market does not provide a basis for the Company's proposed ROE.⁶⁹ And, while the Company also claims that COVID-19 has further weakened its financial credit metrics, it has not provided information specific to the Company to support this claim. And, as discussed above the long-term impact of the COVID-19 pandemic is unknown. It has not proven that a 10.50% is required because of the pandemic. In any event, the ROE as calculated by the Attorney General already considers all the risk necessary to be considered.

Calculation C. He evaluated the TCJA's impact not only from a revenue perspective, but also other financial impacts even before this rate case was filed.

⁶⁸ Initial Brief of Consumers Energy Company, p. 203.

⁶⁹ Attorney General's Initial Brief, pp. 103 – 104.

The commonly used models already consider market conditions and the perception of risk in calculating a ROE. The DCF method provides the minimal return for a company to attract and maintain investment in the company's common equity. It represents the investor's expectation based on currently available market information. It is a measuring stick to compare alternative investment opportunities.⁷⁰ The CAPM method is based on an analysis of risks. It considers two types of risks: risk that investors can diversify away or reduce by combining different investments into a portfolio; and market risk that an investor cannot reduce by diversification. Therefore, the CAPM method is a risk premium model, based on the calculation of the risk differential between investments on the market portfolio and the individual stock. The purpose of using the CAPM model to calculate the required return on the individual investment is to find the equivalent return for an investor based on the relative risk of the investment as compared to the alternative investment opportunities.⁷¹

The Company has not yet explained how the TCJA impacts or COVID-19 are unique to it or make it riskier when compared to other investment opportunities. And, as discussed below, the Attorney General's proposed ROE does consider unique risks related to Consumers Energy and how those risks are perceived.

⁷⁰ Attorney General's Initial Brief, p.64.

⁷¹ Attorney General's Initial Brief, p.66.

E. Problems with the Company's application of quantitative models.

The Company manipulated the various models and their inputs to support its proposed 10.5% ROE.⁷² Rather than go painstakingly through Mr. Coppola's analysis again in response to the Company's Initial Brief, the Attorney General will refer to his analysis of the main fallacies of the Company's calculation of its proposed ROE which can be found on pp. 112-115 of the Attorney General's Initial Brief and Mr. Coppola's Direct Testimony.⁷³

The 9.5% ROE proposed by the Attorney General is a very conservative estimate. While the true cost of equity is approximately 8.59%, the Attorney General's witness recommends a ROE of 9.5% in consideration of any unique risks and circumstances that may exist for the Company and as a bridge between the current ROE and the recommended ROE.

The Attorney General recommends that a ROE of no more than 9.5% be approved by the Commission.

VI. Throughput.

The Company objected to the Attorney General's adjustment to industrial deliveries from 300 Bcf to 308 Bcf because it is higher than the Company's weather

⁷² Initial Brief of Consumers Energy Company, pp. 209 – 218.

⁷³ TR 224 – 238.

adjusted deliveries in the last ten years, customers are using less energy because of the Company's Energy Waste Reduction Program, and that Mr. Coppola's approach simply looked at historic usage and forecasts for one subset of customers to remain at historic levels.⁷⁴ The Company's argument is untrue because Mr. Coppola not only looked at historic levels but he also considered the Company's future projections in recommending his adjustments. Considering the totality of the evidence, the Company's reduced volume projection for the test year is unsupported.

The Attorney General's Initial Brief⁷⁵ addresses the fact that the Company's industrial gas delivery volumes in the past three years have ranged from a high of 62,247 million cubic feet (MMcf) in 2018 to a low of 59,907 MMcf in 2017 with 2019 volumes near the middle at 60,464 MMcf. The Company's projection of 52,482 MMcf for the project test period ending in September 2021 is extremely low in comparison, especially while considering that its projected volume for the whole year of 2021 was 61,743 MMcf.⁷⁶ The projected volume for 2020 was projected at 57,524 MMcf. The 52,482 MMcf is an outlier and the Company does not explain why there is such a significant decline in industrial delivery volumes for the projected test year.

⁷⁴ Initial Brief of Consumers Energy Company, p. 223.

⁷⁵ Throughput and sales were addressed jointly on pages 118 – 122 of the Attorney General's Initial Brief.

⁷⁶ Exhibit AG-51.

