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September 29, 2008

## VIA FACSIMILE AND FEDERAL EXPRESS

Public Utilities Commission of Ohio  
Docketing Division  
180 East Broad Street  
Columbus, OH 43215-3793

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Re: Case No. 08-935-EL-SSO

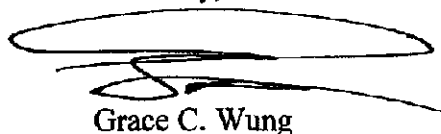
Dear Sir or Madam:

Enclosed for filing please find an original and 20 copies of the Direct Testimony of Michael P. Gorman on behalf of The Commercial Group in the above-referenced case.

Also enclosed are two extra copies of the document to be date-stamped and returned to me in the enclosed, self-addressed Federal Express envelope. Please do not hesitate to contact me at the number above if you have any questions.

Thank you for your assistance in this matter.

Sincerely,



Grace C. Wung

Enclosures

This is to certify that the images appearing are an accurate and complete reproduction of a case file document delivered in the regular course of business.  
Technician TM Date Processed 9/30/2008

**BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

IN THE MATTER OF THE APPLICATION )  
OF OHIO EDISON COMPANY, THE )  
CLEVELAND ELECTRIC ILLUMINATING )  
COMPANY AND THE TOLEDO EDISON )  
COMPANY FOR AUTHORITY TO )  
ESTABLISH A STANDARD SERVICE )  
OFFER PURSUANT TO R.C. 4928.143 IN )  
THE FORM OF AN ELECTRIC SECURITY )  
PLAN )

**Case No. 08-935-EL-SSO**

Direct Testimony of

**Michael Gorman**

On behalf of

**The Commercial Group**

September 29, 2008  
Project 9047



**BRUBAKER & ASSOCIATES, INC.**  
CHESTERFIELD, MO 63017

BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO

IN THE MATTER OF THE APPLICATION    )  
OF OHIO EDISON COMPANY, THE        )  
CLEVELAND ELECTRIC ILLUMINATING    )  
COMPANY AND THE TOLEDO EDISON       )  
COMPANY FOR AUTHORITY TO            )  
ESTABLISH A STANDARD SERVICE       )  
OFFER PURSUANT TO R.C. 4928.143 IN   )  
THE FORM OF AN ELECTRIC SECURITY    )  
PLAN                                    )

Case No. 08-935-EL-SSO

Direct Testimony of Michael Gorman

1    **Q     PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

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

4    **Q     WHAT IS YOUR OCCUPATION?**

5    A     I am a consultant in the field of public utility regulation and a managing principal with the  
6        firm of Brubaker & Associates, Inc., ("BAI") energy, economic, and regulatory  
7        consultants.

8    **Q     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.**

9    A     These are set forth on Appendix A.

10   **Q     ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

11   A     I am appearing on behalf of Wal-Mart Stores East, LP; Sam's East, Inc.; Macy's Inc.;  
12        and BJ's Wholesale Club, Inc. (collectively, the "Commercial Group"). The Commercial  
13        Group purchases electricity from Ohio Edison Company ("OE"), The Cleveland Electric

Illuminating Company ("CEI"), and the Toledo Edison Company ("TE") (collectively, "FirstEnergy" or "Company").

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

A I will respond to certain aspects of FirstEnergy's Electric Security Plan (ESP), and related tariff rate mechanisms. Specifically, I will respond to the following:

1. The proposed use of automatic adjustment riders for a significant portion of total revenues collected from end-users;
2. Proper cost allocation among customer classes using the proposed riders;
3. Other aspects of the Company's proposed riders, including the Generation Service Rider, the Generation Phase-In Rider, the Demand-Side Management (DSM) and Energy Efficiency (EE) Rider, the Non-Distribution Uncollectible Rider, and the fuel cost adjustment rider;
4. FirstEnergy's proposed carrying charge methodology for deferrals;
5. Its proposal for distribution rates and related distribution cost deferrals; and
6. Finally, I will comment on FirstEnergy's proposed significantly excessive earnings test.

**Proposed Riders**

**Q PLEASE SUMMARIZE THE NEW RIDERS PROPOSED BY FIRSTENERGY.**

A FirstEnergy is proposing to implement several new riders as part of its ESP. Based on its filing, over 80% of FirstEnergy's revenue requirement will be recovered via riders.

