BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 010949-EI

In the Matter of

REQUEST FOR RATE INCREASE BY
GULF POWER COMPANY.
_____/

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VOLUME 4

Pages 270 through 391

PROCEEDINGS:	HEARING
BEFORE:	CHAIRMAN LILA A. JABER COMMISSIONER J. TERRY DEASON COMMISSIONER BRAULIO L. BAEZ COMMISSIONER MICHAEL A. PALECKI COMMISSIONER RUDOLPH "RUDY" BRADLEY
DATE:	Monday, February 25, 2002
TIME:	Commenced at 9:30 a.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	JANE FAUROT, RPR Official Commission Reporter
APPEARANCES:	(As heretofore noted.)

I N D E X

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(Transcript follows in sequence from Volume 3.)

MR. MELSON: As Mr. Benore is returning to the stand, we are passing out a similar summary document for his rebuttal testimony.

CHAIRMAN JABER: And, Mr. Melson, clarify for me where these -- because I know Mr. McWhirter will ask the same question, it is a good one, which is where does this information originally derive from?

MR. MELSON: All right. Page 1 comes from the text of the testimony. Page 2 is his Schedule 12. Page 3 comes from his Schedule 12. Page 4 is one of his schedules, and I unfortunately don't have the reference on it. Page 5 -- the next page is Schedule 18, the following page is Schedule 20, and the final page is Schedule 21.

CHAIRMAN JABER: Okay. So all information from exhibits originally filed?

MR. MELSON: From exhibits. Or I think in one case the text on Page 2 is from the testimony itself.

CHAIRMAN JABER: Okay. Thank you.

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CHARLES A. BENORE

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

DIRECT EXAMINATION

BY MR. MELSON:

Q Mr. Benore, you are still under oath. Have you -- I guess state your name one more time for the record.

A Yes. Charles Benore.

Q Have you prefiled rebuttal testimony consisting of 53 pages?

A Yes.

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

A No, sir, I do not.

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

A Yes.

MR. MELSON: Chairman, I would ask that Mr. Rothchild's -- I'm sorry, Mr. Benore's -- I'm going too fast here.

CHAIRMAN JABER: No, we're not.

MR. MELSON: Mr. Benore's rebuttal testimony be inserted into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony Of
Charles A. Benore
Docket No. 010949-EI
Date of Filing: January 22, 2002

Q. Please state your name, address and occupation.

A. My name is Charles A. Benore and my business address is 125 West Street, Bar Harbor, Maine 04609. I am President of Benore Financial Consulting, Inc., a financial consulting company.

Q. Are you the same Charles A. Benore who provided direct testimony on Gulf Power's behalf in this docket?

A. Yes.

Q. What is the purpose of this testimony?

A. The purpose of my testimony is to respond to the testimony of Mr. James A. Rothschild.

Q. Have you prepared an exhibit that contains information to which you will refer in your rebuttal testimony?

A. Yes. I have prepared Exhibit (CAB-2) consisting of 24 schedules numbered Schedule 12 through Schedule 35.

Counsel: We ask that Mr. Benore's Exhibit (CAB-2) consisting of 24 schedules numbered 12 through 35 be marked for identification as Exhibit ___.

COMMENTS ON THE DIRECT TESTIMONY OF MR. ROTHSCHILD

Q. Do you have any fundamental concerns about the return on common stock equity recommended by Mr. Rothschild?

A. Yes, there are several.

1. Mr. Rothschild's return on common stock equity recommendation to the Commission will not produce the growth rate and return that he testifies investors require. By definition, therefore, his recommendation is contradictory and flawed.
2. He ignored the comparable earnings test, which shows the return on common stock equity expected by investors and embedded in their growth and return expectations.
3. He did not recognize the relatively small size of Gulf Power Company and its associated higher business risk in his recommended return on common stock equity.
4. He ignored flotation costs even though such costs are real and need to be recognized.
5. His schedules contain a number of errors, inconsistencies, and misrepresentations of reasonable investor expectations. These problems with his DCF and CAPM analyses are described in detail later in my rebuttal testimony.

BROAD ISSUES

Mr. Rothschild Made a Contradictory Recommendation to the Commission

Q. Why is there a contradiction between Mr. Rothschild's recommended return on common stock equity for Gulf Power Company (or the investor required market return), and the return that his recommendation will produce for investors?

