BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Request for rate increase by Gulf Power Company.) DOCKET NO. 010949-EI

VOLUME NUMBER 2

Pages 50 through 156

IN RE: HEARING

BEFORE: CHAIRMAN LILA A. JABER
COMMISSIONER J. TERRY DEASON
COMMISSIONER BRAULIO L. BAEZ
COMMISSIONER MICHAEL A. PALECKI
COMMISSIONER RUDOLPH "RUDY" BRADLEY

DATE: MONDAY, FEBRUARY 25, 2002

TIME: COMMENCED AT 9:30 A.M.

PLACE: FPSC
4075 ESPLANADE WAY
ROOM 152
TALLAHASSEE, FLORIDA

REPORTED BY: NANCY S. METZKE, RPR, CCR

APPEARANCES: (As heretofore noted.)

I N D E X

EXHIBITS - VOLUME VI

P R O C E E D I N G S

(Transcript continues in sequence from Volume 1)

CHAIRMAN JABER: Thank you. Okay. That concludes opening statements. Mr. Bowden, you have a summary of your testimony? Actually, go ahead, Mr. Stone.

T. J. BOWDEN

was called as a witness on behalf of Gulf Power Company, and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. STONE:

Q Mr. Bowden, you were present when we swore the witnesses in earlier this morning?

A Yes.

Q Okay. And you did take the oath? You did take the oath at that time?

A I did.

Q Would you please state your name and business address for the record?

A Travis J. Bowden, 1 Energy Place, Pensacola, Florida.

Q And you are employed by Gulf Power Company as its president and chief executive officer; is that correct?

A That's correct.

Q Have you filed prefiled testimony consisting of eight pages?

A Yes, I have.

Q Do you have any changes or corrections to that prefiled direct testimony?

A No, I do not have any changes.

Q So if I were to ask you the same questions contained in that prefiled testimony today, your answers would be the same?

A They would be the same.

MR. STONE: We ask that Mr. Bowden's prefiled direct testimony, consisting of eight pages, be inserted into the record as though read.

CHAIRMAN JABER: Prefiled direct testimony of Travis Bowden shall be inserted into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Prepared Direct Testimony of
Travis J. Bowden
Docket No. 010949-EI
In Support of Rate Relief
Date of Filing: September 10, 2001

Q. Please state your name, business address, and occupation.

A. My name is Travis J. Bowden. My business address is One Energy Place, Pensacola, Florida, 32520. I am President and Chief Executive Officer of Gulf Power Company.

Q. Please summarize your educational and professional background.

A. I graduated from the University of Alabama in 1960 with a BS in Accounting. After several years in public accounting with Arthur Andersen and Company, I joined Alabama Power Company in November 1975 where in 1978 I was named Vice President Finance and Treasurer, progressing to Executive Vice President in 1992 before becoming President of Gulf Power Company in 1994.

Q. What is the purpose of your testimony?

A. The primary purpose of my testimony is to emphasize Gulf's need for adequate and timely rate relief, and I will provide an overview of Gulf's filing in this case. I will identify the major factors causing the need for adequate and timely rate relief and the impact these factors have on Gulf's return in the test year. I will also review our efforts to control costs and discuss the innovative programs we have put into place that have resulted in high customer satisfaction ratings and low rates.

Q. Please give an overview of each witness and the topics they will address in this case?

A. Mr. Labrato addresses the overall need for rate relief, financial forecast data, development of the rate base, net operating income, capital structure and revenue deficiency, and other accounting issues.

Mr. Moore addresses construction and completion of the Company's new combined cycle generating unit known as Smith Unit 3, the change in production maintenance philosophy, the production O & M expense budget, the production construction expenditures, the production Benchmark, and the fuel inventories.

Mr. Fisher addresses the distribution O & M budget and construction expenditures, distribution Benchmark, and distribution productivity improvements.

Mr. McMillan addresses the A & G budget, A & G Benchmark, total company Benchmark, and taxes.

Mr. Saxon addresses the planning and budgeting process, assumptions for the forecast, salary increases, general plant construction expenditures, and customer accounting expenses.

Mr. Benore addresses Gulf's cost of common equity.

Mr. Howell addresses the transmission O & M budget and construction expenditures, transmission Benchmark, intercompany interchange, off-system sales, and transmission line rentals.

Ms. Neyman addresses the purpose of marketing functions, the justification of individual program costs, customer service and information, sales expenses, and conservation.

Mr. McGee addresses the forecasts of customers, energy, demand and base rate revenues; and the load research function.

Mr. Thompson addresses rate design and other tariff issues.

Mr. O'Sheasy addresses the cost of service study.

Q. How long has it been since Gulf last filed for an increase to base rates?

A. Gulf's last case was Docket No. 891345-EI filed in 1989 based on a 1990 projected test year.

Q. What are the factors that cause the need for rate relief?

A. The Company's test year for this case reflects one major factor and a number of other conditions that have caused the cost of providing electric service to increase in the twelve and one-half years since the Company's last rate filing in 1989 that makes filing this case necessary. The major factor is the completion and placing into service of Smith Unit 3, a 574 megawatt ("mW") combined cycle generating unit with a budgeted investment of $220.5 million. Other factors contributing to increased costs are: the cumulative effect of inflation, the addition of over 100,000 new customers, the addition of over 1400 miles of new distribution lines and 90 miles of new transmission lines, an increase in customer requirements and expectations primarily caused by the widespread use of computers and other technologies, and the replacement and repair of the aging electrical infrastructure associated with the double-digit customer growth that occurred in the mid 1980's.

Q. Has Smith Unit 3 been permitted pursuant to the Florida Electrical Power Plant Siting Act?

A. Yes. Pre-filed testimony by Gulf's witnesses Mr. Moore and Mr. Howell address in detail this process and the results.

Q. What actions has Gulf taken since its last retail rate case in 1989, Docket No. 891345-EI, to control costs?

A. As discussed in the pre-filed testimony of Gulf's witness, Mr. Saxon, Gulf updates and prepares an annual budget for capital expenditures and O & M expenses. Actual costs are compared to these budgets on a continual basis to ensure that they are consistent with plans and are reasonable. Even though our customer base has grown substantially since 1990, we have fewer employees today than in 1990. We have taken advantage of new technology and have consolidated functions across Southern Company to increase efficiencies at almost every level of the Company.

Q. Are Gulf's test year O & M expenses reasonable?

A. Yes. Since the 1990 test year used in the last case, Gulf's customer base has increased by approximately 32 percent and the Consumer Price Index by approximately 39 percent resulting in a compound growth rate for customers and inflation of 83 percent. The growth of Gulf's O & M over that same period is well below 83 percent. This has resulted in Gulf being under the Commission's Benchmark by $3.7 million. The resulting difference is a strong indicator of the success Gulf has achieved in controlling expenses. Gulf's witness Mr. McMillan discusses this further in his pre-filed testimony.

Q. How has Gulf's emphasis on controlling costs affected the size of Gulf's workforce?

A. At the end of 1990, Gulf had 1626 employees. For the test year, Gulf is budgeting 1382 Gulf employees and 85 Southern Company Services employees on site for a total of 1467, or 159 fewer employees. This is nearly a 10 percent reduction.

Q. With an increase in customers and infrastructure during this time, how was the Company able to operate with a reduced workforce?

A. This reduction in workforce was accomplished through new programs and technologies that have resulted in numerous efficiencies and allowed the continuous improvement in our service levels and customer satisfaction.

Q. Would you please expand further on some of the major programs that have made the Company more efficient.

A. In the Distribution function, the major new programs are the Trouble Call Management System (TCMS), Earned Progression, the Customer Service System (CSS), and more recently the Automated Resource Management System (ARMS). Collectively, these new programs serve to automate the analysis and scheduling of the distribution outage and service response.

Gulf's witness Mr. Fisher has pre-filed testimony with further details on · each of these innovations.

Q. You have described the major new programs for the Distribution function. What are the major new programs in the Power Generation function?

A. The major new programs in the Power Generation function are the Plant Reliability Optimization program (PRO), the Generation Availability Data System (GADS), and the Project Evaluation and Priority System (PREPS). Collectively, these systems automate an extremely complex job of optimizing the impact of the Southern system's maintenance dollars and minimizing outages. Gulf's witness Mr. Moore has pre-filed testimony providing additional detail on these programs.

Q. Are there other economies and efficiencies of a more general nature?

A. Yes. During the 36-month long Y2K effort at Gulf, numerous opportunities to apply new technology and increase efficiencies arose. We were able to consolidate many company specific applications into Southern system-wide applications. One of the most notable improvements was the consolidation of the Southern system's purchasing/inventory applications. Another notable accomplishment from our Y2K efforts was the replacement of the 20-plus year old customer accounting system with the new Customer Service System (CSS). Gulf's witness, Mr. Fisher, addresses CSS in his pre-filed testimony.

Q. Are there any other major economies and efficiencies of a general nature that have affected Gulf's workforce?

A. Yes. Adopting new technologies has had a very positive effect. The personal computer (PC) has had a significant impact on Gulf's efficiency and has helped in the reduction of our workforce. Although no specific analysis has been made to determine the impact of personal computers on the size of the workforce reduction, the PC has affected virtually every job in the Company. We've also installed an 800 megahertz radio system that has revolutionized our abilities to communicate individually and in talk groups across Northwest Florida and the entire Southeast. We now have computers in our line service trucks to speed work orders and material deliveries to work sites. We have computer systems that can track power outages to improve restoration times. And, we are using digital cameras and intranet applications to do engineering work in the field. All of these new technologies have had a positive impact on our workforce.

Q. What has been the effect of these new programs and other innovations?

A. First, Gulf's rates are among the lowest in the state of Florida and the nation. This distinction will also continue to exist after granting this rate increase. Gulf's witness Mr. Labrato's pre-filed testimony provides additional detail on this rate comparison. Second, in a National Customer Value Survey, Gulf has ranked at the top of the comparison group in overall satisfaction. Gulf's witness, Mr. Fisher, in his pre-filed testimony offers more information on the Customer Value Survey. Again, these are two significant indicators that show strong evidence that Gulf's innovative approach is working.

Q. Given the impact of the new programs, innovations, and the cost of the new capacity described above, and all the other test year expenses filed in this case, what is Gulf's projected earnings for the test year without rate relief?

A. Gulf's return on average common equity at present rates for the 12 months ending May 2003 is projected to be 4.43 percent. This is not adequate when compared to the 13.0 percent level Gulf's witness Mr. Benore has determined in his pre-filed testimony to be appropriate for Gulf and will lead to a weakened financial condition and adversely affect our ability to provide reliable electric service to customers.

Q. You mentioned earlier that Gulf needed adequate and timely rate relief, how does the timing affect Gulf's test year return?

A. Because of the magnitude of the investment in Smith Unit 3, the negative effect on Gulf's earnings is material and immediate, as shown by the above-mentioned projected 4.43 percent return on common equity. This issue of timing and adequacy of the test year earnings is supported more fully by Gulf's witness, Mr. Labrato, in his pre-filed testimony.

Q. Does this conclude your testimony?

A. Yes. This concludes my testimony.

MR. STONE: There are no exhibits attached to Mr. Bowden's testimony, nor is he responsible for any MFRs.

BY MR. STONE (Continuing):

Q At this time, Mr. Bowden, would you please summarize your testimony?

A Thank you.

In summarizing my testimony, I'm going to discuss certain issues causing the need for adequate and timely rate relief. The witnesses listed on Pages 2 and 3 of my direct testimony will discuss these and other issues in more depth and detail.

Gulf Power Company continues to meet our goals with respect to customers. We have low rates. We have the lowest rates in Florida and among the lowest rates in the nation. We also serve our customers in a high, reliable way. We've achieved high customer satisfaction ratings in 19 -- in 2000 and 2001, we ranked first in those surveys that we do, to have -- to measure those achievements. This high level of achievement in these fundamental and important areas of providing electric service, I believe, has provided enormous benefits to our customers.

Our last rate increase request occurred some 12 years ago. Since that time, many changes have occurred. We live in a much faster-paced world today. Our customers have very high expectations because of the proliferate use of computers and sophisticated electronic equipment in their homes and businesses.

Financial markets have also changed, they're much more volatile today. Investors have more options, and I believe their expectations are higher. We've had significant growth in northwest Florida in our service area, and we expect that to continue. We will -- by the end of our test period, we will have added more than a hundred thousand new customers, which is a 30-percent increase. Our customer energy use has also increased as shown by the growth in our peak demand which is up some 450 megawatts, which is a 25-percent increase.

We've responded to these changes in a variety of ways and look toward the future. Throughout the company, we've implemented cost controls, and we've achieved significant efficiencies as a result of that. At the end of our test period, we will have ten percent fewer employees than we did at the time of our last filing. We've embraced technology throughout the company. We've also improved and put in place new processes that lend itself to these efficiencies as well. And in conjunction with this Commission, we've engaged in conservation programs that's delayed the need for generation for some number of years.

However, this high growth and higher usage has required significant investment in new facilities on the part of Gulf

Power Company. Foremost among those is Unit 3 at the Smith Plant near Panama City. We're investing some 220 million dollars in that project, and that alone, that project alone accounts for 70 percent of the increase that we're requesting before the Commission today. We've also made other investments in distribution, transmission, and related equipment.