**Q DO YOU FIND THE PROPOSED RIDERS WILL CONTRIBUTE TO THE ENERGY SECURITY AND COMPETITIVE POSITION OF FIRSTENERGY'S OHIO SERVICE TERRITORY?**

**A** No. To the contrary, the Riders proposed by FirstEnergy will have many negative impacts including the following:

1. The riders will not properly allocate costs between customer classes.
2. The riders will reduce FirstEnergy's incentive to manage costs.
3. Recovering a significant amount of revenue via riders will significantly erode ratepayer assurance of paying just and reasonable rates.
4. The riders will result in unnecessary rate volatility, which in turn will likely erode Ohio's competitive business position.

**Q WHY DO YOU BELIEVE FIRSTENERGY PROPOSED RIDERS WILL NOT PROPERLY ALLOCATE COST BETWEEN CUSTOMER CLASSES?**

**A** Many of the costs proposed to be recovered through FirstEnergy's proposed riders will be allocated between customers on a cents per kilowatt-hour basis. An energy cost allocation is not reasonable for the following riders: the Demand-Side Management and Energy Efficiency Rider, the Economic Development Rider, and the Non-Distribution Uncollectible Rider. An energy allocation of the costs included in these riders is inappropriate and unjust, because none of the costs proposed to be recovered through these riders varies with the customer's use of electric energy. Because of this inappropriate and unjust cost allocation, these riders will improperly allocate cost to FirstEnergy's Ohio utilities' high load factor customers.

This inappropriate and unjust allocation shifts the burdens of these costs to customers that are most vulnerable to competition with companies around the country and around the world.

1    **Q     WHY DO YOU BELIEVE THE ESP RIDER RATE MECHANISMS WILL ERODE**  
2       **FIRSTENERGY'S INCENTIVE TO AGGRESSIVELY MANAGE COSTS?**

3    **A     The proposed riders simply track cost and adjust charges to ensure that the rider**  
4       **revenues will provide recovery of rider cost. Therefore, the Company's management**  
5       **need not aggressively manage rider costs in order to earn a fair return, because the cost**  
6       **will simply be passed onto retail customers without a complete review of all revenues**  
7       **and cost of service.**

8           Moreover, during the period between rate cases, which is sometimes referred to  
9       as the "regulatory lag," a utility has a strong incentive to control its costs to be more  
10      profitable to its shareholders and to diminish the need for future rate cases. Between  
11      rate cases, a utility has a profit motivation that causes the utility to be diligent and  
12      efficient in seeking the best pricing possible for its needed equipment, since it benefits  
13      from cost savings during this period. Similarly, a utility may be able to better manage its  
14      costs through more efficient operations. However, if a utility is simply guaranteed  
15      immediate dollar-for-dollar recovery of costs through a rider mechanism, the utility has a  
16      far weaker incentive to be as diligent or efficient in its procurement and operations.

17           To the extent a utility can choose between cost recovery through rates set in a  
18      traditional rate case and immediate recovery of costs through a rider independent of  
19      potential offsets, its reasonably expected choices can lead to increased cost for  
20      customers. For example, assume that persistent bill collection efforts can mitigate the  
21      level of uncollectibles in a year. If a utility knows that it can collect dollar-for-dollar its  
22      actual cost associated with uncollectible expense through a rider, it may choose to  
23      spend less on bill collection efforts between rate cases, since such deferred  
24      expenditures contribute directly to the profitability of the utility. Customers would have  
25      been better off if diligent collection efforts had been performed. A utility might also have  
26      an incentive to classify expenses in a way that maximizes rider collections, rather than

forego recovery until its next rate case. Such choices are not transparent and could increase the difficulty of the Commission's evaluation of the utility's costs in a subsequent rate case and the proposed rider proceedings.

**Q PLEASE EXPLAIN HOW THE ESP RIDERS WILL ERODE RATEPAYERS' PROTECTION OF PAYING JUST AND REASONABLE RATES.**

**A** In establishing a utility's revenue requirement or cost of service in a rate case, the Commission considers all cost of service components, and all revenue available to recover cost of service. These costs components include items such as utility rate base, operating expenses, cost of capital, load growth, and other factors. Under traditional regulation, when the Commission determines that the utility's profit level or rate of return is unreasonably high or low, an adjustment to current rates is made. This complete review of all costs and revenues ensure that rates are just and reasonable.