A. Mr. Rothschild used a definition of the cost of common stock which he does not fulfill in the return he recommends to the Commission. He notes on page 21 beginning on line 4 that the cost of common stock is "the rate of return that must be offered to a common equity investor in order for that investor to be willing to buy the common stock." Common sense and investment theory indicate that the return required by investors is the return available to them from other comparable risk investments. Moreover, as indicated by the DCF model, investors expect to have a reasonable opportunity to earn their required market return through a combination of growth in the common stock price that tracks the growth in earnings/dividends plus the dividend yield on the stock.

Mr. Rothschild's recommendation stops short of fulfilling investor expectations because he does not provide investors with an opportunity to earn the 10.0% market return he testifies they require. For example, the achievable market return for investors using Mr. Rothschild's 10.0% regulatory return recommendation is only 7.3%. Data supporting this calculation is shown on Schedule 12 of my rebuttal exhibit.

This is clearly an untenable outlook for investors. The achievable

market return of 7.3% is less than the yield on Moody's "A" rated utility bonds of 7.66% (1/10/02), which are lower in risk. Mr. Rothschild's recommendation of a regulatory return of 10.0% will produce a market return to investors (7.3%) that is lower than the market return (7.7%) on lower risk bonds with a rating comparable to Gulf Power Company. This is an untenable investment prospect for investors.

Q. What are the expected consequences of adopting Mr. Rothschild's 10.0% return on common stock equity recommendation for Gulf Power Company?

A. Mr. Rothschild's 10.0% return on common stock equity recommendation, if adopted by the Commission, would likely drive the stocks toward book value. Based on data shown in Mr. Rothschild's Exhibit JAR 3, the stock price of companies on the list of companies comparable to Gulf Power would need to drop by 39% to reach book value. His recommendation would therefore deprive investors of a reasonable return on their capital and, therefore, repel rather than attract investors. This would in turn jeopardize the ability of Gulf Power Company to attract capital and fulfill its customer responsibilities. Clearly such a result is contrary to the public interest.

Q. What regulatory return on common stock equity is necessary to fulfill Mr. Rothschild's 10.0% achievable market return for investors?

A. The necessary regulatory return in order for investors to have an opportunity to earn in the market the 10.0% return that Mr. Rothschild

testifies they require is 12.7%, before consideration of flotation costs, and 12.9% with flotation costs. Data supporting this calculation is shown in the lower table on Schedule 12 of my rebuttal exhibit, and on Schedule 27 for flotation costs.

Mr. Rothschild Wrongly Ignores the Comparable Earnings Test

Q. Please explain why you believe Mr. Rothschild erred by ignoring the comparable earnings analysis in determining his recommended return on common stock equity for Gulf Power Company.

A. Mr. Rothschild employed the sustainable growth rate method for determining investor expected growth rates. In its simplest form, this consists of multiplying the expected return on common stock equity ("r") times the retention rate ("b"), which represents the earnings retained to support future growth. It should be clear from the sustainable growth rate formula (r times b) that one of the two elements necessary to determine the growth rate is the expected return on common stock equity. Mr. Rothschild uses the expected return on common stock equity (comparable earnings) for determining the earnings growth of the comparable companies. Yet after concluding his DCF analysis, he ignores the fact that his DCF recommendation relies on comparable earnings to provide the rate of growth used in that analysis.

From another perspective, there is a difference between book and market returns. Book returns, such as the return on common stock equity, are generally not the same as market returns (the sum of the growth rate and yield produced by the DCF model) except when stock prices are

comparable to book value. Nonetheless, the growth rate in the DCF model is functionally related to the book return on common stock as shown by the sustainable growth rate formula used by Mr. Rothschild. The return allowed by regulators, which is represented by "r" (return on common stock equity) in the sustainable growth rate model, is also a book return. Therefore, the comparable earnings model provides an apple-to-apple method of determining the appropriate regulatory return. The return shown by the comparable earnings model is the return on common stock equity expected by investors and embedded in their expected market return (price growth that tracks "br" plus the yield on the stock).

Q. What are the strengths of the comparable earnings method?

A. The comparable earnings model provides a direct rather than indirect method for assessing the investor expected return on common stock equity. Market based models, such as the DCF model, calculate the investor expected market return, which is different from the book return on common stock equity (except when price and book value are comparable). When stock prices are different from book value, as they are under current market conditions, it is necessary to determine the appropriate book regulatory return on common stock equity to produce the expected rate of growth, and to provide investors with an opportunity to earn their required market return. The comparable earnings method provides this information.

