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Service Commission

Exhibit No.:	
Witness:	Michael Gorman
Type of Exhibit:	Direct Testimony
Issues:	Interim Rates
Sponsoring Party:	Missouri Industrial Energy Consumers
Case No.:	ER-2010-0036

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service	)	**Case No. ER-2010-0036 Tariff Nos. YE-2010-0054 and YE-2010-0055**

Direct Testimony and Schedule of

Michael Gorman

On behalf of

Missouri Industrial Energy Consumers

November 3, 2009

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

MIEC Exhibit No. 8
Case No(s). ER-2010-0036
Date 12-07-09 Rptr KF

Project 9187

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service)	Case No. ER-2010-0036 Tariff Nos. YE-2010-0054 and YE-2010-0055

STATE OF MISSOURI)
) SS
COUNTY OF ST. LOUIS)

Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my direct testimony and schedule which were prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. ER-2010-0036.

3. I hereby swear and affirm that the testimony and schedules are true and correct and that they show the matters and things they purport to show.

Michael Gorman

Michael Gorman

Subscribed and sworn to before me this 2nd day of November, 2009.

TAMMY S. KLOSSNER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Charles County
My Commission Expires: Mar. 14, 2011
Commission # 07024862

Tammy S Klossner
Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service	**Case No. ER-2010-0036** **Tariff Nos. YE-2010-0054** **and YE-2010-0055**

<u>Direct Testimony of Michael Gorman</u>

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation and a managing principal with the firm of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A These are set forth in Appendix A of my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of the Missouri Industrial Energy Consumers (MIEC).

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A I will respond to AmerenUE's (Company) request for an interim increase of $37.3 million to be implemented on January 1, 2010. I will also respond to the supporting testimony of Warner Baxter, Lee Nickloy and Gary Weiss.

Q WHAT JUSTIFICATION AND ARGUMENTS DO AMERENUE WITNESSES MAKE IN SUPPORT OF ITS REQUEST FOR AN INTERIM RATE INCREASE?

A AmerenUE witnesses Mr. Baxter and Mr. Nickloy argue that regulatory lag is restricting the Company's ability to recover investments, which is creating a disincentive for the Company to invest in utility plant infrastructure, and is limiting the improvement of its bond ratings. Mr. Baxter specifically states that the Company is concerned about the timing of cost recovery of incremental investments in between rate cases, and states that costs incurred in between rate cases are lost forever. (Baxter at 17). Mr. Nickloy states that credit analysts are primarily concerned about the cash flow coverage metrics and regulatory lag can erode the Company's cash flow coverage in between rate cases. (Nickloy at 2-3).

Regulatory Lag

Q IS REGULATORY LAG A COMMONLY UNDERSTOOD ASPECT OF THE REGULATORY RATEMAKING PROCESS?

A Yes. Regulatory lag works both for and against shareholders/customers, depending on the cycle the utility is in in its construction program. Mr. Baxter acknowledges this reality. (Baxter at 12).

Regulatory lag creates a strong economic incentive for management to aggressively manage costs in between rate cases. Management has an objective of maximizing profits to investors. To meet this objective, management must work diligently in managing its costs at approved rates in order to maximize the earnings from providing utility service. Hence, a positive element of regulatory lag is that it creates a strong management incentive to monitor cost, cost escalation and to be as efficient as possible.

Q WOULD THE ELIMINATION OF REGULATORY LAG ERODE OR ELIMINATE MANAGEMENT'S INCENTIVE TO MANAGE COSTS?

A Yes. Without regulatory lag, management would have much less incentive to manage costs. Management would simply frequently adjust rates to pass all costs on to customers. Management's ability to produce profits that meet investors' return demand would be significantly less affected by management's ability to contain costs.

Q ARE YOU AWARE OF ANY AUTHORITATIVE SOURCES THAT CONSIDER REGULATORY LAG AS A MECHANISM THAT CREATES MANAGEMENT INCENTIVE TO BE EFFICIENT AND MANAGE COSTS?

A Yes. The National Association of Regulatory Utility Commissioners (NARUC) defines regulatory lag in part, "an incentive for cost containment."[1]

Further, in the publication Principles of Public Utility Rates, Bonbright, James C., et al., Second Edition, at 198, the author states as follows:

> Quite aside from the recognized undesirability of too frequent rate revisions, commissions recognize the regulatory lag as a practical means of reducing the tendency of a fixed-profit standard to discourage efficient management.

[1] www.naruc.org/programs.cfm?c=international Glossary of Terms.

