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USAF Utility Law Field Support Center
139 Barnes Drive
Tyndall AFB FL 32403

Ms. Ann Cole, Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: Docket No. 110138-EI

Dear Ms Cole,

Enclosed please find an original and 15 copies of the following testimony, for filing in the subject docket on behalf of Federal Executive Agencies:

Michael P. Gorman 07560-11
Greg R. Meyer 07561-11
David L. Stowe 07562-11

Please let me know if you have any questions or concerns regarding these documents.

Sincerely,

KAREN S. WHITE
Staff Attorney

DOCUMENT NUMBER-DATE

07560 OCT 14 =

FPSC-COMMISSION CLERK

**BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION**

**In Re: Petition for Increase in
Rates by Gulf Power Company**

Docket No. 110138-EI

Direct Testimony and Exhibits of

Michael P. Gorman

On behalf of

Federal Executive Agencies

Project 9517
October 14, 2011



BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

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BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

_____))
In Re: Petition for Increase in) Docket No. 110138-EI
Rates by Gulf Power Company))
_____)

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Direct Testimony of Michael P. Gorman

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**BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION**

_____))
In Re: Petition for Increase in) Docket No. 110138-EI
Rates by Gulf Power Company)
_____)

Direct Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q WHAT IS YOUR OCCUPATION?

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

**Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND
EXPERIENCE.**

A This information is included in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing in this proceeding on behalf of the Federal Executive Agencies
("FEA").

1 **Q WHAT IS THE SUBJECT MATTER OF YOUR TESTIMONY?**

2 A I will recommend a fair return on common equity and overall rate of return for
3 Gulf Power Company ("Gulf Power" or "Company"). I will also comment on the
4 Company's proposed critical peak rate option ("CPRO") for medium and large
5 business customers who are served on time-of-use rates.

6

7 **Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS FOR GULF POWER'S**
8 **RETURN ON EQUITY IN THIS PROCEEDING.**

9 A My recommendations and findings in this proceeding are summarized as follows.

10 1. As shown on my Exhibit MPG-1, I recommend an overall rate of return of
11 6.22%. This overall rate of return is based on a 9.75% return on equity,
12 and my revised capital structure described below.

13 2. I recommend an adjustment to the regulatory capital structure based on
14 an adjustment to the deferred tax balance.

15

16 **Q PLEASE DESCRIBE YOUR PROPOSED CHANGES TO THE COMPANY'S**
17 **CPRO FOR MEDIUM AND LARGE BUSINESS CUSTOMERS.**

18 A I generally endorse the Company's proposal to implement a CPRO for medium
19 and large business customers. However, I propose more transparent terms and
20 conditions of this rate option. Specifically, I recommend the CPRO language be
21 modified to include the following:

22 • A transparent description of when a critical peak can be declared
23 including:

24 1. an assessment of the forecasted temperatures for winter and summer
25 periods;

- 1 2. Stated objectives for real-time pricing thresholds which can be relied
2 on to declare a critical peak; and
3 3. General input as to when the Company could claim a critical peak due
4 to personnel projections of system peak loads.

5 These proposals will be discussed in more detail later in this testimony.
6

7

RATE OF RETURN

Electric Utility Industry Market Outlook

9 **Q PLEASE DESCRIBE THIS SECTION OF YOUR TESTIMONY.**

10 **A** I have reviewed the credit rating and investment return performance of the
11 electric utility industry. Based on the assessments described below, I find the
12 credit rating outlook of the industry to be strong and supportive of the industry's
13 financial integrity. Further, electric utilities' stocks have exhibited strong return
14 performance and are characterized as a safe investment.

15

16 **Q PLEASE DESCRIBE THE ELECTRIC UTILITIES' CREDIT RATING OUTLOOK.**

17 **A** Electric utilities' credit rating outlook has improved over the recent past and is
18 now stable. Standard & Poor's ("S&P") recently provided an assessment of the
19 credit rating of U.S. electric utilities for 2010. S&P's commentary included the
20 following:

Solid Industry Fundamentals Support Stable Outlook

22 Throughout 2010, U.S. electric utilities performed well amid
23 continuing favorable access to capital. With rebounding markets,
24 external financing activity for the U.S. regulated electric utility
25 industry was about \$35 billion, well below the \$48 billion in more

1 difficult market conditions in 2009. Companies have continued to
2 proactively pre-finance maturities, taking advantage of investor
3 appetite and favorable spreads, and focused on strengthening
4 their balance sheets and liquidity. Investor appetite for first
5 mortgage bonds remained healthy, with deals continuing to be
6 oversubscribed. Credit fundamentals indicate that most, if not all,
7 electric utilities should continue to have ample access to capital
8 markets and credit. Liquidity, an industry-wide strength, has been
9 improving. Banking syndicates are expressing willingness to
10 negotiate credit facilities, now with lengthening terms.¹

11 Similarly, Fitch states:

12 **Rating Outlook**

13 Stable Credit Outlook for Most Segments: Relatively low prices
14 for natural gas and power, low interest rates, open capital-market
15 conditions, and a slow economic recovery forecasted by Fitch
16 Ratings for 2011 are the foundation for a stable credit outlook for
17 most business segments within the utilities, power, and gas (UPG)
18 sector. Fitch's 2011 credit outlook for investor-owned gas and
19 electric utilities, utility parent companies, pipelines, and midstream
20 gas companies is stable. A significant exception is the negative
21 2011 credit outlook for competitive generators, whose profit
22 margins and cash flows are subject to continuing compression

¹Standard & Poor's RatingsDirect on the Global Credit Portal: "Industry Economic And Ratings Outlook: Stable Industry Outlook For U.S. Regulated Electric Utilities Supports Ratings," January 14, 2011, emphasis added.

1 from low gas and power prices and an overhang of excess power
2 capacity.²

3 *Value Line* also continues to characterize utility stock investments as a safe
4 haven:

5 **Conclusion**

6 The main appeal of electric utility stocks continues to be the
7 prospect of consistent income in the form of quarterly dividends,
8 coupled with relative stability. Each utility in this Issue offers a
9 dividend, which for the most part, is quite generous in relation to
10 those in other industries. Although valuation concerns have
11 arisen as of late due to the recent increase in utility stock prices,
12 we believe that these equities remain a popular safe haven for
13 conservative investors.³

14 EEI also opined as follows:

15 There was little change during the first half of 2011 in the
16 industry's long-term outlook. Many regulated utilities are engaged
17 in capital spending programs that should, according to Wall Street
18 analysts, help drive slow but steady earnings growth over the next
19 several years.⁴

20
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22

²Fitch Ratings: "2011 Outlook: U.S. Utilities, Power, and Gas," December 20, 2010, emphasis added.

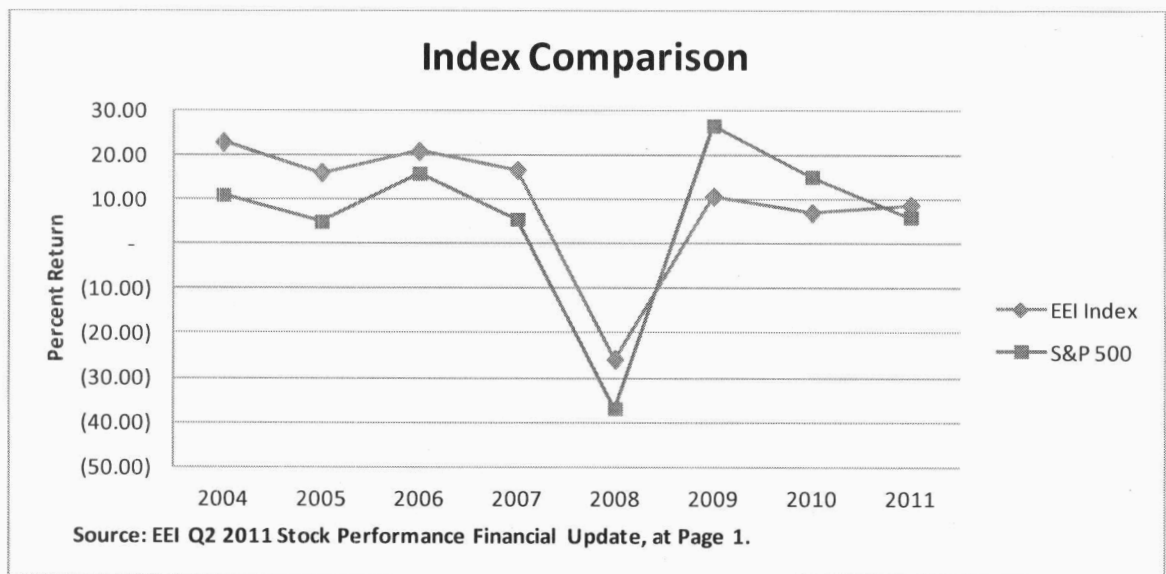
³*Value Line Investment Survey*, November 26, 2010 at 139, emphasis added.

⁴*EEI Q2 2011 Financial Update* at 1.

1 Q PLEASE DESCRIBE ELECTRIC UTILITY STOCK PRICE PERFORMANCE
2 OVER THE LAST SIX YEARS.

3 A As shown in Figure 1 below, the Edison Electric Institute ("EEI") has recorded
4 electric utility stock price performance compared to the market. The EEI data
5 shows that its Electric Utility Index has outperformed the market over the last
6 six years (2004-Second Quarter 2011).

7 Figure 1



1 During 2009 and 2010, the EEI Index underperformed the market, which
2 is not unusual for stocks that are considered “safe havens” during periods of
3 market turbulence.

4 In the first half of 2011, the EEI Index outperformed the market. EEI
5 states the following:

6 The EEI Index slightly outperformed the broad market averages
7 during the first half of 2011, returning 8.8% compared with the
8 Dow Jones’ 8.6% return, the S&P 500’s 6.0% return and the
9 Nasdaq Composite’s 4.6% return. However, the first half of the
10 year was a distinct tale of two quarters, one that highlights the
11 sector’s return to its traditional role as a defensive investment
12 following its reemphasis in recent years of core regulated
13 businesses with slow but predictable earnings growth and steady
14 dividends.⁵

15

16 **Gulf Power’s Investment Risk**

17 **Q PLEASE DESCRIBE THE MARKET’S ASSESSMENT OF THE INVESTMENT**
18 **RISK OF GULF POWER.**

19 A The market’s assessment of Gulf Power’s investment risk is best described by
20 credit rating analysts’ reports. Gulf Power currently has an “A” corporate bond
21 rating from S&P and Fitch, and an “A3” bond rating from Moody’s.

22 Standard & Poor’s states:

23 Standard & Poor’s Ratings Services’ ratings on Gulf Power Co.
24 reflect the consolidated credit profile of its parent, Southern Co.

⁵EEI Q2 2011 Financial Update at 1, emphasis added.

1 Southern has an excellent consolidated business risk profile
2 characterized by stable regulated electric utility operations in
3 Georgia, Alabama, Mississippi, and Florida, which contribute more
4 than 90% of consolidated operating income. The business risk
5 profile benefits from operations in jurisdictions with generally
6 constructive regulatory frameworks, combined with effective
7 management of regulatory relations; strong operating performance
8 and high availability and capacity utilization factors for owned
9 generation; regulatory and operating diversity with a presence in
10 four states; competitive rates for the region that provide some
11 cushion for future rate increases to recover fuel costs and
12 increasing capital expenditures; lack of meaningful unregulated
13 operations; and prudent and reasonably conservative
14 management and financial policies.

15

16 **Outlook**

17 We base the stable outlook on Southern Company and its
18 affiliates on the company's consistent, regulated electric utility
19 operations, which benefit from constructive regulatory frameworks,
20 strong operations, a large service territory with attractive
21 demographics, and proactive and generally conservative
22 management and financial risk practices.⁶

23

24

⁶Standard & Poor's RatingsDirect on the Global Credit Portal: "Gulf Power Co.,"
September 28, 2011.

1 Further, Fitch states:

2 **Rating Rationale**

- 3 • Fitch affirmed the ratings of Gulf Power Company on
4 Sept. 3, 2010. The Rating Outlook is Stable.
- 5 • The ratings and Stable Outlook for Gulf reflect Fitch's
6 expectation that the credit metrics should improve from
7 2009 cyclical lows. The Stable Outlook also reflects a
8 manageable capital-expenditure program, modest debt
9 maturities, and historically constructive rate outcomes.
- 10 • Gulf's cash flow stability is enhanced by several
11 annually adjusted rate riders that provide timely
12 recovery of all prudent costs related to fuel, purchased
13 costs, and environmental expenditures outside of base
14 rates.
- 15 • Fitch expects the still-weak Florida economy and the
16 uncertain utility regulatory situation in the state to
17 gradually improve. While Gulf is heavily dependent on
18 coal-fired generation capacity that must comply with
19 changing emissions standards, the fuel and
20 environmental recovery clauses promote timely
21 recovery of associated costs.⁷
- 22
23

⁷Fitch Ratings Global Power U.S. and Canada Full Rating Report: "Gulf Power Company," October 5, 2010, provided by Gulf Power as Exhibit RST-1, Schedule 8, page 1 of 5.

1 Q WHAT ARE THE IMPORTANT TAKEAWAYS FROM THE CREDIT ANALYSTS'
2 REVIEW OF GULF POWER'S INVESTMENT RISK?

3 A The important takeaways are as follows:

4 1. Credit rating reports indicate that Gulf Power has a stable credit standing,
5 with constructive regulatory frameworks, stable cash flows, and has a
6 manageable capital expenditure program. Together, these indicate that
7 Gulf Power is a reasonably stable investment, based on its low-risk
8 regulated operations.

9
10 **Gulf Power's Capital Structure**

11 Q WHAT IS GULF POWER'S 2012 PROPOSED CAPITAL STRUCTURE?

12 A The Company's 2012 proposed capital structure is shown in Table 1 below.

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<u>Description</u>	<u>Regulatory</u> <u>Capital</u> <u>Weight</u> (1)	<u>Investor</u> <u>Capital</u> <u>Weight</u> (2)
Long-Term Debt	39.29%	47.21%
Short-Term Debt	1.07%	1.29%
Preference Stock	4.36%	5.24%
Common Equity	38.50%	46.26%
Customer Deposits	1.27%	—
Deferred Taxes	15.34%	—
Investment Tax Credit	0.17%	—
Total	100.00%	100.00%

Source: Exhibit No. ____ (RJM-1), Schedule 12.

1 Q ARE YOU PROPOSING ANY ADJUSTMENTS TO GULF POWER'S
2 PROPOSED CAPITAL STRUCTURE?

3 A Yes. As described in the testimony of my colleague, Mr. Greg Meyer, we could
4 not verify the total Company amount of accumulated deferred income taxes.
5 Based on the Company's books and records in this proceeding, we believe that
6 the total Company deferred income taxes should be \$536.6 million rather than
7 the \$492.1 million included in the Company's filing. (McMillan Ex. No. ____
8 (RJM-1) Schedule 12, page 2).

9 Hence, as described in Mr. Meyer's testimony, we are proposing to use
10 the amount of accumulated deferred taxes that we believe can be verified in the
11 Company's filing to produce an appropriate regulatory capital structure. If the
12 Company can explain the difference between the amount of accumulated
13 deferred taxes which are readily determinable from its books and records in this
14 proceeding, and that are actually used in its proposed regulatory capital
15 structure, we may be willing to remove this proposed capital structure
16 adjustment.

17 However, until that happens I recommend the Commission adopt the
18 capital structure for regulatory purposes shown below in Table 2.

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TABLE 2
Gorman's
Proposed Capital Structure

<u>Description</u>	<u>Regulatory Capital Weight</u> (1)	<u>Investor Capital Weight</u> (2)
Long-Term Debt	38.71%	47.21%
Short-Term Debt	1.06%	1.29%
Preference Stock	4.30%	5.24%
Common Equity	37.93%	46.26%
Customer Deposits	1.25%	-
Deferred Taxes	16.59%	-
Investment Tax Credit	<u>0.17%</u>	<u>-</u>
Total	100.00%	100.00%

Source: Exhibit MPG-1.

**Q WHAT IS THE OVERALL RATE OF RETURN BASED ON YOUR PROPOSED
RETURN ON EQUITY?**

**A As shown on Exhibit MPG-1, Gulf Power's overall rate of return, based on a
return on equity of 9.75% and my revised capital structure, is 6.22%.**

RETURN ON EQUITY

Gulf Power's Market Cost of Common Equity

**Q PLEASE DESCRIBE WHAT IS MEANT BY A "UTILITY'S COST OF COMMON
EQUITY."**

**A A utility's cost of common equity is the return investors require on an investment
in the utility. Investors expect to achieve their return requirement from receiving
dividends and stock price appreciation.**

1 Q PLEASE DESCRIBE THE FRAMEWORK FOR DETERMINING A REGULATED
2 UTILITY'S COST OF COMMON EQUITY.

3 A In general, determining a fair cost of common equity for a regulated utility has
4 been framed by two decisions of the U.S. Supreme Court: *Bluefield Water Works*
5 *& Improvement Co. v. Public Serv. Commission of West Virginia*, 262 U.S. 679
6 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591
7 (1944).

8 These decisions identify the general standards to be considered in
9 establishing the cost of common equity for a public utility. Those general
10 standards provide that the authorized return should: (1) be sufficient to maintain
11 financial integrity; (2) attract capital under reasonable terms; and (3) be
12 commensurate with returns investors could earn by investing in other enterprises
13 of comparable risk.

14

15 Q PLEASE DESCRIBE THE METHODS YOU HAVE USED TO ESTIMATE THE
16 COST OF COMMON EQUITY FOR GULF POWER.

17 A I have used several models based on financial theory to estimate Gulf Power's
18 cost of common equity. These models are: (1) a constant growth Discounted
19 Cash Flow ("DCF") model using analyst growth data; (2) a sustainable growth
20 DCF model; (3) a multi-stage growth DCF model; (4) a risk premium ("RP")
21 model, and (5) a Capital Asset Pricing Model ("CAPM"). I have applied these
22 models to a group of publicly traded utilities that I have determined reflect
23 investment risk similar to Gulf Power.

24

25

1 Q HOW DID YOU SELECT A UTILITY PROXY GROUP SIMILAR IN
2 INVESTMENT RISK TO GULF POWER TO ESTIMATE ITS CURRENT
3 MARKET COST OF EQUITY?

4 A I relied on the same electric utility proxy group used by Gulf Power witness
5 Dr. Vander Weide to estimate Gulf Power's return on equity. However, I
6 excluded three companies that have been engaged in merger and acquisitions
7 ("M&A") activity. Excluding companies engaged in M&A activity was a proxy
8 group selection criterion of Dr. Vander Weide (Vander Weide Direct at 29);
9 however, certain proxy companies became engaged in this activity after he
10 compiled his proxy group.

11 I excluded Duke Energy, Progress Energy and Nextera Energy from his
12 proxy group. I excluded companies involved in M&A activity because observable
13 stock price information may reflect the M&A outlooks rather than the stand-alone
14 utility company's outlooks. This, in turn, could significantly skew the equity return
15 estimate.

16

17 Q HOW DOES THE PROXY GROUP INVESTMENT RISK COMPARE TO GULF
18 POWER'S INVESTMENT RISK?

19 A The proxy group is shown on Exhibit MPG-2. This proxy group has an average
20 corporate credit rating from S&P of "BBB+," which is lower than S&P's credit
21 rating for Gulf Power of "A." The proxy group's credit rating from Moody's is
22 "Baa2," which is lower than Gulf Power's credit rating from Moody's of "A3." The
23 proxy group has comparable total investment risk to Gulf Power.

24 The proxy group has an average common equity ratio of 45.9% (including
25 short-term debt) from AUS Utility Reports ("AUS") and 47.7% (excluding short-

1 term debt) from *Value Line* in 2010. This proxy group's common equity ratio is
2 higher than Gulf Power's test year common equity ratio of 46.26% including
3 short-term debt. Gulf Power's common equity ratio is lower than that of the proxy
4 group average but within the variance within the proxy group.