From another perspective, the cost of common stock is not the market return shown by the DCF, ERP, and CAPM models, but is the

book return the firm must earn in order to produce the investor required market return. "Basic Financial Management," as cited on page 24 of my direct testimony, notes:

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

Mr. Rothschild Failed to Recognize that Gulf Power Company's Small Size Increases Its Risk Relative to the Comparable Companies

Q. Please explain why size is important in determining the cost of common stock for companies like Gulf Power Company.

A. Smaller companies generally lack the resources of larger companies and, therefore, are generally less able to cope with unforeseen events. Further, experience shows that investor returns are materially higher for smaller than larger companies, which is consistent with the proposition that their risk is higher.

Ibbotson Associates, which has developed size premiums based on market values, notes on page 107 of its "Valuation Edition, 2001 Yearbook," that:

> One of the most remarkable discoveries in modern finance is that of a relationship between firm size and return. The relationship cuts across the entire size spectrum but is most evident among smaller companies, which have higher returns on average than larger ones.

Q. What is an appropriate size premium for Gulf Power Company?

A. Gulf Power Company's common stock equity is equal to about 4% of that of its parent, Southern Company. Southern Company's market value according to Value Line is $15.8 billion, and at 4% Gulf Power Company's is approximately $630 million. The average market value of the companies on the list of companies comparable to Gulf Power is $5.3 billion, as shown on Schedule 23 of my rebuttal exhibit. Based on the Ibbotson size premium study, the higher return indicated for Gulf Power Company is approximately 0.7%. It is my judgment, nonetheless, that the higher business risk associated with the Company's smaller size is mitigated to a substantial extent by constructive adjustment clauses for fuel, purchase power, capacity, and environmental costs provided by the Florida Public Service Commission. Consequently, the size premium for Gulf Power Company is probably closer to 0.25% than 0.75% in quarter point increments.

Although substantially mitigated by constructive regulatory policies, size is still an important consideration, especially since Mr. Rothschild suggests that his 10.0% recommended return would be closer to 9.75% if the Commission chooses to consider the risk mitigation impact of its adjustment clauses.

Mr. Rothschild Ignored Flotation Costs Which Are Legitimate Costs That Should Be Recognized

Q. Did Mr. Rothschild recognize and make an adjustment for flotation costs?

A. No. Because monies invested by investors are reduced by the amount of

issuance costs, the amount shown on the balance sheet of Gulf Power Company is less than the amount actually invested by investors. Therefore, a higher return on the reduced amount of investment is necessary in order for investors to have an opportunity to earn the return considered fair by the Commission on the full amount of their investment.

Justification for a flotation cost adjustment is provided, and its amount is shown, in Schedule 11 of the exhibit to my direct testimony, and in the lower table on Schedule 27 of my rebuttal exhibit. The adjustment is 0.19%, or 0.2% rounded.

SINGLE-STAGE DCF ISSUES

Q. Please describe the single-stage DCF model used by Mr. Rothschild.

A. The single-stage DCF model used by Mr. Rothschild employed a sustainable growth rate (br + sv), with a yield based on the indicated dividend per share adjusted by one-half of the growth rate. Flotation costs and transformation were ignored. Using the average stock prices for the year ending 11/30/01, Mr. Rothschild's result for the comparable group of companies identified in my direct testimony was 8.86%, and his result for Southern Company was 9.60%. Using stock prices for 11/30/01, his results were 9.63% and 9.64% respectively.

Q. Please summarize the problems you found in Mr. Rothschild's single-stage DCF analysis.

A. I found three categories of problems: data errors, inconsistencies, and

misrepresentations of reasonable investor expectations.

Q. Please identify the data errors you found in his analysis.

A. Using the latest Value Line reports (9/7/01 and 10/5/01) before the 11/30/01 prices shown in his study, I found the following data errors in Mr. Rothschild's single-stage DCF calculations:

1. JAR 3, Page 1: The average price to book value using average prices for the comparable group is 1.87 not 1.92.
2. JAR 3, Page 1: The 11/30/01 market to book value ratio for Southern is 1.45 times instead of 1.71 times.
3. JAR 3, Page 1: The market to book value ratio for Southern based on average for the year prices is 1.81 instead of 1.90.
4. JAR 8: The common shares outstanding are incorrect for Progress Energy and TECO Energy.
5. JAR 8: The growth rate for common shares is incorrect.
6. JAR 8: Footnote [A] states that 0.40 was used for "s" but footnote [J] on JAR 4 states that 0.30 was used for calculating the sustainable growth rate.

Q. What inconsistencies did you find in Mr. Rothschild's analysis?

A. I found the following inconsistencies:

1. Mr. Rothschild used Southern Company for this single-stage version of his DCF analysis, but not for his two-stage DCF model analysis.