Q **CONSISTENT WITH EFFICIENT UTILITY MANAGEMENT, ARE THERE ANY COSTS THAT MAY BE EXCLUDED FROM THIS REGULATORY LAG EFFICIENCY STANDARD IN ORDER TO PROTECT THE FINANCIAL INTEGRITY OF THE UTILITY?**

A Yes. Certain costs such as volatile commodity components, costs that are driven by factors far outside of management control, may be appropriate for regulatory mechanisms which will eliminate or substantially reduce the timing of rate adjustments to reflect changes in utility cost structures. However, these particular cost elements should be treated separately from the utility's overall cost of service structure to reflect these unique characteristics.

Q **DO YOU BELIEVE THE MISSOURI PUBLIC SERVICE COMMISSION (COMMISSION) HAS ALREADY MADE EFFORTS TO MITIGATE AMERENUE'S EXPOSURE TO REGULATORY LAG FOR COSTS THAT IT IS NOT ABLE TO MANAGE?**

A Yes. Costs which are outside of management control are typically the subject of rate mechanisms which can eliminate or mitigate regulatory lag. One such example is a fuel adjustment clause. To the extent a company cannot manage its fuel price variability via contracts, or other mechanisms, regulatory bodies typically approve fuel adjustment mechanisms which allow for deferral accounts and tracking mechanisms that allow a utility to fully recover its prudent and reasonable fuel costs over time.

A second mechanism in Missouri is the pension and other post-employment benefits (OPEB) tracking mechanism. In Missouri, the prescribed level of pension and OPEB expense is included in rates. As the Company actually incurs pension and OPEB expense, that is more/less than what is recovered in rates, it is included in a regulatory asset/liability account. This mechanism stabilizes rates and it provides the Company full assurance of pension and OPEB expense and reduces the uncertainty that this cost will not be fully recovered.

Q DID THE COMPANY CLAIM THAT IT IS CONSISTENTLY UNDER EARNING ITS AUTHORIZED RETURN ON EQUITY?

A Yes. AmerenUE witness Gary Weiss provided a table at page 4 of his testimony, and based on a comparison of actual earned return to its authorized return, Mr. Weiss concluded that the Company has consistently under earned its authorized return on equity by 214 to 270 basis points.

Q DO YOU BELIEVE MR. WEISS'S COMPARISON OF ACTUAL EARNED RETURN ON EQUITY RELATIVE TO THE LAST AUTHORIZED RETURN ON EQUITY SUPPORTS THE COMPANY'S REQUEST FOR AN INTERIM RATE INCREASE?

A No. There are material deficiencies in Mr. Weiss's presentation of the actual earned return on equity relative to an assessment of whether or not AmerenUE's current rates are providing full recovery of costs approved to be recovered in the Missouri jurisdiction. Mr. Weiss's numbers appear to be based on book financial statements, which include costs that are not allowed to be recovered in rates in Missouri, or reflect financial reported expenses, rather than regulatory tracking expense levels that are designed to recover financial expense over time while stabilizing rates.

Also, there were nonrecurring events which would have eroded AmerenUE's earnings during much of this historical time period, that are due to abnormal events not regulatory lag. This includes ice storm damage which caused a significant interruption of the AmerenUE system during 2009. This ice storm resulted in

AmerenUE incurring significant restoration expenses, and also knocked off line one of its largest customers, Noranda Aluminum Company.

These extraordinary events are normalized in rate proceedings, and should be normalized in order to determine whether or not AmerenUE's rates are accurately providing full recovery of utility costs, and producing reasonable utility profits.

Further, and most importantly, Mr. Weiss fails to recognize a $166 million Missouri rate increase that went into effect March 2009.

Q PLEASE EXPLAIN THE EXPENSE ITEMS THAT RESULT IN THE BOOK EARNED RETURN ON EQUITY NOT BEING AN ACCURATE INDICATOR OF WHETHER OR NOT THE RATES CURRENTLY APPROVED FOR AMERENUE ARE RECOVERING ITS APPROVED COST OF SERVICE.

A In AmerenUE's last rate case, expense items for incentive compensation, advertising, lobbying and other expenses are not allowed recovery in the ratemaking process. However, AmerenUE does recognize these expenses in its publically reported earnings to investors. These items can have a significant impact on the bottom line, particularly incentive compensation. These earned returns could be understated due to over $14 million of costs that have not been included in cost of service (e.g., Taum Sauk, incentive compensation, etc.).