In light of the Company's inadequate explanation of why the test year volumes are projected to deviate so much, Mr. Coppola's approach of using the actual gas deliveries from 2019 to project the level of gas deliveries for the projected test year is reasonable. Therefore, the Attorney General recommends that the Commission adopt 60,464 MMcf as the revised forecast of gas deliveries for industrial customers for the projected test year. This level of gas deliveries is 7,982 MMcf higher than forecasted by the Company.

VII. Other O&M Expense.

In her Initial Brief, the Attorney General recommended \$25.6 million in reductions to this category of expenses. See, pages 84 – 104. In this reply brief, the Attorney General is providing additional arguments or comments for select expenses in response to the Company's Initial Brief.

A. Incentive Compensation

Consumers Energy asserts that its EICP is reasonable and beneficial to ratepayers, which is not supported by the record in this case and ratepayers should not be required to fund it.

First, the Company admits in its Initial Brief that it cannot quantify all of the benefits to ratepayers for both operational and financial measures.⁷⁷ In fact, the

⁷⁷ Initial Brief of Consumers Energy Company, p. 279 and 278, respectively.

operational metrics that it did try to quantify generally applied to the provision of electric service and not gas service. And, its claim that benefits associated with only two of the operational goals demonstrate there are substantial benefits associated with these metrics – namely employee safety. However, the purported savings do not take into consideration other ratepayer funded items that may also influence those metrics and therefore the claim has not been substantiated.

Second, the Company also asserts that ratepayers are benefitted because a portion of employee is pay is put at risk.⁷⁸ However, compensation related to the EICP is not truly at risk. Employees qualify for incentive pay at 100% of target if they meet only 6 of 9 measures and 50% of target if they only meet 4 of 9 measures.⁷⁹ The program assumes payout at 100% of target level which the Company expect to occur 8 to 9 times every 10 years.⁸⁰ That means that employees are projected to earn incentive compensation 80% to 90% of the time. In fact, non-officer employees have received payouts of above target 8 of 9 times in the last nine years.⁸¹

Third, with regard to financial measures, the Company argues that while financial incentives may provide benefits to shareholders, this does not mean that

⁷⁸ *Id* at 281.

⁷⁹ 3 TR 267.

⁸⁰ Initial Brief of Consumers Energy Company, p.284.

⁸¹ 3 TR 264.

they do not provide *meaningful* benefits to customers.⁸² The Company does not define what it means by “meaningful.” The Commission requires more than that: “[E]xecutive bonus and employee incentive plans require a showing that the **benefits to ratepayers from the bonus and incentive plans, at a minimum, will be commensurate with the programs costs. Moreover, the utility has the burden of establishing how the proposed programs benefit ratepayers.**”⁸³ Financial measures related to earnings per share and operating cash flow disproportionately benefit shareholders.

Finally, the Company claims that by seeking incentive compensation costs at target levels, the Company absorbs incentive compensation costs in years when actual payments are greater than target which results in shareholders contributing to the cost.⁸⁴ This is no bargain for ratepayers. In years that the payout is at or below target, ratepayers alone will carry the burden of paying for the EICP. And, even if the payout exceeds target, ratepayers will still disproportionately pay for any benefits they may receive and will definitely pay most of the cost for benefits received by shareholders.

⁸² Initial Brief of Consumers Energy Company, p. 278 (emphasis added).

⁸³ Order in Case No. U-14347, dated December 22, 2005 (December 22 Order), P. 34. (Emphasis added).

⁸⁴ Initial Brief of Consumers Energy Company, p.278.

As the Commission noted in its December 22 Order, while Consumers characterized its EICP as an overall part of its compensation package, it was clear that those payments were significantly related to improving the Company's bottom line. "The benefits of improved employee performance because of Consumers' incentive programs accrue to investors in the form of higher prices and dividends but benefit rate payers only tangentially." P. 34. The Attorney General still believes that the Commission's observation is true for both financial and operational measures.

Because, Consumers' EICP programs for both non-officers and officers do not provide a benefit to ratepayers commensurate with the cost, none of the approximately \$ 3.488 million should be included in rates.

VIII. Other Issues

A. Inflationary Adjustments.

The Company criticizes the Attorney General's inflationary adjustments and ponder whether they duplicate other proposed disallowances.⁸⁵ The Company does not support the assertion. Mr. Degenfelder's testimony is pure supposition. He does not provide a specific instance of duplication nor does he refer to any specific adjustment.⁸⁶ In any event, the specific adjustments that Mr. Coppola proposed to

⁸⁵ Initial Brief of Consumers Energy Company, p.45.

