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April 9, 2001

Ms. Dorothy Wideman
Executive Secretary
Michigan Public Service Commission
6545 Mercantile Way
P.O. Box 30221
Lansing, MI 48909

Re: MPSC Case No. U-12752

Dear Ms. Wideman:

Enclosed for filing please find the original and 4 copies of Direct Testimony of Michael Gorman on behalf of ABATE in the above-entitled matter. Proof of Service upon the parties of record is also enclosed. Thank you.

Very truly yours,

CLARK HILL P.L.C.

Thomas E. Maier

TEM/srf
Enclosures

cc: Parties of Record

Before the

Public Service Commission

of the State of Michigan

Case No. U-12752

CONSUMERS ENERGY COMPANY

Direct Testimony of

Michael Gorman

On behalf of

ABATE

April 2001
Project 7582

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

CONSUMERS ENERGY COMPANY

Before the

Public Service Commission of the State of Michigan

Case No. U-12752

Direct Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael Gorman; my business address is 1215 Fern Ridge Parkway, Suite 208; St. Louis, MO 63141-2000.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation with 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 TESTIFYING IN THIS PROCEEDING?

A I am presenting testimony on behalf of the Association of Businesses Advocating Tariff Equity (ABATE). Member companies of ABATE are substantial purchasers of gas services from Consumers Energy Company (Consumers or Company).

Q HAVE YOU PRESENTED TESTIMONY IN PRIOR CONSUMERS PROCEEDINGS BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION (COMMISSION OR MPSC)?

A Yes. I have been involved in prior Consumers proceedings before this Commission.

Q WHAT IS THE SUBJECT MATTER OF YOUR TESTIMONY?

A The purpose of my testimony is to respond to Consumers witness Michael J. Shore's proposed modification to the Company's gas acquisition strategy, and to respond to Consumers witness Charles F. Belknap, Jr.'s proposed gas cost recovery (GCR) factor, for the period April 2001 through March 2002.

Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN THIS PROCEEDING.

A My recommendations are summarized as follows:

1. Consumers should acquire gas using a balanced portfolio of long-term and short-term gas supply contracts. Consumers' gas supply acquisition strategy should be prudent, and attempt to provide customers with gas supply at stable and predictable least cost prices.

2. Consumers' gas acquisition strategy should attempt to mitigate the spot market gas price volatility, thus providing its customers with a gas supply that is priced in a reasonable and more predictable manner.

3. If the Company's proposal to employ a short-term gas acquisition strategy is permitted by the Commission, then Consumers' business risk will be reduced because it will significantly lower its commodity risk. This reduction to its business risk should be recognized in the development of a fair rate of return in Consumers' next rate proceeding.

4. Consumers witness Belknap's proposal to include a $1.00 per Mcf market volatility component in the GCR factor should be rejected. This market volatility component is not justified by the Company's projected cost of gas during the GCR factor plan year.

5. Consumers' proposed market price volatility factor should not be included in a GCR factor. The Company already has an opportunity to recover the difference between its GCR factor price and its actual cost of gas in annual reconciliation proceedings.

<u>Gas Acquisition Strategy</u>

Q PLEASE DESCRIBE THE COMPANY'S PROPOSED GAS ACQUISITION STRATEGY.

A The Company states that its gas acquisition strategy has evolved from relying heavily upon long-term contracts with fixed prices to its current changed policy of relying heavily upon shorter-term contracts with market-based prices (Michael J. Shore at Page 3).

Q DOES THE COMPANY CLAIM ITS OLD GAS ACQUISITION STRATEGY BENEFITED CUSTOMERS?

A Yes. Mr. Shore maintains that under its old gas acquisition strategy: ". . . the Company attempted to maintain a stable and predictable price by entering into long-term forward price agreements for a significant portion of its gas supply." (Id. at Page 9)

Q WHY IS THE COMPANY PROPOSING TO CHANGE ITS GAS ACQUISITION STRATEGY?

A Mr. Shore gives two reasons. First, he notes the volatile gas market recently has resulted in gas prices at the end of the year 2000 being three times higher than they were at the beginning of the year 2000. He concludes that entering into long-term agreements at current gas prices would be ill advised.