This concept of looking at all the utility's cost of service and revenues at current rates during a ratemaking test year is the long-standing rate-setting practice of utility regulatory commissions throughout the U.S. Between rate cases, some utility cost elements may increase, but the increases may be offset by decreases in other cost elements. Even if a utility's cost structure exhibits a net increase over time, this circumstance alone does not mean a rate adjustment is warranted, as increased revenues from additional sales may be adequate to cover the increased costs.

Since all of these factors combine to determine proper rates, looking at selected cost elements in isolation between comprehensive rate cases can tilt the balance of costs, savings, and revenues that determine just and reasonable rates. In the proposed ESP riders, cost and revenue collections will be isolated to a single issue or piece-meal ratemaking. The ESP riders will modify charges to customers by review of only a single category of costs without regard to potential declines to other cost elements or increases

1 in revenue. This single-issue ratemaking rate methodology should be avoided by the  
2 Commission because customer protection will not be maintained.

3 **Q CAN RIDERS CREATE CROSS-SUBSIDIES WITHIN AND BETWEEN RATE**  
4 **CLASSES?**

5 **A** Yes. If the structure of a rider is such that it collects revenues from customers on bases  
6 different from those used in recovering similar costs through base rates, or if the rider is  
7 otherwise not reflective of cost-causation principles in its design and application, it  
8 creates a rate cross-subsidy and should not be approved. Similarly, if a rider is  
9 associated with ratemaking cost that would be allocated among classes on the basis of  
10 demand, it would be improper to collect the charges from customers on a different basis  
11 through a rider, such as on the basis of energy consumption, since charges would not  
12 reflect cost-causation principles, as determined in the more comprehensive analysis of a  
13 rate case.

14 **Generation Service Rider**

15 **Q PLEASE SUMMARIZE FIRSTENERGY'S PROPOSAL FOR A GENERATION**  
16 **SERVICE RIDER.**

17 **A** FirstEnergy has proposed average basic generation service prices of 7.5¢ per kWh, 8.0¢  
18 per kWh, and 8.5¢ per kWh for 2009, 2010 and 2011, respectively. In an effort to  
19 mitigate the impact on retail customers, FirstEnergy is proposing a 10% discount to  
20 these base generation charges through 2011. The discounted generation cost will be  
21 deferred and recovered in a deferral account for future recovery from retail customers.

22 The Company is proposing to recover this generation cost based on seasonal  
23 variation and delivery service voltage level differentiations. (Application at 10).

**Q DO YOU BELIEVE THE COMPANY'S PROPOSAL FOR BASIC GENERATION SERVICE IS REASONABLE?**

**A** I support the Company's proposal for a seasonal, and voltage level adjustment to its generation cost. Further, I support the Company's proposal for an optional time-of-day (TOD) differentiated generation service price option. This TOD price structure will encourage customers to improve more efficient power demands on the utility because more accurate price signals are transmitted to retail customers. However, the company should investigate whether a pricing option based on the functional cost of generation, (i.e., capacity and energy pricing elements) would provide more accurate price signals and allow customers to more economically invest and participate in demand side management and energy efficiency procedures and programs.

**Q SHOULD THE COMPANY'S GENERATION PHASE-IN RIDER (GPI) ALSO TRACK COST BASED ON A SEASONAL VOLTAGE LEVEL AND TOD BASIS?**

**A** Yes. The Company should track generation cost deferrals based on customer class (voltage level), season, and time-of-day period costs. Efforts should be made to recover the deferred generation costs from the retail customers that received the deferred generation credit. This is best accomplished by tracking the deferred generation credit by customer class, season, and TOD.

**Q DO YOU HAVE ANY COMMENTS RELATED TO HOW THE COMPANY IS PROPOSING TO ACCRUE A CARRYING CHARGE ON DEFERRED GENERATION COST?**

**A** Yes. The Company is proposing various deferral mechanisms based on either Company long-term debt, or a possible securitization plan. In either event, a deferral

1 mechanism should be accrued based on the most advantageous carrying cost  
2 alternative available to the Company. That is, the deferral mechanism should provide  
3 full recovery of these deferrals to the Company, but at the lowest possible cost to retail  
4 customers. Accomplishing this objective is fully consistent with the Ohio law's objective  
5 of maintaining a competitive rate structure to support and enhance the economic  
6 development of Ohio, and is consistent with providing full cost recovery to Ohio utilities  
7 in an effort to maintain their financial integrity and ability to offer low-cost, high quality  
8 utility service.