5 I also compared Gulf Power's business risk to the business risk of my
6 proxy group based on S&P's ranking methodology. Gulf Power has an S&P
7 business risk profile of "Excellent," which is identical to the S&P business risk
8 profile of the proxy group. The S&P business risk profile score indicates that Gulf
9 Power's business risk is comparable to that of the proxy group.

10 S&P ranks the business risk of a utility company as part of its corporate
11 credit rating review. (S&P considers total investment risk in assigning bond
12 ratings to issuers, including utility companies. In analyzing total investment risk,
13 S&P considers both the business risk and the financial risk of a corporate entity,
14 including a utility company.) S&P's business risk profile score is based on a five-
15 notch credit rating starting with "Vulnerable" (highest risk) to "Excellent" (lowest
16 risk). The business risk of most utility companies falls within the lowest risk
17 category, "Excellent," or the category one notch higher, "Strong."⁸

18 Based on these proxy group selection criteria, I believe that the proxy
19 group reasonably approximates the investment risk of Gulf Power, and that it can
20 be used to estimate a fair return on equity for Gulf Power.

21
22
23

⁸Standard & Poor's: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007.

1 **Discounted Cash Flow Model**

2 **Q PLEASE DESCRIBE THE DCF MODEL.**

3 A The DCF model posits that a stock price is valued by summing the present value
4 of expected future cash flows discounted at the investor's required rate of return
5 or cost of capital. This model is expressed mathematically as follows:

6
$$P_0 = \frac{D_1}{(1+K)^1} + \frac{D_2}{(1+K)^2} + \dots + \frac{D_\infty}{(1+K)^\infty} \text{ where} \quad \text{(Equation 1)}$$

7
8 P_0 = Current stock price

9 D = Dividends in periods 1 - ∞

10 K = Investor's required return

11 This model can be rearranged in order to estimate the discount rate or
12 investor required return, "K." If it is reasonable to assume that earnings and
13 dividends will grow at a constant rate, then Equation 1 can be rearranged as
14 follows:

15
$$K = D_1/P_0 + G \quad \text{(Equation 2)}$$

16 K = Investor's required return

17 D_1 = Dividend in first year

18 P_0 = Current stock price

19 G = Expected constant dividend growth rate

20 Equation 2 is referred to as the annual "constant growth" DCF model.

21

22

23

24

1 **Q PLEASE DESCRIBE THE INPUTS TO YOUR CONSTANT GROWTH DCF**
2 **MODEL.**

3 A As shown in Equation 2 above, the DCF model requires a current stock price,
4 expected dividend, and expected growth rate in dividends.

5

6 **Q WHAT STOCK PRICE HAVE YOU RELIED ON IN YOUR CONSTANT**
7 **GROWTH DCF MODEL?**

8 A I relied on the average of the weekly high and low stock prices over a 13-week
9 period ended September 16, 2011. An average stock price is less susceptible to
10 market price variations than a spot price. Therefore, an average stock price is
11 less susceptible to aberrant market price movements, which may not be
12 reflective of the stock's long-term value.

13 A 13-week average stock price reflects a period that is still short enough
14 to contain data that reasonably reflect current market expectations, but the period
15 is not so short as to be susceptible to market price variations that may not reflect
16 the stock's long-term value. In my judgment, a 13-week average stock price is a
17 reasonable balance between the need to reflect current market expectations and
18 the need to capture sufficient data to smooth out aberrant market movements.

19

20 **Q WHAT DIVIDEND DID YOU USE IN YOUR CONSTANT GROWTH DCF**
21 **MODEL?**

22 A I used the most recently paid quarterly dividend, as reported in *The Value Line*
23 *Investment Survey*. This dividend was annualized (multiplied by 4) and adjusted
24 for next year's growth to produce the D_1 factor for use in Equation 2 above.

25

1 **Q WHAT DIVIDEND GROWTH RATES HAVE YOU USED IN YOUR CONSTANT**
2 **GROWTH DCF MODEL?**

3 A There are several methods that can be used to estimate the expected growth in
4 dividends. However, regardless of the method, for purposes of determining the
5 market required return on common equity, one must attempt to estimate
6 investors' consensus about what the dividend or earnings growth rate will be, and
7 not what an individual investor or analyst may use to make individual investment
8 decisions.

9 As predictors of future returns, security analysts' growth estimates have
10 been shown to be more accurate than growth rates derived from historical data.⁹
11 That is, assuming the market generally makes rational investment decisions,
12 analysts' growth projections are more likely to influence observable stock prices
13 than growth rates derived only from historical data.

14 For my constant growth DCF analysis, I have relied on a consensus, or
15 mean, of professional security analysts' earnings growth estimates as a proxy for
16 investor consensus dividend growth rate expectations. I used the average of
17 analysts' growth rate estimates from three sources: Zacks, SNL Financial and
18 Reuters. All such projections were available on September 22, 2011, and all
19 were reported online.

20 Each consensus growth rate projection is based on a survey of security
21 analysts. The consensus estimate is a simple arithmetic average, or mean, of
22 surveyed analysts' earnings growth forecasts. A simple average of the growth
23 forecasts gives equal weight to all surveyed analysts' projections. It is
24 problematic as to whether any particular analyst's forecast is more representative

⁹See, e.g., David Gordon, Myron Gordon, and Lawrence Gould, "Choice Among Methods of Estimating Share Yield," *The Journal of Portfolio Management*, Spring 1989.

1 of general market expectations. Therefore, a simple average, or arithmetic
2 mean, of analyst forecasts is a good proxy for market consensus expectations.

3

4 **Q WHAT IS THE GROWTH RATE YOU USED IN YOUR CONSTANT GROWTH**
5 **DCF MODEL?**

6 A The growth rates I used in my DCF analysis are shown in Exhibit MPG-3. The
7 average and median growth rates for my proxy group are 5.26% and 5.33%,
8 respectively.

9

10 **Q WHAT ARE THE RESULTS OF YOUR CONSTANT GROWTH DCF MODEL?**

11 A As shown in Exhibit MPG-4, the average and median constant growth DCF
12 returns for the proxy group are 10.05% and 10.11%.

13

14 **Q DO YOU HAVE ANY COMMENTS CONCERNING THE RESULTS OF YOUR**
15 **CONSTANT GROWTH DCF ANALYSIS?**

16 A Yes. The three- to five-year growth rate exceeds a long-term sustainable growth
17 rate as required by the constant growth DCF model.

18

19 **Q WHY DO YOU BELIEVE THE PROXY GROUP'S THREE- TO FIVE-YEAR**
20 **GROWTH RATE IS IN EXCESS OF A LONG-TERM SUSTAINABLE**
21 **GROWTH?**

22 A The three- to five-year growth rate of the proxy group exceeds the growth rate of
23 the overall U.S. economy. As developed below, the consensus of published
24 economists projects that the U.S. Gross Domestic Product ("GDP") will grow at a
25 rate of no more than 5.1% and 4.7% over the next 5 and 10 years, respectively.

1 A company cannot grow, indefinitely, at a faster rate than the market in which it
2 sells its products. The U.S. economy, or GDP, growth projection represents a
3 ceiling, or high-end, sustainable growth rate for a utility over an indefinite period
4 of time.

5

6 **Q WHY IS THE GDP GROWTH PROJECTION CONSIDERED A CEILING**
7 **GROWTH RATE FOR A UTILITY?**

8 A Utilities cannot sustain indefinitely a growth rate that exceeds the growth rate of
9 the overall economy. Utilities' earnings/dividend growth is created by increased
10 utility investment or rate base. Such investment, in turn, is driven by service area
11 economic growth and demand for utility service. In other words, utilities invest in
12 plant to meet sales demand growth, and sales growth, in turn, is tied to economic
13 growth in their service areas. The Energy Information Administration ("EIA") has
14 observed that utility sales growth is less than U.S. GDP growth, as shown in
15 Exhibit MPG-5. Utility sales growth has lagged behind GDP growth for more
16 than a decade. Hence, nominal GDP growth is a very conservative, albeit
17 overstated, proxy for electric utility sales growth, rate base growth, and earnings
18 growth. Therefore, GDP growth is a conservative proxy for the highest
19 sustainable long-term growth rate of a utility.

20

21 **Q IS THERE RESEARCH THAT SUPPORTS YOUR POSITION THAT, OVER**
22 **THE LONG TERM, A COMPANY'S EARNINGS AND DIVIDENDS CANNOT**
23 **GROW AT A RATE GREATER THAN THE GROWTH OF THE U.S. GDP?**

24 A Yes. This concept is supported in both published analyst literature and academic
25 work. Specifically, in a textbook entitled "Fundamentals of Financial

1 Management," published by Eugene Brigham and Joel F. Houston, the authors
2 state as follows:

3 The constant growth model is most appropriate for mature
4 companies with a stable history of growth and stable future
5 expectations. Expected growth rates vary somewhat among
6 companies, but dividends for mature firms are often expected to
7 grow in the future at about the same rate as nominal gross
8 domestic product (real GDP plus inflation).¹⁰

9

10 **Sustainable Growth DCF**

11 **Q PLEASE DESCRIBE HOW YOU ESTIMATED A SUSTAINABLE LONG-TERM**
12 **GROWTH RATE FOR YOUR SUSTAINABLE GROWTH DCF MODEL.**

13 **A** A sustainable growth rate is based on the percentage of the utility's earnings that
14 are retained and reinvested in utility plant and equipment. These reinvested
15 earnings increase the earnings base (rate base). Earnings grow when plant
16 funded by reinvested earnings are put into service, and the utility is allowed to
17 earn its authorized return on such additional rate base investment.

18 The internal growth methodology is tied to the percentage of earnings
19 retained in the company and not paid out as dividends. The earnings retention
20 ratio is 1 minus the dividend payout ratio. As the payout ratio declines, the
21 earnings retention ratio increases. An increased earnings retention ratio will fuel
22 stronger growth because the business funds more investments with retained
23 earnings. As shown in Exhibit MPG-6, *Value Line* projects that the proxy group

¹⁰"Fundamentals of Financial Management," Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation at 298.

1 will have a declining dividend payout ratio over the next three to five years.
2 These dividend payout ratios and earnings retention ratios then can be used to
3 develop a sustainable long-term earnings retention growth rate. A sustainable
4 long-term retention ratio will help us gauge whether analysts' current three- to
5 five-year growth rate projections can be sustained over an indefinite period of
6 time.

7 The data used to estimate the long-term sustainable growth rate is based
8 on the Company's current market to book ratio and on *Value Line's* three-to-five
9 year projections of earnings, dividends, earned returns on book equity, and stock
10 issuances.

11 As shown in Exhibit MPG-7, page 1 of 2, the average and median
12 sustainable growth rates for the proxy group using this internal growth rate model
13 are 4.66% and 4.90%, respectively.

14

15 **Q WHAT IS THE CONSTANT GROWTH DCF ESTIMATE USING THIS**
16 **SUSTAINABLE LONG-TERM GROWTH RATE?**

17 **A** A DCF estimate based on this sustainable growth rate is developed in Exhibit
18 MPG-8. As shown there, a sustainable growth DCF analysis produces group
19 average and median DCF results of 9.43% and 9.17%, respectively.

20 The sustainable growth DCF result is based on the dividend and price
21 data used in my constant growth DCF study (using analyst growth rates) and the
22 sustainable growth rate discussed above and developed in Exhibit MPG-7.

23

24

25

1 **Multi-Stage Growth DCF Model**

2 **Q HAVE YOU CONDUCTED ANY OTHER DCF STUDIES?**

3 A Yes. My first constant growth DCF is based on consensus analysts' growth rate
4 projections, so it is a reasonable reflection of rational investment expectations
5 over the next three to five years. The limitation on the constant growth DCF
6 model is that it cannot reflect a rational expectation that a period of high/low
7 short-term growth can be followed by a change in growth to a rate that is more
8 reflective of long-term sustainable growth. Hence, I performed a multi-stage
9 growth DCF analysis to reflect this outlook of changing growth expectations.

10

11 **Q PLEASE DESCRIBE YOUR MULTI-STAGE GROWTH DCF MODEL.**

12 A The multi-stage growth DCF model reflects the possibility of non-constant growth
13 for a company over time. The multi-stage growth DCF model reflects three
14 growth periods: (1) a short-term growth period, which consists of the first five
15 years; (2) a transition period, which consists of the next five years (6 through 10);
16 and (3) a long-term growth period, starting in year 11 through perpetuity.

17 For the short-term growth period, I relied on the consensus analysts'
18 growth projections described above in relationship to my constant growth DCF
19 model. For the transition period, the growth rates were reduced or increased by
20 an equal factor, which reflects the difference between the analysts' growth rates
21 and the GDP growth rate. For the long-term growth period, I assumed each
22 company's growth would converge to the maximum sustainable growth rate for a
23 utility company as proxied by the consensus analysts' projected growth for the
24 U.S. GDP of 4.9%.

25

1 **Q HOW DID YOU DETERMINE THE CONSENSUS REASONABLE**
2 **SUSTAINABLE LONG-TERM GROWTH RATE?**

3 A A reasonable growth rate that can be sustained in the long run should be based
4 on consensus analysts' projections. *Blue Chip Economic Indicators* publishes
5 consensus GDP growth projections twice a year. Based on its latest issue, the
6 consensus economists' published GDP growth rate outlook is 5.1% to 4.7% over
7 the next 5 and 10 years, respectively.¹¹

8 Therefore, I propose to use the midpoint (4.9%) of the consensus
9 economists' projected average 5-year and 10-year GDP consensus growth rates,
10 as published by *Blue Chip Economic Indicators*, as an estimate of sustainable
11 long-term growth. This consensus GDP growth forecast represents the most
12 likely views of market participants because it is based on published economist
13 projections. *Blue Chip Economic Indicators'* projections reflect real GDP growth
14 of 3.0% and 2.6%, and GDP inflation of 2.1% and 2.1%¹² over the 5-year and
15 10-year projection periods, respectively.

16

17 **Q DO YOU CONSIDER OTHER SOURCES OF PROJECTED LONG-TERM GDP**
18 **GROWTH?**

19 A Yes. The U.S. EIA in its Annual Energy Outlook projects the real GDP out until
20 2035. In its 2011 Annual Report, the EIA projects real GDP through 2035 to be
21 in the range of 2.1% to 3.2%, with a midpoint or reference case of 2.7%.¹³

22 Also, the Congressional Budget Office ("CBO") makes long-term
23 economic projections -- including one for the period 2016-2019. The CBO, like

¹¹*Blue Chip Economic Indicators*, March 10, 2011 at 15.

¹²GDP growth is the product of real and inflation GDP growth.

¹³DOE/EIA Annual Energy Outlook 2011 With Projections to 2035, April 2011.

1 the consensus *Blue Chip Economic* projections, is projecting real GDP growth of
2 2.3% during the period beyond five years, with GDP price inflation around 1.6%.
3 The CBO's projections are lower than the consensus economists as published by
4 *Blue Chip Economic Indicators*.

5 The real GDP and nominal GDP growth projections made by the U.S. EIA
6 and those made by the CBO support the use of the consensus analyst 5-year
7 and 10-year projected GDP growth outlooks as a reasonable market assessment
8 of long-term prospective GDP growth.

9

10 **Q WHAT STOCK PRICE, DIVIDEND AND GROWTH RATES DID YOU USE IN**
11 **YOUR MULTI-STAGE GROWTH DCF ANALYSIS?**

12 A I relied on the same 13-week stock price and the most recent quarterly dividend
13 payment data discussed above. For stage one growth, I used the consensus
14 analysts' growth rate projections discussed above in my constant growth DCF
15 model. The transition period begins in year 6 and ends in year 10. For the
16 long-term sustainable growth rate starting in year 11, I used 4.9%, the average of
17 the consensus economists' 5-year and 10-year projected nominal GDP growth
18 rates.

19

20 **Q WHAT ARE THE RESULTS OF YOUR MULTI-STAGE GROWTH DCF**
21 **MODEL?**

22 A As shown in Exhibit MPG-9, the average and median DCF returns on equity for
23 the proxy group are 9.78%.

24

25

1 Q PLEASE SUMMARIZE THE RESULTS FROM YOUR DCF ANALYSES.

2 A The results from my DCF analyses are summarized in Table 3 below:

3

4

5

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8

TABLE 3	
<u>Summary of DCF Results</u>	
<u>Description</u>	<u>Return</u>
Constant Growth DCF Model (Analysts' Growth)	10.05%
Constant Growth DCF Model (Sustainable Growth)	9.43%
Multi-Stage Growth DCF Model	<u>9.78%</u>
Average DCF Return	9.75%

9

10 For reasons set forth above, I believe my constant growth DCF model
11 based on analysts' growth is overstated because short-term analyst growth rate
12 projections exceed reasonable estimates of long-term sustainable growth.
13 Therefore, the DCF model based on analysts' growth rate estimates should not
14 be used on a stand-alone basis. I recommend it be averaged with my other DCF
15 estimates to produce a reasonable DCF point estimate that can be used to derive
16 Gulf Power's return on equity. The constant growth DCF model based on the
17 sustainable growth approach produces a growth rate that is sustainable in the
18 long term in comparison to GDP growth, but that growth rate may not reflect
19 analysts' short-term growth outlooks. The multi-stage growth DCF model return
20 reflects the expectation of changing growth rates over time. Based on all my
21 DCF studies, I find that a reasonable DCF return estimate is 9.75%.

22
23
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1 **Risk Premium Model**

2 **Q PLEASE DESCRIBE YOUR BOND YIELD PLUS RISK PREMIUM MODEL.**

3 A This model is based on the principle that investors require a higher return to
4 assume greater risk. Common equity investments have greater risk than bonds
5 because bonds have more security of payment in bankruptcy proceedings than
6 common equity and the coupon payments on bonds represent contractual
7 obligations. In contrast, companies are not required to pay dividends or
8 guarantee returns on common equity investments. Therefore, common equity
9 securities are considered to be more risky than bond securities.

10 This risk premium model is based on two estimates of an equity risk
11 premium. First, I estimated the difference between the required return on utility
12 common equity investments and U.S. Treasury bonds. The difference between
13 the required return on common equity and the Treasury bond yield is the risk
14 premium. I estimated the risk premium on an annual basis for each year over the
15 period 1986 through the second quarter of 2011. The common equity required
16 returns were based on regulatory commission-authorized returns for electric
17 utility companies. Authorized returns are typically based on expert witnesses'
18 estimates of the contemporary investor required return.

19 The second equity risk premium estimate is based on the difference
20 between regulatory commission-authorized returns on common equity and
21 contemporary "A" rated utility bond yields. I selected the period 1986 through the
22 second quarter of 2011 because public utility stocks consistently traded at a
23 premium to book value during that period. This is illustrated in Exhibit MPG-10,
24 which shows that the market to book ratio since 1986 for the electric utility
25 industry was consistently above 1.0. Over this period, regulatory authorized

1 returns were sufficient to support market prices that at least exceeded book
2 value. This is an indication that regulatory authorized returns on common equity
3 supported a utility's ability to issue additional common stock without diluting
4 existing shares. It further demonstrates that utilities were able to access equity
5 markets without a detrimental impact on current shareholders.

6 Based on this analysis, as shown in Exhibit MPG-11, the average
7 indicated equity risk premium over U.S. Treasury bond yields has been 5.21%.
8 Of the 26 observations, 20 indicated risk premiums fall in the range of 4.40% to
9 6.09%. Since the risk premium can vary depending upon market conditions and
10 changing investor risk perceptions, I believe using an estimated range of risk
11 premiums provides the best method to measure the current return on common
12 equity using this methodology.

13 As shown in Exhibit MPG-12, the average indicated equity risk premium
14 over contemporary Moody's utility bond yields was 3.79% over the period 1986
15 through the second quarter of 2011. The indicated equity risk premium estimates
16 based on this analysis primarily fall in the range of 3.03% to 4.62% over this time
17 period.