2. His two-stage DCF analysis used returns on common stock equity of 12.0%, 13.0%, and 13.5% compared to 13.0% for his single-stage, comparable company analysis.

Q. Why do you say that Mr. Rothschild's model contains misrepresentations of reasonable investor expectations?

A. I say that because:

1. Mr. Rothschild used a book value for Southern Company that apparently includes Mirant, a company that was spun-off from Southern Company in April 2001, well before the preparation of his testimony.
2. He based his analysis in part on an average of prices over the twelve months ending 11/30/01, despite the efficient market theory that indicates new information is reflected in stock prices almost immediately.
3. He ignored investor return on common stock equity expectations based on Value Line (13.5%) and Zacks' (14.85%) information and substituted his own lower numbers.
4. He concluded that the investor required market return is 9.63% based on 11/30/01 prices on JAR 4, page 1. This result cannot be replicated using the DCF model with a sustainable growth rate, which suggests that there may be errors or improper modeling on JAR 4 page 1.

Use of Southern Company

Q. The errors and inconsistencies that you identified are straightforward. Would you be more specific in your comments about the misrepresentations of reasonable investor expectations that you found in Mr. Rothschild's analysis?

A. In light of the fact that Mr. Rothschild used Southern Company data which preceded the spin-off of Mirant in performing his single-stage DCF analysis, I did not review his analysis of Southern Company. Another reason for not including Southern Company in my review is that Mr. Rothschild did not include Southern Company in his two-stage DCF or CAPM analyses.

Representative Stock Prices

Q. Please explain why you believe it is inappropriate to use stock prices that go back as far as December 1, 2000 to measure the cost of common stock for Gulf Power Company in 2002.

A. Mr. Rothschild used average prices for the year-ending 11/30/01 for one of his single-stage DCF analyses. It is generally conceded in this electronic age that investors reflect new information into stock prices almost instantaneously with its release. To assume that average prices over the year ending 11/30/01 are representative of current investor expectations is unreasonable, especially as the electric utility industry incurs distortions associated with the structural change from monopoly to competition. It is my judgment that the 11/30/01 price is the only one of the two he used that is representative of investor expectations for his

single-stage DCF analysis.

Furthermore, Mr. Rothschild used the price-to-book ratio of 1.7 based on 11/30/01 prices for determining the investment cost of the cash flows in his two-stage DCF analysis. It is inconsistent to use average year prices in one part of the analysis and year-end prices in another part.

Use of Investor Expected Returns on Common Stock Equity Versus Those of Mr. Rothschild

Q. You expressed a concern that Mr. Rothschild ignored investor expectation data from Value Line and Zacks and substituted his own judgment about the investor expected return on common stock equity in his sustainable growth rate calculations. Please explain your concern.

A. Mr. Rothschild's single-stage DCF model is not based on the investor expectations he shows on JAR 4, page 1. He developed his sustainable growth rate using a return on common stock equity of 13.0% for the comparable company group instead of using the 13.5%, 2004-06 normalized level shown by Value Line, and the 14.85% shown by Zacks (footnote [A] on JAR 4, page 1). Presumably the 13.0% represents his judgment after considering the lower returns on average common stock equity for the comparable group in 1999 (12.4%) and 2000 (12.9%) that are also shown on JAR 4, page 1.

The problem with Mr. Rothschild's choice of 13.0% is that it is unrepresentative of investor expectations. Whatever informational value investors find in short-term historical data is already embedded in their projected returns on common stock equity. Therefore, weighing historical

and projected results essentially double-counts short-term historical guidance. Moreover, short-term historical data adds little value to determining longer-term expectations during abnormal conditions such as those which exist today when the industry is progressing from a monopoly to a more competitive industry structure, and material distortions to earning assets, earnings, and dividends occur.

Therefore, Mr. Rothschild should have used investor expected returns on common stock equity of 13.5% and 14.85% in his sustainable growth rate calculations.

Inability to Replicate Mr. Rothschild's Single-Stage DCF Model Results

Q. Using the "br+sv" DCF model, were you able to replicate the 9.63% investor required return shown for Mr. Rothschild's 11/30/01 single-stage DCF growth analysis?

A. No. The numbers don't add up. Using stock prices on 11/30/01, Mr. Rothschild claims that the investor required market return is 9.63%. However, when running the 13.0% return on common stock equity, with 2001 book value of $22.76, dividends per share (DPS) of $1.85, and yield of 5.32% on the forward dividend with an external growth rate of 0.14%, the indicated investor required market return is 10.3%. The calculations supporting this result are shown in the upper table on Schedule 13 of my rebuttal exhibit. Of course, as I explained earlier, the 13.0% return that Mr. Rothschild inputs into his model is not representative of investor expectations in any event.