Second, Mr. Shore concludes that the expansion of the gas customer choice (GCC) program has two significant consequences on the Company's gas acquisition strategy. First, the Company is exposed to greater load loss because all of its customers can eventually buy gas supply from alternative suppliers by April 2003. Second, Mr. Shore concludes that adjusting its gas acquisition strategy will set its GCR prices at market, which will contribute to the development of a competitive gas market. (Shore at Pages 9-10)

Q ARE THERE ANY CUSTOMER BENEFITS UNDER CONSUMERS' PROPOSED NEW GAS ACQUISITION STRATEGY?

A The development and encouragement of a competitive market will certainly benefit customers. However, for customers that prefer a gas supplier that prices its gas on a balanced portfolio of short-term and long-term gas supply contracts, Consumers' proposal is not beneficial. If Consumers acquires gas only on the short-term market, said customers will be forced to leave Consumers for an alternate gas supplier. Therefore, Consumers' proposed new gas acquisition strategy will remove at least one gas supplier that offers a balanced supply portfolio from the market, itself. Consumers' proposal to remove itself as an alternative supplier with a balance portfolio of gas supply will not benefit the market.

Q DOES CONSUMERS' PROPOSED NEW GAS ACQUISITION STRATEGY BENEFIT THE COMPANY?

A Yes. It significantly reduces its commodity risk. By reducing its commodity risk, its shareholder risk will be reduced. Consumers' commodity risk will be reduced primarily for two reasons. First, the Company's gas acquisition volume risk will be reduced. The Company maintains that under the new GCC program, it is uncertain of what its future gas sales load will be. By relying primarily on the short-term market, it can better match its supply agreements with its customers' demand. Therefore, the Company's risk of contracting for more gas supply than customer load will be mitigated significantly. Thus, the Company's gas volume supply risk will be reduced.

Second, the Company's GCR prices will always be set at the short-term market. Therefore, it will have minimal risk of having a long-term agreement that is priced above the market. Long-term gas supply contracts can stabilize gas prices and make them more predictable, but long-term supply contracts entail price risk of either benefiting customers by being below market, or burdening customers by being above short-term markets. By ensuring that its gas prices are always at the short-term market, Consumers reduces its risk of above market gas cost.

Q WHAT ARE THE IMPLICATIONS OF REDUCING THE COMPANY'S COMMODITY RISK?

A By reducing the Company's commodity risk, its business risk will decrease. Reducing the Company's business risk will have a positive impact on its cost of capital. Therefore, the Company's overall rate of return should decrease by either one of two mechanisms.

First, if its business risk is reduced, the Company can use more debt capital to finance its utility assets. Increasing the amount of debt and reducing its common equity capital in a utility's capital structure, while maintaining its credit rating, will lower its overall cost of capital. The cost of capital declines because the use of less common equity reduces the Company's operating income and income tax expense. This happens because common equity is the highest cost form of capital and is subject to income taxes.

Alternatively, if the Company does not adjust its capital structure to reflect the reduced business risk, a reduction to the Company's authorized return on common equity would be justified. A reduction to the authorized return on equity would be justified if the reduced business risk is not offset by an increase to financial risk (i.e., higher debt ratio to total capital) as discussed above. The magnitude of an adjustment to the Company's return on equity should be the subject of the next base rate proceeding.

Q WHAT DO YOU MEAN BY BUSINESS AND FINANCIAL RISK?

A The Company's total investment risk is generally broken down into business risk and financial risk. Business risk relates to the uncertainty a company will be able to fully recover its cost, including earning its cost of capital, in selling its products. Business risk factors relate to sales impacted by economic slow downs, loss of customers, etc. Business risks also relate to management's ability to control expenses, and efficiently run the company. Financial risk relates to how a utility finances its assets. A utility that does not have any debt on its balance sheet has no financial risk. Conversely, financial risk of a utility increases as its total debt load increases.