In addition to that, our operation and maintenance expenses are increasing. With the construction of the Unit 3 at Smith, the distribution and transmission facilities, those cause higher expenses, and those are reflected in our test period. Also, during this time, since we filed our last case, inflation has increased also. As measured by the CPI, it's up almost 40 percent.

Our other equipment continues to age. When equipment ages, it costs more to maintain that equipment. In spite of this, our expenses are under the Commission's benchmark by some 3.7 million dollars.

If you look at the company's financial picture, without rate relief, our return on equity projections for the 12 months ending May 2003, which is the test period, is 4.43 percent. This compares to the 13 percent cost of capital that Mr. Benore testifies to as appropriate for Gulf Power Company. Without rate relief, our earnings shortfall is substantial and immediate. We face a weakened financial condition that will adversely affect the ability of the company to provide electric service that our customers are currently enjoying.

I discussed changes earlier, but there's also been three significant events that have occurred since we filed this case on September the 10th. The day after we filed was the first of those events, and that was the terrorist attacks that we all remember very well. Those attacks have significantly increased the security needs of Gulf Power Company. We've taken steps to address those, not only in Gulf, but throughout the entire Southern Company System. Mr. Fisher, who will testify in this case, is responsible for that activity in Gulf Power Company.

The second event I'll mention is the recession and the bankruptcies and credit problems that energy and other companies have experienced. As you know, this country is in a recession. We have a much more volatile credit environment today, and our credit rating agencies that rate our securities and others have significantly increased the surveillance of us and other companies that they rate.

MR. BURGESS: Commissioners, you know, maybe this is proper, but my understanding is that this is summary, and he's speaking to items that have happened subsequent to the filing of his testimony. So, you know, it seems like it is beyond the testimony. There are issues in the case on the security measures, but I think it's improper for this amount of time to be spent on summarizing an eight-page testimony.

CHAIRMAN JABER: Thank you, Mr. Burgess.

Mr. Stone, the objection is outside the scope of testimony.

MR. STONE: Commissioner, we'd ask for some latitude in regards -- there have been changes since our filing. There are issues identified with the case, and Mr. Bowden's testimony is in the nature of a summary of the over -- or an overview of our case. Each of these areas he's talking about are touched on in his testimony in regards to being an overview of the case. He will be brief, and we'll be able to complete the summary briefly.

CHAIRMAN JABER: Mr. Burgess, I'll overrule the objection with the notation that they did say that this was in lieu of opening statements.

But, Mr. Bowden, it is eight pages of testimony, so let's go ahead and try to wrap it up.

THE WITNESS: Thank you.

A The third thing I'll mention is the regulatory agencies that have issued recent orders have been focusing on incentive-based regulation. Some recent decisions in the Georgia -- by the Georgia and Mississippi Public Service

Commissions and the Federal Energy Regulatory Commission in an RTO case, focused on performance-based regulation and broader ROE, return-on-equity ranges. There's also incentive approaches before this Commission, including the one in this case.

As I previously said, Gulf Power has provided very reliable service at low rates with high customer satisfaction ratings. In fact, our base rates are lower today than they were 20 years ago. In Mr. Labrato's testimony, he provides information that shows how our rates compare to other electric utilities, using the Jacksonville Electric Authority survey of residential customers.

Our customers also experience high reliability. Mr. Moore, in his testimony, will discuss system reliability and the efficiency of our generating units. We've achieved the highest generation availability in the Southern System on our generating units. And I think maximizing that utilization of those units has brought significant savings to our customers.

Mr. Fisher and Mr. Kilgore will discuss the new programs and technologies that we've implemented to improve reliability, customer service, work-force efficiency, and productivity. We've seen improvements in the number of minutes of interruption. We've got an excellent record of Commission complaints. We've had no infractions in almost four years. We also, as you recall, received favorable comments at the public service hearings that you conducted both in Pensacola and Panama City.

As I said earlier, we're a leader in customer-satisfaction ratings, and Mr. Fisher will cover the surveys that measure our results in those. In achieving this, we are still under the benchmark used by this Commission to measure expenses by some 3.7 million dollars, and Mr. McMillan will testify to that in his testimony.

As I mentioned earlier, regulatory commissions are considering incentive-based approaches. I think to recognize our superior performance and the importance of continuing that performance in the future, at the low rates that I mentioned on Page 7 of my testimony, I suggest two thoughts for the Commission's consideration: One is to increase the return on equity by some 50 to one hundred basis points. The second one is to consider expanding the Commission's already range that it uses from two hundred basis points to three hundred basis points.

I believe these suggestions could be included in an incentive sharing plan, a plan that would be based on the performance measures that incent this company to provide highly reliable service at low rates with high levels of customer satisfaction. Such a plan could also include a provision for customers to share in earnings above certain levels. I believe a plan like this is appropriate for the future as customers would continue to benefit from the outstanding performance that we have achieved in areas that are critically important in providing electric service. In addition to that, customers would also be able to share in those earnings.

I think we've demonstrated in Gulf Power Company that we know our customers. We know their expectations. We know their needs. And I think this is evidenced by the surveys that we have been able to achieve. While we are proud of our history, we know that we should look at it and consider, but the past is not indicative of the circumstances we now face. We've got to look ahead and plan for the future, and that's what we've done in the case that we filed before this Commission. That completes my summary of my testimony.

MR. STONE: We tender Mr. Bowden for cross examination.

CHAIRMAN JABER: Thank you, Mr. Bowden. Let me ask, FEA, FIPUG and OPC, what order do you want to go in with cross examination?

MR. BURGESS: I'm indifferent to that. Whatever your preference or the other parties' preference is.

CHAIRMAN JABER: Okay. For the sake of ease, I'm going to start right here, and this is the order we're going to use for the entire hearing. We're going to do

FEA, FIPUG, OPC.

Okay, FEA.

MR. ERICKSON: No questions.

CHAIRMAN JABER: FIPUG.

MS. KAUFMAN: We have no questions.

CHAIRMAN JABER: Mr. Burgess.

MR. BURGESS: I just have a few questions.

EXAMINATION

BY MR. BURGESS:

Q Mr. Bowden, on Page 4 of your testimony, you indicate that through the 1990s you've taken advantage of new technology and consolidated functions to increase efficiency; is that correct?

A Yes, that's correct.

Q You don't intend to stop taking advantage of these technologies and efficiences, do you?

A Of course not. No, sir.

Q Thank you.

How do you -- with regard to Issue 37, and you address this in your summary as well, about an expanded basis point spread around the ROE granted. One of the things that's stated is that a three hundred basis point spread around the cost of equity would facilitate revenue sharing. Are you speaking of like the one currently in place?

A I'm not speaking of the one currently in place. I think that it could be included in an incentive plan that would include performance measures, that would measure the company in critical areas of providing customer service, and I think I've enumerated those in my mind that are critically important. Those being the rate levels of the company, the reliability of the service provided the customers, as well as the customer satisfaction with that. So I think such a plan could include that. It could be built around performance levels and measurements that this Commission could agree to, and I think would be a very good benefit to customers in the future.

Q Right. I heard that in your summary as well, but my question, though, is how the expanded amounts surrounding the ROE facilitates the implementation of a sharing plan?

A I think you could do that through a sharing plan, that if you achieve certain levels, if you perform by the benchmarks that's given in such a plan, then you achieve earnings at those levels and you have the performance that would generate that, then the company and the customer could share. If the company did not perform like that, there would be no sharing because there would be no earnings that would be available to that. It would not occur.

Q Well, are those items that you pointed out with regard to the incentives that you were just speaking of, are those included in the sharing plan currently in place?

A No, they are not.

Q Okay.

A The sharing plan currently in place, has to do with just revenues. If we exceed revenue levels, then there is a sharing of revenues.

Q Okay. So how does the expanded range facilitate implementation of a sharing plan like the current one?

A I think you could develop a sharing plan, as I said, where you would establish critical areas that are important in serving customers. And I've identified three I think are important. That's the rate levels, the reliability, and customer satisfaction. You could set criteria by which companies are expected to perform against those levels. If they achieve all those, then they would -- and they also had earnings above that, it doesn't necessarily mean that they will have earnings above certain levels, but if they did, then they would share those earnings with customers.

Depending on the success of the company in achieving those accomplishments, you would alter the sharing. If they did part of it, the sharing would be reduced. If they did none of it, there would be no sharing, even though there were earnings above certain levels. And if the earnings didn't occur, then there would not be any earnings to share.

Q Thank you, Mr. Bowden.

MR. BURGESS: That's all we have.

CHAIRMAN JABER: Mr. Bowden, something Mr. Burgess just asked you I need clarification on. You want to be able to tie performance earnings to, I'm guessing, revenue refunds, some sort of refund to the customer?

WITNESS BOWDEN: That's correct, Commissioner. You would have earnings, and if you had earnings' levels and those were achieved, then the company would share that with the customers. And to the extent the customer would share that, you would refund revenues to them. That's correct.

CHAIRMAN JABER: Okay. And the criteria you propose we establish rate level, reliability, customer satisfaction, how would we measure the criteria? Do you know?

WITNESS BOWDEN: You could set levels by comparing, say, on rate levels, how we compare to, say, other utilities in the southeast or in some area. On reliability, you could establish, I think using common measurement that Mr. Fisher will testify to with respect to a SAIDI measurement, of certain minutes of interruption, bogey against that.

With respect to customer satisfaction, we do surveys that put us into quartiles. I think in that case our objective would be to be in the highest quartile of those surveys. So those type measurements are what you would come up with to measure whether or not a company was performing those critical areas or critical functions in serving customers.

CHAIRMAN JABER: And would the Commission measure, or are you proposing you would issue the surveys and you would do the measurements and report back to us?

WITNESS BOWDEN: In such a plan, the measurements would be set out in the plan, and they would be some that the Commission could monitor very easily, in my opinion.

CHAIRMAN JABER: On the sharing with customers, did you have a proposal in mind, a percentage in mind?

WITNESS BOWDEN: I don't have a specific percentage at this time. The concepts I'm talking about are concepts that I have in my mind. We would be happy to sit down and develop a proposal and put it in writing and submit it to this Commission. We would be glad to do that, but I do not have that available today.

CHAIRMAN JABER: Staff? Staff, do you have questions?

MS. STERN: No questions.

CHAIRMAN JABER: Commissioners.

COMMISSIONER DEASON: Madam Chairman, I have a few questions.

Just to continue on with what the chairman was asking you, when you mentioned performance-based regulation, do you have a specific proposal you wish to pursue within the context of this proceeding, or is this something that you're laying foundation for for future consideration?

WITNESS BOWDEN: Commissioner, I think we would be willing to pursue it, in the context of this case as well, under the guidelines I've laid out where you would establish critical things that are critical in the providing of electric service. And the ones that I've mentioned in my mind are three that would be appropriate. You would set guidelines -- Excuse me.

COMMISSIONER DEASON: No, no. Go ahead.

WITNESS BOWDEN: Pardon me?

COMMISSIONER DEASON: Please proceed. I didn't mean to interrupt.

WITNESS BOWDEN: You would set those guidelines, then you would establish measuring points that the performance would be measured against. And then if a company exceeded certain earnings levels, then that would create the opportunity for sharing that between the company and the customer.

COMMISSIONER DEASON: Well, let me ask you this:

Under traditional regulation, traditional rate-based regulation, we set a range for ROE, and it is assumed. And that range, normally, it's a two hundred basis point range. I know that you're proposing a wider range. But regardless of what range we set, typically it is assumed that if a company is earning within that range, those earnings are reasonable and that if you exceed that, then it triggers a mechanism, some of our surveillance procedures, and we review that. And, obviously, if you earned under that, there is the assumption that you may need to file, seek rate relief if other measures can't be undertaken to address your earnings. That's the way it is traditionally done.

Now what you're proposing here, how does that -- how does that mesh with the way it's traditionally done, and are you talking about sharing earnings only when you exceed that range?

WITNESS BOWDEN: You would set up the ranges, and I'm proposing to expand that range by 150 basis points for, I think, some key reasons that I believe that would be helpful to the company in making us financially sound and also would aid in us retaining our credit rating that we would have. But, yes, above that range that we would set, then the earnings sharing then would begin. And that would take place in increments of, say, 50 basis points. Then you were to get --

COMMISSIONER DEASON: Let me interrupt for just a second. I'm trying to understand.

Normally, if you earn outside that range, still you keep it until there is a rate proceeding to readjust rates on a going-forward basis, but you're indicating that outside the scope of another rate proceeding there would be mechanisms that would trigger earnings automatically? Is that what you're saying?

WITNESS BOWDEN: It would trigger the sharing automatically, and I think that would benefit the customers. They would not have to wait for a rate proceeding to take place before they started sharing, if those earnings took place over and above the top of that range, that's correct. And I think it would give the -- it would send the signal that this Commission is giving to the company, that those are important activities for this company to be engaged in in providing electric service. It would also tell the customers that this Commission considered those things to be important, and I think this Commission could favorably drive the way electric service is delivered to our customers in northwest Florida under a plan like this.