Q WHY DO YOU SAY THAT MR. WEISS IGNORED A SIGNIFICANT RATE INCREASE FOR AMERENUE THAT TOOK EFFECT IN MARCH 2009?

A Mr. Weiss's earned return on equity assessments go for 12-month periods each month out through August of 2009. Hence, Mr. Weiss's earned return on equity assessments only reflect five months of rate increases that were approved at the end of March 2009. This is significant because AmerenUE's revenue collections are more heavily weighted in the third quarter of the calendar year. Thus, the strongest earnings quarter related to AmerenUE's last rate increase is not completely reflected in Mr. Weiss's return. Hence, Mr. Weiss is significantly understating the earnings at current approved rates for AmerenUE.

Q **CAN THE IMPLEMENTATION OF INTERIM RATES RESULT IN CUSTOMERS BEING CHARGED RATES WHICH ARE NOT JUST AND REASONABLE?**

A Yes. In order for rates to be shown to be just and reasonable, it is necessary for the Commission to review a fully developed record on revenues at current rates, and operating expenses underlying AmerenUE's cost of providing high quality, reliable utility service. Without the benefit of a full record, and rates being implemented on an interim basis with only piecemeal evaluation of certain costs, customers will be harmed by paying rates that are not just and reasonable.

Q **IS THERE REASON TO BELIEVE THAT AMERENUE'S PROPOSAL FOR AN INTERIM RATE INCREASE IN THIS PROCEEDING WOULD RESULT IN RATES THAT ARE NOT JUST AND REASONABLE?**

A Yes. AmerenUE's interim rate increase is based on only one cost item with no consideration of all other aspects of its overall cost of service. Based on Mr. Weiss's testimony, the interim revenue requirement is based on the change in "net utility plant" between September 2008 and May 2009. This net plant increase, viewed in isolation, resulted in a $37.28 million revenue requirement increase.

Mr. Weiss is failing to recognize other aspects of AmerenUE's overall cost of service, and therefore is not properly identifying a revenue deficiency that is adequate for supporting an interim rate increase.

Q ARE THERE ANY COST DECREASES THAT WILL OFFSET THE PROPOSED INTERIM RATE INCREASE AS DISCUSSED BY THE COMPANY'S WITNESS MR. BAXTER?

A Yes. Based on Mr. Baxter's interim testimony, the increase in net plant supports an approximately $37.3 million interim rate increase. However, this claimed cost increase is largely offset by a decline in AmerenUE's cost of capital since its last rate case. AmerenUE's capital structure in this case includes a lower common equity ratio compared to the capital structure approved in its last rate case.

As shown on my Schedule MPG-1, based on the final order in ER-2008-0318, AmerenUE was authorized a common equity ratio of 52.00%[2] and a return on equity of 10.76%.[3] In this rate case, the Company is requesting a capital structure that includes a common equity ratio of 47.39%, which is around 5 percentage points lower than the common equity ratio included in the Commission's last authorized rate of return.

This reduction in common equity ratio lowers AmerenUE's cost of capital. As shown on my Schedule MPG-1, using AmerenUE's last authorized return on equity of 10.76%, Ameren's proposed capital structure in this case compared to the capital structure in ER-2010-0036, will lower AmerenUE's cost of service by $24.8 million, on the rate base approved in AmerenUE's last rate case.

[2] ER-2008-0318, Report and Order, January 27, 2009 at 15.
[3] ER-2008-0318, Report and Order, January 27, 2009 at 32.

Hence, this lower cost of capital almost eliminates approximately two-thirds of the increased revenue requirement associated with an increase in net plant.

Q **HAVE YOU BEEN INVOLVED IN PROCEEDINGS WHERE A UTILITY HAS JUSTIFIED AN AWARD OF AN INTERIM RATE INCREASE?**

A Yes. It is my understanding that the general practice for awarding a utility an interim rate increase is generally tied to a demonstration of financial need. That is, a utility will show that without a rate increase, it will experience severe financial hardship, which could threaten its ability to provide high quality reliable utility service. This is a high standard for a utility to meet, but is necessary in order to ensure that rates are always just and reasonable and provide strong management incentive to be efficient and manage cost.