18

19 **Q DO YOU BELIEVE THAT THESE EQUITY RISK PREMIUM ESTIMATES ARE**
20 **BASED ON A TIME PERIOD THAT IS TOO LONG OR TOO SHORT TO DRAW**
21 **ACCURATE RESULTS CONCERNING CONTEMPORARY MARKET**
22 **CONDITIONS?**

23 **A** No. Contemporary market conditions can change dramatically during the period
24 that rates determined in this proceeding will be in effect. A relatively long period
25 of time where stock valuations reflect premiums to book value is an indication

1 that the authorized returns on equity and the corresponding equity risk premiums
2 were supportive of investors' return expectations and provided utilities access to
3 the equity markets under reasonable terms and conditions. Further, this time
4 period is long enough to smooth abnormal market movement that might distort
5 equity risk premiums. While market conditions and risk premiums do vary over
6 time, this historical time period is a reasonable period to estimate contemporary
7 risk premiums.

8 The time period I use in this risk premium study is a generally accepted
9 period to develop a risk premium study using "expectational" data. Conversely,
10 studies have recommended that use of "actual achieved return data" should be
11 based on very long historical time periods. The studies find that achieved returns
12 over short time periods may not reflect investors' expected returns due to
13 unexpected and abnormal stock price performance. However, these short-term
14 abnormal actual returns would be smoothed over time and the achieved actual
15 returns over long time periods would approximate investors' expected returns.
16 Therefore, it is reasonable to assume that averages of annual achieved returns
17 over long time periods will generally converge on the investors' expected returns.

18 My risk premium study is based on expectational data, not actual returns,
19 and, thus, need not encompass very long time periods.
20

21 **Q** **BASED ON HISTORICAL DATA, WHAT RISK PREMIUM HAVE YOU USED**
22 **TO ESTIMATE GULF POWER'S COST OF EQUITY IN THIS PROCEEDING?**

23 **A** The equity risk premium should reflect the relative market perception of risk in
24 the utility industry today. I have gauged investor perceptions in utility risk today
25 in Exhibit MPG-13. On that exhibit, I show the yield spread between utility bonds

1 and Treasury bonds over the last 30 years. As shown in this exhibit, the 2008
2 utility bond yield spreads over Treasury bonds for "A" rated and "Baa" rated utility
3 bonds are 2.25% and 2.97%, respectively. The utility bond yield spreads over
4 Treasury bonds for "A" and "Baa" rated utility bonds for 2009 are 1.96% and
5 2.98%, respectively. In 2010, these spreads declined to 1.21% and 1.71%,
6 respectively. These utility bond yield spreads over Treasury bond yields are now
7 lower than the 30-year average spreads of 1.59% and 1.99%, respectively.

8 A current 13-week average "A" rated utility bond yield of 4.92%, when
9 compared to the current Treasury bond yield of 3.88% as shown in Exhibit
10 MPG-14, page 1 of 3, implies a yield spread of around 1.04%. This current utility
11 bond yield is lower than the 30-year average spread for "A" utility bonds of
12 1.59%. The current spread for the "Baa" utility yields of 1.48% is also lower than
13 the 30-year average spread of 1.99%.

14 These reduced utility bond yield spreads are clear evidence that the
15 market considers the utility industry to be a relatively low risk investment and
16 demonstrates that utilities continue to have strong access to capital.

17

18 **Q HOW DID YOU ESTIMATE GULF POWER'S COST OF COMMON EQUITY**
19 **WITH THIS RISK PREMIUM MODEL?**

20 A I added a projected long-term Treasury bond yield to my estimated equity risk
21 premium over Treasury yields. The 13-week average 30-year Treasury bond
22 yield, ending September 16, 2011 was 3.88%, as shown in Exhibit MPG-14,
23 page 1 of 3. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond
24 yield to be 4.2%, and a 10-year Treasury bond yield to be 3.1%.¹⁴ Using the

¹⁴*Blue Chip Financial Forecasts*, September 1, 2011 at 2.

1 projected 30-year bond yield of 4.2%, and a Treasury bond risk premium of
2 4.40% to 6.09%, as developed above, produces an estimated common equity
3 return in the range of 8.60% (4.20% + 4.40%) to 10.29% (4.20% + 6.09%), with a
4 midpoint of 9.45%. Because of the very large difference between current and
5 projected Treasury bond rates, I recommend an equity risk premium above the
6 midpoint of my estimated range. Therefore, rather than relying on the 9.45%
7 midpoint of this range, I recommend moving it halfway between the midpoint
8 (9.45%) and the high-end range of 10.3%. Therefore, my proposed equity risk
9 premium return is 9.87%, rounded to 9.90%. I believe this is a reasonable return
10 estimate recognizing the unusually low level of long-term Treasury bond yields in
11 the current market.

12 I next added my equity risk premium over utility bond yields to a current
13 13-week average yield on "Baa" rated utility bonds for the period ending
14 September 16, 2011 of 5.36%. Adding the utility equity risk premium of 3.03% to
15 4.62%, as developed above, to a "Baa" rated bond yield of 5.36%, produces a
16 cost of equity in the range of 8.39% (5.36% + 3.03%) to 9.98% (5.36% + 4.62%),
17 with a midpoint of 9.19%. Again, recognizing the low bond yields currently, I
18 recommend moving to halfway between the midpoint (9.19%) and high-end
19 (9.98%), or 9.59%, rounded to 9.60%.

20 My risk premium analyses produce a return estimate in the range of
21 9.60% to 9.90%, with a midpoint estimate of approximately 9.75%.

22
23
24
25

1 **Capital Asset Pricing Model ("CAPM")**

2 **Q PLEASE DESCRIBE THE CAPM.**

3 A The CAPM method of analysis is based upon the theory that the market required
4 rate of return for a security is equal to the risk-free rate, plus a risk premium
5 associated with the specific security. This relationship between risk and return
6 can be expressed mathematically as follows:

7
$$R_i = R_f + B_i \times (R_m - R_f) \text{ where:}$$

8 R_i = Required return for stock i

9 R_f = Risk-free rate

10 R_m = Expected return for the market portfolio

11 B_i = Beta - Measure of the risk for stock

12 The stock-specific risk term in the above equation is beta. Beta
13 represents the investment risk that cannot be diversified away when the security
14 is held in a diversified portfolio. When stocks are held in a diversified portfolio,
15 firm-specific risks can be eliminated by balancing the portfolio with securities that
16 react in the opposite direction to firm-specific risk factors (e.g., business cycle,
17 competition, product mix, and production limitations).

18 The risks that cannot be eliminated when held in a diversified portfolio are
19 nondiversifiable risks. Nondiversifiable risks are related to the market in general
20 and are referred to as systematic risks. Risks that can be eliminated by
21 diversification are regarded as non-systematic risks. In a broad sense,
22 systematic risks are market risks, and non-systematic risks are business risks.
23 The CAPM theory suggests that the market will not compensate investors for
24 assuming risks that can be diversified away. Therefore, the only risk that
25 investors will be compensated for are systematic or non-diversifiable risks. The

1 beta is a measure of the systematic or non-diversifiable risks.

2

3 **Q PLEASE DESCRIBE THE INPUTS TO YOUR CAPM.**

4 A The CAPM requires an estimate of the market risk-free rate, the company's beta,
5 and the market risk premium.

6

7 **Q WHAT DID YOU USE AS AN ESTIMATE OF THE MARKET RISK-FREE**
8 **RATE?**

9 A As previously noted, *Blue Chip Financial Forecasts'* projected 30-year Treasury
10 bond yield is 4.2%.¹⁵ The current 30-year Treasury bond yield is 4.34%. I used
11 *Blue Chip Financial Forecasts'* projected 30-year Treasury bond yield of 4.2% for
12 my CAPM analysis.

13

14 **Q WHY DID YOU USE LONG-TERM TREASURY BOND YIELDS AS AN**
15 **ESTIMATE OF THE RISK-FREE RATE?**

16 A Treasury securities are backed by the full faith and credit of the United States
17 government. Therefore, long-term Treasury bonds are considered to have
18 negligible credit risk. Also, long-term Treasury bonds have an investment
19 horizon similar to that of common stock. As a result, investor-anticipated long-
20 run inflation expectations are reflected in both common-stock required returns
21 and long-term bond yields. Therefore, the nominal risk-free rate (or expected
22 inflation rate and real risk-free rate) included in a long-term bond yield is a
23 reasonable estimate of the nominal risk-free rate included in common stock
24 returns.

¹⁵*Blue Chip Financial Forecasts*, September 1, 2011 at 2.

1 Treasury bond yields, however, do include risk premiums related to
2 unanticipated future inflation and interest rates. A Treasury bond yield is not a
3 risk-free rate. Risk premiums related to unanticipated inflation and interest rates
4 are systematic or market risks. Consequently, for companies with betas less
5 than 1.0, using the Treasury bond yield as a proxy for the risk-free rate in the
6 CAPM analysis can produce an overstated estimate of the CAPM return.

7

8 **Q WHAT BETA DID YOU USE IN YOUR ANALYSIS?**

9 A As shown in Exhibit MPG-15, the proxy group average *Value Line* beta estimate
10 is 0.71.

11

12 **Q HOW DID YOU DERIVE YOUR MARKET RISK PREMIUM ESTIMATE?**

13 A I derived two market risk premium estimates, a forward-looking estimate and one
14 based on a long-term historical average.

15 The forward-looking estimate was derived by estimating the expected
16 return on the market (as represented by the S&P 500) and subtracting the risk-
17 free rate from this estimate. I estimated the expected return on the S&P 500 by
18 adding an expected inflation rate to the long-term historical arithmetic average
19 real return on the market. The real return on the market represents the achieved
20 return above the rate of inflation.

21 Morningstar's *Stocks, Bonds, Bills and Inflation 2011 Classic Yearbook*
22 publication estimates the historical arithmetic average real market return over the
23 period 1926 to 2010 as 8.7%.¹⁶ A current consensus analysts' inflation

¹⁶Morningstar, Inc. Ibbotson *S&P 500 2011 Classic Yearbook* at 86.

1 projection, as measured by the Consumer Price Index, is 2.2%.¹⁷ Using these
2 estimates, the expected market return is 11.09%.¹⁸ The market risk premium
3 then is the difference between the 11.09% expected market return, and my 4.2%
4 risk-free rate estimate, or 6.89%, rounded to 6.90%.

5 The historical estimate of the market risk premium was also estimated by
6 Morningstar in *Stocks, Bonds, Bills and Inflation 2011 Classic Yearbook*. Over
7 the period 1926 through 2010, Morningstar's study estimated that the arithmetic
8 average of the achieved total return on the S&P 500 was 11.9%,¹⁹ and the total
9 return on long-term Treasury bonds was 5.9%.²⁰ The indicated market risk
10 premium is 6.0% (11.9% - 5.9% = 6.0%).

11

12 **Q HOW DOES YOUR ESTIMATED MARKET RISK PREMIUM RANGE**
13 **COMPARE TO THAT ESTIMATED BY MORNINGSTAR?**

14 A Morningstar's analysis indicates that a market risk premium falls somewhere in
15 the range of 6.0% to 6.7%. My market risk premium falls in the range of 6.0% to
16 6.9%. My average market risk premium of 6.45% (rounded to 6.5%) is within
17 Morningstar's range.

18 Morningstar estimates a forward-looking market risk premium based on
19 actual achieved data from the historical period of 1926 through 2010. Using this
20 data, Morningstar estimates a market risk premium derived from the total return
21 on large company stocks (S&P 500), less the income return on Treasury bonds.
22 The total return includes capital appreciation, dividend or coupon reinvestment
23 returns, and annual yields received from coupons and/or dividend payments.

¹⁷ *Blue Chip Financial Forecasts*, September 1, 2011 at 2.

¹⁸ $\{ [(1 + 0.087) * (1 + 0.024)] - 1 \} * 100$.

¹⁹ Morningstar, Inc. Ibbotson *S&P 500 2011 Classic Yearbook* at 86.

²⁰ *Id.*

1 The income return, in contrast, only reflects the income return received from
2 dividend payments or coupon yields. Morningstar argues that the income return
3 is the only true risk-free rate associated with the Treasury bond and is the best
4 approximation of a truly risk-free rate. I disagree with this assessment from
5 Morningstar, because it does not reflect a true investment option available to the
6 marketplace and therefore does not produce a legitimate estimate of the
7 expected premium of investing in the stock market versus that of Treasury
8 bonds. Nevertheless, I will use Morningstar's conclusion to show the
9 reasonableness of my market risk premium estimates.

10 Morningstar's range is based on several methodologies. First,
11 Morningstar estimates a market risk premium of 6.7% based on the difference
12 between the total market return on common stocks (S&P 500) less the income
13 return on Treasury bond investments. Second, Morningstar found that if the New
14 York Stock Exchange (the "NYSE") was used as the market index rather than the
15 S&P 500, that the market risk premium would be 6.5% and not 6.7%. Third, if
16 only the two deciles of the largest companies included in the NYSE were
17 considered, the market risk premium would be 6.0%.²¹

18 Finally, Morningstar found that the 6.7% market risk premium based on
19 the S&P 500 was impacted by an abnormal expansion of price-to-earnings
20 ("P/E") ratios relative to earnings and dividend growth during the period 1980
21 through 2001. Morningstar believes this abnormal P/E expansion is not
22 sustainable. Therefore, Morningstar adjusted this market risk premium estimate
23 to normalize the growth in the P/E ratio to be more in line with the growth in

²¹Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. Morningstar, Inc. *Ibbotson S&P 500 Valuation Yearbook* at 54.

1 dividends and earnings. Based on this alternative methodology, Morningstar
2 published a long-horizon supply-side market risk premium of 6.0%.²²

3

4 **Q WHAT ARE THE RESULTS OF YOUR CAPM ANALYSIS?**

5 A As shown in Exhibit MPG-16, based on a market risk premium of 6.5%, a risk-
6 free rate of 4.2%, and a beta of 0.71, my CAPM analysis produces a return of
7 8.82%. Using Morningstar's high-end market risk premium of 6.7% would
8 produce a CAPM return of 8.96%. I am concerned with the low estimates
9 produced by my CAPM analysis at this time. I will use the high end of this range,
10 8.96% (rounded to 9.00%).

11

12 **Return on Equity Summary**

13 **Q BASED ON THE RESULTS OF YOUR RETURN ON COMMON EQUITY**
14 **ANALYSES DESCRIBED ABOVE, WHAT RETURN ON COMMON EQUITY DO**
15 **YOU RECOMMEND FOR GULF POWER?**

16 A Based on my analyses, I estimate Gulf Power's current market cost of equity to
17 be 9.75%.

18

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TABLE 4	
<u>Return on Common Equity Summary</u>	
<u>Description</u>	<u>Results</u>
DCF	9.75%
Risk Premium	9.75%
CAPM	9.00%

²²*Id.* at 66.

1 electric utilities have a financial risk profile of "Aggressive." Gulf Power has an
2 "Excellent" business risk profile and an "Intermediate" financial risk profile.

3

4 **Q PLEASE DESCRIBE S&P'S USE OF THE FINANCIAL BENCHMARK RATIOS**
5 **IN ITS CREDIT RATING REVIEW.**

6 A S&P evaluates a utility's credit rating based on an assessment of its financial and
7 business risks. A combination of financial and business risks equates to the
8 overall assessment of Gulf Power's total credit risk exposure. S&P publishes a
9 matrix of financial ratios that defines the level of financial risk as a function of the
10 level of business risk.

11 S&P publishes ranges for three primary financial ratios that it uses as
12 guidance in its credit review for utility companies. The three primary financial
13 ratio benchmarks it relies on in its credit rating process include: (1) debt to
14 Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"),
15 (2) Funds From Operations ("FFO") to total debt, and (3) total debt to total
16 capital.

17

18 **Q HOW DID YOU APPLY S&P'S FINANCIAL RATIOS TO TEST THE**
19 **REASONABLENESS OF YOUR RATE OF RETURN RECOMMENDATIONS?**

20 A I calculated each of S&P's financial ratios based on Gulf Power's cost of service
21 for retail operations. While S&P would normally look at total consolidated
22 financial ratios in its credit review process, my investigation in this proceeding is
23 to judge the reasonableness of my proposed cost of capital for rate-setting in
24 Gulf Power's regulated utility operations. Hence, I am attempting to determine
25 whether the rate of return and cash flow generation opportunity reflected in my

1 proposed rate of return for Gulf Power will support target investment grade bond
2 ratings and Gulf Power's financial integrity.

3

4 **Q DID YOU INCLUDE ANY OFF-BALANCE SHEET DEBT ("OBSD")?**

5 A Yes. As shown in Exhibit MPG-17, page 3 of 4, I used an OBSD amount of
6 \$33.9 million. This OBSD is attributed to Gulf Power's operating leases and
7 purchase power agreements as estimated by S&P.

8

9 **Q HOW DID YOU ESTIMATE GULF POWER'S OBSD?**

10 A The OBSD is estimated by S&P and can be found in Exhibit MPG-17, page 4 of
11 4. Because I am focused on Florida retail operations, I included only the amount
12 of total Gulf Power OBSD that is clearly tied to provision of retail electric utility
13 service in Florida. Therefore, I only included the amount of OBSD attributable to
14 operating leases.

15 The OBSD obligations were stated on a total Company basis. However,
16 for the operating characteristics in determining FFO and EBITDA, I allocated a
17 portion of the debt interest expense and debt amortization imputations
18 associated to OBSD to Florida retail operations. A portion of total Company
19 imputed interest and amortization expense was allocated to Florida based on an
20 allocation of Florida rate base to total Company rate base.

21

22 **Q PLEASE DESCRIBE THE RESULTS OF THIS CREDIT METRIC ANALYSIS**
23 **FOR GULF POWER.**

24 A The S&P financial metric calculations for Gulf Power are developed on Exhibit
25 MPG-17, page 1 of 4.

1 As shown on Exhibit MPG-17, page 1 of 4, column 1, based on an equity
2 return of 9.75%, Gulf Power will be provided an opportunity to produce a debt to
3 EBITDA ratio of 3.8x. This is at the high end of S&P's new "Significant" guideline
4 range of 3.0x to 4.0x.²⁴ This ratio supports an investment grade credit rating.

5 Gulf Power's retail operations FFO to total debt coverage at a 9.75%
6 equity return would be 26%, which is within the new "Significant" metric guideline
7 range of 20% to 30%. The FFO/total debt ratio will support an investment grade
8 bond rating.

9 Finally, Gulf Power's total debt ratio to total capital is 55%. This is within
10 the new "Aggressive" guideline range of 50% to 60%. This total debt ratio will
11 support an investment grade bond rating.

12 At my recommended return on equity and Gulf Power's proposed capital
13 structure, the Company's financial credit metrics are supportive of its current
14 "BBB" utility bond rating.

15

16 **Q DO YOU BELIEVE THIS CREDIT METRIC EVALUATION OF GULF POWER**
17 **AT YOUR PROPOSED RETURN ON EQUITY PROVIDES MEANINGFUL**
18 **INFORMATION TO HELP THE COMMISSION DETERMINE THE**
19 **APPROPRIATENESS OF YOUR RECOMMENDATION?**

20 **A** Yes. While S&P calculates these credit metrics based on total Company
21 operations, and not the retail operations of Gulf Power (as I have performed in
22 this study), they still provide meaningful information to evaluate the
23 reasonableness of my proposed rate of return for Gulf Power in this case.
24 Further, while credit rating agencies also consider other financial metrics and

²⁴Standard & Poor's RatingsDirect: "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

1 qualitative considerations, these metrics are largely driven by the cost of service
2 items of depreciation expense and return on equity. Hence, to the extent these
3 important aspects of cost of service impact Gulf Power's internal cash flows, the
4 relative impact on Gulf Power will be measured by these credit metrics. As
5 illustrated above, an authorized return on equity of 9.75% will support internal
6 cash flows that will be adequate to maintain Gulf Power's current investment
7 grade bond rating.

8

9 **RESPONSE TO GULF POWER WITNESS DR. JAMES VANDER WEIDE**

10 **Q WHAT IS GULF POWER'S RETURN ON EQUITY RECOMMENDATION?**

11 A Gulf Power's rate of return witness, Dr. Vander Weide, recommends a return on
12 equity of 11.7%, which is based on an estimated proxy group return on equity of
13 10.8%, increased by 0.90% to include a leverage risk return on equity adder.
14 This leverage return adder is based on Dr. Vander Weide's belief that Gulf Power
15 has greater financial risk than the proxy group. (Vander Weide Direct at 4).