CHAIRMAN JABER: How often would you review earnings to determine if a sharing is appropriate?

WITNESS BOWDEN: I think you would monitor the earnings on a periodic basis. But then the sharing process would be on an annual basis.

CHAIRMAN JABER: All right. Well that brings us back to Commissioner Deason's question then because, in terms of surveillance, the PSC does that on an annual basis. So how would your approach be different from what the PSC does through surveillance reports each year?

WITNESS BOWDEN: I think you would use the surveillance reports in establishing whether or not a refund was appropriate, similarly the way we do it under the current revenue-sharing plan that we have before the Commission. And any sharing would take place on an annual basis between the company and the customer.

COMMISSIONER DEASON: Well, let me ask, I know that this is based upon setting criteria or goals, and you've addressed areas where you would set those goals or those targets, being rate levels, reliability, and customer satisfaction, what if a situation results that the company exceeds its authorized return on equity, the range, and it doesn't meet these goals? Are you proposing then that you would refund a hundred percent back to customers and would not share in those excess earnings.

WITNESS BOWDEN: I would propose that you could either do that, or you could retain those revenues subject to your jurisdiction if that event occurred. If the company did not achieve those goals, then it would not benefit from the plan.

COMMISSIONER DEASON: Have there been any other jurisdictions that you're aware of that has addressed a situation which you are outlining for us?

WITNESS BOWDEN: In the State of Mississippi, they've operated under an incentive plan for a number of years. And in December of this past year, a case was filed there where they reiterated that plan. And in that particular case, for instance, they determined the cost of equity to be 11.75 percent, but because of the performance aspects of the plan, they set rates at 12.88 percent, over a hundred basis points difference, because of the performance of the company. And then they also -- they have this plan in effect, and it's based on the performance measures that I have indicated previously. And it's been in effect for a number of years, and I think has been very successful.

In addition to that --

COMMISSIONER DEASON: I assume there's an order out by the Mississippi Commission which sets out this plan?

WITNESS BOWDEN: There is, yes.

COMMISSIONER DEASON: Are there any other plans that you're aware of?

WITNESS BOWDEN: There's also -- in January of this year, the Federal Energy Regulatory Commission issued an order in the midwest ISO case, where a midwest ISO had applied for tariffs to serve their customers. In that plan, they asked for incentives to carry out those tariffs. And while I understand that some of the actions of the Commission are still subject to hearing, the reports that I read indicated that the FERC was very interested in incentive mechanisms to promote the additional investment in transmission facilities, to also provide a reasonable return for companies engaged in the transmission business, and they established a zone of reasonableness from about nine plus percent to 15 percent and set the rates to begin with at 13 percent.

COMMISSIONER DEASON: Do you think this is something the Commission should do on a generic basis if we were so inclined to go forward with some type of performance-based regulation plan for all of the investor-owned electric utilities, or do you think it should be company specific?

WITNESS BOWDEN: Commissioner, I think all the companies are different in a lot of aspects, and I can't speak to the other companies, whether they would have interest in a plan like this or not, but I think it would be very appropriate for Gulf Power Company. I think we've demonstrated in the past that we can perform at a high level, and I think that brings enormous benefits to customers, and I think it's appropriate and would be timely for that to be considered in our case at this time.

COMMISSIONER DEASON: Do you think that there's -- I know that we're in the process now of just establishing the record, and we're just beginning, and there's going to be many witnesses to follow. But as you understand the layout of, at least your case, and the witnesses that will be testifying, do you think we're going to have sufficient information in this case to come up with a specific performance-based regulation plan for Gulf Power?

WITNESS BOWDEN: I certainly believe so. And we would be happy to reduce to writing the ideas that I've discussed and present those back to the Commission in whatever form is appropriate for further discussion or consideration in the Commission making this decision.

I think we have a new day today. I think you can see a lot of activity around the country talking about incentive rates, and I take note also of the Commission's mission statement. You mentioned that you were interested in pursuing incentive rates, and I think it would be appropriate to start, and I believe Gulf Power Company is the right company to begin that process with.

COMMISSIONER DEASON: Let me ask you kind of a hypothetical question. If we conclude -- if at the conclusion of this hearing and all of the evidence and the briefs, staff's recommendation, if the Commission is still at that point uncomfortable with going forward with a specific performance-based regulation plan and felt like we needed an additional proceeding to address that one issue straight on, I guess you would endorse that and would participate in that proceeding?

WITNESS BOWDEN: Absolutely. Yes, sir.

CHAIRMAN JABER: Commissioner Bradley, Commissioner Palecki, Commissioner Baez.

COMMISSIONER BRADLEY: Yes, thank you, Madam Chair.

My questions are somewhat along the same line as Commissioner Deason's questions. Most of them were tied into performance bonuses and incentive plans. The first question is this: In Issue 34, the company asked for a performance bonus. What criteria should the Commission use in determining if the reward is justified?

WITNESS BOWDEN: The things I've looked at, Commissioner, if I didn't think Gulf Power Company had performed in a superior way, I would not suggest such a recommendation. I think this record will show that we have done that, and we have the ability to do that in the future. So I think what it would do would be to recognize that we have been able to do that. And the big thing though is it would incent the company to continue that into the future. So I think that would be the benefit of it. The customers would continue to enjoy the fact that we perform at a high level, and it would incent the company to do that. It would send a message by this Commission to the company and to customers that these are important areas in providing electric service to customers in northwest Florida. So I think that would be the basis for my making the recommendation to you.

COMMISSIONER BRADLEY: Madam Chair.

CHAIRMAN JABER: Go ahead.

COMMISSIONER BRADLEY: I think you probably are getting a little bit ahead of my questions, but I want you to answer these specifically though. How do customers benefit from Gulf's being given a performance reward?

WITNESS BOWDEN: I think they benefit a number of ways, Commissioner, because the high level of performance that we've demonstrated in providing low rates, highly reliable service, it satisfies them. I think it's a big benefit. I think another benefit too is the fact that it would help this company remain in a sound financial condition. I think there's a perception among many people that it's adverse to a customer's interest to be served by a sound, financially sound utility. That is certainly not the case in my opinion.

If you have a financially sound utility, they can provide service at much lower rates than a weak financial company can. You always hear the argument that if you are sound financially that you can attract capital at lower rates, and that's certainly the case. But I think it's a much broader impact than that. It goes throughout our company. When we buy goods and services, if we are financially sound, we are better able to negotiate good terms and conditions from vendors. It also allows you to deal with more vendors. People want to do business with you if you're sound and there's not any risk, significant risk for payment.

A lot of times opportunities come up that you can take advantage of on a quick basis if you're financially sound. If you're weak, you can't do that. And probably the biggest thing that would be beneficial to customers, we're in a long-term business. We make a lot of investments and a lot of decisions that have long-term impact. A financially sound company can make those decisions, balancing the short term versus the long term. Whereas, if a weak financial company made that, they'd be looking solely at the short-term aspects of things. And it is a significant difference to be in that position, to be able to look long term and balance those needs and make the right operational and economic decision on behalf of the company.

I tell you, I've been in this business for a long time, a number of years. I've been on both sides of being weak and sound. There's no doubt in my mind that a sound company can bring benefits to a company in the way of better service and much lower cost than a weak company can.

And the other thing I'd like to point out, there's not much difference between being weak and sound. I'm not talking about 50 percent or even 10 percent. In our case, it's as much as one or two percent to be the difference in us being weak or marginal and being sound. So the payoffs, I think, are immense to our customers.

COMMISSIONER BRADLEY: Madam Chair, another question. How did you decide on the 50 to one hundred basis points?

WITNESS BOWDEN: Commissioner, I looked at what other -- this Commission had done in past history with respect to Gulf Power Company. In the revenue sharing settlement that we had in 1999, there was a recognition of 50 basis points on our return on equity in that case. You go back to the early '80s in a conservation case, there was a ten percent -- ten basis point recognition in that case. And I understand in the early '80s, the GPIF factor in the fuel-clause proceedings was established. That has a 25 basis point in that. I looked at what's been done in Florida. I also looked outside, and I mentioned these two recent decisions that I mentioned earlier. In the case of Mississippi, they added over a hundred basis points to their situation.

So those are the things I looked at, and I considered also the FERC decision in the midwest ISO case that I also mentioned. Those are the factors that I considered in coming up with the recommendation that I made to the Commission.

COMMISSIONER BRADLEY: Madam chair?

CHAIRMAN JABER: Uh-huh.

COMMISSIONER BRADLEY: Have performance bonuses ever been awarded by the PSC or other regulators?

WITNESS BOWDEN: Yes, sir. I mentioned the Mississippi case. In that case, as I said earlier, they established the cost of equity at 11.75 percent, but because of good performance in the company there, they increased that over a hundred basis points to 12.88 percent. No doubt about it, they did that.

COMMISSIONER BRADLEY: One last question.

CHAIRMAN JABER: Go ahead.

COMMISSIONER BRADLEY: Is this award based on past performance, is it -- or is it an incentive for future performance?

WITNESS BOWDEN: I think it recognizes the past performance and our ability to operate in a superior way, but I think that the benefits that the customers would gain out of it are that it would incent the company to continue that in the future.

COMMISSIONER BRADLEY: Thank you, madam chair.

CHAIRMAN JABER: Thank you.

Commissioner Palecki.

COMMISSIONER PALECKI: Mr. Bowden, are you familiar with the settlement that was reached in the last Florida Power & Light rate case wherein there was a sharing mechanism that was agreed upon between Florida Power & Light and Office of Public Counsel?

WITNESS BOWDEN: I am generally familiar with that, yes, sir.

COMMISSIONER PALECKI: And would you agree that

that plan worked out in a manner that benefited the ratepayers as well as Florida Power & Light?

WITNESS BOWDEN: As far as -- to my knowledge, it did so, yes.

COMMISSIONER PALECKI: The reason I ask you those questions is you've come in this morning with several new stipulations, and I know the company, Office of Public Counsel, and all of the parties have been working very diligently to reach settlements on many of the issues in this case, and I would just encourage you to continue in those efforts, especially with regard to incentive rates in this case. And I know that Mr. Shreve, and I believe Mr. Burgess, were involved, both involved in the Florida Power & Light settlement, and I think we all felt that that settlement was good for both the company and the ratepayers. Hopefully, you'll continue your negotiations through this proceeding.

WITNESS BOWDEN: I'll take that with a lot of advice and we will do so. And I've mentioned that we also had a settlement with Mr. Shreve about the same time as the Florida Power & Light case occurred as well, and we have a revenue sharing in effect. The difference in what I'm talking about today is the fact that this would be a performance-based plan where it would depend on the company achieving performance goals as opposed to the current plan which relies on revenues exceeding certain designated levels. The incentive plan that I mentioned today would put the burden on the company to perform, and I think that would be a better plan in my opinion.

COMMISSIONER PALECKI: And with a performance-based plan such as this, you would eliminate practices such as deferring maintenance in order to maximize short-term profits? This would incent the company to make sure that maintenance and other expenses necessary to provide reliable service continue on rather than trying to cut corners in order to maximize profits?

WITNESS BOWDEN: I think if you did cut corners, your reliability would suffer, and the performance would suffer, and the opportunity for the sharing would be eliminated if that occurred. So the performance-based plan, I think, encourages companies to be, to take actions to provide reliable service.

COMMISSIONER PALECKI: Thank you.

CHAIRMAN JABER: Commissioner Baez.

COMMISSIONER BAEZ: Mr. Bowden, a couple of questions to clarify in my mind how you would expect at least this theoretical incentive program to work. First of all, you speak of a reward. You mentioned 50 basis points for past performance. That's independent of this hundred basis points expansion of the range that you're also discussing, right?

WITNESS BOWDEN: Commissioner, what I'm suggesting is add to what's determined to be the cost of capital, this 50 basis points. Then around that you would set the band, which is currently two hundred basis points. And what I'm suggesting is to expand that to three hundred basis points.

COMMISSIONER BAEZ: To three hundred?

WITNESS BOWDEN: Yes, sir

COMMISSIONER BAEZ: And the nature of the banding is, you say it's two hundred. It's a hundred on either side?

WITNESS BOWDEN: That's correct.

COMMISSIONER BAEZ: This additional hundred basis point expansion, would you expect it to be balanced on either side as well?

WITNESS BOWDEN: Yes.

COMMISSIONER BAEZ: Or are we talking about a hundred basis points on the high end?

WITNESS BOWDEN: Well, my suggestion, that would certainly be one way to do it. But I think if you were symmetrical, that would also be better.

COMMISSIONER BAEZ: And then whatever sharing mechanisms were appropriate would be beyond this, and assuming for a moment, as you've suggested, that it be symmetrical. So what you're actually doing is bumping up the high end by 50 basis points; is that fair?

WITNESS BOWDEN: That's correct.

COMMISSIONER BAEZ: Okay. The sharing mechanisms would be applicable to this additional 50 basis points? I guess what I'm trying to get at is the incentive plan, the sharing mechanisms that will be part of that. Would they be applicable in your estimation, or in your understanding of what you're proposing only to this additional -- this increment to the banding, to the range?