9 Toward this objective, I recommend the carrying charge in the event the utility's  
10 cost of capital is adopted to fully include all deferred tax offsets associated with  
11 unrecovered generation prices, and carry "net of tax" balance at the utility's cost of  
12 long-term debt.

13 In the event a securitization plan is adopted, the Commission should carefully  
14 consider the mechanics and protocols of securitization financing in order to ensure that it  
15 maximizes the expected cost benefits to retail customers. Toward this objective,  
16 important aspects related to a securitization plan include:

- 17 1. Maximizing the use of low-cost securitization bonds to the extent it lowers retail  
18 customers' costs;
- 19 2. Retaining deferred tax balances associated with securitization costs to use as a  
20 reduction to utility capital requirements and non-securitization charges; and
- 21 3. Minimizing the overall charges to customers. This includes the cost of securitization  
22 bonds and all other cost of service components included in retail rates.

24 All of these aspects should be carefully considered in a special securitization  
25 proceeding where the Commission carefully considers the economic benefits from the  
26 use of securitization bonds.

**Demand-Side Management and Energy Efficiency Rider**

**Q PLEASE DESCRIBE THE COMPANY'S PROPOSED DEMAND-SIDE MANAGEMENT (DSM) AND ENERGY EFFICIENCY (EE) RIDER.**

**A** FirstEnergy witness Hussing states that the Company's DSM and EE rider will recover costs incurred by the Company associated with energy efficiency and demand-side management programs, and would also provide recovery of lost distribution revenues. He states that in an effort to encourage customers to implement energy efficiency initiatives, the rider is structured in such a way that customers may avoid a charge by implementing customer-sided programs that help the Company secure compliance with R.C. 4928.64 and 4928.66. (Hussing Direct Testimony at 10 and 11).

**Q SHOULD THE COMPANY'S PROPOSED DSM/EE RIDER BE MODIFIED?**

**A** Yes. The Company's proposed DSM/EE rider and its general DSM/EE programs should be modified as follows:

1. I agree with the Company's proposal that customers that undertake DSM/EE programs on their own should be able to opt out or avoid paying the DSM/EE rider charges. However, this opt-out provision should be expanded to include customers that have already made investments in DSM/EE programs. Customers should be allowed to avoid the DSM/EE rider by making investments or changing operating procedures tailored to maximize efficiency at their facility.
2. The Company's proposal for general constraints on the types of investments which will allow a customer to opt out are too restrictive, and will not necessarily achieve the overall goal of maximizing the utilization efficiency of the utility system.
3. The Company's DSM/EE programs should be expanded to provide an option for customers to participate in wholesale demand response programs or other DSM/EE programs at the wholesale level. To the extent wholesale programs offer a viable means for customers to modify load consumption in response to wholesale market pricing signals, customers should be allowed to participate in these programs in an effort to maximize the efficiency of the wholesale and the retail power delivery system.
4. The Company's proposal to recover lost distribution revenues in a DSM/EE rider should be rejected. And

1 5. The Company's proposal to recover the DSM/EE costs on an energy basis does not  
2 correspond to the actual cost and benefits of the DSM/EE programs. Specifically,  
3 these programs will be designed to produce both capacity and energy efficiencies  
4 and savings. Therefore, allocating these costs on purely an energy basis can erode  
5 the economic benefits to retail customers of pursuing DSM/EE programs, and can be  
6 an impediment to the full economic benefits of such programs.

7 **Q WHY IS IT IMPORTANT TO ALLOW CUSTOMERS THAT UNDERTAKE DSM/EE**  
8 **INVESTMENTS ON THEIR OWN TO BE ABLE TO AVOID OR OPT OUT OF THESE**  
9 **DSM/EE CHARGES AND PROGRAMS SPONSORED BY THE COMPANY?**

10 **A** Many industrial and large commercial customers have already undertaken DSM/EE  
11 programs for many years. Many large users have made significant investments in  
12 DSM/EE programs, and have modified consumption in order to reduce costs and  
13 maximize energy efficiency. These customers should not be required to subsidize  
14 DSM/EE programs for other customers, particularly not other large industrial and  
15 commercial customers with whom they compete. Such a requirement would result in the  
16 subsidization of DSM/EE programs to customers that did not get out front with these  
17 efficiency programs from other customers who did.