Alternative Measures of the Investor Required Return for Gulf Power Company's Comparable Companies

Q. If Mr. Rothschild had used the average of the Value Line and Zacks' projected returns on common stock equity of 14.2% (13.5% and 14.85%) for his sustainable growth rate approach, what would Mr. Rothschild's single-stage DCF analysis show as the investor expected market return?

A. Using a 14.2% return on common stock and the book value for 2001, which better corresponds with the 11/30/01 common stock prices than 2000 book value, the indicated investor required market return is 11.5% before flotation costs and transformation. Supporting data is shown in the table at the bottom of Schedule 13 of my rebuttal exhibit.

Q. If Mr. Rothschild had used the average of the five-year earnings growth rates provided by four vendors, and recent, representative stock prices, what investor required market return is shown?

A. As noted in the response to Staff Production of Document Request Item No. 55, which requested updated information on the cost of equity, the indicated investor required market return using the most recent data is 12.1%, before flotation costs and transformation. This calculation is shown in Schedule 27 of my rebuttal exhibit.

TWO-STAGE DCF MODEL ISSUES

Q. Please describe the two-stage DCF model used by Mr. Rothschild.

A. Mr. Rothschild's two-stage DCF model determined the present value of

investor cash flows, or dividends per share plus the terminal price 40 years after initiating the investment. For the first five years, he used the dividends projected by Value Line, and for the next 35 years he essentially used the sustainable growth rate method (br+sv) employing returns on common stock equity of 12.0%, 13.0%, and 13.5%. He then determined the discount rate that equated the cash flows with the purchase price. The discount rate is the market rate of return required by investors.

Q. Did you find any problems with his two-stage DCF analysis?

A. Yes. Again I have categorized the problems as data errors, inconsistencies, and misrepresentations of reasonable investor expectations.

Errors:

1. Mr. Rothschild did not use either the year-to-date average price, or the 11/30/01 price for his analysis, but instead used an artificial price (approximately the ratio of 1/30/01 prices to 2000 book value times 2001 book value).
2. He used an incorrect 2005 book value for Ameren which caused the average book value for that year to be incorrect.
3. The previously cited data errors on his Schedule JAR 8 also affected his second-stage DCF analysis.
4. He erroneously used the retention rate for the first year of the stage-one analysis (41.33%) rather than the retention rate for the last year of that analysis (47.39%) as the rate carried forward into

stage two.

Inconsistencies:

1. He used Southern Company for his single-stage version of his DCF analysis but not for his two-stage DCF model analysis.
2. His two-stage DCF analysis used returns on common stock equity of 12.0%, 13.0%, and 13.5%, compared to 13.0% for his single-stage analysis.

Misrepresentation of Reasonable Investor Expectations:

1. He used his expected returns on common stock equity rather than those of investors.

Q. Please explain the fourth item that you identified in your list of errors.

A. The first stage portion of Mr. Rothschild's analysis used Value Line investor expected data inputs that resulted in a terminal retention rate of 47.39% for 2005. In 2006, however, when Mr. Rothschild begins his second stage, he drops the retention rate to the 2001 level of 41.33%. This error effectively institutes a new dividend policy for the comparable companies.

Mr. Rothschild Used His Own Expected Returns on Common Stock Equity Instead of Those of Investors

Q. Did Mr. Rothschild use his interpretation of investor expected returns on common stock equity instead of those provided by investors, as shown by Value Line and Zacks?

A. Yes. Mr. Rothschild used expected returns on common stock equity of

12.0%, 13.0%, and 13.5% in his analysis in lieu of those provided by investors of 13.5% by Value Line and 14.85% by Zacks. He notes that historical returns were lower and that analysts' estimates have an upward bias in justifying the write down of investor expectations. This is clearly wrong, because in concluding what future returns on common stock equity are expected to be, whatever guidance is provided by short-term historical results would already be embedded in investors' future expectations. Moreover, it is unlikely that investors would pay much heed to short-term historical results as the industry undergoes a structural change from monopoly to competition. Further, investors invest based on their expectations and not on after-the-fact results.

Q. If Mr. Rothschild had used the correct values for actual current stock prices, investor expected returns on common stock equity provided by Value Line and Zacks, and investor expected dividend policy, what would his two-stage DCF analysis show the investor expected market return to be?