16

17 **Q HOW DID DR. VANDER WEIDE DEVELOP HIS RETURN ON EQUITY
18 RANGE?**

19 A Dr. Vander Weide developed his return on equity recommendation by applying
20 the DCF, Risk Premium and CAPM models to a utility proxy group. Dr. Vander
21 Weide arrived at his recommendations by reviewing Gulf Power's business
22 operations, market conditions, and utility industry trends at the time of his filing.

23

24

25

1 **Q PLEASE SUMMARIZE DR. VANDER WEIDE'S PROPOSED RETURN ON**
2 **EQUITY FOR GULF POWER.**

3 A As shown below in Table 5, his analyses produce an average return on equity of
4 10.8% and a range of 10.7% to 11.0%. Dr. Vander Weide increased his proxy
5 group estimated return range by 0.26% to account for flotation costs. However,
6 as I will discuss in more detail below, making reasonable adjustments to
7 Dr. Vander Weide's DCF and CAPM studies produces a return on equity for Gulf
8 Power of well less than 10%. Dr. Vander Weide's return on equity adders for a
9 leverage adjustment and flotation cost should be rejected.

10

11 **Q HOW DID DR. VANDER WEIDE DEVELOP HIS LEVERAGE ADJUSTMENT?**

12 A He develops this on his Exhibit ___ (JVW-1), Schedule 10. On that schedule, he
13 develops a post-tax cost of equity using his proposed 10.8% cost of equity, and
14 the market weighted average capital structure for his proxy group. This produced
15 a weighted average cost of capital, post-tax, of 7.337%.

16 He then estimated the return on common equity that would produce the
17 same post-tax weighted average cost of capital (7.337%) when applied to Gulf
18 Power's book value capital structure. As shown on his Schedule 10, a return on
19 book value equity at 11.7% would produce the same post-tax cost of equity on
20 Gulf Power's book value capital structure, as he produced using the market value
21 capital structure of his proxy group.

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TABLE 5
Gulf Power's ROE Analysis

<u>Model</u>	<u>Vander Weide Proposed</u>	<u>Adjusted</u>
DCF	10.7%	10.1%
Ex Ante Risk Premium	11.0%	9.8%
Ex Post Risk Premium	10.8%	9.5%
CAPM Historical (MRP)	9.2%	9.0%
CAPM DCF (MRP)	10.7%	
Range	9.2% - 11.0%	9.0% - 10.1%
Point Estimate	10.8%	9.6%
Leverage Adder	0.9%	Reject
Recommendation	11.70%	9.6%

Sources:
Vander Weide Direct at 41, 46 and 47.

Q WHY IS DR. VANDER WEIDE'S PROPOSED LEVERAGE EQUITY RETURN ADDER UNREASONABLE?

A The leverage adjustment increases the return on equity to reflect Gulf Power's greater book value financial risk compared to its market value financial risk. However, such an adjustment to the equity return is erroneous for at least two reasons.

First, Dr. Vander Weide's contention that an adjustment should be made for differentials in book value and market value financial risk is without merit. The implicit premise of Dr. Vander Weide's leverage adjustment is that financial risk is measured differently using book value capitalization versus market value capitalization. This premise is without merit, because the Company's financial

1 risk is tied to both its book value capitalization which in turn drives its market
2 value capitalization. They are not separate factors. Second, Dr. Vander Weide's
3 proposed leverage adjustment is really nothing more than a flawed market-to-
4 book ratio adjustment. The leverage equity return adder results in an excess
5 return on incremental utility plant investments.

6 For these reasons, the leverage adjustment is without merit, and should
7 continue to be rejected by the Commission just as it was in Gulf Power's last rate
8 case.

9

10 **Q WHY DO YOU BELIEVE THAT A COMPANY DOES NOT HAVE DIFFERENT**
11 **FINANCIAL RISK WHETHER IT IS MEASURED ON BOOK VALUE OR**
12 **MARKET VALUE CAPITAL STRUCTURE?**

13 **A** The company's financial risk concerns its ability to meet its financial obligations.
14 Its ability to meet its financial obligations is tied to its ability to reliably produce
15 internal generation of earnings and cash to pay its financial obligations. A
16 company does not have one level of financial risk based on its book value capital
17 structure, and another level of financial risk based on its market value capital
18 structure.

19

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1 **Q HOW DOES BOOK VALUE LEVERAGE ESTABLISH A COMPANY'S**
2 **FINANCIAL RISK?**

3 A Book value leverage represents the utility's contractual obligations to pay debt
4 interest and principal payments. These book value financial obligations must be
5 paid from utility operating cash flows.

6 In generating free cash flow, the utility must make debt interest payments
7 from operating income, and produce net cash flow after interest payments are
8 made to support debt principal payments, construction expenditures, and to pay
9 common dividends. Internal cash flows must support book value leverage. If
10 cash flows are not adequate to meet book value obligations, the company can be
11 forced into default. Financial risk concerns the likelihood a utility cannot pay
12 these financial obligations.

13 The market value capital structure leverage does not measure whether a
14 utility's earnings and free cash flow will cover its contractual financial obligations.
15 These cash flows do drive stock valuations which produce the market
16 capitalization structure. Nevertheless, the resulting stock valuations and market
17 capitalization do not describe how reliably the internally generated cash flows will
18 cover the fixed financial obligations of the company.

19 For these reasons, the financial risk is best described by the book value
20 financial obligations in relationship to the cash flows produced on the company's
21 books and records.

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1 **Q WHY WILL DR. VANDER WEIDE'S LEVERAGE RETURN ADDER PROVIDE**
2 **EXCESSIVE COMPENSATION ON INCREMENTAL UTILITY PLANT**
3 **INVESTMENTS?**

4 **A**Because it will provide Gulf Power an excessive risk adjusted return on
5 incremental plant investments, I will use Dr. Vander Weide's DCF results to
6 illustrate this point.

7 If Gulf Power were to repurchase its own stock, it would expect to earn a
8 market-based return of 10.80% based on Dr. Vander Weide's unadjusted DCF
9 results. However, if the Commission accepted Dr. Vander Weide's leverage
10 adjusted return, it could earn a return on incremental utility plant investments of
11 11.70% (the 10.80% plus 0.90% leverage adjustment).

12 If the utility was considering its options for reinvesting its retained
13 earnings, it could be faced with the alternative investments of: (1) repurchase its
14 own stock at a 10.80% return, or (2) invest in new utility plant at a 11.70% return.
15 These are comparable risk investments because utility plant investments drive
16 earnings, and earnings drive dividends and stock price. Under Dr. Vander
17 Weide's proposal, the utility would be encouraged to gold-plate utility plant
18 investment because it would be provided with an above-market risk adjusted
19 return on such investments. Providing a utility an incentive to earn more than a
20 fair risk adjusted return on utility plant investments will result in rates not being
21 just and reasonable.

22

23 **Q WHY IS DR. VANDER WEIDE'S FLOTATION COST ADJUSTMENT FLAWED?**

24 **A**Dr. Vander Weide increased his DCF, risk premium and CAPM estimates by
25 approximately 0.26% to include a flotation cost adjustment. This flotation cost

1 adjustment is not based on Gulf Power actual common stock flotation cost and
2 should therefore be rejected. Rather, as discussed at page 27 and Appendix 3 of
3 Dr. Vander Weide's direct testimony, he derives a flotation cost adjustment
4 based on published academic literature. Because he does not show that his
5 adjustment is based on Gulf Power's actual and verifiable flotation expenses,
6 there simply are no means of verifying whether Dr. Vander Weide's proposal is
7 reasonable or appropriate.

8

9 **Q PLEASE DESCRIBE DR. VANDER WEIDE'S DCF ANALYSIS.**

10 A Dr. Vander Weide applied the traditional DCF model to a utility proxy group.
11 Based on his utility group, his DCF study produces a return in the range of 10.7%
12 to 11.4%. (Vander Weide Direct at 30 and Schedule 1).

13

14 **Q DO YOU TAKE ISSUE WITH DR. VANDER WEIDE'S DCF ANALYSES?**

15 A Yes. I have two major issues concerning his DCF analyses. Dr. Vander Weide's
16 constant growth DCF study is overstated because the analysts' three- to five-
17 year growth rates he uses are not reasonable estimates of long-term sustainable
18 growth. The constant growth DCF model used by Dr. Vander Weide requires an
19 estimated long-term sustainable growth. In contrast, the analysts' growth rates
20 he relies on reflect only the outlooks over the next three to five years. To the
21 extent the analysts' growth rate estimates are not reasonable estimates of
22 long-term sustainable growth, then the DCF return estimate he produces from
23 this study is not reliable. Because the analysts' growth rates exceed a
24 reasonable estimate of long-term sustainable growth, Dr. Vander Weide's DCF
25 return estimate is inflated and should be rejected.

1 Second, I believe his DCF return estimate is unreasonable because he
2 relies on a quarterly compounding version of the DCF model. For the reasons
3 set forth below, the quarterly compounding of the DCF model overestimates a
4 utility's cost of capital because it provides utilities with an opportunity to earn the
5 dividend reinvestment return twice: first, through authorized returns on equity
6 and earnings to the utility, and a second time after dividends are actually paid to
7 investors and reinvested in alternative investments to the utility stock the
8 dividend was earned upon.

9

10 **Q PLEASE DESCRIBE WHY YOU BELIEVE DR. VANDER WEIDE'S THREE- TO**
11 **FIVE-YEAR ANALYSTS' GROWTH RATE PROJECTIONS ARE NOT**
12 **REASONABLE ESTIMATES OF LONG-TERM SUSTAINABLE GROWTH.**

13 **A**As shown on his Schedule 1, page 1, the growth rates from his proxy group in
14 every instance but a few exceed the projected nominal growth of the U.S. GDP.
15 As stated above, consensus economists' projections of long-term growth for the
16 U.S. GDP are around 4.9%. In contrast, of Dr. Vander Weide's 24 utility
17 company proxy group, approximately 17 of the companies have growth rate
18 estimates that exceed the long-term projected growth of U.S. GDP. On average,
19 his proxy group growth rate is 6.01%.

20 I explained above that both practitioners and academics support the
21 notion that long-term sustainable growth cannot be greater than the economy in
22 which the company sells its good and services. Growth can exceed the service
23 area economic growth over short periods of time, but over the long-term the
24 expectation that the growth will exceed the economy in which it sells its services
25 is not rational nor reasonable. Because Dr. Vander Weide's growth rates exceed

1 the long-term expected growth of the U.S. GDP, his DCF return estimate is
2 unreasonable and should be rejected.

3

4 **Q IS A QUARTERLY COMPOUNDING ADJUSTMENT TO A DCF RETURN**
5 **ESTIMATE REASONABLE?**

6 A No. Including the quarterly compounding adjustment to Gulf Power's authorized
7 return on equity is inappropriate. If a quarterly compounding adjustment is added
8 to a DCF return estimate, shareholders will be permitted to earn the dividend
9 *reinvestment return* twice: (1) through the higher authorized return on equity,
10 and (2) through actual receipt of dividends and the reinvestment of those
11 dividends throughout the year. This double counting of the dividend
12 reinvestment return is not reasonable and will unjustly inflate Gulf Power's rates.

13

14 **Q PLEASE EXPLAIN WHY THE QUARTERLY COMPOUNDING RETURN**
15 **SHOULD NOT BE INCLUDED IN GULF POWER'S AUTHORIZED RETURN**
16 **ON EQUITY.**

17 A Simply put, the quarterly compounding component of the return is not a cost to
18 the utility. Only the utility's cost of common equity capital should be included in
19 the authorized return on equity.

20 This issue surrounds whether or not the DCF return estimate should
21 include the expectations by investors that they will receive cash flows within the
22 year, that can be reinvested in other investments of comparable risk, and thus
23 the cash flows will produce compounded returns throughout the year. The
24 relevant issue for setting rates is whether or not that reinvestment return is a cost
25 to the utility. It is not!

1 The reinvestment return is not a cost to the utility and therefore should not
2 be included in the authorized return on equity. While it is reasonable for
3 investors to expect to have the opportunity to earn the compounded return
4 produced by cash flows received within the year, the compound return is not paid
5 to investors by the utility.

6

7 **Q CAN YOU PROVIDE AN EXAMPLE OF WHY THE COMPOUNDING RETURN**
8 **ESTIMATE IS NOT A COST TO THE UTILITY?**

9 **A** Yes. I will provide two examples to help illustrate this point. First, consider the
10 cost to the utility of an outstanding utility bond. Most utility bonds pay a coupon
11 every six months. The utility annual cost paid to the bond investor is the sum of
12 the two semi-annual coupon payments. A bond investor expects to receive the
13 semi-annual coupon payments from the utility, but also has an opportunity to
14 reinvest the first coupon payment for the remaining six months of the year to
15 enhance his end-of-year return. This compound return component is, however,
16 not a cost to the utility because the utility does not pay the extra return.

17 For example, assume Gulf Power has an outstanding bond with a face
18 value of \$1,000, at an interest rate of 6% which is paid in two semi-annual \$30
19 coupon payments. Gulf Power's cost of this bond is 6%. This 6% cost to Gulf
20 Power is based on a \$30 coupon payment paid in month 6 and month 12 for an
21 annual payment of \$60 relative to the \$1,000 face value of the bond. However,
22 the bond investor would have an annual expected return on this bond of 6.1%.
23 This annual expected return would be realized by receiving the first \$30 semi-
24 annual coupon payment from Gulf Power and reinvesting it for the remaining six
25 months of the year. This would produce \$0.89 of semi-annual compounding

1 return ($\$30 \times [(1.06)^{\frac{1}{2}} - 1]$). Hence, the bond investor would receive \$60 from
2 Gulf Power, and \$0.89 from investing the first coupon for a total annual return of
3 6.09%, or 6.1%.

4 Importantly, if Gulf Power were to recover a 6.1% cost of this bond in its
5 cost of service, and paid that return out to the bond investor, then the bond
6 investor would receive \$60.89 from Gulf Power, rather than the \$60.00 actual
7 cost, but the bond investor could still reinvest the semi-annual coupon, now
8 \$30.89 for the remaining six months of the year. This would provide the investor
9 with the reinvestment return twice, once from utility ratepayers, and a second
10 time after the semi-annual coupon payment was paid and reinvested.

11 Reflecting this compounding assumption in the authorized return on
12 equity therefore will double count the reinvestment return opportunity.

13

14 **Q DOES THIS EXAMPLE ALSO APPLY TO UTILITY STOCK INVESTMENTS?**

15 **A** Yes. Assume now that an investor purchased Gulf Power stock for \$100, and
16 expects to receive four quarterly dividends of \$1.50, or \$6.00 per year. The
17 expected cost to the utility of this dividend payment over the year would be
18 \$6.00, or 6.0%. However, the expected effective yield of the dividend to
19 investors would be 6.13% because the quarterly dividends could be reinvested
20 for the remaining term of the year. Hence, the expected end-of-year value of
21 those four \$1.50 quarterly dividend payments to the investor would be \$6.13.²⁵
22 Again, the utility pays \$6.00 of annual dividends. The \$0.13 is not paid to
23 investors from the utility, but is rather earned in the other investments that earn
24 the same return, which the dividends were invested in throughout the year.

²⁵ $1.5 \times (1.06)^{.75} + 1.5 \times (1.06)^{.5} + 1.5 \times (1.06)^{.25} + 1.5 = \$6.13.$

1 Importantly, the reinvestment return of the dividends is not paid by the
2 utility, and therefore is not part of the utility's cost of capital. Again, if this
3 dividend reinvestment return is included in the utility's authorized return on
4 equity, then investors will receive the dividend reinvestment return twice, once
5 through the authorized return on equity, and a second time when dividends are
6 actually received by investors and reinvested.

7

8 **Q CAN DR. VANDER WEIDE'S DCF ANALYSIS BE USED TO PRODUCE A**
9 **RELIABLE DCF RETURN FOR GULF POWER IN THIS CASE?**

10 **A** Yes. Reflecting a period of abnormally high short-term growth, followed by a
11 decline to long-term sustainable growth, removing his quarterly compounding
12 assumption, and excluding his flotation cost adjustment, the data used by
13 Dr. Vander Weide in his DCF study can produce a reasonable return estimate for
14 Gulf Power.

15

16 **Q WHAT RETURN ON EQUITY WOULD DR. VANDER WEIDE'S DCF DATA**
17 **SUGGEST IS APPROPRIATE FOR GULF POWER IN THIS CASE.**

18 **A** I apply a multi-stage DCF model to Dr. Vander Weide's utility proxy group. In this
19 analysis, I used the average of his four growth rate estimates for the first growth
20 stage (includes the period from year 1 to year 5); the second stage is the
21 transition stage from year 6 to year 10; and for the third growth rate stage, which
22 starts in year 11 to perpetuity, I used the projected average 5- to 10-year GDP
23 growth rate of 4.9%.

24

25

1 Applying the multi-stage DCF version to Dr. Vander Weide's utility group
2 yields average and median DCF returns of 10.09% and 10.14%, respectively, as
3 shown in Exhibit MPG-18.

4
5 **Q PLEASE DESCRIBE DR. VANDER WEIDE'S EX ANTE RISK PREMIUM**
6 **METHODOLOGY.**

7 A Dr. Vander Weide estimated a DCF return on a proxy group of electric
8 companies relative to the utility bond yield with a rating of "A." He performed this
9 analysis for a period from September 1999 through December 2010. Based on
10 this study, Dr. Vander Weide asserts that his risk premium estimate was 4.9% for
11 this historical period based on prospective DCF return estimates relative to bond
12 yields.

13 To this estimated market risk premium of 4.9%, he added a projected "A"
14 rated Moody's bond utility yield of 6.15%. He then concluded that this produced
15 a return on common equity of 11.0%.

16
17 **Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH DR. VANDER WEIDE'S**
18 **EX ANTE RISK PREMIUM ANALYSIS.**

19 A I believe Dr. Vander Weide's estimated market risk premium from his ex post risk
20 premium study represents a very high-end estimate of an appropriate risk
21 premium for this proceeding. However, because bond yields are relatively low
22 currently, it can be used to produce a reasonable return on equity estimate for
23 Gulf Power. Hence, applying his estimate of a 4.9% equity risk premium, to the
24 current observable "A" rated utility bond yield of 4.92%, produces a return on
25 equity for Gulf Power of 9.82% in this proceeding.

1 **Q PLEASE DESCRIBE DR. VANDER WEIDE'S EX POST RISK PREMIUM**
2 **METHODOLOGY.**

3 A In Dr. Vander Weide's ex post methodology, he compared the historical realized
4 return on the S&P 500 relative to estimated changes in bond price for an "A"
5 rated utility bond. He performed a second ex post risk premium analysis
6 comparing the historical achieved return on the S&P Utility Index, relative again
7 to changes in "A" rated utility bond yields.

8 Based on this analysis, Dr. Vander Weide estimates an equity risk
9 premium in the range of 4.64% (based on S&P 500) to 4.1% (based on utility
10 yields). He then applies this estimated equity risk premium to his projected "A"
11 rated utility bond yield of 6.15% to produce an estimated equity risk premium in
12 the range of 10.2% to 10.8% as outlined at page 38 of his testimony. He then
13 added 26 basis points for a flotation cost, and proposes a point estimate for his
14 risk premium study of 10.8%.

15

16 **Q DO YOU BELIEVE THAT DR. VANDER WEIDE'S EX POST RISK PREMIUM**
17 **RECOMMENDATION IS REASONABLE?**

18 A No, for several reasons. First, his projected "A" rated utility bond yield of 6.15%
19 substantially exceeds current observable utility bond yields of 4.92%. While
20 these bond yields are low, Dr. Vander Weide's projected yield is abnormally high.
21 Reflecting just the high-end of his estimated equity risk premium using his ex
22 post risk premium study of 4.6%, with current bond yields of 4.92%, would
23 indicate a fair return on equity for Gulf Power in this case of 9.52%. Using his
24 low-end estimate of 4.1%, would indicate a return on equity of 9.02%. As such,
25 Dr. Vander Weide's recommended return on equity with this methodology

1 substantially overstates current observable market costs.