18 **Q WHY IS IT APPROPRIATE TO ALLOW CUSTOMERS TO PARTICIPATE DIRECTLY**  
19 **IN WHOLESALE MARKET CAPACITY RESPONSE AND OTHER TYPES OF DSM**  
20 **AND EE PROGRAMS?**

21 **A** Ohio should allow retail customers to participate in wholesale market demand response,  
22 and other DSM/EE programs to maximize the efficiency of the demand in the wholesale  
23 market place. Approximately 90% of participants in these programs in the Midwest ISO  
24 are retail customers that receive this opportunity directly through their utility providers.  
25 (Coordination of Retail Demand Response with Midwest ISO Wholesale Markets, May  
26 2008, p. xiii). As such, Ohio should allow its retail customers the same opportunities

1 that exists in other jurisdictions, and allow retail customers to directly participate in  
2 demand response programs and other DSM/EE programs offered by their wholesale  
3 market participants, including the regional transmission organizations.

4 **Q WHY WOULD IT BE INAPPROPRIATE TO RECOVER THE COSTS OF DSM/EE**  
5 **PROGRAMS PURELY ON AN ENERGY ALLOCATION?**

6 A Allocating DSM and EE costs on purely an energy allocator misstates how these costs  
7 would be incurred by the Company, and the benefits they will create. Indeed, many  
8 DSM and EE programs are designed to reduce peak demand, and not just reduce  
9 energy consumption. A reduction in peak demand should be allocated based on a  
10 demand allocation function and not an energy allocator. As such, DSM/EE riders should  
11 be allocated between customers, recognizing that these programs will benefit customers  
12 by a reduction in capacity costs and energy costs.

13 **Q WHY SHOULD LOST DISTRIBUTION REVENUE NOT BE INCLUDED AS A**  
14 **COMPONENT OF RECOVERY IN THIS RIDER?**

15 A The Company should be allowed to charge rates that are expected to fully recover its  
16 cost of distribution service. However, DSM/EE sales reductions may not prevent this full  
17 cost recovery. The Company will only lose DSM/EE sales profit margins to the extent  
18 normal sales and demand growth do not offset the DSM/EE sales declines. Indeed,  
19 sales changes are a dynamic factor that will be impacted by factors other than DSM/EE  
20 programs. The bottom line is that the Company will only experience a loss of revenue  
21 requirement to the extent it does not fully recover its operating expenses and earn a  
22 return in line with what the Commission determines to be a fair rate of return.

23 Simply assuming, as FirstEnergy implicitly does, that lost distribution sales  
24 caused by DSM/EE activities will cause them to under-recover distribution utility cost of

1 service is, at best, speculative single issue ratemaking, and including lost margin in the  
2 DSM/EE rider would be bad regulatory policy. FirstEnergy's proposal will tip the balance  
3 of setting just and reasonable distribution rates in favor of the Company, and will expose  
4 its retail customers to unnecessary and unjustifiable rate increases under its DSM/EE  
5 rider for nothing more than an assumption that DSM/EE sales reductions will cause it to  
6 under-recover distribution costs.

7 Rate increases should not be based on simple, and unsupported assumptions.

8 **Q PLEASE OUTLINE HOW YOU PROPOSE TO DESIGN A DEMAND-SIDE**  
9 **MANAGEMENT AND ENERGY EFFICIENCY RIDER.**

10 **A** The Company should be allowed to recover legitimate and Commission approved  
11 demand-side management and energy efficiency costs from customers that benefit from  
12 those expenditures. To the extent large commercial and industrial customers undertake  
13 demand-side management and energy efficiency programs on their own, they should be  
14 able to opt out of FirstEnergy's demand-side management and energy efficiency  
15 programs, and avoid paying this DSM/EE rider charge.

16 This flexibility will ensure that industrial and large commercial customers can  
17 undertake DSM and EE programs on their own, and will not be required to pay a portion  
18 of a utility-sponsored program. Also, large customers should not be required to  
19 subsidize DSM/EE program cost as these businesses are in fiercely competitive  
20 environments, and this unjust subsidization will limit their ability to compete successfully  
21 in their own markets. The participation and pricing of a DSM/EE program and rider  
22 charge should not be in contradiction to the ESP's overall objective of maintaining  
23 competitive rates in the state of Ohio.