A. Using the 13.5% investor expected return on common stock equity provided by Value Line, the indicated market return expectation by investors using a combined internal and external growth rate of 6.54% is 11.4% before flotation costs and transformation. Supporting data is shown on Schedule 14 of my rebuttal exhibit.

Using Zack's 14.85% investor expected return on common stock equity indicates an investor required market return of 12.0%, using a combined internal and external growth rate of 7.18%. Supporting data is

shown on Schedule 15 of my rebuttal exhibit.

DCF MODEL CONCLUSIONS

Q. What are your conclusions about Mr. Rothschild's single-stage DCF analysis for the list of companies comparable to Gulf Power?

A. Mr. Rothschild's single-stage DCF analysis contained a number of factual errors, misrepresentations of investor expectations, and the numbers shown on his JAR 4, page 1 for 11/30/01 stock prices do not add up. This analysis is badly flawed, and I recommend it not be considered in determining the regulatory return on common stock equity for Gulf Power Company.

Using the average sustainable growth rate based on Value Line and Zacks' expected returns on common stock equity, the investor expected market return is 11.5% as shown on Schedule 13 of my rebuttal exhibit.

Using an alternative measure based on projected five-year growth rates and representative stock prices, Mr. Rothschild's single-stage DCF, based on the update to my DCF analysis, would show an investor expected market return of 12.1% (see Schedule 27 of my rebuttal exhibit).

The 11.5% (Schedule 13) to 12.1% (Schedule 27) investor market return expectations are substantially higher than the 9.63% shown on Mr. Rothschild's JAR 4, page 1, for the list of companies comparable to Gulf Power.

Q. What are your conclusions about Mr. Rothschild's two-stage DCF analysis for the list of companies comparable to Gulf Power?

A. Mr. Rothschild's two-stage DCF analysis contained a number of errors, and misrepresented investor expectations. The most serious of the problems with his analysis is the use of his judgment about expected returns on common stock equity rather than those of investors, artificial rather than actual stock prices for the comparable companies, and the use of an erroneous dividend policy for the second stage of the analysis rather than a continuation of one already in place determined by investors.

After correcting these problems, and using the appropriate investor expected returns on common stock of 13.5% from Value Line, and 14.85% from Zacks, the two-stage DCF model indicates an investor expected market return of 11.4% (Schedule 14) and 12.0% (Schedule 15) respectively, before flotation costs and transformation. These expected market returns that are representative of investor expectations are materially higher than the 9.80% shown by Mr. Rothschild on his Schedule JAR 2.

Q. What is your overall conclusion about Mr. Rothschild's DCF analysis?

A. Mr. Rothschild's DCF analysis is badly flawed primarily because he chose to use his judgments about investor expected returns on common stock equity rather than those of investors. Had he used investor expected returns on common stock equity and several other assumptions consistent with reasonable investor expectations, he would have found that the required investor market return was considerably higher than shown in his

testimony.

Corrected for infirmities, his DCF analysis shows an investor required market return of 11.5% for his single-stage DCF, and a range of 11.4% to 12.0% (with a midpoint of 11.7%) for his two-stage DCF analysis, before flotation costs and transformation.

Q. What regulatory return is necessary so that investors can earn the 11.7% market return indicated by the recalculated two-stage DCF analysis?

A. In order for investors to have a reasonable opportunity to earn the 11.7% market return, a regulatory return of 14.2% is necessary. Supporting data is shown on Schedule 16 of my rebuttal exhibit.

EQUITY RISK PREMIUM ISSUES

CAPM, Version One

Q. Please explain the first of two versions of the CAPM used by Mr. Rothschild.

A. Mr. Rothschild's first version of the CAPM determined the investor expected rate of inflation (2.0%) to which he added the historic, real market return (6.6% to 7.2%) to determine the investor expected nominal market return of 8.9%, the midpoint of 8.6% to 9.2%.

Schedule JAR 9 extends the analysis beyond the stopping point in JAR 2 using the standard form of the CAPM. The real market return of 6.6% to 7.2% (not the nominal market return of 8.9%) is reduced by the nominal debt return of 1.33% (not the real debt return of –0.67%) to

determine the market equity risk premiums of 5.27% to 5.87%. The 5.27% to 5.87% market equity risk premiums were adjusted for the lower risk of the list of companies comparable to Gulf Power compared to the market by using the Value Line beta of 0.52, which indicated an equity risk premium of 2.75% to 3.06%, or what Mr. Rothschild describes as the risk adjusted equity premium. Normally this risk adjusted equity risk premium is added to the debt return to show the market return required by investors. Had this been done, his analysis would show a required market return for the list of companies comparable to Gulf Power of 4.08% to 4.39% (2.75% plus 1.33% and 3.06% plus 1.33%), which is of course unreasonable on its face.