2

3 **Q PLEASE DESCRIBE DR. VANDER WEIDE'S CAPM STUDIES.**

4 A Dr. Vander Weide performed a historical DCF study based on a market risk
5 premium of 6.7%, a risk-free rate of 4.5%, and beta estimate of 0.67. This study
6 produced a return on equity estimate of 8.94%. He then added 26 basis points
7 for flotation cost to produce a historical CAPM return estimate of 9.2% (page 41).
8 He also performed a DCF-based CAPM study, where he estimated the market
9 risk premium using a DCF return on the S&P 500. Based on that study,
10 Dr. Vander Weide estimated a market risk premium of 8.85%, and use of his risk-
11 free rate of 4.45%, and beta estimate of 0.67, produced a CAPM return estimate
12 of 10.44%. He then added his 26 basis point flotation cost adjustment to this
13 return to produce a CAPM return estimate of 10.7% (page 46).

14

15 **Q DO YOU HAVE ANY CONCERNS WITH DR. VANDER WEIDE'S HISTORICAL**
16 **CAPM RETURN ESTIMATE?**

17 A No, but I do believe for the reasons set forth above, his proposal to include a
18 26 basis point flotation cost adjustment is not just nor reasonable. Therefore, it
19 should be rejected.

20

21 **Q DO YOU HAVE ANY CONCERNS WITH DR. VANDER WEIDE'S DCF-BASED**
22 **CAPM RETURN ESTIMATE?**

23 A Yes. I believe his market risk premium of 8.85% is overstated because it reflects
24 an excessive projected return on the market. Therefore, I believe this CAPM
25 return estimate should be rejected.

1 **Q PLEASE DESCRIBE DR. VANDER WEIDE'S DCF-BASED CAPM ANALYSIS.**

2 A Dr. Vander Weide estimates a forward-looking return on the market of 13.3%.
3 From this market return estimate he subtracts his risk-free rate, a long-term
4 Treasury bond yield of 4.45%. From this he produced a market risk premium of
5 8.85% (13.3% less 4.45%). He relies on a beta of 0.67, risk-free rate of 4.45%,
6 and market risk premium of 8.85% to produce a bare bones CAPM of 10.4%. He
7 then adds a 0.26% flotation cost adjustment to produce a 10.7% DCF-based
8 CAPM estimate. (Vander Weide Direct at 46 and Schedule 8).

9

10 **Q IS DR. VANDER WEIDE'S DCF-BASED CAPM ESTIMATE REASONABLE?**

11 A No. Dr. Vander Weide's DCF-based CAPM analysis is based on a market risk
12 premium of 8.85%. As discussed in my CAPM analysis, that market risk
13 premium is significantly higher than the historical market risk premium of 6.7%.
14 Dr. Vander Weide's 13.3% DCF market return used to derive the market risk
15 premium of 8.85% is highly inflated and unreliable. This market return estimate
16 is based on a DCF analysis that includes a growth rate projection of around
17 10.8% and a dividend yield of 2.5%. Dr. Vander Weide's risk premium is
18 dramatically overstated because it is based on a DCF return produced by
19 irrationally high growth outlooks, and is, therefore, not reliable.

20 More specifically, it is simply irrational to expect that securities market
21 capital appreciation and growth will be above 10.0% for an indefinite period of
22 time. This is important because the DCF model requires a sustainable long-term
23 growth rate, not simply a growth rate that might be appropriate for the next five
24 years. The growth rate for the overall securities market must reflect the economy
25 in which its companies operate, and the earnings and dividend-paying ability of

1 those companies. Companies produce earnings and dividends by selling goods
2 and services in the marketplace. Hence, companies' earnings growth and sales
3 growth opportunities cannot be substantially in excess of the expected growth in
4 the overall economy. It is simply not a rational expectation to believe that, for an
5 extended period of time, the growth rate of companies will both exceed the
6 growth of the overall economy in which they sell their goods and services and
7 produce earnings to pay dividends. As I mentioned above, *Blue Chip Financial*
8 *Forecasts* projects an average 5- to 10-year nominal growth in the GDP, or
9 overall U.S. economy, of 4.9%.²⁶ Hence, expecting a growth rate of 10.6%, in
10 essence, assumes that the securities market can grow at a rate almost twice that
11 of the overall U.S. economy. This is simply not a rational expectation.

12

13

CPRO PARAMETERS

14 **Q HAVE YOU REVIEWED THE PROPOSED CPRO PROPOSED BY GULF**
15 **POWER?**

16 **A** Yes. Gulf Power witness James I. Thompson (Direct at page 14) outlines the
17 Company's proposal for a new critical peak rate option for medium and large-
18 sized business customers. The CPRO is available with the General Demand
19 Service ("GSDT") and Large Power Service Time-of-Use ("LPT") rates. The
20 CPRO provides customers the opportunity to reduce their demand costs if they
21 can reduce their load during critical peak periods.

22 Under the CPRO, demand charges for customers would be broken into
23 three parts instead of two. During non-critical peak periods, customers would
24 pay a maximum demand charge and an on-peak demand charge. If a critical

²⁶*Blue Chip Economic Indicators*, March 10, 2011.

1 peak period is called, customers would also be billed a critical peak period
2 demand charge. If customers can reduce demand when a critical peak is called,
3 they can avoid this CPRO demand rate. If customers have flexibility, the
4 availability of this critical peak charge will allow them to reduce their overall
5 demand cost relative to the Company's standard tariff rate options.

6

7 **Q ARE THERE BENEFITS TO A CPRO PROGRAM?**

8 **A** Yes, several. The CPRO can help reduce Gulf Power's system demand during
9 critical peaks. This may allow the Company to avoid high-cost power generation,
10 high-cost purchases, and/or defer the development of new generation units to
11 meet peak demand.

12 Customers that have the load flexibility can also use the CPRO rate to
13 reduce cost and improve their competitiveness in their own markets. As such,
14 the CPRO rate can help to retain and attract businesses to Gulf Power's service
15 territory and support the local economies. Finally, the CPRO is a tariff-based
16 demand response type program, which generally is consistent with the policy
17 objectives of Florida to create more power efficiencies and reduce peak
18 demands.²⁷

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²⁷Gulf Power is subject to the Florida Energy Efficiency and Conservation Act ("FEECA") and is currently working toward its conservation goals approved by the Florida Public Service Commission ("PSC") in Order No. PSC-09-0855-FOF-EG. Its 2012 goal is to reduce commercial/industrial summer and winter peaks by 2.1 MW and 0.8 MW, respectively.

1 **Q DO YOU HAVE ANY RECOMMENDATIONS REGARDING THE CPRO FOR**
2 **GSDT AND LPT CUSTOMERS?**

3 A Yes. I am proposing three adjustments that should serve to increase customer
4 participation on this rate. My three adjustments are as follows:

5 1. The CPRO tariff language should further clarify when a critical peak can
6 be declared.

7 2. The tariff should clearly define the allowed frequency of critical peak
8 periods.

9 3. The tariff applicability should be modified so customers can place less
10 than their full load on this rate. Customers should be allowed to
11 designate a portion of their load as firm, and place a portion on the CPRO
12 rate.

13

14 **Q UNDER THE PROPOSED CPRO TARIFF, WHEN CAN A CRITICAL PEAK**
15 **EVENT BE DECLARED?**

16 A In the Company's proposed tariff, a critical peak may be designated at any time
17 at the Company's discretion. No further explanation is provided in the tariff.

18

19 **Q DID THE COMPANY PROVIDE ANY FURTHER EXPLANATION OF WHEN**
20 **CRITICAL PEAK PERIODS MAY BE DESIGNATED?**

21 A Yes, but only in a discovery request. In the Company's response to Staff's First
22 Set of Interrogatories, question #19, the Company listed three indicators that
23 would be used to determine when a critical peak event will be called. Those
24 indicators include the following:

25

- 1 1. Forecasted temperatures above (summer) or below (winter) certain
- 2 thresholds;
- 3 2. Market real-time-price thresholds; and
- 4 3. When Gulf Power's system control personnel project a system load peak
- 5 is probable.

6

7 **Q WOULD THESE PARAMETERS BE MORE APPROPRIATE FOR INCLUSION**

8 **IN THE CPRO TARIFF FOR DESIGNATION OF WHEN A CRITICAL PEAK**

9 **PERIOD CAN BE DECLARED BY THE COMPANY?**

10 **A Yes.** Transparency with regard to when Gulf Power can declare a critical peak

11 event will assist customers on the CPRO tariff to anticipate when critical peak

12 periods will be declared and to prepare for them. Providing customers clear

13 CPRO guidelines will permit them to form outlooks on critical peak frequency and

14 will allow the implementation of procedures that will allow them to comply with

15 CPRO declarations and minimize their compliance costs.

16 For these reasons, I believe the three factors identified by the Company

17 in response to a Staff data request, and as currently being used for designation

18 of critical pricing periods in the Company's Rate Schedule RSVP, should be

19 more clearly specified to provide CPRO customers clear transparency of when

20 critical peak periods will occur.

21 Toward this objective, I recommend the Company identify the forecasted

22 temperatures for summer and winter periods, identify market clearing price

23 thresholds which can trigger a critical peak period, and provide guidance to

24 customers when its control personnel may project a system peak load to be

1 probable. These factors should be included in the CPRO so customers electing
2 this rate option can plan for critical peak events.

3

4 **Q UNDER THE CPRO, DOES THE COMPANY STATE HOW MUCH OF THE**
5 **CUSTOMER'S LOAD MUST BE PLACED ON THE CPRO TARIFF?**

6 A Yes. Under the applicability provisions of the tariff, Gulf Power requires that on
7 an annual basis, customers place their entire electrical requirements on the
8 CPRO tariff.

9

10 **Q DO YOU BELIEVE THAT THE CPRO TARIFF SHOULD BE MODIFIED TO**
11 **ALLOW CUSTOMERS TO TAKE A PORTION OF THEIR LOAD UNDER A**
12 **STANDARD TARIFF, AND PLACE A PORTION OF IT ON THE CPRO**
13 **OPTION?**

14 A Yes. Gulf Power should be able to depend on the load enrolled on the CPRO
15 tariff as a resource to help manage load during critical peak periods. Some
16 customers may be interested in participating in the CPRO program, but may not
17 be able to offer all of their load due to plant minimum requirements, safety issues
18 or economic restrictions on the cost/benefit of CPRO. Allowing them to offer only
19 a portion of their load into a CPRO program would provide better information to
20 Gulf Power about how much load is potentially available for curtailment in
21 response to a critical peak event. And, because of this more flexible option, Gulf
22 Power may have more load offered into a critical peak curtailment program than
23 might otherwise be available.

24

25

1 Q UNDER THE CPRO TARIFF, HOW OFTEN CAN A CRITICAL PEAK BE
2 DECLARED?

3 A Under the tariff option, the Company states that the duration of any single critical
4 peak period may range from one to two hours in length, and the total number of
5 hours designated as critical peak periods may not exceed 87 hours per year.

6

7 Q DO YOU BELIEVE THE COMPANY HAS PROVIDED ENOUGH LIMITATIONS
8 IN THESE CRITICAL PEAK DESIGNATIONS?

9 A No. I believe some further restrictions should be included in the designation of
10 critical peaks. For example, those may include the following:

- 11 1. Only one critical peak period may be called on any given day.
12 2. No more than four critical peak events can be called in a given week.

13 The critical peak frequency and duration periods should comply with load
14 studies by Gulf Power to help ensure this rate can be used as a supply-side
15 resource to balance supply and demand during critical peak periods.

16

17 Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

18 A Yes, it does.

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Qualifications of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q PLEASE STATE YOUR OCCUPATION.

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

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

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

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

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

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

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

20 At BAI, I also have extensive experience working with large energy users
21 to distribute and critically evaluate responses to requests for proposals ("RFPs")
22 for electric, steam, and gas energy supply from competitive energy suppliers.
23 These analyses include the evaluation of gas supply and delivery charges,
24 cogeneration and/or combined cycle unit feasibility studies, and the evaluation of
25 third-party asset/supply management agreements. I have participated in rate

1 cases on rate design and class cost of service for electric, natural gas, water and
2 wastewater utilities. I have also analyzed commodity pricing indices and forward
3 pricing methods for third party supply agreements, and have also conducted
4 regional electric market price forecasts.

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

7

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

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

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Gulf Power Company

Rate of Return

Regulatory Capital Structure

<u>Line</u>	<u>Description</u>	<u>Amount (000)</u> (1)	<u>Weight</u> (2)	<u>Cost</u> (3)	<u>Weighted Cost</u> (4)
1	Long-Term Debt	\$ 648,775	38.71%	5.48%	2.12%
2	Short-Term Debt	17,691	1.06%	2.12%	0.02%
3	Preference Stock	72,003	4.30%	6.65%	0.29%
4	Customer Deposits	20,951	1.25%	6.00%	0.08%
5	Deferred Taxes	277,966	16.59%	0.00%	0.00%
6	Investment Tax Credit	2,886	0.17%	8.45%	0.01%
7	Common Equity	<u>635,732</u>	<u>37.93%</u>	<u>9.75%</u>	<u>3.70%</u>
8	Total	\$ 1,676,004	100.00%		6.22%

Investor Capital Structure

<u>Line</u>	<u>Description</u>	<u>Amount (000)</u> (1)	<u>Weight</u> (2)	<u>Cost</u> (3)	<u>Weighted Cost</u> (4)
9	Long-Term Debt	\$ 648,775	47.21%	5.48%	2.59%
10	Short-Term Debt	17,691	1.29%	2.12%	0.03%
11	Preference Stock	72,003	5.24%	6.65%	0.35%
12	Common Equity	<u>635,732</u>	<u>46.26%</u>	<u>9.75%</u>	<u>4.51%</u>
13	Total	\$ 1,374,201	100.00%		7.48%

Source:
Page 2.

Gulf Power Company

Rate of Return Revised 13-Month Average Cost of Capital (\$ 000)

<u>Line</u>	<u>Description</u>	<u>Company Total</u> (1)	<u>Specific Adjustments</u> (2)	<u>Company Adjusted</u> (3)	<u>Ratio</u> (4)	<u>Pro Rata Adjustments</u> (5)	<u>System Adjusted</u> (6)	<u>Jurisdictional Factor</u> (7)	<u>Jurisdictional Capital Structure</u> (8)	<u>Ratio</u> (9)	<u>Cost Rate</u> (10)	<u>Weighted Cost Rate</u> (11)
1	Long-Term Debt	\$ 1,243,391	\$ (103,362)	\$ 1,140,029	38.72%	\$ (477,133)	\$ 662,896	97.86993%	\$ 648,775	38.71%	5.48%	2.12%
2	Short-Term Debt	33,897	(2,811)	31,086	1.06%	\$ (13,010)	\$ 18,076	97.86993%	17,691	1.06%	2.12%	0.02%
3	Preferred Stock	137,998	(11,475)	126,523	4.30%	\$ (52,953)	\$ 73,570	97.86993%	72,003	4.30%	6.65%	0.29%
4	Common Equity	1,212,629	(95,520)	1,117,109	37.94%	\$ (467,541)	\$ 649,568	97.86993%	635,732	37.93%	11.70%	4.44%
5	Customer Deposits	36,031	-	36,031	1.22%	\$ (15,080)	\$ 20,951	100.00000%	20,951	1.25%	6.00%	0.08%
6	Deferred Taxes	536,612 ¹	(48,169)	488,444	16.59%	\$ (204,427)	\$ 284,016	97.86993%	277,966	16.59%	0.00%	0.00%
7	Investment Credit - Zero Cost	6,108	(1,036)	5,072	0.17%	\$ (2,123)	\$ 2,949	97.86993%	2,886	0.17%	8.45%	0.01%
8	Total	\$ 3,206,666	\$ (262,373)	\$ 2,944,294		\$ (1,232,268)²	\$ 1,712,025		\$ 1,676,004	100.00%		6.96%

Sources:

Minimum Filing Requirements Section D -Cost of Capital, Schedule D-1a, Page 1 of 3.

¹ Minimum Filing Requirements Section B - Rate Base Schedules.

¹ Exhibit No. ____ (RJM-1), Schedule 12, Page 2 of 5

Gulf Power Company

Proxy Group - Investment Risk

<u>Line</u>	<u>Company</u>	<u>Corporate Credit Ratings</u> ¹		<u>Common Equity Ratios</u>		<u>S&P Business Risk Score</u> ⁴ (5)
		<u>S&P</u> (1)	<u>Moody's</u> (2)	<u>AUS</u> ² (3)	<u>Value Line</u> ³ (4)	
1	ALLETE	BBB+	Baa1	56.4%	55.8%	Strong
2	Alliant Energy	BBB+	Baa1	51.3%	49.5%	Excellent
3	Amer. Elec. Power	BBB	Baa2	43.2%	46.7%	Excellent
4	Centerpoint Energy	BBB	Baa3	26.7%	26.2%	Excellent
5	Consol. Edison	A-	Baa1	51.3%	50.9%	Excellent
6	Dominion Resources	A-	Baa2	37.6%	42.8%	Excellent
7	Hawaiian Elec.	BBB-	Baa2	46.9%	54.3%	Strong
8	IDACORP, Inc.	BBB	Baa2	50.1%	50.7%	Excellent
9	Integrus Energy	BBB+	Baa1	55.9%	56.8%	Strong
10	Pepco Holdings	BBB+	Baa3	47.8%	51.0%	Excellent
11	PG&E Corp.	BBB+	Baa1	47.6%	49.3%	Strong
12	Pinnacle West Capital	BBB	Baa3	48.9%	54.7%	Excellent
13	Portland General	BBB	Baa2	47.7%	47.0%	Excellent
14	SCANA Corp.	BBB+	Baa3	42.2%	47.1%	Excellent
15	Sempra Energy	BBB+	Baa1	46.9%	49.6%	Excellent
16	Southern Co.	A	Baa1	44.7%	45.7%	Excellent
17	TECO Energy	BBB+	Baa3	41.6%	40.8%	Excellent
18	UIL Holdings	BBB	Baa3	45.3%	41.6%	Excellent
19	Westar Energy	BBB	Baa3	42.8%	46.4%	Excellent
20	Wisconsin Energy	A-	A3	44.6%	49.0%	Excellent
21	Xcel Energy Inc.	A-	Baa1	45.0%	46.3%	Excellent
22	Average	BBB+	Baa2	45.9%	47.7%	Excellent
23	Gulf Power Company	A ⁵	A3 ⁵		38.0% ⁶	Excellent

Sources:

¹ SNL Financial, <http://www.snl.com>, downloaded on September 19, 2011.

² AUS Utility Reports, September 2011.

³ The Value Line Investment Survey, August 5, August 26 and September 23, 2011.

⁴ S&P RatingsDirect: "U.S. Regulated Electric Utilities, Strongest to Weakest," July 5, 2011.

⁵ Exhibit No. __ (RST-1), Schedule 4.

⁶ Exhibit MPG-1, Page 1 of 1.