**Non-Distribution Uncollectible Rider (NDU)**

**Q PLEASE DESCRIBE THE COMPANY'S PROPOSED NON-DISTRIBUTION  
UNCOLLECTIBLE (NDU) RIDER MECHANISM**

A The Company's proposed NDU Rider mechanism will recover uncollectible non-distribution related costs. According to the direct testimony of Gregory Husing at pp.12-14, the Company's collection practices that are guided by the rules of the Commission necessitate the need for this rider.

**Q PLEASE EXPLAIN FURTHER.**

A. According to the Company, the Commission's rules on collection practices require substantial notice periods and seasonal shut-off moratoria. These rules promote social objectives, which in turn have a cost in the form of uncollectible costs, and the Company must have the ability to recover these uncollectible costs resulting from state policy. According to the Company, since collection policy is dictated by state policy, and since the Company serves as the default service provider, it does not have as good of an opportunity to manage its collection costs as third-party CRES suppliers that can establish their own credit rules to minimize uncollectible accounts.

**Q DO YOU AGREE WITH THE COMPANY'S RATIONALE FOR THE NDU RIDER?**

A. No. The issue of managing the collection of uncollectible accounts is not a new issue. The Company has historically had to manage this uncollectible expense and under traditional ratemaking has had an incentive to aggressively do so. For reasons discussed previously in my testimony, a rider that automatically allows the Company to pass on the costs associated with uncollectible accounts removes all incentive to aggressively manage this expense.

1 Q WHAT IS YOUR RECOMMENDATION WITH RESPECT TO THE NDU RIDER?

2 A I recommend that the Commission not approve the Company's proposed NDU Rider.

3 **Distribution Service**

4 Q PLEASE DESCRIBE THE COMPANY'S PROPOSAL FOR DISTRIBUTION RATES.

5 A FirstEnergy is proposing a \$75 million increase for Ohio Edison ("OE"), a \$40.5 million  
6 increase for Toledo Edison ("TE"), and a \$34.5 million increase for Cleveland Electric  
7 Illuminating Company ("CEI"). FirstEnergy proposes to implement these new distribution  
8 rate increases on January 1, 2009 for OE and TE, and May 1, 2009 for CEI. Further, the  
9 Company proposes to defer approximately \$25 million of distribution-related cost for  
10 CEI, during the period of January 1, 2009 through April 31, 2009.

11 The Company asserts that these revenue requirements are based on a 10.5%  
12 return on equity. The Company is proposing to not seek additional distribution rate  
13 increases before January 1, 2014.

14 Also, the Company is proposing a Distribution Service Improvement (DSI) rider  
15 with the following features:

- 16 1. A performance test to adjust cost recovery in the DSI rider. The performance  
17 test relates to a SADI mechanism, and a time response program. The  
18 Company proposes up to a 15% annual adjustment to the DSI charge each  
19 calendar year through 2013, based on SADI and time response performance.
- 20 2. The Company proposes to defer storm damage cost in excess of \$13.9  
21 million.
- 22 3. The Company proposes to defer effectively the entire incremental revenue  
23 requirement for capital additions related to line extension cost and new plant  
24 investments. These deferred cost would then be subject to recovery in  
25 distribution rates in 2014.

**Q IS THE COMPANY'S PROPOSAL FOR DISTRIBUTION RATES REASONABLE?**

A No. The Company's proposal for a modified version of the rate increase has not been shown to be just and reasonable and should not be permitted. Further, the Company's proposal for a 10.5% return on equity has not been shown to be appropriate in recognition of significant risk reduction aspects of the new Ohio law, and FirstEnergy's significant use of automatic rate adjustment riders. Therefore, a 10.5% equity return is not appropriate for FirstEnergy in this case.

**Q WHY DO YOU BELIEVE THAT A 10.5% RETURN ON EQUITY IS EXCESSIVE FOR FIRSTENERGY GIVEN THE NEW OHIO LAW?**

A A 10.5% return on equity that is based on traditional ratemaking practices would not be appropriate for a utility which recovers 80% of its revenue requirement in tracker mechanisms, or with full deferral authority. These tracker mechanisms and full deferral authority will provide significantly enhanced assurance of full cost recovery, and significantly lower the operating risk of Ohio utilities. This reduced operating risk will benefit Ohio utilities, and result in significantly more rate volatility risk to retail customers. As such, it would be appropriate to reduce the authorized return on equity to reflect the reduction to operating risk for Ohio utilities, but also result in lower retail distribution rates to customers to compensate them for assuming a greater cost recovery risk volatility inherent in the new regulatory mechanism. As such, a return on equity of around 10% would be more appropriate, and I would also recommend the Commission limit the common equity ratio of total capital structure used to develop rates to no higher than 50% for any of the FirstEnergy utilities if their significant rider proposals and deferred cost recovery are permitted. This lower return on equity, and limited use of higher cost common equity capital, will minimize their revenue requirement, and compensate customers for assuming significant cost recovery risk.