Q **IS THERE ANY EVIDENCE THAT AMERENUE'S CURRENT RATES ARE PROVIDING ADEQUATE FINANCIAL COVERAGES OF ITS FIXED OBLIGATIONS IN PROVIDING SERVICE TO CUSTOMERS IN MISSOURI?**

A The Company has not provided such a demonstration but its Federal Energy Regulatory Commission (FERC) documents show that it is currently earning a pre-tax interest coverage ratio of approximately three times based on rates that are in effect in calendar year 2009. Further, the Company still maintains an investment grade bond rating of "BBB," "Baa1," and "A" from Standard & Poor's, Moody's and Fitch, respectively. AmerenUE's current bond rating outlook is stable. Hence, this credit rating is a strong indication that it does have access to capital, and can weather the normal regulatory lag for costs typically regarded as within management's control until rates can be adjusted based on a full and complete record of AmerenUE's cost of service. For all these reasons, the Company's request for an interim rate increase should be rejected.

Q ARE THERE ANY OTHER ARGUMENTS OFFERED BY MR. BAXTER WHICH YOU BELIEVE SUPPORT HIS REQUEST FOR AN INTERIM RATE INCREASE?

A There are other arguments but none of them support the Company's proposal. Mr. Baxter argues at page 10, that the Company is currently operating in one of the worst economic periods our country has ever experienced. However, as noted above, AmerenUE's bond rating and access to capital remain fairly strong. Contrary to Mr. Baxter's assertion, the need for the Commission to ensure that any rates charged to customers in this economy are just and reasonable is critically important to preserve the economic health of many of the companies that AmerenUE serves. As such, this distressed economic environment should give the Commission great pause before approving a rate increase of any sort.

Mr. Baxter also opines that AmerenUE's rates are 40% below national averages and 20% below other utilities in Missouri. Importantly, a major contributing factor to the competitive position of AmerenUE's rates has been effective regulation of AmerenUE. Importantly, AmerenUE has sought rate relief in the past which the Commission has found to be unreasonably high, and has modified the Company's rate increase proposals down to a reasonable level. The Commission should continue to exercise sound regulatory oversight of AmerenUE to ensure its rates remain competitive.

As such, Mr. Baxter has not offered any arguments that would support an increase in AmerenUE's rates without a full record that establishes that a rate increase would result in just and reasonable rates.

Q CAN YOU SUMMARIZE YOUR RESPONSE TO THE COMPANY'S REQUEST FOR AN INTERIM RATE INCREASE IN THIS PROCEEDING?

A Yes. First, the Company's request for the Commission to eliminate regulatory lag by implementing rate increases without a complete review of costs and revenues is unreasonable and should be rejected. The Commission has already implemented many regulatory mechanisms which mitigate regulatory lag for costs which are outside of AmerenUE's management's control. For costs which are within its management's control, regulatory lag acts as a strong incentive for AmerenUE to control costs.

Second, the Company has not accurately assessed whether or not current rates are producing the level of earnings approved by the Commission. In his demonstration, Mr. Weiss did not properly adjust the earned return on equity for costs which are not permitted to be recovered from Missouri retail customers' rates (incentive compensation, advertising, lobbying expenses), he did not adjust for costs which are tracked in Missouri ratemaking which can result in ratemaking expenses being more or less than actual reported expenses (e.g., pension and OPEB expense), he failed to reflect cost normalization for abnormal events (ice storm) and he failed to reflect a significant revenue increase which went into effect in March 2009. Mr. Weiss's return on equity demonstration is completely inadequate to determine whether or not current rates in Missouri are appropriate, and just and reasonable.

Finally, the Company's request to eliminate all aspects of regulatory lag will severely limit the Commission's ability to set rates which are just and reasonable. In order to set rates that are just and reasonable, the Commission needs a fully developed record on all revenues, expenses and invested capital cost to determine what level of rates are appropriate to be charged to Missouri retail customers.

Q **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

A Yes, it does.

Appendix A

Qualifications of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q PLEASE STATE YOUR OCCUPATION.

A I am a consultant in the field of public utility regulation and a Managing Principal with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A In 1983 I received a Bachelors of Science Degree in Electrical Engineering from Southern Illinois University, and in 1986, I received a Masters Degree in Business Administration with a concentration in Finance from the University of Illinois at Springfield. I have also completed several graduate level economics courses.

In August of 1983, I accepted an analyst position with the Illinois Commerce Commission (ICC). In this position, I performed a variety of analyses for both formal and informal investigations before the ICC, including: marginal cost of energy, central dispatch, avoided cost of energy, annual system production costs, and working capital. In October of 1986, I was promoted to the position of Senior Analyst. In this position, I assumed the additional responsibilities of technical leader on projects, and my areas of responsibility were expanded to include utility financial modeling and financial analyses.