WITNESS BOWDEN: What I'm proposing, that you would share, maybe starting with that increment, but going beyond that upper limit. If you got above that with earnings, you would share that with customers.

COMMISSIONER BAEZ: There would still be sharing applicable?

WITNESS BOWDEN: Absolutely.

COMMISSIONER BAEZ: So there's no magic or limitation to this expansion of the range that we're talking about?

WITNESS BOWDEN: There would not be a limitation with that, but what I said is that at a certain level I think I would cap it so that someone could say it's not completely open-ended.

COMMISSIONER BAEZ: Exactly.

WITNESS BOWDEN: But I would not cap it at the 150-basis-point parameter. It would be beyond that somewhat.

COMMISSIONER BAEZ: Okay. I have no other questions.

CHAIRMAN JABER: Yes. Go ahead, Commissioner Bradley.

COMMISSIONER BRADLEY: Mr. Bowden, you know, this incentive plan is really generating a lot of discussion, and I was just wondering if it's possible for you to provide an exhibit that outlines, in detail, the specifics of your incentive plan to the members of the Commission, maybe not today, but sometime very soon?

WITNESS BOWDEN: Commissioner, I would be happy to do that. At the first break that we have, I will consult with counsel and other members of the Gulf Power Company team that's here, and we will advise you very soon as to when we could produce such a filing. And I would defer to the advice of my counsel on how be would go about doing that, but we would certainly be willing and able to do that.

COMMISSIONER BAEZ: Madam chair, and I would have a question on that. I think it's entirely -- it would be beneficial for all of us to have somehow reduced to writing what exactly it is that you're describing or suggesting. But I do have a question as to what, I guess what the import or how that affects the record or a recommendation ultimately.

CHAIRMAN JABER. Right. Can we come back to the exhibit? I will not forget to identify it if it's appropriate, but let's come back to it.

Mr. Burgess.

MR. BURGESS: Yes.

CHAIRMAN JABER: I know that the commissioners have asked questions on procedure and things that you probably want to follow up on, so I'm going to give you this opportunity right now.

MR. BURGESS: Thank you, chairman, I appreciate that.

EXAMINATION

BY MR. BURGESS:

Q Mr. Bowden, I understand from what you were saying that you believe the Commission has the authority to issue an order here whereby it would be able to capture continuing jurisdiction over the company's revenues out into the future; is that right?

A Based on the advice of counsel, I think that they would do that, but I would defer to his counsel on that particular item.

Q Okay. Well, wouldn't that mean that, just trying to understand legally the context of this, wouldn't that mean that, even without an incentive plan, the Commission could then issue an order saying if you go above a certain level, you'll refund those revenues to the customers?

A It's my understanding, Mr. Burgess, that the incentive plan would not change the Commission's rights or obligations in any way.

Q Right. And as I understand from what you're saying then, that you would understand that they have that authority at this point?

A That's my understanding, yes.

Q Okay.

MR. STONE: Commissioner, if I may. Mr. Burgess is asking questions in the nature of legal questions, legal opinions. Mr. Bowden is the president and chief executive officer of Gulf Power Company. He is an accountant by trade. To the extent that we're talking about matters that are legal opinions, I don't believe Mr. Bowden is expressing a legal opinion, does not mean to imply that he is, and I would prefer that Mr. Burgess not ask questions that would call for a legal opinion. If he continues in that vein, I may be forced to object.

CHAIRMAN JABER: Yeah. Mr. Burgess, I don't think it's risen to a level of an objection. Perhaps Mr. Stone is asking for clarification. You're not asking Mr. Bowden for answers that call for a legal opinion, are you?

MR. BURGESS: No, I was just trying to understand the context in which he was presenting this. As a matter of fact, to make sure that I don't ask any objectionable questions, I would request that the Commission, in recognition of the fact that I have not participated at all in the existing stipulation with Gulf Power or with Florida Power & Light for that matter, that the Commission indulge Public Counsel as a party to allow Mr. Shreve, who has participated, to ask a few more questions so that we can understand, in light of what Mr. Palecki is talking about, the possibility of our going forward with further agreements on this.

CHAIRMAN JABER: That's fine. Did you have any other questions though before we turn it to Mr. Shreve?

MR. BURGESS: I did not have any. Thank you.

CHAIRMAN JABER: Okay.

COMMISSIONER JACOB: Thank you, Madam Chairman. Of course, I was involved in the Gulf stipulation as well as the Florida Power & Light stipulation, and I think most of this discussion so far, even if it is in the nature of a prehearing statement, goes well beyond anything that has been raised in the testimony in the case.

EXAMINATION

BY MR. SHREVE:

Q I guess my question would be, from the proposal that's been made by Mr. Bowden, within the proposal you're making, you would have the Commission order a refund at a certain point?

A Such a plan would have criteria and measurements in there that would give rise to a sharing if earnings were achieved at those levels.

Q But you are saying that the Commission should order a refund of funds at or above a certain point based on some criteria or whatever?

A Mr. Shreve, I don't know the legalities of that. As I said, you know, I am talking in concepts. We can reduce to writing the ideas that I've expressed today. It would call for sharing of revenues, if certain performance-based criteria were met and if those earnings levels were achieved.

Q And if these, the criteria were met, then there would be a refund to the customers?

A That is correct.

Q Ordered by the Public Service Commission?

A Well, the plan would provide that, and I assume that if the Commission ordered such a plan, then that would be the order of the refund.

CHAIRMAN JABER: Mr. Shreve, if I could interrupt. Your proposal would have us approving the plan and concept, and the refund would be triggered automatically once the criteria are met?

WITNESS BOWDEN: Yes, Commissioner. Yes, ma'am.

MR. SHREVE: Okay. I think this is where we're going wrong because, in the past, all plans have been stipulated also by the parties, and then that was approved by the Commission. Now we're talking a totally different ball game. We're talking about the Commission ordering a refund. And if we accept what Mr. Bowden's plan would be, is that the Commission would have the authority to order a refund, then it might solve another problem because we have always had problems with over earnings. If we narrow the range back down to 50 basis points and set the mid point, which is where the Commission would say the company should be earning, then the Commission could order a refund of all over earnings above a certain point.

CHAIRMAN JABER: Question?

MR. STONE: Commissioner Jaber.

CHAIRMAN JABER: Mr. Stone, hang on one second.

Mr. Shreve, I think you were trying to ask for clarification from the witness, right? So that would be a question?

MR. SHREVE: Well, it's almost in the nature of an opening statement since we didn't get to go until after the opening statement was made. Normally, the company would make their opening statement first, and we wouldn't be in this position. We would have been able to comment after that. But if we're going to the point that the Commission can order refunds, then there may be some points that we would want to see about ordering over earnings that we've had in a position in the past of not being able to do.

MR. STONE: Commissioner Jaber, if I may. Mr. Shreve has offered a rebuttal opening statement, and I understand that. I would simply point out that what Mr. Bowden has testified to on cross examination, we're no longer in the opening statement stage of this case. He is on the witness stand. He is offering sworn testimony, and he was responding to questions. What Mr. Bowden has offered is the company would be willing to accept a mechanism, and so that does not change the fundamental premise under which the Commission operates. What he is saying is that the company is willing to accept such a mechanism if it has the performance-based criteria that he has established. Now maybe --

CHAIRMAN JABER: Mr. Stone, let me interrupt you because I don't want the attorneys to try to summarize the witness' testimony.

Let me do this, Mr. Bowden, what Mr. Shreve was pointing out, clarify it for me. You acknowledge that your proposal that you testified to on your direct and you responded to by the commissioners' questions is different from the over-earnings situation?

WITNESS BOWDEN: It's different from the over -- it would be a plan that would address earnings that would exceed certain levels.

CHAIRMAN JABER: Okay. But it's different from the traditional surveillance plan that the --

WITNESS BOWDEN: Yes, Commissioner. Yes.

CHAIRMAN JABER: Okay. And what you propose is different from any sort of revenue-sharing plan that you and other utilities currently have?

WITNESS BOWDEN: Yes.

CHAIRMAN JABER: You're proposing a performance-based approach that would allow the Commission to approve the terms that would be triggered upon certain criteria being met?

WITNESS BOWDEN: That's correct.

CHAIRMAN JABER: Okay. Mr. Shreve, do you have any questions of this witness? And let me tell you that the reason I switched back to OPC is because I recognize the commissioners asked questions that took us outside of opening statements, but Mr. Bowden was responding to questions from the commissioners. So if you have any other questions to follow up on what the commissioners asked, I'd love for you to take advantage of that.

MR. SHREVE: Commissioner, I don't think so. I think with your questions it clarified the position that really the orders we're talking about are affirming agreements between the parties. We'll certainly be glad to talk to Gulf Power and the other parties any time they want to talk about it.

CHAIRMAN JABER: Thank you, sir.

Ms. Kaufman.

MR. McWHIRTER: I'd like to ask a couple of questions.

CHAIRMAN JABER: Briefly, and then we're going to take a break, and then you're next.

EXAMINATION

BY MR. McWHIRTER:

Q Mr. Bowden, as I understood your plan, instead of the traditional two hundred basis point spread around the rate of return set by the Commission, you want that to go up 150 on the high side and 150 below on the low side?

A That's correct.

Q Is that your plan in its entirety, or are there some other components to it that would involve refunds?

A As I suggested, that is a separate recommendation that the Commission could adopt. But what I said is that I think that could be incorporated in a performance plan that would be even better than just handling that, as a separate particular item.

Q The proposal on the table today has nothing to do with this refund program. It is a proposal just to increase the band around the authorized return on equity; is that correct?

A I think what I have proposed is both of those, to increase the band, and I've also suggested that it could be incorporated in a performance plan that would set criteria and also would lead to a sharing if earnings exceeded certain levels based on performance.

Q Is there a plan on the table today that's part of the record of this proceeding that we can examine and understand?

A I believe that the Commission asked me to develop such a plan, and I believe I agreed that we would do so and submit that to the Commission and to the parties for that purpose.

CHAIRMAN JABER: No, actually, Mr. Bowden, we haven't taken that up yet.

WITNESS BOWDEN: I'm sorry. I'm sorry.

CHAIRMAN JABER: That's all right. But Mr. McWhirter's question is, based on the testimony that has been prefiled, is there a plan that's set out -- articulated that the Commission could consider?

WITNESS BOWDEN: That is not in the prefiled testimony, no.

CHAIRMAN JABER: Was that your question? I don't mean to speak.

MR. McWHIRTER: Yes, that's essentially it. I'm going to not ask any more questions because I think I might be going beyond what the commissioners asked, although I have intriguing thoughts that I'd like to develop.

CHAIRMAN JABER: Thank you, sir.

FEA, did you have any questions?

MR. SHROPSHIRE: No, ma'am.

CHAIRMAN JABER: Thank you.

Mr. Bowden, now I want to take up the Commissioners' request for an exhibit. There are various witnesses that testified on the performance-based approach, is there a way to develop an exhibit based on what's currently in the testimony?

WITNESS BOWDEN: I believe there is, Commissioner. We could do that and I think accomplish that, yes.

CHAIRMAN JABER: Okay. Commissioner Baez had a very good point, and, frankly, it was my concern. In identifying such an exhibit, we have to recognize that parties prefile their testimony and they prefile their exhibits, and we do that so as to avoid surprise. That's not to say that commissioners can't ask for additional exhibits, but we have to be mindful of the fact that we want parties to have adequate due process in being able to respond to those exhibits.

So, Commissioner Bradley, maybe there's a way to have Mr. Bowden identify -- prepare an exhibit that actually takes from all of the other testimony and, for the sake of ease, puts it all in one place for us. That's really -- is that what you had in mind, Commissioner Baez?

COMMISSIONER BAEZ: That's fine. I mean any solution that will give us the best-available picture of what to think of. I don't want to -- I guess my concern was starting to add things, but as I go back to something that Commissioner Deason had mentioned or had asked Mr. Bowden was, is there a proposal now that is part of the record that's been proposed by the company? I'm assuming the answer -- I remember the answer being, no, there is no specific proposal. So what we've been discussing here is somehow principles, and I want to take that opportunity that, even though there is no proposal being considered, I think enough discussion has been had that I would assume has created a good opportunity for off-line, you know, conversations. I know that Mr. Shreve looked a little excited about that, but --

CHAIRMAN JABER: In a good way.

COMMISSIONER BAEZ: In a good way, and I mean that in a good way. That we've opened up -- somehow our discussion has opened up some kind of opportunity. It doesn't have to take place as part of the hearing.

CHAIRMAN JABER: Right. But I'll tell you, an exhibit that compiles in one place from pieces of testimony that is in the record is probably helpful to generate more thought, not just by the parties but by the commissioners too. So that's the exhibit, Commissioner Bradley, that I think we should identify.

Okay. Let's call that --

MR. McWHIRTER: May I ask a proposal question, Madam Chairman?

CHAIRMAN JABER: Yes.

MR. McWHIRTER: This is a quasi judicial proceeding, and I presume that when that exhibit is introduced into evidence we would have the opportunity to inquire about it and make discovery to further assist the Commission in determining whether that proposal, even though based on evidence that's in the record, would be in the public interest.