Gulf Power Company

Consensus Analysts' Growth Rates

Line	Company	Zacks		SNL		Reuters		Average of Growth Rates
		Estimated Growth % ¹	Number of Estimates	Estimated Growth % ²	Number of Estimates	Estimated Growth % ³	Number of Estimates	
		(1)	(2)	(3)	(4)	(5)	(6)	
1	ALLETE	5.00%	N/A	5.00%	3	6.00%	3	5.33%
2	Alliant Energy	6.00%	N/A	6.00%	3	6.00%	5	6.00%
3	Amer. Elec. Power	4.00%	N/A	4.50%	4	4.23%	8	4.24%
4	Centerpoint Energy	5.70%	N/A	7.00%	3	5.67%	7	6.12%
5	Consol. Edison	3.00%	N/A	4.00%	1	3.87%	7	3.62%
6	Dominion Resources	5.00%	N/A	4.00%	1	3.92%	7	4.31%
7	Hawaiian Elec.	8.60%	N/A	3.00%	1	7.03%	4	6.21%
8	IDACORP, Inc.	4.70%	N/A	5.00%	3	4.67%	3	4.79%
9	Integrus Energy	4.70%	N/A	4.50%	4	7.00%	5	5.40%
10	Pepco Holdings	4.30%	N/A	5.00%	5	3.28%	4	4.19%
11	PG&E Corp.	5.00%	N/A	5.50%	2	5.17%	9	5.22%
12	Pinnacle West Capital	5.30%	N/A	5.50%	4	6.48%	6	5.76%
13	Portland General	5.00%	N/A	5.00%	4	5.51%	7	5.17%
14	SCANA Corp.	4.30%	N/A	4.00%	2	4.52%	6	4.27%
15	Sempra Energy	7.00%	N/A	6.30%	3	7.76%	5	7.02%
16	Southern Co.	5.00%	N/A	5.20%	4	5.91%	10	5.37%
17	TECO Energy	4.70%	N/A	6.00%	2	6.11%	10	5.60%
18	UIL Holdings	4.00%	N/A	4.00%	3	4.03%	4	4.01%
19	Westar Energy	6.10%	N/A	5.00%	3	5.95%	6	5.68%
20	Wisconsin Energy	8.00%	N/A	5.50%	2	8.16%	7	7.22%
21	Xcel Energy Inc.	4.90%	N/A	4.50%	4	5.26%	10	4.89%
22	Average	5.25%	N/A	4.98%	3	5.55%	6	5.26%
23	Median							5.33%

Sources and Notes:

¹ Zacks Elite, <http://www.zackselite.com/>, downloaded on September 22, 2011.

² SNL Interactive, <http://www.snl.com/>, downloaded on September 22, 2011.

³ Reuters, <http://www.reuters.com/>, downloaded on September 22, 2011.

N/A: Not Available.

Gulf Power Company

Consensus Analysts' Growth Rates Constant Growth DCF Model

<u>Line</u>	<u>Company</u>	<u>13-Week AVG Stock Price</u> ¹ (1)	<u>Analysts' Growth</u> ² (2)	<u>Annualized Dividend</u> ³ (3)	<u>Adjusted Yield</u> (4)	<u>Constant Growth DCF</u> (5)
1	ALLETE	\$39.29	5.33%	\$1.78	4.77%	10.11%
2	Alliant Energy	\$39.52	6.00%	\$1.70	4.56%	10.56%
3	Amer. Elec. Power	\$37.32	4.24%	\$1.84	5.14%	9.38%
4	Centerpoint Energy	\$19.34	6.12%	\$0.79	4.34%	10.46%
5	Consol. Edison	\$53.98	3.62%	\$2.40	4.61%	8.23%
6	Dominion Resources	\$48.35	4.31%	\$1.97	4.25%	8.56%
7	Hawaiian Elec.	\$23.59	6.21%	\$1.24	5.58%	11.79%
8	IDACORP, Inc.	\$38.08	4.79%	\$1.20	3.30%	8.09%
9	Integrus Energy	\$49.72	5.40%	\$2.72	5.77%	11.17%
10	Pepco Holdings	\$19.01	4.19%	\$1.08	5.92%	10.11%
11	PG&E Corp.	\$41.58	5.22%	\$1.82	4.61%	9.83%
12	Pinnacle West Capital	\$42.99	5.76%	\$2.10	5.17%	10.93%
13	Portland General	\$24.32	5.17%	\$1.06	4.58%	9.75%
14	SCANA Corp.	\$38.99	4.27%	\$1.94	5.19%	9.46%
15	Sempra Energy	\$51.06	7.02%	\$1.92	4.02%	11.04%
16	Southern Co.	\$40.20	5.37%	\$1.89	4.95%	10.32%
17	TECO Energy	\$18.15	5.60%	\$0.86	5.00%	10.61%
18	UIL Holdings	\$32.34	4.01%	\$1.73	5.56%	9.57%
19	Westar Energy	\$25.88	5.68%	\$1.28	5.23%	10.91%
20	Wisconsin Energy	\$30.85	7.22%	\$1.04	3.61%	10.83%
21	Xcel Energy Inc.	\$23.98	4.89%	\$1.04	4.55%	9.44%
22	Average	\$35.17	5.26%	\$1.59	4.80%	10.05%
23	Median		5.33%			10.11%

Sources:

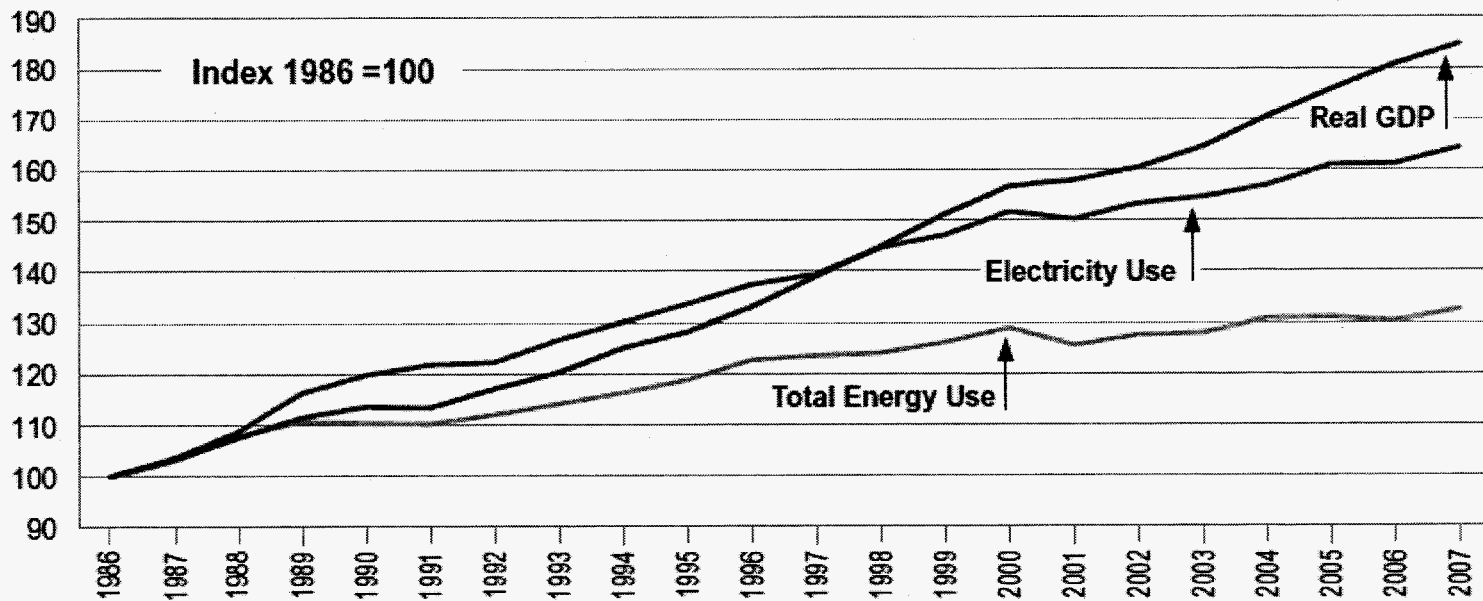
¹ <http://moneycentral.msn.com>, downloaded on September 22, 2011.

² Exhibit MPG-3, Page 1 of 1.

³ *The Value Line Investment Survey*, August 5, August 26 and September 23, 2011.

Gulf Power Company

Electricity Sales Are Linked to U.S. Economic Growth



1986 represents the base year. Graph depicts increases or decreases from the base year.

Source: U.S. Department of Energy, Energy Information Administration (EIA).

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Gulf Power Company

Payout Ratios

<u>Line</u>	<u>Company</u>	<u>Dividends Per Share</u>		<u>Earnings Per Share</u>		<u>Payout Ratio</u>	
		<u>2010</u> (1)	<u>Projected</u> (2)	<u>2010</u> (3)	<u>Projected</u> (4)	<u>2010</u> (5)	<u>Projected</u> (6)
1	ALLETE	\$1.76	\$1.95	\$2.19	\$3.25	80.37%	60.00%
2	Alliant Energy	\$1.58	\$2.10	\$2.75	\$3.60	57.45%	58.33%
3	Amer. Elec. Power	\$1.71	\$2.10	\$2.60	\$3.75	65.77%	56.00%
4	Centerpoint Energy	\$0.78	\$0.90	\$1.07	\$1.35	72.90%	66.67%
5	Consol. Edison	\$2.38	\$2.48	\$3.47	\$3.95	68.59%	62.78%
6	Dominion Resources	\$1.83	\$2.45	\$2.89	\$3.75	63.32%	65.33%
7	Hawaiian Elec.	\$1.24	\$1.30	\$1.21	\$2.00	102.48%	65.00%
8	IDACORP, Inc.	\$1.20	\$1.50	\$2.95	\$3.30	40.68%	45.45%
9	Integrus Energy	\$2.72	\$2.72	\$3.24	\$4.00	83.95%	68.00%
10	Pepco Holdings	\$1.08	\$1.16	\$1.24	\$1.65	87.10%	70.30%
11	PG&E Corp.	\$1.82	\$2.20	\$2.82	\$4.25	64.54%	51.76%
12	Pinnacle West Capital	\$2.10	\$2.30	\$3.08	\$3.50	68.18%	65.71%
13	Portland General	\$1.04	\$1.20	\$1.66	\$2.25	62.65%	53.33%
14	SCANA Corp.	\$1.90	\$2.10	\$2.98	\$3.50	63.76%	60.00%
15	Sempra Energy	\$1.56	\$2.50	\$4.02	\$5.50	38.81%	45.45%
16	Southern Co.	\$1.80	\$2.20	\$2.37	\$3.25	75.95%	67.69%
17	TECO Energy	\$0.82	\$1.05	\$1.13	\$1.75	72.57%	60.00%
18	UIL Holdings	\$1.73	\$1.73	\$1.99	\$2.35	86.93%	73.62%
19	Westar Energy	\$1.24	\$1.44	\$1.80	\$2.40	68.89%	60.00%
20	Wisconsin Energy	\$0.80	\$1.65	\$1.92	\$2.75	41.67%	60.00%
21	Xcel Energy Inc.	\$1.00	\$1.15	\$1.56	\$2.00	64.10%	57.50%
22	Average	\$1.53	\$1.82	\$2.33	\$3.05	68.13%	60.62%

Source:

The Value Line Investment Survey, August 5, August 26 and September 23, 2011.

Gulf Power Company

Sustainable Growth Rates

Line	Company	3 to 5 Year Projections										Sustainable
		Dividends	Earnings	Book Value	Book Value	Adjustment	Adjusted	Payout	Retention	Internal	Growth	
		Per Share	Per Share	Per Share	Growth	ROE	Factor	ROE	Ratio	Rate	Growth Rate	Rate
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	
1	ALLETE	\$1.95	\$3.25	\$32.75	3.74%	9.92%	1.02	10.11%	60.00%	40.00%	4.04%	5.03%
2	Alliant Energy	\$2.10	\$3.60	\$30.15	2.93%	11.94%	1.01	12.11%	58.33%	41.67%	5.05%	5.51%
3	Amer. Elec. Power	\$2.10	\$3.75	\$36.00	4.91%	10.42%	1.02	10.67%	56.00%	44.00%	4.69%	4.94%
4	Centerpoint Energy	\$0.90	\$1.35	\$12.00	9.77%	11.25%	1.05	11.77%	66.67%	33.33%	3.92%	4.31%
5	Consol. Edison	\$2.48	\$3.95	\$42.60	2.35%	9.27%	1.01	9.38%	62.78%	37.22%	3.49%	4.01%
6	Dominion Resources	\$2.45	\$3.75	\$27.00	5.51%	13.89%	1.03	14.26%	65.33%	34.67%	4.94%	4.90%
7	Hawaiian Elec.	\$1.30	\$2.00	\$18.75	3.65%	10.67%	1.02	10.86%	65.00%	35.00%	3.80%	5.34%
8	IDACORP, Inc.	\$1.50	\$3.30	\$39.20	4.80%	8.42%	1.02	8.62%	45.45%	54.55%	4.70%	4.84%
9	Integrus Energy	\$2.72	\$4.00	\$41.75	2.13%	9.58%	1.01	9.68%	68.00%	32.00%	3.10%	3.18%
10	Pepco Holdings	\$1.16	\$1.65	\$21.20	2.44%	7.78%	1.01	7.88%	70.30%	29.70%	2.34%	2.36%
11	PG&E Corp.	\$2.20	\$4.25	\$37.75	5.75%	11.26%	1.03	11.57%	51.76%	48.24%	5.58%	6.25%
12	Pinnacle West Capital	\$2.30	\$3.50	\$39.50	3.13%	8.86%	1.02	9.00%	65.71%	34.29%	3.08%	3.76%
13	Portland General	\$1.20	\$2.25	\$25.75	4.02%	8.74%	1.02	8.91%	53.33%	46.67%	4.16%	4.20%
14	SCANA Corp.	\$2.10	\$3.50	\$37.25	5.03%	9.40%	1.02	9.63%	60.00%	40.00%	3.85%	4.99%
15	Sempra Energy	\$2.50	\$5.50	\$50.75	6.22%	10.84%	1.03	11.16%	45.45%	54.55%	6.09%	6.22%
16	Southern Co.	\$2.20	\$3.25	\$25.00	5.41%	13.00%	1.03	13.34%	67.69%	32.31%	4.31%	5.99%
17	TECO Energy	\$1.05	\$1.75	\$13.25	5.58%	13.21%	1.03	13.57%	60.00%	40.00%	5.43%	5.80%
18	UIL Holdings	\$1.73	\$2.35	\$27.00	4.85%	8.70%	1.02	8.91%	73.62%	26.38%	2.35%	2.25%
19	Westar Energy	\$1.44	\$2.40	\$23.45	1.99%	10.23%	1.01	10.34%	60.00%	40.00%	4.13%	4.72%
20	Wisconsin Energy	\$1.65	\$2.75	\$19.75	3.97%	13.92%	1.02	14.19%	60.00%	40.00%	5.68%	4.91%
21	Xcel Energy Inc.	\$1.15	\$2.00	\$21.25	4.86%	9.41%	1.02	9.64%	57.50%	42.50%	4.09%	4.37%
22	Average	\$1.82	\$3.05	\$29.62	4.43%	10.51%	1.02	10.74%	60.62%	39.38%	4.23%	4.66%
23	Median											4.90%

Sources and Notes:

Cols. (1), (2) and (3): *The Value Line Investment Survey*, August 5, August 26 and September 23, 2011.

Col. (4): [Col. (3) / Page 2 Col. (2)] ^ (1/5) - 1.

Col. (5): Col. (2) / Col. (3).

Col. (6): [2 * (1 + Col. (4))] / (2 + Col. (4)).

Col. (7): Col. (6) * Col. (5).

Col. (8): Col. (1) / Col. (2).

Col. (9): 1 - Col. (8).

Col. (10): Col. (9) * Col. (7).

Col. (11): Col. (10) + Page 2 Col. (9).

Gulf Power Company

Sustainable Growth Rates

Line	Company	13-Week	2010	Market	Common Shares		Growth	S Factor ³	V Factor ⁴	S * V ⁵
		Average	Book Value	to Book	Outstanding (in Millions) ²					
		Stock Price ¹	Per Share ²	Ratio	2010	3-5 Years				
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1	ALLETE	\$39.29	\$27.26	1.44	35.80	40.00	2.24%	3.23%	30.61%	0.99%
2	Alliant Energy	\$39.52	\$26.09	1.51	110.89	116.00	0.91%	1.37%	33.98%	0.47%
3	Amer. Elec. Power	\$37.32	\$28.33	1.32	480.81	500.00	0.79%	1.04%	24.08%	0.25%
4	Centerpoint Energy	\$19.34	\$7.53	2.57	424.70	430.00	0.25%	0.64%	61.06%	0.39%
5	Consol. Edison	\$53.98	\$37.93	1.42	291.62	310.00	1.23%	1.75%	29.73%	0.52%
6	Dominion Resources	\$48.35	\$20.65	2.34	581.00	580.00	-0.03%	-0.08%	57.29%	-0.05%
7	Hawaiian Elec.	\$23.59	\$15.67	1.51	94.69	110.00	3.04%	4.58%	33.57%	1.54%
8	IDACORP, Inc.	\$38.08	\$31.01	1.23	49.41	51.00	0.64%	0.78%	18.58%	0.14%
9	Integrus Energy	\$49.72	\$37.57	1.32	77.35	78.30	0.24%	0.32%	24.44%	0.08%
10	Pepco Holdings	\$19.01	\$18.79	1.01	225.08	250.00	2.12%	2.15%	1.15%	0.02%
11	PG&E Corp.	\$41.58	\$28.55	1.46	395.23	425.00	1.46%	2.13%	31.34%	0.67%
12	Pinnacle West Capital	\$42.99	\$33.86	1.27	108.77	123.00	2.49%	3.16%	21.24%	0.67%
13	Portland General	\$24.32	\$21.14	1.15	75.32	76.50	0.31%	0.36%	13.08%	0.05%
14	SCANA Corp.	\$38.99	\$29.15	1.34	127.00	150.00	3.38%	4.53%	25.23%	1.14%
15	Sempra Energy	\$51.06	\$37.54	1.36	240.45	245.00	0.38%	0.51%	26.47%	0.14%
16	Southern Co.	\$40.20	\$19.21	2.09	843.34	910.00	1.53%	3.21%	52.21%	1.68%
17	TECO Energy	\$18.15	\$10.10	1.80	214.90	220.00	0.47%	0.84%	44.35%	0.37%
18	UIL Holdings	\$32.34	\$21.31	1.52	50.51	50.00	-0.20%	-0.31%	34.11%	-0.10%
19	Westar Energy	\$25.88	\$21.25	1.22	112.13	128.00	2.68%	3.27%	17.88%	0.58%
20	Wisconsin Energy	\$30.85	\$16.26	1.90	233.77	224.00	-0.85%	-1.61%	47.30%	-0.76%
21	Xcel Energy Inc.	\$23.98	\$16.76	1.43	482.33	498.00	0.64%	0.92%	30.12%	0.28%
22	Average	\$35.17	\$24.09	1.53	250.24	262.61	1.13%	1.56%	31.33%	0.43%

Sources and Notes:

¹ <http://moneycentral.msn.com>, downloaded on September 22, 2011.

² *The Value Line Investment Survey*, August 5, August 26 and September 23, 2011.

³ Expected Growth in the Number of Shares, Column (3) * Column (6).

⁴ Expected Profit of Stock Investment, [1 - 1 / Column (3)].

⁵ Column (7) * Column (8).

Gulf Power Company

Sustainable Growth Rates Constant Growth DCF Model

<u>Line</u>	<u>Company</u>	<u>13-Week AVG Stock Price¹</u> (1)	<u>Sustainable Growth²</u> (2)	<u>Annualized Dividend³</u> (3)	<u>Adjusted Yield</u> (4)	<u>Constant Growth DCF</u> (5)
1	ALLETE	\$39.29	5.03%	\$1.78	4.76%	9.79%
2	Alliant Energy	\$39.52	5.51%	\$1.70	4.54%	10.05%
3	Amer. Elec. Power	\$37.32	4.94%	\$1.84	5.17%	10.12%
4	Centerpoint Energy	\$19.34	4.31%	\$0.79	4.26%	8.58%
5	Consol. Edison	\$53.98	4.01%	\$2.40	4.62%	8.64%
6	Dominion Resources	\$48.35	4.90%	\$1.97	4.27%	9.17%
7	Hawaiian Elec.	\$23.59	5.34%	\$1.24	5.54%	10.88%
8	IDACORP, Inc.	\$38.08	4.84%	\$1.20	3.30%	8.15%
9	Integrus Energy	\$49.72	3.18%	\$2.72	5.64%	8.82%
10	Pepco Holdings	\$19.01	2.36%	\$1.08	5.82%	8.18%
11	PG&E Corp.	\$41.58	6.25%	\$1.82	4.65%	10.90%
12	Pinnacle West Capital	\$42.99	3.76%	\$2.10	5.07%	8.82%
13	Portland General	\$24.32	4.20%	\$1.06	4.54%	8.75%
14	SCANA Corp.	\$38.99	4.99%	\$1.94	5.22%	10.22%
15	Sempra Energy	\$51.06	6.22%	\$1.92	3.99%	10.22%
16	Southern Co.	\$40.20	5.99%	\$1.89	4.98%	10.97%
17	TECO Energy	\$18.15	5.80%	\$0.86	5.01%	10.81%
18	UIL Holdings	\$32.34	2.25%	\$1.73	5.46%	7.71%
19	Westar Energy	\$25.88	4.72%	\$1.28	5.18%	9.90%
20	Wisconsin Energy	\$30.85	4.91%	\$1.04	3.54%	8.45%
21	Xcel Energy Inc.	\$23.98	4.37%	\$1.04	4.53%	8.90%
22	Average	\$35.17	4.66%	\$1.59	4.77%	9.43%
23	Median		4.94%			9.17%

Sources:

¹ <http://moneycentral.msn.com>, downloaded on September 22, 2011.