⁸⁶ See, 3 TR 996.

capital expenditures and O&M were only a fraction of the total amount proposed by the Company. *If*, there was any duplication, it would be insignificant. The reality is that the Company was asked repeatedly to identify labor and non-labor inflationary adjustments, and except for the Corporate Services area, it did not do so although it appears that the Company used them in other areas.⁸⁷

The Company also argued that Mr. Coppola's claims that the Company used two different inflation factors was incorrect and that only one witness, Ms. Gaston, used an inflation factor.⁸⁸ However, the record on the whole demonstrates that the Company's witnesses used some type of inflationary measure in projecting future costs and it appears that 3.0% or 3.2% was used most often to forecast labor costs across other areas with a CPI inflation rate being used to forecast non-labor costs. In fact, the Company recommended that the Commission adopt Staff's non-labor inflation rates, which does not make sense unless the Company had otherwise used inflationary adjustments in projecting future costs.⁸⁹ When specifically asked for the inflation adjustments for labor for all departments, the Company responded that a 3.2% labor inflation rate was used.⁹⁰ A labor escalation rate of 3.2% is a

⁸⁷ See, Exhibit AG-35 (page 1 of 5).

⁸⁸ Initial Brief of Consumers Energy Company, p.151.

⁸⁹ Initial Brief of Consumers Energy Company, pp. 151-152.

⁹⁰ See, Exhibit AG-35 (AG-CE-423).

wage inflation escalator despite the Company's spin that only the CPI is an inflation escalator applied to non-labor costs.

The Company does not appear to have a consistent approach to forecasting labor and non-labor inflation adjustments when forecasting future costs. As noted above, it appears that some witnesses used a 3% or 3.2% labor escalation rate with a CPI inflation rate for non-labor costs. It also appears that other witnesses used projected cost increases without specifically identifying them as labor and non-labor cost escalations.⁹¹ The Company has not proven that Mr. Coppola's inflationary adjustments are improper.

Finally, the Company's argument that the use of two separate inflation rates is not the same as a blended rate should be rejected and that the Attorney General's reliance on the Commission's order in U-20162 is misplaced.⁹² While it is true that the order in U-20162 addressed a composite rate which consisted of labor and non-labor components, the Attorney General does not believe that there is anything in that order that would restrict its application to the situation in this case. The effect of applying two separate inflation escalator rates, one for labor and another for non-

⁹¹ See, Exhibit AG-80 (AG-CE-549). See also, Exhibits AG-72 and 73 (AG-CE-510 and 513).

⁹² Initial Brief of Consumers Energy Company, pp. 150 – 151.

labor is the same as a blended rate when both are applied to the same costs. The Company's own witness admitted as much.⁹³

The Commission should adopt the Attorney General's inflationary adjustments.

B. Pension and OPEB Accounting Mechanism

The Company recommended that the Commission approve its proposed pension and OPEB mechanism.⁹⁴ The Attorney General objected to the mechanism in her initial brief based on descriptions provided in response to discovery, which was entered into the record as Attorney General Exhibits.⁹⁵ The description of the mechanism provided in the Company's brief is vague. It is not clear if costs in excess of amounts approved in rates would be subject to reasonableness and prudence review before the Company is allowed to recover them in the future. In addition, the Company references to the approval of a mechanism for pension and OPEB in a prior case, U-14347 as a basis for approving its proposal in this case. However, given the very limited description of its proposed mechanism, it is not clear that the two mechanisms are similar. It is not reasonable or prudent to approve

⁹³ See, Exhibit AG-76 (AG-CE-533).

⁹⁴ Initial Brief of Consumers Energy Company, pp. 307 – 309.

⁹⁵ See, Attorney General's Initial Brief, pp. 148 – 150.

this impromptu proposal without providing the parties a better opportunity to vet the Company's claims.

RELIEF REQUESTED

The Attorney General respectfully requests the Administrative Law Judge to issue a proposal for decision that is consistent with the positions set forth in the Attorney General's Initial Brief and this Reply Brief.

Respectfully submitted,

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PROOF OF SERVICE - U-20650

The undersigned certifies that a copy of the *Attorney General's Reply Brief* was served upon the parties listed below by emailing the same to them at their respective e-mail addresses on the 9th day of July 2020.

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