From another perspective, the last line on his Schedule JAR 9 shows a midpoint risk premium applicable to electric companies of 6.23%. To this one would add the debt return, which he shows as 1.33%. The sum, or investor required market return, is 7.56%. In either event, the results are untenable since single A rated utility bonds, which are lower in risk, currently yield 7.66% (Moody's 01/10/02).

Q. What problems did you observe on his Schedule JAR 9?

A. There are several.

1. Mr Rothschild was inconsistent on line 9 of his analysis on Schedule JAR 9 when he adjusted the *real* market return by the *nominal* interest rate. It is not appropriate to mix apples and oranges (real and nominal rates) in developing the investor expected, nominal equity risk premium.

2. He shows a different conclusion on Schedule JAR 2 than on his Schedule JAR 9.

3. He produced untenable results using the standard version of the CAPM.

Q. What is your overall conclusion about Mr. Rothschild's inflation adjusted, real return method to determine the investor expected market return for the CAPM?

A. The analysis is seriously flawed and, therefore, should not be used for determining the investor required market return for Gulf Power Company.

CAPM, Version Two

Q. Please describe the second CAPM used by Mr. Rothschild.

A. Mr. Rothschild's second CAPM method determined that the historical equity risk premium for common stocks versus long-term Treasury bonds was 4.0%, instead of the 7.3% shown by Ibbotson using the arithmetic average for 1926-2000. Using geometric average returns, he showed 1926-1999 returns for various debt securities. He then adjusted these returns by subtracting the long-term Treasury bond return and another amount which he calculated was required to maintain consistency with his equity risk premium of 4% over long-term Treasury bonds.

Mr. Rothschild properly acknowledged the problems using Treasury bond yields (flight to quality and perhaps scarcity premiums in Treasury note and bond yields) and therefore used long-term corporate bonds for his analysis. His analysis showed an investor required market return for

the list of companies comparable to Gulf Power of 8.94%, before flotation costs and transformation, and a required return of 10.62% for the market. It is not clear why Mr. Rothschild uses the market return for the upper end of his analysis.

Q. Did you note any errors, inconsistencies, or misrepresentations of reasonable investor expectations, which you believe are present in Mr. Rothschild's CAPM analysis?

A. I did not note any errors in Mr. Rothschild's CAPM analysis, but there are some inconsistencies and misrepresentations of investor expectations which are noted below.

Inconsistencies:

1. Mr. Rothschild's yield on JAR 9 for Treasury bills is 1.33% versus 1.60% on JAR 10.
2. He used short-term Treasury bills for his CAPM Version One versus long-term corporate bonds for his Version Two.

Misrepresentations of Reasonable Investor Expectations:

1. Mr. Rothschild inappropriately used the geometric average instead of the arithmetic average Ibbotson Associates' data to determine investor expectations.
2. He inappropriately used a 4 percentage point equity risk premium relative to long-term Treasury bonds to represent investor expectations.
3. He failed to recognize that empirical studies show the standard CAPM model understates the investor expected return for low beta

stocks and also for small stocks, both of which apply to Gulf Power Company.

4. He improperly represented data from the Credit Suisse First Boston (CSFB) study in supporting his analysis.

The Arithmetically Derived Equity Risk Premium Provides the Correct Assessment of Investor Expected Returns

Q. Why is it wrong to use geometric measures of historical returns to reflect investor future return expectations?

A. Ibbotson Associates, the source of Mr. Rothschild's data, states on page 61 of its "Valuation Edition 2001 Yearbook":

> The equity risk premium data presented in this book are arithmetic average risk premia as opposed to geometric average risk premia. ***The arithmetic average equity risk premium can be demonstrated to be most appropriate when discounting future cash flows.*** For use as the expected equity risk premium in either the CAPM or the building block approach, ***the arithmetic mean or the simple difference of the arithmetic means of stock market returns and riskless rates is the relevant number.*** This is because both the CAPM and the building block approach are additive models, in which the cost of capital is the sum of its parts. The geometric average is more appropriate for reporting past performance, since it represents the compound average return. [Emphasis added.]