In 1987, I was promoted to Director of the Financial Analysis Department. In this position, I was responsible for all financial analyses conducted by the staff. Among other things, I conducted analyses and sponsored testimony before the ICC on rate of return, financial integrity, financial modeling and related issues. I also supervised the development of all Staff analyses and testimony on these same issues. In addition, I supervised the Staff's review and recommendations to the Commission concerning utility plans to issue debt and equity securities.

In August of 1989, I accepted a position with Merrill-Lynch as a financial consultant. After receiving all required securities licenses, I worked with individual investors and small businesses in evaluating and selecting investments suitable to their requirements.

In September of 1990, I accepted a position with Drazen-Brubaker & Associates, Inc. In April 1995 the firm of Brubaker & Associates, Inc. (BAI) was formed. It includes most of the former DBA principals and Staff. Since 1990, I have performed various analyses and sponsored testimony on cost of capital, cost/benefits of utility mergers and acquisitions, utility reorganizations, level of operating expenses and rate base, cost of service studies, and analyses relating industrial jobs and economic development. I also participated in a study used to revise the financial policy for the municipal utility in Kansas City, Kansas.

At BAI, I also have extensive experience working with large energy users to distribute and critically evaluate responses to requests for proposals (RFPs) for electric, steam, and gas energy supply from competitive energy suppliers. These analyses include the evaluation of gas supply and delivery charges, cogeneration and/or combined cycle unit feasibility studies, and the evaluation of third-party asset/supply management agreements. I have also analyzed commodity pricing indices and forward pricing methods for third party supply agreements, and have also conducted regional electric market price forecasts.

In addition to our main office in St. Louis, the firm also has branch offices in Phoenix, Arizona and Corpus Christi, Texas.

Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?

A Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of service and other issues before the Federal Energy Regulatory Commission and numerous state regulatory commissions including: Arkansas, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Michigan, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, and before the provincial regulatory boards in Alberta and Nova Scotia, Canada. I have also sponsored testimony before the Board of Public Utilities in Kansas City, Kansas; presented rate setting position reports to the regulatory board of the municipal utility in Austin, Texas, and Salt River Project, Arizona, on behalf of industrial customers; and negotiated rate disputes for industrial customers of the Municipal Electric Authority of Georgia in the LaGrange, Georgia district.

Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANIZATIONS TO WHICH YOU BELONG.

A I earned the designation of Chartered Financial Analyst (CFA) from the CFA Institute. The CFA charter was awarded after successfully completing three examinations which covered the subject areas of financial accounting, economics, fixed income and equity valuation and professional and ethical conduct. I am a member of the CFA Institute's Financial Analyst Society.

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AmerenUE

Rate of Return Reduction Impact

1. Proposed Capital Structure[1]

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
1	Long-Term Debt	$ 3,001,633,545	45.532%	5.774%	2.629%	2.629%
2	Short-Term Debt	$ 47,612,601	0.722%	3.384%	0.024%	0.024%
3	Preferred Stock	$ 114,502,040	1.737%	5.189%	0.090%	0.146%
4	Common Stock	$ 3,428,579,662	52.009%	**10.760%**	5.596%	9.085%
5	Total	**$ 6,592,327,848**	**100.000%**		**8.340%**	**11.884%**
6	Composite Tax Rate					38.400%

2. Proposed Capital Structure with ROE Reduction[2]

Line	Description	Amount (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
7	Long-Term Debt	$ 3,651,044,928	51.008%	5.967%	3.044%	3.044%
8	Short-Term Debt	$ -	0.000%	0.928%	0.000%	0.000%
9	Preferred Stock	$ 114,502,040	1.600%	5.189%	0.083%	0.135%
10	Common Stock	$ 3,392,179,086	47.392%	**10.760%**	5.099%	8.278%
11	Total	**$ 7,157,726,054**	**100.000%**		**8.226%**	**11.457%**
12	Pre-Tax ROR Impact of ROE Adjustment					0.43%
13	Electric Rate Base[3]					$ 5,786,786,650
14	Revenue Impact of ROE Adjustment					**$ 24,755,419**

Sources:

[1] Report and Order, January 27, 2009, at 12, 15 and 32, and O'Bryan Rebuttal, Ex. 8, Schedule MGO-RE1.

[2] ER-2010-0036, Schedule MGO-E1.

[3] ER-2010-0036, Order Approving Compliance Tariff Sheets, February 19, 2009, Staff Rate Base.