1    **Q     WHY DO YOU BELIEVE THE COMPANY'S PROPOSAL FOR DEFERRING**  
2       **REVENUE REQUIREMENT ASSOCIATED WITH LINE EXTENSION COST AND NEW**  
3       **DISTRIBUTION PLANT INVESTMENTS IS UNJUST AND UNREASONABLE?**

4    **A     The Company's proposal to defer the revenue requirements associated with new line**  
5       **extensions and new plant investments, will result in the over-recovery of**  
6       **distribution-investment costs. The "net" investment in distribution plant will decline as**  
7       **depreciation expense is recovered during the period rates initially set in this proceeding**  
8       **are in effect. As the Company recovers additional depreciation expenses, its**  
9       **accumulated depreciation reserve will increase, and the rate base value of 2009 net**  
10      **distribution plant will decline. That decline in distribution rate base would normally be**  
11      **offset by incremental plant additions to rate base in the form of line extensions and new**  
12      **plant investment. The ultimate impact on distribution plant rate base then will be the**  
13      **combination of decreases in the net plant value of distribution plant at the beginning of**  
14      **2009, and plant additions for each year during the rate moratorium period.**

15           Under the Company's proposal, however, distribution rates would be frozen  
16      based on the 2009 rate base value distribution-related plant. All incremental additions to  
17      distribution plant would then be deferred in a deferral account. That deferral account will  
18      then be subject to recovery at the end of the rate moratorium period. As such, the  
19      Company is not giving proper recognition that new plant additions to its distribution rate  
20      base after 2009 will be offset by reductions to distribution rate base caused by the  
21      increase to depreciation reserve and, thus, reductions to net distribution plant. That is,  
22      the impact on rate base will be the combination of plant additions less reductions in net  
23      plant caused by the buildup of accumulated depreciation reserve. This change in net  
24      plant and rate base can be supported at current distribution rates without a rate increase  
25      or cost deferral.

1           As a result, the Company's combined rate moratorium, along with deferrals of all  
2           the revenue requirements associated with incremental plant investments, will allow it to  
3           over-recover its distribution plant investment during the rate moratorium period.

4    **Q    WHY DO YOU BELIEVE THAT THE COMPANY'S PROPOSAL FOR PRICE**  
5           **ADJUSTMENTS IF PERFORMANCE TARGETS ARE BEING MET IS**  
6           **UNREASONABLE?**

7    **A    The Company should be expected to achieve certain levels of reliability and safety in**  
8           **providing service to retail customers. Hence, the Company should not be rewarded by**  
9           **pricing enhancement by simply accomplishing what they are expected to provide. In**  
10           **other words, it should be expected that the Company will meet these reliability standards**  
11           **and the incentive for doing so will be the privilege of providing regulated utility service to**  
12           **retail customers. No rate adjustment, or financial incentive above a fair and reasonable**  
13           **return on equity, should be exchanged for encouraging utility management to provide**  
14           **reliable service.**

15    **Earnings Test Proposal**

16   **Q    PLEASE DESCRIBE THE COMPANY'S PROPOSAL FOR A SIGNIFICANTLY**  
17           **EXCESSIVE EARNINGS TEST.**

18   **A    FirstEnergy witness Michael Vilbert is proposing a significant earnings test tied to a rate**  
19           **of return on average total capital. As discussed at page 6 of his testimony, he proposes**  
20           **to estimate the after-tax net income adjusted for non-recurring costs, as a percentage of**  
21           **total capital. He defines total capital as the sum of common equity, preferred equity and**  
22           **long-term debt. He proposes to estimate common equity based on an average year**  
23           **concept.**