CHAIRMAN JABER: Yeah. Legal, remind me. I think traditionally we allow a week or two for objections to the late-filed exhibits and/or responses.

MS. STERN: Yes, that's correct.

CHAIRMAN JABER: So, Mr. McWhirter, at the end of the proceeding, let's establish what those time lines should be.

MR. McWHIRTER: Thank you.

CHAIRMAN JABER: Okay. Late-filed --

COMMISSIONER DEASON: Madam Chairman, let me just say one thing. I certainly support the late-filed exhibit, and I think it's something that would be worthwhile. Just let me say, as one commissioner, I guess this was probably alluded to in some of my earlier questioning. I'm just concerned, at least based upon my preliminary review of the prefiled testimony, I'm concerned that we're not going to be able to get a plan presented with enough specificity that we're going to be able to act on it in this proceeding; and that's why I alluded to having some type of a more generic proceeding where we have an actual proposal on the table and -- but anyway, just having said that, I certainly support the late-filed exhibit. I think it's going to be worthwhile.

But it seems to me that if you're going to have a workable plan, you need to have some predefined -- it needs to be predefined; that tries to contemplate things that may happen in the future, and that means having a lot of specifics. And I'm just not sure that we're going to be able to design something based upon prefiled testimony with that amount of specificity, but I certainly await the late-filed exhibit.

CHAIRMAN JABER: Yeah, and I think there was some consensus in that regard; but, you know, selfishly, I believe that a late-filed exhibit like that could actually generate some discussion and foundation for future proceedings.

Commissioner Bradley, did you want to add anything?

COMMISSIONER BRADLEY: It's just that I'm not trying to overly complicate this issue, and I would defer to Commissioner Deason for his wisdom as it relates to this matter and how we might be able to more effectively and efficiently deal with the issue.

COMMISSIONER DEASON: Well, I appreciate that. And, no, I think you're right on the right track. I think that we need to get a late-filed exhibit which sets out, at least in a general context, the basis for a performance-based regulatory plan, incentive plan. And to the extent that there has been information prefiled to incorporate that and we can get it all on one piece of paper, I think it gives us a very important and worthwhile framework to at least consider.

My only concern was, is that I'm just, I guess, thinking out loud here because we are at the very early stages of this hearing, and I don't know exactly where we're going to end up at the end; but just sitting here based upon what has been prefiled, I think that it may be a little premature to think that we're going to come out as a Commission with a very specific performance-based plan for this company. It may be the subject of another day and another hearing at some time in the future. That was my only concern.

But, no, I certainly support getting the late-filed exhibit. I think it's a step in the right direction. It's something that would be very useful.

MS. KAUFMAN: Chairman Jaber, excuse me. I just wanted to make one more comment, and I sense that the commissioners want this exhibit; and so, you know, I understand that. I just want to get on the record that I'm very concerned about the due process aspect of this. There is no plan put forth in Gulf's prefiled testimony. Intervenor time for our experts to evaluate and respond to the plan is long past, so that causes me some concern. I understand we'll have the ability to, I suppose, comment on it or even object at the point in time that it's filed with you, but I think that if this was something that Gulf wanted you all to take action on and deal with in this rate case, then the burden was on them to provide the plan in their testimony so we could have done discovery, taken depositions, filed controverting testimony if that was what we decided to do. So I have a little bit of concern the way it appears to be that they're going to be making some sort of a proposal in this case for the first time.

CHAIRMAN JABER: Ms. Kaufman, I understand your concerns, but I would note that Issues 34 and 37 go to this. I think the commissioners' concerns, myself included, would be the specificity of the plan. I mean I think Issues 34 and 37 touch on Gulf's proposal. But that being said, Late-filed Exhibit 25 will be a compilation of information which serves as the basis for the performance plan.

And Mr. Bowden, do you think since you're only looking at the prefiled testimony and preparing a one -- an exhibit, one exhibit, that uses the prefiled testimony information, I'm thinking two weeks should give you enough time.

WITNESS BOWDEN: Yes, commissioner.

CHAIRMAN JABER: Okay.

MR. BURGESS: Chairman Jaber, might I ask that the company -- that part of this exhibit include a reference to the specific prefiled testimony for each item that's in this late-filed exhibit?

CHAIRMAN JABER: Mr. Bowden, is that something that you can go ahead and do?

WITNESS BOWDEN: We will endeavor to do that.

MR. BURGESS: Thank you, Madam Chairman.

CHAIRMAN JABER: So that will include references to the testimony.

All right. Commissioners, any other questions?

COMMISSIONER DEASON: Not to over complicate, but we need to clarify right now so maybe it will solve an objection later when the exhibit is filed, does it allow Mr. Bowden to make references to decisions from other jurisdictions? He alluded to Mississippi, FERC. I don't know if there was another state or not. Because we need to know now whether that's permissible or not. I'm not taking a position one way or the other. I just want to get it clarified so that maybe at least everyone knows what the groundrules are.

CHAIRMAN JABER: Mr. Bowden, did you say the Mississippi PSC had actually issued an order?

WITNESS BOWDEN: Yes, in December of last year, there was an order in a case there. But this plan has been in effect in Mississippi for several years, and this was a filing under that plan, so --

CHAIRMAN JABER: Well, commissioner, legal would have to correct me if I'm wrong, but I thought in briefs parties could refer to any PSC orders.

MS. STERN: PSC orders, orders out of the jurisdiction that would be relied on for information other than legal argument, we would typically judicially notice. That's my understanding.

CHAIRMAN JABER: During the break, would you please ask Mr. MacLean about that because I think the commissioners were told we didn't have to officially recognize orders from other state commissions and federal orders, so get that clarified. And when we come back on the record, you can address Commissioner Deason on that question.

MS. STERN: Okay.

CHAIRMAN JABER: Go ahead, Commissioner Bradley.

COMMISSIONER BRADLEY: Yes, madam chair. I would like to clear up something here by making a statement that my questions were based upon Issues 34 and 37.

CHAIRMAN JABER: Thank you.

Commissioner Baez, did you have --

COMMISSIONER BAEZ: No.

CHAIRMAN JABER: All right. Any other questions of Mr. Bowden before we let him off the stand? Redirect.

MR. STONE: Briefly.

EXAMINATION

BY MR. STONE:

Q Mr. Bowden, there was a question asked of you earlier about whether it was necessary to do this on a generic basis or whether it could be done on a company-specific basis, and as I recall your response, you indicated that you could not speak for the other companies but that Gulf was prepared to accept such a plan as you propose; is that correct?

A Yes, sir.

Q Okay. If the company -- if the Commission were to act for Gulf Power Company in this context, would that give the Commission an opportunity to gain experience with such a plan before implementing it on a generic basis?

A I think it would, and I think Gulf Power Company is a good company to do that with. We are, I guess, the smallest, but maybe the best in the state, and I think it would be a good place to start, and we'd be kind of like a pilot program on a company-wide basis; and I think it would be a good thing for this Commission to consider.

COMMISSIONER DEASON: Do you think that other companies might object, that if we use you, we'd be setting the bar too high?

WITNESS BOWDEN: I'll let them speak to that.

CHAIRMAN JABER: Any other questions, Mr. Stone?

MR. STONE: That's all I have.

CHAIRMAN JABER: Thank you, Mr. Bowden.

WITNESS BOWDEN: Thank you.

CHAIRMAN JABER: Okay. We are going to take a break which will include a lunch break. We're going to come back at 12:15.

(Whereupon, there was a recess taken at 11:35 until 12:15)

CHAIRMAN JABER: Let's get back on the record.

Okay. By my copy of the prehearing order, it looks like we're on Mr. Benore.

Ms. Stern, were you able to get with the company and determine that Mr. McGee could be excused from the hearing?

MS. STERN: Yes.

CHAIRMAN JABER: Great. Mr. McGee shall be excused from attending the rest of the hearing, and our next witness is Mr. Benore.

C. A. BENORE

was called as a witness on behalf of Gulf Power Company, and, having been duly sworn, testified as follows:

EXAMINATION

BY MR. MELSON:

Q Mr. Benore, you were sworn this morning, were you not?

A Yes, I was.

Q Would you please state your name and business address for the record?

A Charles A. Benore. 125 West Street, Bar Harbor, Maine.

Q By whom are you employed and in what capacity?

A Benore Financial Consulting, as its president.

Q And have you prefiled direct testimony in this docket consisting of 30 pages?

A Yes, I have.

Q Do you have any changes or corrections to that testimony?

A No, sir, I do not.

Q And if I were to ask you the same questions today, would your answers be the same?

A Yes, they would.

MR. MELSON: Chairman, I'd ask that Mr. Benore's direct testimony be inserted in the record as though read.

CHAIRMAN JABER: Yes, the prefiled direct testimony of Charles A. Benore shall be inserted into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Prepared Direct Testimony of
Charles A. Benore
Docket No. 010949-EI
Date of Filing: September 10, 2001

Q. Please state your name and business address.

A. My name is Charles A. Benore, President, Benore Financial Consulting, Inc., 125 West Street, Bar Harbor, Maine 04609.

Q. Please describe the financial consulting services of Benore Financial Consulting, Inc. (BFC).

A. BFC provides testimony and advisory consulting services to utility companies. As a result of my three decades of experience as a utility analyst and investment advisor, I am knowledgeable about investor attitudes and requirements, and the ability of utility companies to attract capital.

Q. Please describe your educational background.

A. I am a graduate of Ohio University with a Bachelor of Science degree in finance, and of The Ohio State University with a Master of Arts degree in economics. I was elected to Phi Kappa Phi and Beta Gamma Sigma honorary societies.

Q. Please summarize your professional experience.

A. I have presented testimony before 30 state Public Service Commissions, the Federal Energy Regulatory Commission, and the Securities and

Exchange Commission on rate of return and other subjects. I have also appeared before several Subcommittees in the U.S. House of Representatives and the U.S. Senate on utility financial matters.

I worked as a security analyst for about 30 years; and for each of the 22 years that *Institutional Investor* magazine polled investors, while I worked as a utility analyst, I was ranked as a leading utility analyst. I have also served on an Informational Task Force to the Energy Transition Team of the Reagan Administration on "Recommendations to Restore the Financial Health of the U.S. Electrical Power Industry," and as a task force member of the Financial Accounting Standards Board on utility accounting from an investor perspective. I was a faculty member for the Bank of New York (Irving Trust) Utility Finance Seminars for regulators and management on investor attitudes and the cost of capital for over fifteen years before forming my own firm.

Q. What is the purpose of your testimony?

A. I have been retained by Gulf Power Company (Company) to determine its cost of common stock equity.

Q. Have you prepared exhibits that contain information referred to in your testimony?

A. Yes. An index of schedules is provided in Schedule 1. A statement of my occupational and educational history and qualifications is attached to this testimony as Schedule 2, pages 1-3. Schedule 3 through Schedule11 are also part of my testimony and were prepared by me except for page 2 of

Schedule 3, which was prepared by Southern Company.

Q. Do you have additional comments concerning your exhibit to your testimony?

A. No.

Counsel: We ask that Mr. Benore's Exhibit (CAB-1) consisting of 11 Schedules be marked as Exhibit ___.

Q. What return do you recommend the Commission allow on Gulf Power Company's common stock equity?

A. I recommend the Commission allow a return on Gulf Power Company's common stock equity of at least 13.0 percent. A summary of the model results and my recommendation follow on Schedule 1a.

GUIDING PRINCIPLES

Q. What economic, financial, and legal principles did you rely on in determining Gulf Power Company's cost of common equity capital?

A. Gulf Power Company, like other investor-owned companies, is owned and financed by investors who invest savings into its securities with the expectation of earning a fair, risk-adjusted return. Investors are guided by the principle that returns should rise and fall with higher and lower levels of risk. U.S. government bond rates of return represent to them the cost of lowest risk, long-term capital.

For a given level of risk, investors attempt to maximize the return on their savings and invest in those companies that provide the highest expected return relative to the level of risk. Therefore, rational investors will not invest in securities that provide less than fair, risk-adjusted returns across markets (among utility common stocks, and versus other common stocks and bonds).

The choice of investment is voluntary, and investors have thousands of alternatives in which to invest. Since investors invest to earn as high a return as possible for a given level of risk, or the highest return on a risk-adjusted basis across markets, Gulf Power Company's securities must offer sufficiently attractive returns so that investors will invest in its securities.

Another important consideration in making the Company's securities sufficiently attractive to investors is to recognize that Gulf Power Company, unlike many non-regulated companies that do not provide indispensable services, cannot stop necessary investments in plant, or legislated environmental investment, when the availability of capital is constrained in the market, as it is from time to time.

Therefore, Gulf Power Company, which provides customers with indispensable energy services, must be sufficiently strong financially to cope with unforeseen events, and its securities must be attractive enough to access capital during adverse as well as more normal, market conditions.

The investor, therefore, is critical to the process of providing utility services to Gulf Power Company's customers. Existing investors expect and deserve fair treatment. New investors must be induced to invest in Gulf Power Company's securities instead of thousands of other investment possibilities.