Q WHAT SUPPORT DO YOU HAVE THAT A REDUCTION TO THE COMPANY'S COMMODITY RISK WILL ALLOW THE COMPANY TO EITHER MODIFY ITS CAPITAL STRUCTURE, OR JUSTIFY A LOWER RETURN ON EQUITY?

A Several bond rating agencies have stated that if a utility eliminates or reduces its commodity risk, its business risk will decrease, thus allowing it to use a higher amount of debt in financing utility assets.

For example, Standard & Poor's (S&P) concludes that a transmission and distribution electric utility can finance with a higher debt to total capital ratio than can an electric generating company. S&P observes that an electric transmission and distribution company will remain a regulated utility operation, and a generation company is in a commodity business. (S&P's Global Utilities Rating Service Industry Commentary, March 1997)

Similarly, Fitch IBCA concludes that utility companies that have no supply risk or commodity price exposure can have a higher percentage of debt to total capital, relative to a company with commodity price exposure. (Fitch IBCA Electric Distribution Credit Criteria at Page 71, Global Power/Electric Special Report, October 7, 1999)

Hence, credit rating agencies allow a utility that has reduced its business risk to increase its leverage in financing its utility assets without impacting its credit standing. In the event a utility chooses not to increase its leverage, then the reduced business risk should be reflected in the return on common equity. The return on common equity should reflect the total risk of the utility, i.e., both its business and financial risk. If the utility's financial risk remains constant, and its business risk declines, then the overall risk of the utility will be reduced. This reduction in risk should be recognized by a lower return on equity.

Q SHOULD THE COMMISSION DIRECT CONSUMERS TO PURSUE A BALANCED PORTFOLIO OF LONG-TERM AND SHORT-TERM GAS SUPPLY CONTRACTS IN FULFILLING ITS OBLIGATION TO SUPPLY ITS CUSTOMERS?

A Yes. Consumers is obligated to act prudently in providing service to its gas customers. Managing the price volatility in short-term gas markets with a balanced portfolio of long-term and short-term gas supply contracts is a prudent action. Mr. Shore's own testimony establishes the volatility in the short-term gas market where he observed that the cost of gas increased by over 300% during 2000. If Consumers' total gas supply were based on short-term gas markets, then its GCR factors would vary by the significant volatility in spot gas cost. This price volatility is unreasonable and can be mitigated by sound and prudent gas acquisition planning.

Q WILL CUSTOMERS BE EXPOSED TO SIGNIFICANT FINANCIAL RISK IF THE COMPANY PROCURES ALL OF ITS GAS ON A SHORT-TERM MARKET?

A Yes. The volatility in the short-term gas market can create, and has created, huge swings in the cost of gas. Significant increases to the cost of gas can drive up customers' production cost, or living cost, in a dramatic fashion. As an example, one of the often-cited causes of the financial debacle in California is that distribution utilities were required to buy all power supply on the short-term power market. If the utilities had been allowed to enter into a balanced portfolio of power supply, most of the disruption in the California market may have been avoided. The same financially disastrous results could happen to Michigan customers if Consumers secures all of its gas supply on a short-term market.

Q HOW CAN CONSUMERS MANAGE THE UNCERTAINTY OF FUTURE LOAD IN CREATING A BALANCED PORTFOLIO OF LONG-TERM AND SHORT-TERM GAS SUPPLY CONTRACTS?

A The phase-in to full GCC will be done over the next two years. During that time period, the Commission should consider mechanisms that will allow Consumers to better compete for customer load, and create assurance that its prudent gas supply cost will be recovered. Over the last three years, Consumers demonstrated that it was able to control its cost of gas in volatile markets. Because of its expertise in managing gas supply price risk, Consumers should be in a good position to retain sales customer load. Any changes to the GCR methodology can be explored by Consumers, the Commission and interested parties up through the beginning of full GCC.

Proposed GCR Factor in Plan Year

Q WHAT GCR FACTOR IS CONSUMERS PROPOSING FOR THE PLAN YEAR?