1    **Q     DO YOU BELIEVE MR. VILBERT'S PROPOSED EARNINGS TEST IS**  
2       **REASONABLE?**

3    **A     No. Mr. Vilbert's earnings test is inconsistent with traditional ratemaking principles and**  
4       **should be rejected. Specifically, utilities' earnings have traditionally been set based on**  
5       **the opportunity to recover reasonable and prudent cost and earn a fair return on**  
6       **common equity. This ratemaking methodology has been used successfully for many**  
7       **years, to protect retail customers and has help to support utilities financially integrity,**  
8       **credit ratings, and access to debt and equity capital market under reasonable terms and**  
9       **prices.**

10   **Q     HOW SHOULD A SIGNIFICANT EARNINGS TEST BE EMPLOYED BY THE**  
11       **COMMISSION TO DETERMINE WHETHER OR NOT RATES IMPOSED ON RETAIL**  
12       **CUSTOMERS ARE EXCESSIVE?**

13   **A     Rates charged to Ohio customers should provide no more than fair and reasonable**  
14       **compensation. I recommend this test be based on whether the FirstEnergy utilities are**  
15       **earning the Commission approved return on common equity. If the return on equity is**  
16       **equal to or more than the Commission approved return on equity, than no increase in**  
17       **utility rates or riders is necessary and should be permitted.**

18           This should be accomplished as follows. First, from the same twelve month time  
19       period, all reasonable and prudent operating expenses related to the provision of  
20       regulated utility service should be subtracted from all revenue generated from current  
21       utility rates and utility rider charges to produce the utility operating income at current  
22       revenue. Second, the utility operating income should be converted to a rate of return on  
23       utility rate base. The utility rate base should reflect only reasonable and prudent utility  
24       plant that is used and useful in providing utility service based on the same twelve month

1 period as the utility operating income. The rate of return is the product of operating  
2 income divided by rate base. Third, a reasonable utility capital structure should be used  
3 to determine the rate of return on common equity by subtracting the weighted cost of  
4 debt and preferred equity from the rate of return on utility rate base. This will produce  
5 the weighted common equity return. Next, the return on common equity is determined  
6 by dividing the weighted common equity return by the capital structure's ratio of common  
7 equity to total capital. Finally, if the return on common equity is equal to or higher than  
8 the last Commission approved return on equity than no increased to the utility's rates or  
9 rider mechanisms should be permitted.

10  
11 This test will ensure rates are just and reasonable, and the utility is fairly compensated.  
12

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

14 **A** Yes.

**Qualifications of Michael Gorman**

**Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

**A** Michael Gorman. My business mailing 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 Bachelor of Science Degree in Electrical Engineering from Southern Illinois University, and in 1986, I received a Master's 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.

1 Among other things, I conducted analyses and sponsored testimony before the ICC  
2 on rate of return, financial integrity, financial modeling and related issues. I also  
3 supervised the development of all Staff analyses and testimony on these same  
4 issues. In addition, I supervised the Staff's review and recommendations to the  
5 Commission concerning utility plans to issue debt and equity securities.

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

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

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

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

3 **Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

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

17 **Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANI-**  
18 **ZATIONS TO WHICH YOU BELONG.**

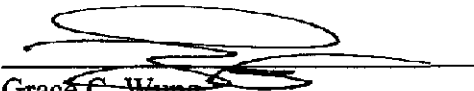
19 **A** I earned the designation of Chartered Financial Analyst ("CFA") from the CFA  
20 Institute. The CFA charter was awarded after successfully completing three  
21 examinations which covered the subject areas of financial accounting, economics,  
22 fixed income and equity valuation and professional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

**IN THE MATTER OF THE APPLICATION OF  
OHIO EDISON COMPANY, THE  
CLEVELAND ELECTRIC ILLUMINATING  
COMPANY AND THE TOLEDO EDISON  
COMPANY FOR AUTHORITY TO  
ESTABLISH A STANDARD SERVICE  
OFFER PURSUANT TO R.C. 4928.143 IN  
THE FORM OF AN ELECTRIC SECURITY  
PLAN**

 **MARIA E. DECKER**  
Notary Public, State of Missouri  
St. Louis City  
Commission # 05706793  
My Commission Expires May 05, 2009

**CERTIFICATE OF SERVICE**

I hereby certify that a copy of the "Direct Testimony of Michael P. Gorman on behalf of The Commercial Group" was served via first class mail upon the following parties of record this 29<sup>th</sup> day of September, 2008.

  
Grace C. Wung

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