² Exhibit MPG-7, page 1 of 2.

³ *The Value Line Investment Survey*, August 5, August 26 and September 23, 2011.

Gulf Power Company

Multi-Stage Growth DCF Model

Line	Company	13-Week AVG	Annualized	First Stage	Second Stage Growth					Third Stage	Multi-Stage
		Stock Price ¹	Dividend ²	Growth ³	Year 6	Year 7	Year 8	Year 9	Year 10	Growth ⁴	Growth DCF
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1	ALLETE	\$39.29	\$1.78	5.33%	5.26%	5.19%	5.12%	5.04%	4.97%	4.90%	9.78%
2	Alliant Energy	\$39.52	\$1.70	6.00%	5.82%	5.63%	5.45%	5.27%	5.08%	4.90%	9.73%
3	Amer. Elec. Power	\$37.32	\$1.84	4.24%	4.35%	4.46%	4.57%	4.68%	4.79%	4.90%	9.87%
4	Centerpoint Energy	\$19.34	\$0.79	6.12%	5.92%	5.72%	5.51%	5.31%	5.10%	4.90%	9.52%
5	Consol. Edison	\$53.98	\$2.40	3.62%	3.84%	4.05%	4.26%	4.47%	4.69%	4.90%	9.20%
6	Dominion Resources	\$48.35	\$1.97	4.31%	4.41%	4.50%	4.60%	4.70%	4.80%	4.90%	9.02%
7	Hawaiian Elec.	\$23.59	\$1.24	6.21%	5.99%	5.77%	5.56%	5.34%	5.12%	4.90%	10.86%
8	IDACORP, Inc.	\$38.08	\$1.20	4.79%	4.81%	4.83%	4.85%	4.86%	4.88%	4.90%	8.17%
9	Integrus Energy	\$49.72	\$2.72	5.40%	5.32%	5.23%	5.15%	5.07%	4.98%	4.90%	10.81%
10	Pepco Holdings	\$19.01	\$1.08	4.19%	4.31%	4.43%	4.55%	4.66%	4.78%	4.90%	10.61%
11	PG&E Corp.	\$41.58	\$1.82	5.22%	5.17%	5.12%	5.06%	5.01%	4.95%	4.90%	9.58%
12	Pinnacle West Capital	\$42.99	\$2.10	5.76%	5.62%	5.47%	5.33%	5.19%	5.04%	4.90%	10.30%
13	Portland General	\$24.32	\$1.06	5.17%	5.13%	5.08%	5.04%	4.99%	4.95%	4.90%	9.55%
14	SCANA Corp.	\$38.99	\$1.94	4.27%	4.38%	4.48%	4.59%	4.69%	4.80%	4.90%	9.92%
15	Sempra Energy	\$51.06	\$1.92	7.02%	6.67%	6.31%	5.96%	5.61%	5.25%	4.90%	9.40%
16	Southern Co.	\$40.20	\$1.89	5.37%	5.29%	5.21%	5.14%	5.06%	4.98%	4.90%	9.98%
17	TECO Energy	\$18.15	\$0.86	5.60%	5.49%	5.37%	5.25%	5.13%	5.02%	4.90%	10.09%
18	UIL Holdings	\$32.34	\$1.73	4.01%	4.16%	4.31%	4.46%	4.60%	4.75%	4.90%	10.21%
19	Westar Energy	\$25.88	\$1.28	5.68%	5.55%	5.42%	5.29%	5.16%	5.03%	4.90%	10.34%
20	Wisconsin Energy	\$30.85	\$1.04	7.22%	6.83%	6.45%	6.06%	5.67%	5.29%	4.90%	8.99%
21	Xcel Energy Inc.	\$23.98	\$1.04	4.89%	4.89%	4.89%	4.89%	4.90%	4.90%	4.90%	9.44%
22	Average	\$35.17	\$1.59	5.26%	5.20%	5.14%	5.08%	5.02%	4.96%	4.90%	9.78%
23	Median										9.78%

Sources:

¹ <http://moneycentral.msn.com>, downloaded on September 22, 2011.

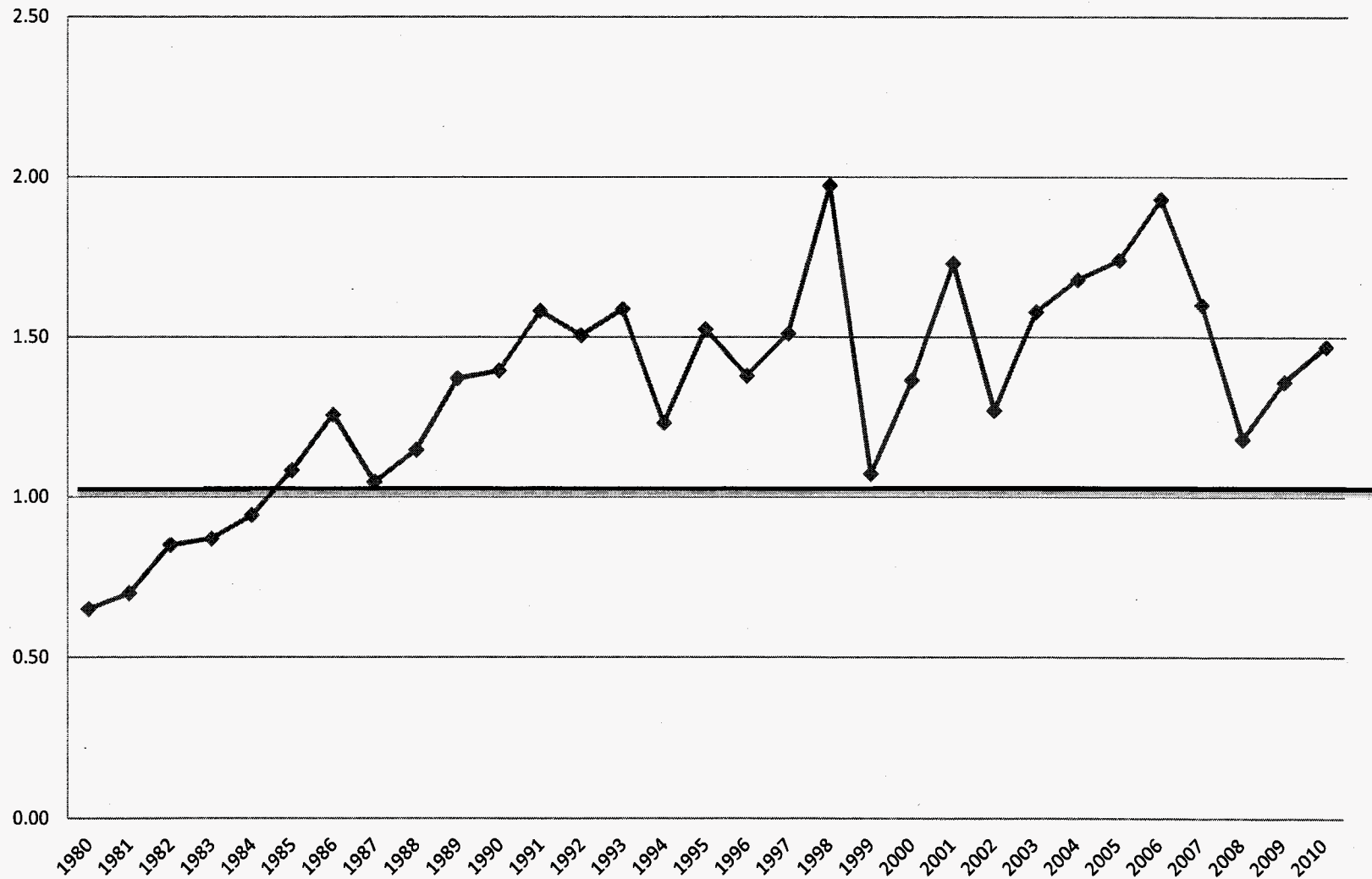
² Exhibit MPG-3, Page 1 of 1.

³ *The Value Line Investment Survey*, August 5, August 26 and September 23, 2011.

⁴ *Blue Chip Economic Indicators*, March 10, 2011 at 15.

Gulf Power Company

Common Stock Market/Book Ratio



Sources:

2001 - 2010: AUS Utility Reports.

1980 - 2000: Mergent Public Utility Manual, 2003.

Gulf Power Company

Equity Risk Premium - Treasury Bond

<u>Line</u>	<u>Year</u>	<u>Authorized Electric Returns¹</u> (1)	<u>Treasury Bond Yield²</u> (2)	<u>Indicated Risk Premium</u> (3)
1	1986	13.93%	7.78%	6.15%
2	1987	12.99%	8.59%	4.40%
3	1988	12.79%	8.96%	3.83%
4	1989	12.97%	8.45%	4.52%
5	1990	12.70%	8.61%	4.09%
6	1991	12.55%	8.14%	4.41%
7	1992	12.09%	7.67%	4.42%
8	1993	11.41%	6.59%	4.82%
9	1994	11.34%	7.37%	3.97%
10	1995	11.55%	6.88%	4.67%
11	1996	11.39%	6.71%	4.68%
12	1997	11.40%	6.61%	4.79%
13	1998	11.66%	5.58%	6.08%
14	1999	10.77%	5.87%	4.90%
15	2000	11.43%	5.94%	5.49%
16	2001	11.09%	5.49%	5.60%
17	2002	11.16%	5.43%	5.73%
18	2003	10.97%	4.96%	6.01%
19	2004	10.75%	5.05%	5.70%
20	2005	10.54%	4.65%	5.89%
21	2006	10.36%	4.91%	5.45%
22	2007	10.36%	4.84%	5.52%
23	2008	10.46%	4.28%	6.18%
24	2009	10.48%	4.08%	6.40%
25	2010 ³	10.34%	4.25%	6.09%
26	Q2 2011 ³	10.24%	4.45%	5.79%
27	Average	11.45%	6.24%	5.21%

Sources:

¹ Regulatory Research Associates, Inc., *Regulatory Focus*, Jan. 85 - Dec. 06, and July 5, 2011.

² Economic Report of the President 2010: Table 73. The yields from 2002 to 2005 represent the 20-Year Treasury yields obtained from the Federal Reserve Bank.

³ St. Louis Federal Reserve: Economic Research, <http://research.stlouisfed.org/>.

Gulf Power Company

Equity Risk Premium - Utility Bond

<u>Line</u>	<u>Year</u>	<u>Authorized Electric Returns¹</u> (1)	<u>Average "A" Rated Utility Bond Yield²</u> (2)	<u>Indicated Risk Premium</u> (3)
1	1986	13.93%	9.58%	4.35%
2	1987	12.99%	10.10%	2.89%
3	1988	12.79%	10.49%	2.30%
4	1989	12.97%	9.77%	3.20%
5	1990	12.70%	9.86%	2.84%
6	1991	12.55%	9.36%	3.19%
7	1992	12.09%	8.69%	3.40%
8	1993	11.41%	7.59%	3.82%
9	1994	11.34%	8.31%	3.03%
10	1995	11.55%	7.89%	3.66%
11	1996	11.39%	7.75%	3.64%
12	1997	11.40%	7.60%	3.80%
13	1998	11.66%	7.04%	4.62%
14	1999	10.77%	7.62%	3.15%
15	2000	11.43%	8.24%	3.19%
16	2001	11.09%	7.76%	3.33%
17	2002	11.16%	7.37%	3.79%
18	2003	10.97%	6.58%	4.39%
19	2004	10.75%	6.16%	4.59%
20	2005	10.54%	5.65%	4.89%
21	2006	10.36%	6.07%	4.29%
22	2007	10.36%	6.07%	4.29%
23	2008	10.46%	6.53%	3.93%
24	2009	10.48%	6.04%	4.44%
25	2010 ³	10.34%	5.46%	4.88%
26	Q2 2011 ³	10.24%	5.60%	4.64%
27	Average	11.45%	7.66%	3.79%

Sources:

¹ Regulatory Research Associates, Inc., *Regulatory Focus*, Jan. 85 - Dec. 06, and July 5, 2011.

² Mergent Public Utility Manual, Mergent Weekly News Reports, 2003. The utility yields for the period 2001-2009 were obtained from the Mergent Bond Record. The utility yields were obtained from <http://credittrends.moodys.com/>.

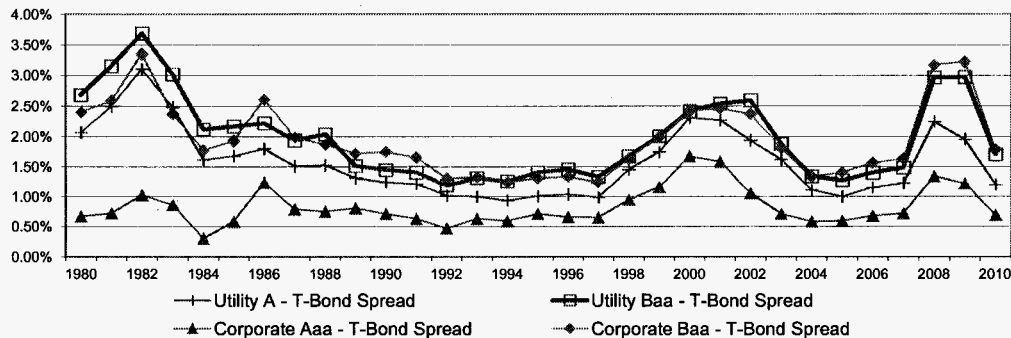
³ www.moodys.com, Bond Yields and Key Indicators.

Gulf Power Company

Bond Yield Spreads

Line	Year	Public Utility Bond Yields					Corporate Bond Yields				
		T-Bond Yield ¹ (1)	A ² (2)	Baa ² (3)	A-T-Bond Spread (4)	Baa-T-Bond Spread (5)	Aaa ¹ (6)	Baa ¹ (7)	Aaa-T-Bond Spread (8)	Baa-T-Bond Spread (9)	Baa Utility - Corporate (10)
1	1980	11.27%	13.34%	13.95%	2.07%	2.68%	11.94%	13.67%	0.67%	2.40%	0.28%
2	1981	13.45%	15.95%	16.60%	2.50%	3.15%	14.17%	16.04%	0.72%	2.59%	0.56%
3	1982	12.76%	15.86%	16.45%	3.10%	3.69%	13.79%	16.11%	1.03%	3.35%	0.34%
4	1983	11.18%	13.66%	14.20%	2.48%	3.02%	12.04%	13.55%	0.86%	2.37%	0.65%
5	1984	12.41%	14.03%	14.53%	1.62%	2.12%	12.71%	14.19%	0.30%	1.78%	0.34%
6	1985	10.79%	12.47%	12.96%	1.68%	2.17%	11.37%	12.72%	0.58%	1.93%	0.24%
7	1986	7.78%	9.58%	10.00%	1.80%	2.22%	9.02%	10.39%	1.24%	2.61%	-0.39%
8	1987	8.59%	10.10%	10.53%	1.51%	1.94%	9.38%	10.58%	0.79%	1.99%	-0.05%
9	1988	8.96%	10.49%	11.00%	1.53%	2.04%	9.71%	10.83%	0.75%	1.87%	0.17%
10	1989	8.45%	9.77%	9.97%	1.32%	1.52%	9.26%	10.18%	0.81%	1.73%	-0.21%
11	1990	8.61%	9.86%	10.06%	1.25%	1.45%	9.32%	10.36%	0.71%	1.75%	-0.30%
12	1991	8.14%	9.36%	9.55%	1.22%	1.41%	8.77%	9.80%	0.63%	1.66%	-0.25%
13	1992	7.67%	8.69%	8.86%	1.02%	1.19%	8.14%	8.98%	0.47%	1.31%	-0.12%
14	1993	6.59%	7.59%	7.91%	1.00%	1.32%	7.22%	7.93%	0.63%	1.34%	-0.02%
15	1994	7.37%	8.31%	8.63%	0.94%	1.26%	7.96%	8.62%	0.59%	1.25%	0.01%
16	1995	6.88%	7.89%	8.29%	1.01%	1.41%	7.59%	8.20%	0.71%	1.32%	0.09%
17	1996	6.71%	7.75%	8.17%	1.04%	1.46%	7.37%	8.05%	0.66%	1.34%	0.12%
18	1997	6.61%	7.60%	7.95%	0.99%	1.34%	7.26%	7.86%	0.65%	1.25%	0.09%
19	1998	5.58%	7.04%	7.26%	1.46%	1.68%	6.53%	7.22%	0.95%	1.64%	0.04%
20	1999	5.87%	7.62%	7.88%	1.75%	2.01%	7.04%	7.87%	1.17%	2.00%	0.01%
21	2000	5.94%	8.24%	8.36%	2.30%	2.42%	7.62%	8.36%	1.68%	2.42%	0.00%
22	2001	5.49%	7.76%	8.03%	2.27%	2.54%	7.08%	7.95%	1.59%	2.46%	0.08%
23	2002	5.43%	7.37%	8.02%	1.94%	2.59%	6.49%	7.80%	1.06%	2.37%	0.22%
24	2003	4.96%	6.58%	6.84%	1.62%	1.89%	5.67%	6.77%	0.71%	1.81%	0.07%
25	2004	5.05%	6.16%	6.40%	1.11%	1.35%	5.63%	6.39%	0.58%	1.34%	0.00%
26	2005	4.65%	5.65%	5.93%	1.00%	1.28%	5.24%	6.06%	0.59%	1.41%	-0.14%
27	2006	4.91%	6.07%	6.32%	1.16%	1.41%	5.59%	6.48%	0.68%	1.57%	-0.16%
28	2007	4.84%	6.07%	6.33%	1.23%	1.49%	5.56%	6.48%	0.72%	1.64%	-0.15%
29	2008	4.28%	6.53%	7.25%	2.25%	2.97%	5.63%	7.45%	1.35%	3.17%	-0.20%
30	2009	4.08%	6.04%	7.06%	1.96%	2.98%	5.31%	7.30%	1.23%	3.22%	-0.24%
31	2010	4.25%	5.46%	5.96%	1.21%	1.71%	4.94%	6.04%	0.69%	1.79%	-0.08%
32	Average	7.40%	9.00%	9.39%	1.59%	1.99%	8.24%	9.36%	0.83%	1.96%	0.03%

Yield Spreads
 Treasury Vs. Corporate & Treasury Vs. Utility



Sources:

¹ Economic Report of the President 2008: Table 73 at 316. The yields from 2002 to 2005 represent the 20-Year Treasury yields obtained from the Federal Reserve Bank.

² *Mergent Public Utility Manual* 2003. Moody's Daily News Reports.