Q. What legal principles did you rely on in determining Gulf Power Company's cost of common equity capital?

A. I relied on my understanding of the U.S. Supreme Court decisions in the Bluefield, Hope, and Permian Basin cases.

Bluefield: "A public utility is entitled to such rates as will permit it to earn a return...equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties...." "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."

Hope: "...the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock."

"By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."

Permian Basin: Regulatory decisions should: "... reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed...."

These principles were more recently confirmed by the Duquesne decision.

Q. What do these decisions mean to you for determining the cost of common equity capital for Gulf Power Company?

A. The cost of common stock should: (1) provide Gulf Power Company with a competitive, and achievable, investor return relative to other investments on a risk-adjusted basis; (2) enable the Company to attract capital on reasonable terms; and (3) allow Gulf Power to have a reasonable level of financial integrity.

ECONOMIC AND CAPITAL MARKET CONDITIONS

Q. Please describe the economic outlook, and capital market conditions and availability as they relate to Gulf Power Company.

Economic Outlook:

The U.S. economy is currently operating at a relatively low level of inflation, and investors generally believe that inflation will be contained at about 2.5 percent to 3 percent in the latest Value Line economic forecast. However, there is considerable uncertainty about the near-term growth rate of gross domestic product. Some investors fear an economic recession, and financial and economic problems in Japan, while others expect the growth rate in the economy to slow, but for the U. S. economy to avoid falling into an economic recession.

Value Line's latest economic forecast of August 10, 2001 in "Ratings & Reports," page 1480, shows projected real GDP growth of 1.6 percent for 2001 followed by 3.0 percent in 2002, and 3.8 percent for 2004-06. Meanwhile, the consumer price index is projected by Value Line to increase between 2.5 percent and 3.0 percent for 2001, 2002, and 2004-2006. For 2001, the average bond yield for AAA corporate bonds is 7.6 percent, and 7.9 percent and 8.0 percent for 2002 and 2004-06, respectively. For my cost of common stock equity analysis for Gulf Power Company, I used the current 7.1 percent yield for AAA corporate bonds.

Capital Market Developments

The dramatic slowdown in the growth rate for the U. S. economy along with related investor concern about a recession and falling earnings, coupled with an apparent overvaluation of technology stocks, has caused the common stock market to substantially decline. More recently, the stock market has partially recovered, but investors remain uncertain about when the economic recovery will occur and how strong it will be. Accordingly, capital market conditions have improved, but because of reduced investor confidence, are generally less favorable for raising capital than in recent years.

Capital Access Problems

The *Wall Street Journal* reports that banks have tightened credit, and some household names like Xerox have had trouble accessing the credit markets. For utilities, *Bloomberg* reports that PSI Energy (previously Public Service of Indiana), a subsidiary of Cinergy, withdrew a planned debt offering in what was described as a troubled debt market. *Yahoo* also notes that: "There is currently $311 million outstanding under the credit agreement, which was established after the Pennsylvania problems blocked GPU participation in the commercial paper market, the company said."

Another notable utility development is the precarious financial condition of two of the largest U. S. utilities, Southern California Edison and Pacific Gas & Electric. One of the companies has filed for bankruptcy protection, and the other is on the verge of bankruptcy. Both companies are unable to pass along higher costs of energy supply to customers as a result of regulatory restructuring. This development has reminded investors that even during periods of low inflation and moderate construction programs that electric power companies are subject to substantial risk.

Recent Favorable Performance of Electric Stocks Disguises Problems

Nonetheless, investor concerns about an economic recession combined with the defensive nature of electric utility stocks (betas under 0.60 generally) along with expectations that the Federal Reserve will lower interest rates, caused electric utility stock prices to sharply rise in 2000.

This recent relative performance pattern is similar to 1998 when electric utilities did well for a while, but after investor attitudes became more positive, electric stock prices went back to their underlying investment fundamentals, and resumed their dramatic under-performance relative to the market until more recently when recession concerns reappeared.

Accordingly, it is questionable that the recent superior performance of electric stocks reflects a change in investor attitudes toward the regulated business of electric power companies. Further, the improved market performance of electric stocks also reflects earnings growth from non-regulated sales of electric power. As shown in Schedule 3, page 1 a longer view of the relative price performance of Standard & Poor's Electric Stocks, even with help from non-regulated business activities, versus the market, or the S&P 500, is very discouraging.

A similar discouraging performance can be observed in the spread between Moody's "A1" utility bond yields and long-term Treasuries. In the mid to late 1990s, the yield spread was about 75 basis points, or utility bond yields were higher than Treasuries by about 75 basis points. In mid-1998, the spread began to increase to the 125-150 basis points range as investors apparently became more concerned about competition risk for electric power companies. The more recent adjustment to about 200 basis points corresponds with the announcement by the Treasury of buying back its debt in early 2000. A chart showing the yield spread appears as Schedule 3, page 2.

ELECTRIC UTILITY STOCKS'

INVESTMENT FUNDAMENTALS ARE POOR

<u>Relative Performance</u>

Q. What has been the relative performance of electric stocks versus the market?

A. Electric company common stock prices have dramatically under-performed the market. Since the onset of investor concern about wholesale and retail competition in the summer of 1993, the S&P Electric Stocks are up only 25 percent compared to 173 percent for the market, or the S&P 500. The annual performance differential is about 19 percent annually, or well above the differential risk. Supporting data is charted in Schedule 3, page 1.

Short of stopping investment in electric stocks, investors have sent about as strong a signal as possible that the return prospects for electric stocks have not been competitive with other common stock investment alternatives.

The poor performance of utility bonds and electric common stocks versus Treasury bonds and the S&P 500 clearly demonstrates that investors' perception of risk in electric stocks has risen; and that electric stocks, except when considerable uncertainty is present in the market, have not been competitive with other common stock investment alternatives available to investors.

Falling Relative Profitability and Rising Risk

Q. Why have electric stocks lagged behind the market, and why should it be of concern to the Florida Public Service Commission?

A. There are three primary reasons for the non-competitive position of electric stocks relative to the market. The first is regulatory allowed returns on common stock equity have been too low. Second, regulatory restructuring, and wholesale, and to an increasing degree retail, competition have increased investor risk. Third, investors do not have an opportunity to earn the lower than appropriate returns allowed by regulators.

Allowed regulatory returns on common stock equity for the five years ending in 1990 averaged 13.1 percent, or 92 percent of the earned return on year-end common stock equity for the S&P 500. For the five years ending in 1995, the regulatory return fell to 78 percent of the S&P 500 return, and for the most recent five years ending in 2000 to 54 percent. Therefore, there has been a dramatic decline in the relative profitability of electric power companies based on allowed regulatory returns from almost parity with common stocks generally as measured by the S&P 500 to about one-half in the most recent five-year period. Unfortunately, the dramatic relative fall in profitability, or the regulatory return on common stock equity, for electric utilities occurred at the same time as the introduction of competition and higher risk into the electric power industry. Supporting data is shown in Schedule 4, page 1.

Importantly, the projected return on common stock equity for the S&P 500 using growth estimates from First Call, IBES, and Zacks is expected to rise slightly to 22 percent. Therefore, just to hold to the already lower relative level of profitability, allowed returns on common stock would need to increase from current levels. Supporting data is shown in Schedule 4, page 2.

Simply put, (1) falling returns relative to other investment opportunities, (2) rising risk, and (3) the inability to earn allowed regulatory returns in the market, drove investors away from electric stocks to other investment alternatives, and are responsible for the very poor relative price performance of electric stocks.

<u>Investor Market Returns Versus Regulatory Book Returns</u>

Q. Please explain why investors do not have an opportunity to earn the returns that regulators allow.

A. Many regulatory commissions rely on market based models, or the discounted cash flow (DCF), the equity risk premium (ERP) or bond yield plus equity risk premium, and capital asset pricing (CAPM) models to determine allowed returns. These models, when properly used, do indicate the investor-required-market-return. However, it should be recognized that these models determine the required <u>market return</u> by investors and not the regulatory return, which is a <u>book return</u>. When one return is exchanged for the other, or market returns indicated by the DCF, ERP, and CAPM models are used for the regulatory allowed return, investors are unable to achieve the return they require under current market conditions.

Q. Please explain why investors cannot achieve the allowed regulatory return under current market conditions.

A. The DCF, ERP, and CAPM models only work for regulatory purposes when the price-to-book-value ratio is not significantly different from 1.0 times. Under current market conditions where prices are closer to 1.5 to 2.0 times book value, the regulatory return indicated by market based models will not yield, or produce, the intended growth rate and return required by investors. This can be illustrated with a simple mathematical example.

<u>Mathematical Example of Problem</u>

Q. Please provide a mathematical example that shows that the DCF model (and other market based models in an efficient market with proper modeling) does not work for regulatory purposes when the price-to-book value ratio is significantly different from 1.0.

<u>Column A</u>

A. The mathematics are shown in the illustrative example provided on Schedule 1b. In this illustrative example, it is assumed in Column A that investors expect a 13.0 percent return on common stock equity, or book value, so that earnings per share are $3.25 ($25.00 book value times 13.0 percent ROE). With a dividend of $2.00, the dividend payout ratio is 61.5 percent (DPS/EPS or $2.00/$3.25), and the earnings retention rate is

38.5 percent (percentage of earnings retained and not paid out as dividends, or 1.0 minus the dividend payout ratio). Sustainable earnings growth, therefore, is the return on common stock equity times the earnings retention rate or 5.0 percent (13.0 percent ROE times 38.5 percent earnings retention rate). This is the expected rate of growth for the price of the common stock in this illustration.

The expected-market-return to the investor is the price growth of 5.0 percent plus the current yield on the stock, which is also 5.0 percent (dividend of $2.00 divided by the price of $40.00), or 10.0 percent (Column A, row 10).

The table shows the method and building blocks to support the investor-expected-market-return of 10.0 percent with the expected 13.0 percent return on common stock equity in Column A. Row number and column letter identify each item in the table, and a formula for the derivation of the values in Columns A, B, and C are also shown.

Column B

For Column B, it is assumed that the 10.0 percent market-required-return determined using the DCF test (in an efficient market, the DCF, ERP and CAPM investor-required-market returns should be similar) is adopted as the regulatory-allowed-return. As shown, the regulatory return on common stock equity is much lower than the 13.0 percent expected by investors and embedded in their earnings and common stock price growth expectations.

The 10.0 percent regulatory-allowed-return will produce only a 2.0 percent growth rate and a 7.0 percent (Column B, rows 8 and 10) market return to investors (price growth of 2.0 percent plus the current yield of 5.0 percent). The 10.0 percent regulatory return, instead of the 13.0 percent expectation of investors, produces insufficient earnings to produce the earnings growth rate and total return expected by investors of 10.0 percent. Therefore, the allowed return of 10.0 percent, which produces only a 7.0 percent investor achievable-market-return, yields unacceptable results for investors.

Columns C and D

Column C shows that investors can only earn their required 10.0 percent market return when the price-to-book-value ratio is 1.0 times instead of 1.6 times in the illustration, or when the price and book value are both $25.00. In that event, an allowed regulatory return of 10.0 percent produces a market return to investors of 10.0 percent (Column C, row 10).

Unfortunately, as shown in Column D, a price drop of nearly 40 percent would be necessary to achieve the results shown in Column C, which is representative of current market conditions. I do not know of any investors who would invest on the basis of incurring a near 40 percent decline in the value of their investment before having the opportunity to earn their required 10.0 percent market return. *Investors invest to make, not lose, money and knowledgeable investors would reject the common stock in this illustrative example as an investment.*

This example, therefore, clearly shows that: (1) market-based tests (DCF, ERP, and CAPM) only work for regulatory purposes when the price-to-book ratio is not significantly different from 1.0; and (2) that it is necessary to transform regulatory-allowed-returns under current market conditions to the necessary level so that investors have a reasonable opportunity to earn their required market returns, or in this example 13.0 percent. Otherwise, the ability to attract capital will deteriorate and hinder the ability of Gulf Power Company to provide reliable utility services to customers.

Transformation Specifics

Q. Please explain what transformation is.

A. Transformation is the process that determines the necessary regulatory book return so that investors have an opportunity to earn their required market return. From another perspective, it is the determination of the appropriate regulatory return on common stock equity that yields or produces the investor expected growth rate and market return. Transformation is a necessary prerequisite to capital attraction and reliable utility services to customers.

Q. How is transformation done?

A. Transformation is easily done through an iterative process that determines the necessary regulatory return to produce sufficient earnings and related earnings growth so that investors have an opportunity to earn their required return in the market.

Q. Why is transformation necessary?

A. Common sense and investment theory indicate that investors must receive fair compensation for the use of their capital, or comparable returns on a risk adjusted basis versus other investment opportunities. If not, they will over time invest their capital elsewhere. This is because informed investors have many alternative investment alternatives where their return expectations have a reasonable chance for a given risk level to be fulfilled.

Therefore, it is necessary that the regulatory return, which is a book return, provide investors with a reasonable opportunity to earn their required market return. This is accomplished through transformation of the standard DCF return, and the return from other market based models, into the necessary regulatory return.