A Consumers witness Charles F. Belknap, Jr. is proposing a GCR factor of $5.6862 per Mcf during the period April 2001 through March 2002. (Direct Testimony, Belknap, Page 3) Mr. Belknap's Exhibit A-(CFB-2) Page 1 shows the development of the GCR factor. As shown on this exhibit, Mr. Belknap develops his GCR factor based on a projected gas cost of $4.6862 per Mcf, and a $1.00 per Mcf market volatility component.

Q IS MR. BELKNAP'S PROPOSED GCR FACTOR REASONABLE?

A No. Mr. Belknap's proposal to include $1.00 per Mcf market volatility component in the GCR factor should be rejected. The $1.00 market volatility component is not cost based. The Company's GCR factor would be just and reasonable if it is designed to cover more than a reasonable projection of gas cost during the plan year. Therefore, the Company's GCR factor should be reduced from $5.682 per Mcf to $4.6862 per Mcf, or Consumers' projected gas cost.

Q IF THE COMPANY'S PROJECTED COST OF GAS DURING THE PLAN YEAR IS LESS THAN ITS ACTUAL COST OF GAS, DOES IT HAVE A MECHANISM WHERE IT CAN RECOVER THE SHORT FALL?

A Yes. The difference between the Company's projected and actual gas cost can be trued-up in the annual GCR reconciliation. The reconciliation proceedings are designed to protect both the Company and its customers. The Company's proposal for ongoing price adjustments in the GCR factor up to $1.00 per Mcf is not just and reasonable, is not based on reasonable estimate of future gas costs, and should, therefore, be rejected.

Q AT PAGE 5 OF HIS TESTIMONY, MR. BELKNAP TESTIFIES THAT THE MARKET VOLATILITY FACTOR WILL MINIMIZE THE AMOUNT OF OVER/UNDER COLLECTIONS IN RECONCILIATION PROCEEDS. CAN THE AMOUNT OF OVER/UNDER COLLECTIONS BE MANAGED WITHOUT A MARKET VOLATILITY FACTOR?

A Yes. A balanced gas supply portfolio will stabilize Consumers' gas supply cost by reducing the gas price volatility inherent by acquiring gas supply using only short-term supply contracts, as Consumers proposes. Hence, the gas price volatility, and over/under recovery concern, is created by Consumers' proposed new short-term gas acquisition practice.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes.

Qualifications of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael P. Gorman. My business mailing address is P. O. Box 412000, 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000.

Q PLEASE STATE YOUR OCCUPATION.

A I am a consultant in the field of public utility regulation 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. Continuing, I have also conducted regional electric market price forecasts.

In addition to our main office in St. Louis, the firm also has branch offices in Kerrville, Texas; Plano, Texas; Denver, Colorado; and Chicago, Illinois.

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 regulatory commissions in Arizona, Delaware, Georgia, Illinois, Indiana, Michigan, Missouri, New Mexico, Oklahoma, Tennessee, Texas, Vermont, West Virginia and Wisconsin. 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 YOU BELONG TO.

A I earned the designation of Chartered Financial Analyst (CFA) from the Association for Investment Management and Research (AIMR). 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 AIMR's Financial Analyst Society.

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the Matter of the Application of CONSUMERS ENERGY COMPANY for Approval of a Gas Cost Recovery Plan and Authorization of Gas Cost Recovery Factors for the 12-Month Period April 2001 - March 2002	))))))	Case No. U-12752

PROOF OF SERVICE

STATE OF MICHIGAN)
) ss.
COUNTY OF INGHAM)

Kristi Grieve, being duly sworn, deposes and says that she is an employee of Clark Hill P.L.C., and that on April 9, 2001, a copy of the Direct Testimony of Michael Gorman was served on behalf of ABATE upon:

See attached service list

Except as otherwise noted on the attached list, service was accomplished by depositing same in a regular mail depository, enclosed in envelopes bearing postage fully prepaid and addressed properly.

Kristi Grieve

Kristi Grieve

Subscribed and sworn to before me
this 9th day of April, 2000.

Shelly R. Fletcher

Shelly R. Fletcher, Notary Public
Ingham County, Michigan
Commission Expires: January 29, 2005

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U-12752

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