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Treasury and Utility Bond Yields

<u>Line</u>	<u>Date</u>	<u>Treasury Bond Yield¹</u> (1)	<u>"A" Rated Utility Bond Yield²</u> (2)	<u>"Baa" Rated Utility Bond Yield²</u> (3)
1	09/16/11	3.32%	4.59%	5.23%
2	09/09/11	3.30%	4.46%	5.04%
3	09/02/11	3.52%	4.47%	5.04%
4	08/26/11	3.53%	4.67%	5.26%
5	08/19/11	3.57%	4.47%	5.01%
6	08/12/11	3.66%	4.71%	5.23%
7	08/05/11	3.88%	4.77%	5.25%
8	07/29/11	4.25%	5.09%	5.54%
9	07/22/11	4.26%	5.24%	5.67%
10	07/15/11	4.21%	5.25%	5.68%
11	07/08/11	4.35%	5.28%	5.71%
12	07/01/11	4.36%	5.40%	5.81%
13	06/24/11	4.19%	5.62%	5.21%
14	13-Wk Average	3.88%	4.92%	5.36%
15	Spread		1.04%	1.48%

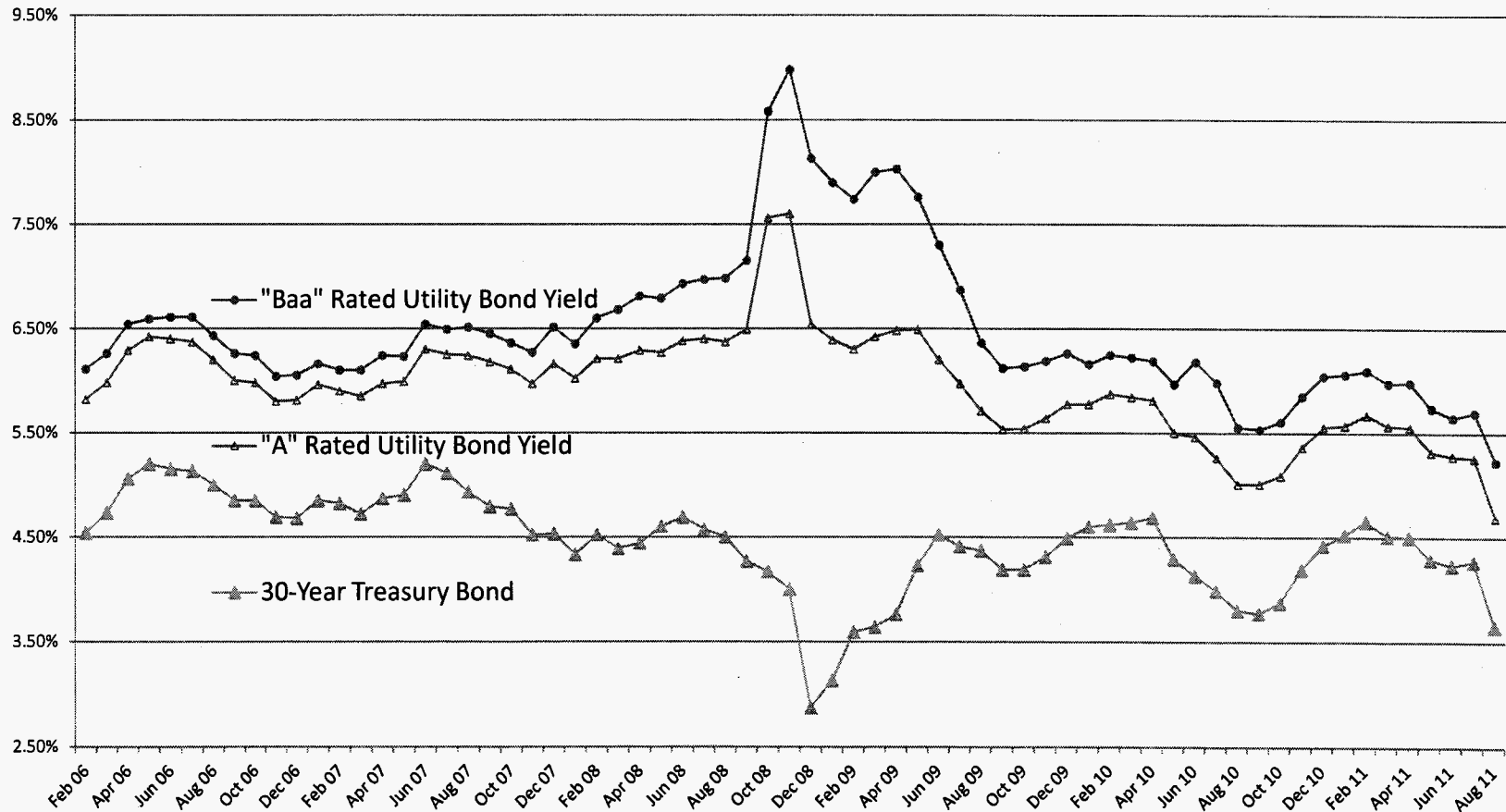
Sources:

¹ St. Louis Federal Reserve: Economic Research, <http://research.stlouisfed.org>.

² www.moodys.com, Bond Yields and Key Indicators.

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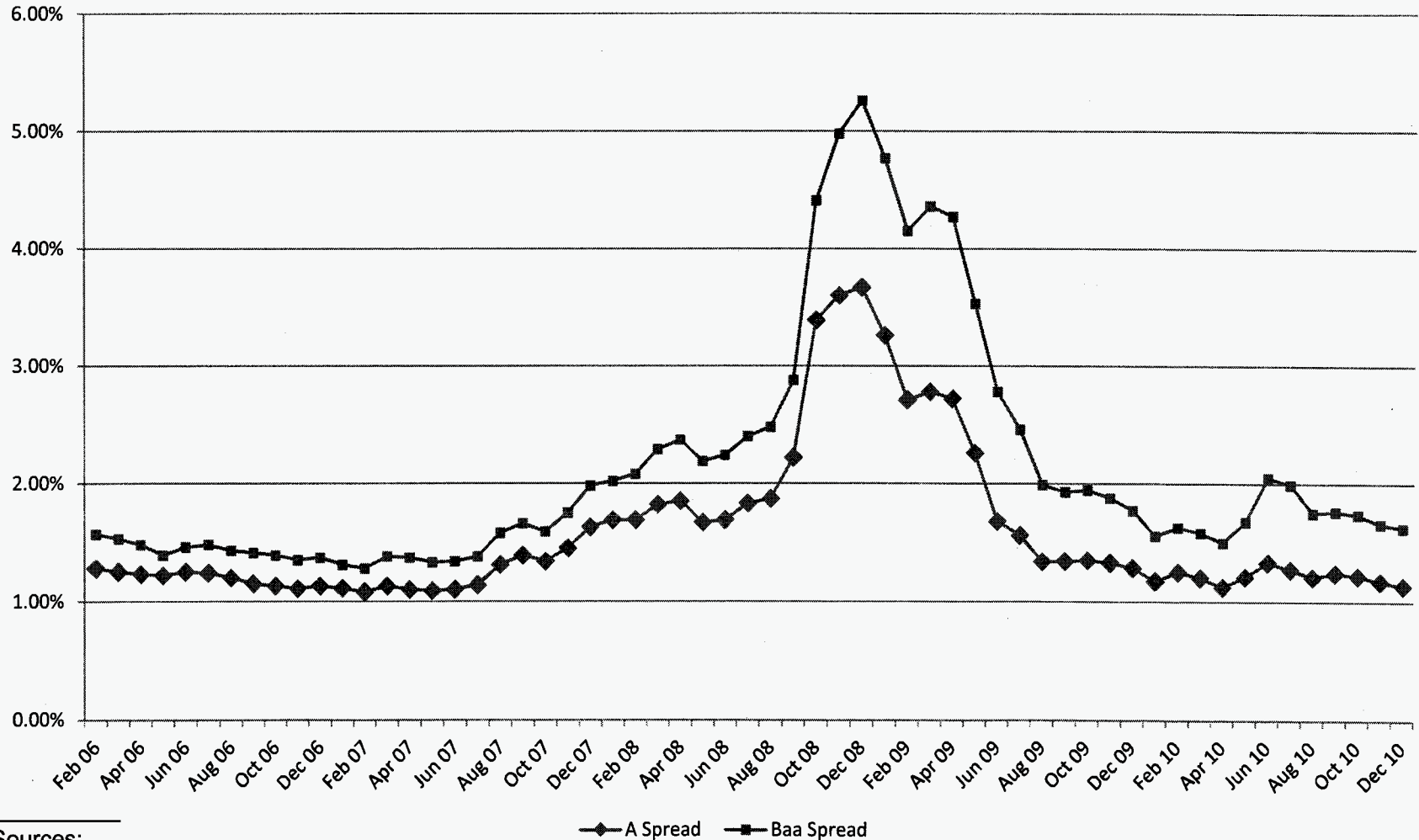
Trends in Utility Bond Yields



Sources:
Merchant Bond Record.
www.moodys.com, Bond Yields and Key Indicators.
St. Louis Federal Reserve: Economic Research, <http://research.stlouisfed.org/>

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Spread Between "A" and "Baa" Rated Utility Bond Yield and 30-Year Treasury Bond Yield



Sources:
 Merchant Bond Record.
 www.moodys.com, Bond Yields and Key Indicators.
 St. Louis Federal Reserve: Economic Research, <http://research.stlouisfed.org/>

Gulf Power Company

Value Line Beta

<u>Line</u>	<u>Company</u>	<u>Beta</u>
1	ALLETE	0.70
2	Alliant Energy	0.70
3	Amer. Elec. Power	0.70
4	Centerpoint Energy	0.80
5	Consol. Edison	0.65
6	Dominion Resources	0.70
7	Hawaiian Elec.	0.70
8	IDACORP, Inc.	0.70
9	Integrus Energy	0.90
10	Pepco Holdings	0.80
11	PG&E Corp.	0.55
12	Pinnacle West Capital	0.70
13	Portland General	0.75
14	SCANA Corp.	0.65
15	Sempra Energy	0.80
16	Southern Co.	0.55
17	TECO Energy	0.85
18	UIL Holdings	0.70
19	Westar Energy	0.75
20	Wisconsin Energy	0.65
21	Xcel Energy Inc.	0.65
22	Average	0.71

Source:
The Value Line Investment Survey,
August 5, August 26 and September 23, 2011.

Gulf Power Company

CAPM Return

<u>Line</u>	<u>Description</u>	<u>Gorman Market Risk Premium (1)</u>	<u>Morningstar Market Risk Premium (2)</u>
1	Risk-Free Rate ¹	4.20%	4.20%
2	Risk Premium ²	6.50%	6.70%
3	Beta ³	0.71	0.71
4	CAPM	8.82%	8.96%

Sources:

¹ *Blue Chip Financial Forecasts*; September 1, 2011, at 2.

² Morningstar, Inc. *Ibbotson S&P 500 2011 Classic Yearbook* at 86, and
Morningstar, Inc. *Ibbotson S&P 500 2011 Valuation Yearbook* at 54 and 66.

³ *The Value Line Investment Survey*, May 6, May 27, and June 24, 2011.

Gulf Power Company

Standard & Poor's Credit Metrics

<u>Line</u>	<u>Description</u>	Retail	S&P Benchmark ^{1/2}			<u>Reference</u>
		Cost of Service	<u>Intermediate</u>	<u>Significant</u>	<u>Aggressive</u>	
		<u>Amount (000)</u>	(2)	(3)	(4)	
		(1)				(5)
1	Rate Base	\$ 1,676,004				Exhibit No. ____ (RJM-1), Schedule 2.
2	Weighted Common Return	3.70%				Page 2, Line 7, Col. 4.
3	Pre-Tax Rate of Return	8.37%				Page 2, Line 8, Col. 5.
4	Income to Common	\$ 62,012				Line 1 x Line 2.
5	EBIT	\$ 140,287				Line 1 x Line 3.
6	Depreciation & Amortization	\$ 95,180				Exhibit No. ____ (RJM-1), Schedule 4.
7	Imputed Amortization	\$ 3,736				Page 4, Line 12, Col. 1.
8	Deferred Income Taxes & ITC	\$ 77,058				Exhibit No. ____ (RJM-1), Schedule 4.
9	Funds from Operations (FFO)	\$ 237,986				Sum of Lines 4, and 6 to 8.
10	Imputed Interest Expense	\$ 519				Page 4, Line 11, Col. 1.
11	EBITDA	\$ 239,722				Sum of Lines 5 through 7 and Line 10.
12	Total Debt Ratio	55%	35% - 45%	45% - 50%	50% - 60%	Page 3, Line 5, Col. 2.
13	Debt to EBITDA	3.8x	2.0x - 3.0x	3.0x - 4.0x	4.0x - 5.0x	(Line 1 x Line 12) / Line 11.
14	FFO to Total Debt	26%	30% - 45%	20% - 30%	12% - 20%	Line 9 / (Line 1 x Line 12).

Sources:

¹ Standard & Poor's: "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

² S&P RatingsDirect: "U.S. Regulated Electric Utilities, Strongest to Weakest," October 4, 2011.

Note:

Based on the May 2009 S&P metrics, Gulf Power Company has an "Excellent" business profile and an "Intermediate" financial profile.

Gulf Power Company

Standard & Poor's Credit Metrics (Pre-Tax Rate of Return)

<u>Line</u>	<u>Description</u>	<u>Amount (000)</u> (1)	<u>Weight</u> (2)	<u>Cost</u> (3)	<u>Weighted Cost</u> (4)	<u>Pre-Tax Weighted Cost</u> (5)
1	Long-Term Debt	\$ 648,775	38.71%	5.48%	2.12%	2.12%
2	Short-Term Debt	17,691	1.06%	2.12%	0.02%	0.02%
3	Preference Stock	72,003	4.30%	6.65%	0.29%	0.29%
4	Customer Deposits	20,951	1.25%	6.00%	0.08%	0.08%
5	Deferred Taxes	277,966	16.59%	0.00%	0.00%	0.00%
6	Investment Tax Credit	2,886	0.17%	8.45%	0.01%	0.01%
7	Common Equity	<u>635,732</u>	<u>37.93%</u>	<u>9.75%</u>	<u>3.70%</u>	<u>5.85%</u>
8	Total	\$ 1,676,004	100.00%		6.22%	8.37%
9	Tax Conversion Factor*					1.5812

Sources:

Exhibit MPG-1, Page 1 of 1.

* Exhibit No. ____ (RJM-1), Schedule 10.

Gulf Power Company

Standard & Poor's Credit Metrics (Financial Capital Structure)

<u>Line</u>	<u>Description</u>	<u>Amount (000)</u> (1)	<u>Weight</u> (2)
1	Long-Term Debt	\$ 648,775	46.07%
2	Short-Term Debt	17,691	1.26%
3	Preference Stock	72,003	5.11%
4	Off Balance Sheet Debt ¹	<u>33,900</u>	<u>2.41%</u>
5	Total Long-Term Debt	\$ 772,369	54.85%
6	Common Equity	<u>635,732</u>	<u>45.15%</u>
7	Total	\$ 1,408,101	100.00%

Sources:

Exhibit MPG-17, page 2 of 4.

¹ Page 4, Lines 5 and 8, Col. 1.

Gulf Power Company

Standard & Poor's Credit Metrics (Operating Leases)

<u>Line</u>	<u>Description</u>	<u>Amount (000)</u> (1)	<u>Reference</u> (2)
<u>Jurisdictional Allocator</u>			
1	Jurisdictional Rate Base	\$ 1,676,004	Exhibit No. ____ (RJM-1), Schedule 2.
2	Total Company Rate Base	<u>3,169,109</u>	Exhibit No. ____ (RJM-1), Schedule 2.
3	Total Rate Base	\$ 4,845,113	Line 1 + Line 2.
4	Allocation Factor	0.35	Line 1 / Line 3.
<u>Total Company¹</u>			
5	Operating Leases	\$ 2,800	
6	Imputed Interest Expense	\$ 200	
7	Imputed Amortization Expense	\$ 2,000	
8	Purchase Power Agreements	\$ 31,100	
9	Imputed Interest Expense	\$ 1,300	
10	Imputed Amortization Expense	\$ 8,800	
<u>Jurisdiction Allocation</u>			
11	Imputed Interest Expense	\$ 519	Line 4 * Lines 6 and 9.
12	Imputed Amortization Expense	\$ 3,736	Line 4 * Lines 7 and 10.

Source:

¹ Standard & Poor's RatingsDirect, "Gulf Power Co.," September 28, 2011 at 5.

Gulf Power Company

Dr. Vander Weide Revised DCF Multi-Stage Growth DCF Model

Line	Company	Stock Price (1)	Annualized Dividend (2)	First Stage Growth (3)	Second Stage Growth					Third Stage Growth ¹ (9)	Multi-Stage Growth DCF (10)
					Year 6 (4)	Year 7 (5)	Year 8 (6)	Year 9 (7)	Year 10 (8)		
1	ALLETE	\$36.44	\$1.76	5.33%	5.26%	5.19%	5.12%	5.04%	4.97%	4.90%	10.10%
2	Alliant Energy	\$36.60	\$1.58	8.20%	7.65%	7.10%	6.55%	6.00%	5.45%	4.90%	10.42%
3	Amer. Elec. Power	\$36.32	\$1.68	3.92%	4.08%	4.25%	4.41%	4.57%	4.74%	4.90%	9.46%
4	Centerpoint Energy	\$16.08	\$0.78	6.84%	6.52%	6.19%	5.87%	5.55%	5.22%	4.90%	10.62%
5	Consol. Edison	\$49.06	\$2.38	4.27%	4.38%	4.48%	4.59%	4.69%	4.80%	4.90%	9.80%
6	Dominion Resources	\$43.24	\$1.83	3.50%	3.73%	3.97%	4.20%	4.43%	4.67%	4.90%	8.97%
7	Duke Energy	\$17.81	\$0.98	4.40%	4.48%	4.57%	4.65%	4.73%	4.82%	4.90%	10.50%
8	Hawaiian Elec.	\$22.51	\$1.24	8.03%	7.51%	6.99%	6.47%	5.94%	5.42%	4.90%	11.83%
9	IDACOFW, Inc.	\$36.70	\$1.20	4.67%	4.71%	4.75%	4.79%	4.82%	4.86%	4.90%	8.27%
10	Integrus Energy	\$50.75	\$2.72	7.93%	7.43%	6.92%	6.42%	5.91%	5.41%	4.90%	11.61%
11	NextEra Energy	\$52.87	\$2.00	6.61%	6.33%	6.04%	5.76%	5.47%	5.19%	4.90%	9.31%
12	Pepco Holdings	\$18.79	\$1.08	7.00%	6.65%	6.30%	5.95%	5.60%	5.25%	4.90%	11.71%
13	PG&E Corp.	\$47.25	\$1.82	6.49%	6.23%	5.96%	5.70%	5.43%	5.17%	4.90%	9.36%
14	Pinnacle West Capital	\$41.36	\$2.10	6.50%	6.23%	5.97%	5.70%	5.43%	5.17%	4.90%	10.76%
15	Portland General	\$21.28	\$1.04	5.40%	5.32%	5.23%	5.15%	5.07%	4.98%	4.90%	10.18%
16	Progress Energy	\$44.29	\$2.48	3.58%	3.80%	4.02%	4.24%	4.46%	4.68%	4.90%	10.32%
17	SCANA Corp.	\$40.95	\$1.90	4.78%	4.80%	4.82%	4.84%	4.86%	4.88%	4.90%	9.73%
18	Sempra Energy	\$52.27	\$1.56	6.63%	6.34%	6.05%	5.77%	5.48%	5.19%	4.90%	8.39%
19	Southern Co.	\$37.91	\$1.82	5.39%	5.31%	5.23%	5.15%	5.06%	4.98%	4.90%	10.09%
20	TECO Energy	\$17.40	\$0.82	7.10%	6.73%	6.37%	6.00%	5.63%	5.27%	4.90%	10.54%
21	UIL Holdings	\$29.48	\$1.73	3.43%	3.68%	3.92%	4.17%	4.41%	4.66%	4.90%	10.53%
22	Westar Energy	\$25.09	\$1.24	7.80%	7.32%	6.83%	6.35%	5.87%	5.38%	4.90%	11.05%
23	Wisconsin Energy	\$59.29	\$1.60	10.07%	9.21%	8.35%	7.49%	6.62%	5.76%	4.90%	8.81%
24	Xcel Energy Inc.	\$23.62	\$1.01	6.45%	6.19%	5.93%	5.68%	5.42%	5.16%	4.90%	9.84%
25	Average	\$35.72	\$1.60	6.01%	5.83%	5.64%	5.46%	5.27%	5.09%	4.90%	10.09%
26	Median										10.14%

Sources:

Exhibit ____ (JVW-1, Schedule 1).

¹ Blue Chip Economic Indicators, March 10, 2011 at 15.