<u>Customer Benefits from Transformation</u>

Q. From Gulf Power Company's customer perspective, why is transformation necessary?

A. Transformation from a customer perspective is necessary to:

1. avoid dictating rather than reflecting investor expectations, driving the stocks to book value, causing investors to lose money, and repelling rather than attracting investors;
2. insure that Gulf Power Company has financial integrity;
3. provide investors with an opportunity to earn competitive returns in Gulf Power Company's common stock (its comparable companies) versus other stocks so that capital attraction can reliably occur;
4. protect Gulf Power Company's customers from higher risk and related capital costs, less reliable access to the capital markets,

and over time deteriorating service.

Regulatory Response to Problem

Q. Is there any evidence that regulatory commissions are concerned about the inability of investors in regulated utilities to have an opportunity to earn their required market returns when the DCF, ERP, and CAPM models are used to determine regulatory allowed returns?

A. Yes. I conducted a study for investor-owned electric utilities of the regulatory-allowed-returns, and the DCF (k = DPS1/Po + g) investor-required-market-returns, for years 1985 through 1999, using both Value Line projected earnings and dividend growth rates, which were updated annually, for 32 larger electric companies. As shown in Schedule 5, regulatory allowed returns have exceeded investor-required-market-returns indicated by the earnings per share version of the DCF model by 1 to 3 percentage points in recent years versus similar returns when price-to-book ratios were close to 1.0. The same is true for the dividend per share version of the DCF model where allowed regulatory returns exceeded the DCF model results by 4 to 6 percentage points in recent years.

Q. Why do you believe regulators are generally allowing higher returns than indicated by the DCF, ERP, and CAPM models?

A. It is clear from this study that regulatory commissions for various reasons have concluded that higher returns than indicated by cost of common stock models that determine the investor-required-market return are necessary for protecting consumer interests. Regulators, in my judgment, have observed that regulatory-allowed-returns in recent years have been insufficient to enable investors to earn risk-adjusted returns comparable to other common stocks as shown in the chart on Schedule 3, page 1. It logically follows that over time, if regulatory returns continue to be too low and investors are unable to earn required returns that both old and new investors will increasingly turn to other common stock investments. This outcome, which will hinder the ability of regulated utility companies to attract capital at reasonable costs, is contrary to the interests of Gulf Power Company's customers.

Furthermore, regulators probably recognize that investors are not as mechanized in making investments as the models suggest. Each of the models used to measure investor expectations is theoretically based and makes assumptions about investor behavior that may not prevail in the real world of investing.

Therefore, regulators have been allowing higher regulatory-allowed-returns than indicated by market-based models.

<u>Non-Transformation Possible Consequences</u>

Q. What are the long-term consequences for the financial integrity of utilities and their ability to provide energy services to their customers by using the non-transformed-market-required returns shown at this time by the DCF, ERP, and CAPM models?

A. Over time, the poor stock performance results since 1993 would likely continue, and jeopardize the ability of Gulf Power Company to access the capital markets. This in turn could undermine Gulf Power Company's ability to provide reliable utility services to customers.

Transformation Conclusion

In the capital markets, I believe it is fair to say that there is no free lunch. Investors are already voting with their feet and moving out of electric stocks, as shown on Schedule 3, page 1. New investors have been buying, but at decreasing prices relative to other common stocks. Eventually, if this trend continues, Gulf Power Company will ultimately need to rely on speculative investors with high return expectations and uncertain capital inflows. Surely this would be adverse to the interests of Gulf Power Company's customers.

Q. Have utility companies ever faced problems in raising capital?

A. Yes. Utilities experienced capital attraction problems in 1974-75 when companies rated "Baa" ("BBB" S&P equivalent) by Moody's were unable to sell long-term, first mortgage bonds. There were ten consecutive months spanning 1974-75 when "Baa" rated utility companies by Moody's were not in the market, although "A" rated companies were able to sell long-term bonds in each of the ten months. Subsequently, a number of companies involved with nuclear power construction went bankrupt, or nearly so, and were blocked from the capital markets. More recently, Federal Reserve Chairman Greenspan noted problems of investment grade companies attracting capital during the Russian debt default in 1998.

Most recently, banks have begun to tighten credit, as noted earlier in my testimony; household names like Xerox were denied access to the short-term credit market; and Cinergy's PSI Energy (previously Public Service of Indiana) withdrew a planned "bond sale in what has been an uncertain environment for most corporate bonds," according to *Bloomberg*, a financial news service GPU as noted by *Yahoo* has had problems in the commercial paper market. Of course, two other utilities, Pacific Gas & Electric and Southern California Edison, have filed for bankruptcy protection, or are on the verge of doing so, and have been denied access to the capital markets.

Q. Should capital attraction problems that occur from time to time be of interest to the Commission?

A. Yes. Because of the indispensable nature of electric power service and future uncertainty, it is important that Gulf Power Company be financially strong so that it can attract needed capital in both easy and difficult capital market conditions at reasonable costs.

Recommendations

Q. In light of the growing risk of capital attraction problems at this time for electric power companies and the weak investment fundamentals of electric stocks generally, what do you recommend to the Commission?

A. I recommend the Commission recognize the strong signal sent by the market that past allowed returns, which cannot be achieved by investors, have been inadequate relative to other investment alternatives; and that higher returns be allowed to restore investor confidence, and provide a firm basis for investors to invest in Gulf Power Company's securities.

Once the slowdown in the economy ends, investors will likely turn their attention to "offensive" instead of "defensive" stocks, and as a result will be less interested in investing in electric common stocks including the Company's comparable companies, or Gulf Power Company.

It is important, therefore, to improve the investment outlook for Gulf Power Company by increasing the allowed return on common stock equity to at least 13.0 percent so that its common stock (its comparable companies) is competitive with other common stock investment alternatives.

<u>Meaning Versus Measurement</u>

From another perspective, it is also useful to consider that meaning and measurement can be very different in terms of using judgment to interpret the results of theoretical models.

Reliance on theoretical models for determining the cost of common stock creates the danger of over-quantification of a complex issue. In the November/December 1997, *Financial Analysts Journal*, Jack Gray in "Overquantification," pages 5-11, put it very succinctly.

> The moral is that the precise measurement or calculation of a thing is profoundly different from the interpretation, significance, and meaning of that thing. Meaning is important, not measurement per se. We confuse the two because measurement appears to be precise, objective, and

simple (it is not any of those) whereas meaning appears to be vague (or at least flexible), subjective, and complex (it is all of those.) By overemphasizing the first at the expense of the second, we are vulnerable to the bean-counter's paradigm: If it cannot be quantified or measured, it has no significance (an extreme form of which is that there is no meaning, only measurement).

Q. What do you believe has meaning for Gulf Power Company?

A. What has meaning in my judgment for Gulf Power Company is that investors have rejected past regulatory returns for electric and gas utilities as too low relative to returns offered by other investment alternatives on a risk-adjusted basis. It is important, therefore, that Gulf Power Company be allowed a higher return on its common stock equity investment so that it is competitive with other investment opportunities available to investors.

SUMMARY OF GULF POWER COMPANY'S REGULATORY RETURN ON COMMON STOCK EQUITY REQUIREMENT

Comparable Companies

Q. Please summarize your analysis of the return on common stock equity that you recommend be allowed for Gulf Power Company.

A. I recommend that comparable risk companies be used to improve the accuracy of Gulf Power Company's cost of common equity estimate, and to better reflect the risk of Gulf Power Company, rather than using Southern Company, which is a much larger company and one whose recent lines of business involved higher business risk activities.

Nine risk measures were considered in selecting companies comparable in risk to Gulf Power Company as well as consideration of the merger status of companies. While these companies best reflect the risk of the Company, it is my judgment that the risk of Gulf Power Company's common stock equity is moderately lower than for its comparable companies. An adjustment to recognize the lower risk will be made in the final recommendation of the regulatory return on common stock equity to the Commission.

A discussion of risk measures used to determine the Company's comparable companies, the specific selection criteria, and Gulf Power Company's eight comparable companies are shown in Schedule 6.

Cost of Common Stock Definition

In my analysis, the cost of common stock definition provided by Petty, Keown, Scott, and Martin in *Basic Financial Management*, Sixth Edition, Page 933, Prentice Hall was used. They note:

> The cost of common stock: The rate of return the firm must earn in order for the common stockholders to receive their required return.

Tests Employed

Three market-based models, or the DCF, ERP, and CAPM, were employed to determine the investor-required-market return. The investor-required-market return was then transformed into the necessary book, or regulatory-allowed-return, to enable investors to have an opportunity to achieve their required-market-return. The comparable earnings model was also used to determine the expected return on common stock equity by investors.

A full description of the four cost estimation models, methodology, and data inputs are provided in Schedule 7 for the DCF Model, Schedule 8 for the Equity Risk Premium model, Schedule 9 for the CAPM, and Schedule 10 for the Comparable Earnings method.

<u>Discounted Cash Flow</u>

Q. What market and regulatory returns did your standard (price-to-book ratio = 1.0), and transformed DCF model analyses show?

A. The standard DCF model indicated an investor required market return of 11.7 percent before and 11.9 percent after flotation costs. If the 11.7 percent return were used as the allowed regulatory return, however, the investor-achievable-market-return would only be 9.8 percent. Therefore, it is necessary to transform the 11.7 percent investor-required-market return into the regulatory-book-return that will produce sufficient earnings to enable the investor expected growth rate and return to occur. The necessary regulatory return to produce an 11.7 percent market return for investors is 13.6 percent before flotation costs.

Supporting data including a description and methodology for the DCF model is shown in Schedule 7.

Equity Risk Premium

Q. Please review the results of your price-equals-book-value Equity Risk Premium test for Gulf Power Company.

A. The Equity Risk Premium (ERP) test consists of the sum of the bond yield plus the additional return necessary to compensate investors for the higher risk of investing in Gulf Power Company's common stock (its comparable companies). As with the DCF model that shows investor-required-market returns, it is necessary to recognize material differences in stock prices versus book values.

The higher return required by investors for investing in Moody's Electric Common Stocks than in long-term U.S. Government bonds, or the equity risk premium, is 5.0 percentage points.

The equity risk premium of 5.0 percentage points plus the yield on long-term U.S. Government bonds over the last month of 6.4 percent, normalized for the impact of the Treasury's planned buyback of its long-term debt, shows an investor-required-market-return of 11.4 percent before flotation costs. Investor risk for Gulf Power Company is moderately lower than for Moody's Electric Companies. Nonetheless, investors look forward when investing, and therefore, projected data, where available, is preferred for determining investor expectations. Projected CAPM equity risk premiums for Gulf Power Company's comparable companies are materially higher than historical at 5.1 percent versus 3.9 percent respectively. Therefore, the historical equity risk premium requirement of investors using Moody's Electric Power Companies is likely to understate investor requirements. On balance, I believe the 5.0 percentage point equity risk premium is appropriate to use for Gulf Power Company.

In order for investors to have an opportunity to earn their required market return of 11.4 percent, a regulatory return of 13.3 percent is necessary. Supporting data including a model description and methodology are provided in Schedule 8.

Capital Asset Pricing Model

Q. What did your price-equals-book-value CAPM test show the market and regulatory returns for Gulf Power Company to be?

A. Two different versions of the CAPM (standard CAPM and Morin Empirical CAPM) showed an average required-market-return by investors for Gulf Power Company of 11.4 percent before flotation costs. A regulatory return of 13.3 percent is necessary so that investors have an opportunity to earn their required market return of 11.4 percent.

Supporting data, description and methodology for the CAPM appear in Schedule 9.

Comparable Earnings

Q. Did you also perform a comparable earnings analysis of the investor-expected-return on common equity for Gulf Power Company?

A. Yes. The Comparable Earnings (return on common stock equity comparable to other similar risk stocks) test shows a cost of common equity for Gulf Power Company of 13.3 percent. Because this is a book-to-book test, or the investor expected return on common stock equity and the regulatory allowed return on common stock equity, there is no need for transformation.

A description and justification for the Comparable Earnings Model along with the data inputs are shown on Schedule10.

Flotation Cost Adjustment

Q. Why is an adjustment necessary for flotation costs, and how did you determine the flotation cost adjustment for Gulf Power Company?

A. The amount of common stock equity invested by investors is reduced by issuance costs in the sale of new common stock when recorded on the balance sheet of Gulf Power Company. Consequently, the earnings base (amount of investment after issuance costs) is lower than the investment by investors. It is necessary, therefore, to increase the return to investors so that resulting earnings on the reduced investment represent a fair return on the full amount of their investment. The necessary adjustment based on flotation costs of 3 percent is 0.2 percent.

An explanation for why a flotation cost adjustment is necessary is provided in Schedule 11.

OVERALL RECOMMENDATION TO THE COMMISSION FOR GULF POWER COMPANY

Q. What return on common stock equity do you recommend the Commission allow Gulf Power Company?

A. I recommend a return that will enable Gulf Power Company to provide investors with a reasonable opportunity to earn their required-market-return. This is a necessary prerequisite for capital attraction and reliable utility services to customers.

The three market based tests used, with transformation, show an average expected market return by investors of 13.4 percent before flotation costs, and with flotation costs of 0.2 percent, 13.6 percent. The comparable earnings test indicates a 13.3 percent investor expected return on common stock equity, which would indicate a 13.3 percent regulatory return on common stock equity.

As noted on Schedule 6, Gulf Power Company's risk is similar to its comparable companies. Nonetheless, the Company's financial risk is considerably below its comparable companies, and its revenues are entirely derived from the electric power businesses, while those of its comparable companies reflect in some instances natural gas distribution revenues and non-utility revenues. Moreover, the Florida Public Service Commission's regulatory ranking is a bit higher than for the Company's comparable companies. However, the Company is much smaller than its comparable companies, which increases its business risk.

Overall, it is my judgment that at least a 13.0 percent return on common stock equity for Gulf Power Company is necessary to: (1) fulfill investor expectations, (2) enable Gulf Power Company to reliably access the capital markets in good and bad market conditions, and (3) continue to provide reliable service at reasonable costs to its customers. Therefore, I recommend the Florida Public Service Commission allow a return on Gulf Power's common stock equity of at least 13.0 percent.

Q. Does that complete your testimony?
A. Yes, thank you, it does.

BY MR. MELSON:

Q Mr. Benore, you had one exhibit, CAB-1, attached to your direct testimony consisting of 11 schedules; is that correct?

A Yes.

Q And some of the information on those schedules has been updated to a more recent vintage in exhibits to your rebuttal testimony; is that correct?

A That is correct.

Q Other than those updates, do you have any changes or corrections to your CAB-1?

A No, sir.

MR. MELSON: Chairman, I'd ask that Mr. Benore's Exhibit CAB-1 be identified as Exhibit 26.

CHAIRMAN JABER: CAB-1 shall be identified as Exhibit 26.

BY MR. MELSON:

Q Mr. Benore, would you please summarize your testimony for the Commission.

And, commissioners, we have provided a handout that's up on the bench in front of you that is some excerpts from his testimony and exhibits that he's going to use with his summary.

A Good afternoon. It's my pleasure to be here to talk to you about the cost of common stock for Gulf Power

Company and to tell you why I believe that it is 13.0 percent. To help me, I've enlisted the aid of a handout which I believe you have a copy of. And if you'd go to Page 2 of that handout, please. Here you can see the tests that I performed. There are three with and without transformation. Those being the DCF, the equity risk premium, and the CAPM; and I also performed a comparable earnings test.

A transformation, which I'd like to talk about shortly, simply recognizes the difference between book and market returns, and it simply provides investors with an opportunity to earn or achieve the intended return in the marketplace. The average of these four tests, as you can see down towards the bottom of the page, is about 13 and a half percent and because of my belief that risk for Gulf Power Company is somewhat below that, of the comparable companies, my recommendation is 13.0 percent.

Turning to Page 3 of your handout, I'd like to express to you the definition that I employed for determining the cost of common stock. It is the rate of return that the firm must earn. Firm must earn, that's a book return or the regulatory return on common stock equity, in order for the common stockholders to receive their required rate of return. And, of course, they receive their return in the marketplace. That's a market return, and like in the DCF, it's generally thought to be the sum of the growth rate or the growth in the stock price plus the yield on the stock.

Turning next, if I may, to Page 4. Transformation, we note here, is the process that determines the necessary regulatory book return so that investors have an opportunity to earn their required market return. Nothing more or nothing less. It's not a free ride for investors. It simply provides equity or the ability for the investor to achieve, in the market, the return that they require, and then so that capital attraction and reliable utility services to customers can occur.

On the next page of your handout is a mathematical example to show how transformation works. If you would focus, please, on Column A in the grid, Row 3, you will see there that the investor-expected ROE is 13.0 percent. This is sort of like the regulatory allowed return, and you run -- when you run through the math using the sustainable growth rate method, you will find that that will produce a return to the investor on Row 10 of 10.0 percent. So this is differentiating between book and market returns. The problem is, is that when you take that 10-percent market return indicated by the DCF equity risk premium and CAPM and use it in Column B, Row 3 as the allowed regulatory return, we generate a big problem. And that is shown in B-10 where the investor then can only achieve a seven percent return.

It is true, as shown in Column C, that when price equals book value, the allowed return of 10 would then produce a 10 percent return. But the problem as shown in Column D in a practical sense is that would require a haircut of nearly 40 percent in the price of the stock, and there is no reasonable investor that's going to first incur a 40-percent decline in the price of the stock before they have an opportunity to earn their required return on equity. So I strongly, strongly believe that transformation is a very important consideration, if you will, please, in your determination of the allowed regulatory return for Gulf Power Company.

Turning to Page 6 then, transformation is necessary to avoid driving the stocks to book value, dictating rather than reflecting investor expectations, causing investors to lose money, and repelling rather than attracting investors. And for the customer, at the bottom of the page, perhaps at the top of our list nonetheless, they're protected from higher risk and related capital costs, less reliable access to the capital markets; and three, over time, deteriorating service.

I'd like now, if I may, on the two remaining pages, to shift focus, to a more practical focus. Profits or the return on equity drive earnings. Earnings drive prices, and prices are what investors are primarily interested in. And what we show you here in the left column is the realized return for the S&P 500 or for the stock market. And then we show a five-year average, and then we show you the electric utility, regulatory ROEs, and then, again, a five-year average for 1990, 1995, and the year 2000.

Please note, if you will, that in 1990, the regulatory allowed return was pretty comparable, although a little bit less, at 92 percent, than the market return on common stock equity that drives earnings and drives prices and investor attractiveness. That dropped to 78 percent in 1995, and it dropped still further to just 54 percent in the year 2000. So investors relative to the market have taken nearly a 50-percent haircut in returns, and that's a big cut.

That, combined with not being able to earn the allowed returns unless transformation is used, along with rising risk in the industry, shows you what you might expect to have happened on Page 8; and that is, electric utility stocks have been in the doghouse. The market here is sending a very strong message to any and all that care to observe it, the bottom line is the electric utilities. They've been flagged. No real price appreciation at all. The upper line is the S&P 500, or the market. And I think a clearer reading and a fair reading of this chart is that electric stocks have been shunned in the marketplace, and the reason I believe that that is so is because returns have been too low to compensate them relative to the opportunities that existed elsewhere. And I ask you, if I may, to observe the message that the market is sending here and to allow this company what I believe to be a fair and reasonable return, to give it financial integrity and the ability to properly serve its customers, which I strongly believe is 13.0 percent.

Thank you. If there are some questions, I'd be most pleased to try to respond to them.

CHAIRMAN JABER: Thank you, Mr. Benore.

Okay. Mr. Stone, as I understand it, all the parties have waived cross examination, but that leaves commissioners and staff.

Staff, you don't have questions either, right.

MR. ELIAS: We have no questions. The deposition transcript covers our areas of concern.

CHAIRMAN JABER: Okay. Commissioners, do you have any questions?

(NO RESPONSE).

CHAIRMAN JABER: All right. Thank you very much.

WITNESS BENORE: You're very welcome.

MR. McWHIRTER: Madam chairman.

CHAIRMAN JABER: Oh, I'm sorry.

MR. McWHIRTER: I have a procedural question. Is this document an exhibit, or is it something that we're going to discard?

CHAIRMAN JABER: It's my understanding that this was prepared for purposes of using it during the summary of testimony.

Mr. Melson, were you going to ask for it to be identified?

MR. MELSON: We were not going to ask. We don't mind if it is. Everything on this exhibit is contained in the prefiled testimony or in the prefiled exhibits. But for ease of reference, it probably would not hurt to give it a number.

CHAIRMAN JABER: Mr. McWhirter, what's your pleasure?

MR. McWHIRTER: Well, most of the exhibits we've seen in advance and have had an opportunity to examine, and I don't dispute the fact that this may be based upon something that's in the record, but it gives me moment for pause. And I think, just procedurally, I would have to object to its introduction into evidence.

CHAIRMAN JABER: Well, let's determine if it's something that the commissioners would find useful. Commissioners, do you have any opinion on this?

COMMISSIONER DEASON: Madam Chairman, in retrospect, I do have a question on Page 7 of the handout, so maybe it would be fine to at least go ahead and identify it, if there is no objection to that.

CHAIRMAN JABER: Mr. McWhirter, I understand your objection is that this is an exhibit that you have not seen. With Mr. Melson's representation that this is just a compilation of what's already in the composite exhibits already admitted into the record, do you still have an objection?

MR. McWHIRTER: Well, the problem I'd have with it is if the commissioners, in making your decision, looked at this document for brief reference and didn't look at the evidence as a whole. You might -- there are other things in the evidence as a whole that are not included in this exhibit, and it would --

CHAIRMAN JABER: Would we make you feel comfortable by letting you know that we're going to look at the evidence as a whole?

MR. McWHIRTER: I presume you will, Madam Chairman, and I would be remiss to say anything other than that.

CHAIRMAN JABER: Okay. Well, then this will be identified as Exhibit 27.

MR. MELSON: Thank you.

CHAIRMAN JABER: And it will be called cost of common stock summary.

Commissioner Deason, you had --

COMMISSIONER DEASON: Yes, I have a question. On Page 7 of Exhibit 27, the column entitled Realized S&P 500 ROE, how were those numbers determined?

WITNESS BENORE: They were determined by dividing the earnings per share by the book value per share of those companies, the S&P 500 composite.

COMMISSIONER DEASON: Okay. And this is the earnings per share as reported in audited financial statements.

WITNESS BENORE: I can't speak for Standard and Poors, but I believe that what they would do is to pull together the -- probably the SEC reports as a database, and from that they would accumulate the data, go through a market weighting mechanism that they use, and then report the earnings per share as well as the book value results. The investment community and, in fact, they do it for us. They show us this return on common stock equity. It's part of something called the Analysts Handbook that is available from Standard and Poors and I believe is probably the most widely used document for financial information about the S&P 500.

COMMISSIONER DEASON: There appears to be a -- I think you're reading a lot more into my question than is there, but I appreciate your explanation.

WITNESS BENORE: I'm sorry.

COMMISSIONER DEASON: I just see what appears to be much more volatility in the realized ROEs for the S&P 500 as opposed to the ROEs which have been granted by regulatory agencies for regulated electric utilities. Now I assume it's not your position that we should be just as volatile as the earned ROEs for the S&P 500 in for our regulatory decisions.

WITNESS BENORE: You're absolutely correct. But if I may, I'd like to make one clarification. I'm also not recommending something approaching a 20-percent return on common stock equity for Gulf Power Company. I'm recommending 13 percent, for a large part, for what you've pointed out; and that is, that there is more volatility and uncertainty in the profitability of the S&P 500; and because of the more stability of Gulf Power and electric power companies in general, that return would not be justified for them. That is, 20 percent would be too high given the lower level of risk that they have.

COMMISSIONER DEASON: And just as like, for example, in 1991, an earned ROE for the S&P 500 of 10.25 percent probably would be part of that fluctuation which would be on the low end, and we would not want to err on the side of awarding too low of a return on equity either for any given year, correct?

WITNESS BENORE: That is correct.

COMMISSIONER DEASON: Okay. So this is just -- well, I guess, can you then tell me what the purpose of this exhibit is?

WITNESS BENORE: Yes. I think I can best explain it to you, if we started, for example, with 1990 and you were earning $14.20 an hour, and maybe you had a shorter commute as you go over to the electric utility column and lower transportation costs and you considered a job that was giving you $12.70 an hour to be fair in light of your circumstance. However, in the year 2000, you're presented with a job that will give you $20.90 cents an hour versus another one that will give you $11.43 an hour; and I think you don't have to ask me what the answer would be. Most people would prefer, all other the things being equal, the much higher wages that they could earn for the S&P 500 company than for the electric utility. And I think the answer is that that's simple in terms of the investor as well. They seek to make money, and they will go where they can make the most money for a given level of risk. And here, I think, they would be attracted to the non-utility option or the S&P 500, and I think that's borne out by the graph on the following page, or Page 8 of your handout.

COMMISSIONER DEASON: Thank you.

CHAIRMAN JABER: Redirect?

MR. MELSON: No redirect, and we would move Exhibit 26 and 27.

CHAIRMAN JABER: Okay. 26 is admitted into the record without objection.

Mr. McWhirter, you're now comfortable with exhibit 27?

MR. McWHIRTER: No, ma'am.

CHAIRMAN JABER: No?

MR. McWHIRTER: No. No, no.

CHAIRMAN JABER: All right. But you have an objection on Exhibit 27?

MR. McWHIRTER: I have no objection.

CHAIRMAN JABER: Oh. Exhibit 27 is admitted into the record.

And, Mr. Benore, thank you for your testimony.

WITNESS BENORE: You're welcome.

(Whereupon, transcript continues in sequence in Volume 3)

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CERTIFICATE

STATE OF FLORIDA)
COUNTY OF LEON)

I, NANCY S. METZKE, Certified Shorthand Reporter and Registered Professional Reporter, certify that I was authorized to and did stenographically report the foregoing proceedings and that the transcript is a true and complete record of my stenographic notes.

DATED this 25th day of February, 2002.

Nancy S. Metzke

NANCY S. METZKE, CCR, RPR