Morin in "Regulatory Finance," page 298, states:

> This appendix shows why arithmetic rather than geometric means should be used for forecasting, discounting, and estimating the cost of capital. Similar treatments and demonstrations are available from Brealey and Myers (1991), Ibbotson Associates (1993), and Litzenberger (1984). This appendix draws from the three aforementioned sources, particularly the latter.
>
> By definition, the cost of equity capital is the annual discount rate that equates the discounted value of expected future cash flows (from dividends and the sale of the stock at the end of the investor's investment horizon) to the current market price of a share in the firm. The discount rate that equates the discounted value of future expected dividends and the end of period expected stock price to the current stock price is ***a prospective arithmetic***, rather than a prospective geometric mean rate of return. Since future dividends and stock prices cannot be predicted with certainty, the "expected" annual rate of return that investors require is an average "target" percentage rate around which the actual, year-by-year returns will vary. ***This target rate is, in effect, an arithmetic average.*** [Emphasis added.]

From still another perspective, if the utility was expected to earn 10% on its common stock equity, after two years one would expect (assuming no dividends or external financing) that its common stock

equity would have grown by 21%. However, if the actual rate of growth were 0% in the first year and 20% in the second year, its common stock equity would have increased by only 20%, not 21%.

The geometric rate of growth in the second outcome (0% and 20%) is 9.54%. Had one wanted the utility to earn 9.54%, therefore, one would have had to allow a return of 10.0%. Therefore, it is essential that arithmetic returns be used to set returns on common stock equity. Use of the geometric mean return will produce a downward bias in the return on equity necessary to fulfill investor expectations.

Q. Nonetheless, Mr. Rothschild's position is that the arithmetic mean overstates actual returns received by investors (page 82, lines 4-5), and cites numerous examples (page 83 - 85) that he alleges support the use of the geometric mean to measure the cost of common stock for Gulf Power Company. Please comment.

A. Mr. Rothschild is right as far as his supporting evidence goes, but all that evidence relates to the use of geometric returns for presenting historical results, not for estimating expected future results.

In my three decades of experience in working with individual and institutional investors, I have never talked to an individual investor who asked me about geometric averages on either a historic or prospective basis. I cannot recall an institutional investor that looked at historical returns calculated with the geometric mean to determine expected future returns. This experience is supported by Value Line which shows even historic returns based on the arithmetic mean.

Value Line shows the arithmetic and not the geometric total return in its reports to investors. Value Line notes:

> We are adding a new box to show "Total Return." On every report, in a box in the lower right hand corner of the stock price chart, we will now show total return for each stock (appreciation or depreciation of the stock plus cash dividends) for the past 1 year, 3 years, and 5 years. We will also show the total return of the stock market for the same time periods. The market measure used will be the ***Value Line Arithmetic Index***, which is representative of the stock market as a whole, and is an equally weighted price index of all stocks covered in The Value Line Investment Survey. [Emphasis added.]

Mr. Rothschild Erred by Selecting the Lowest, Round Number Equity Risk Premium Possible Over 1926-2000

Q. Mr. Rothschild determined that the equity risk premium was declining based on a 30 year moving average of historic equity risk premiums, and provided alleged supporting citations from Federal Reserve Chairman Greenspan and a Credit Suisse First Boston report to investors. Please explain why you believe he erred in using a 4% equity risk premium.

A. A review of arithmetic, historical equity risk premiums shown in Ibbotson's "Valuation Edition 2001 Yearbook," pages 208-209, for long-term government bond total returns, and pages 198-199, for large company stocks total returns, shown on Schedule 17 of my rebuttal exhibit, indicates that the time period used by Mr. Rothschild for his equity risk

premium is the lowest, using the 30 year moving average, for 1926-2000.

It is clear that a 4% geometric average return (the chart shows higher equity risk premiums based on arithmetic returns) is not representative of the thirty year moving average over 1926-2000, and Mr. Rothschild should not expect investors to make a similar conclusion. The range of equity risk premiums is 3% to 13% with a range midpoint of 8%. The range midpoint of about 8% is a more reasonable investor expectation. It is also reasonably close to the average of the arithmetic equity risk premiums for 1926-2000 of 7.3% based on total return, and 7.8% based on the income return.

Mr. Rothschild Failed to Observe that Empirical Studies Show that the Standard CAPM Understates Investor Required Returns for Low Beta Stocks and Small Companies Like Gulf Power Company

Q. Why do you conclude that the standard CAPM understates investor required returns for companies like Gulf Power?

A. Virtually all empirical studies of standard CAPM model results show that the CAPM understates the investor required market return for low beta stocks like Gulf Power Company. Additionally, empirical research indicates that the standard CAPM understates expected market returns for small company stocks, which also includes Gulf Power Company. Please see citations on Schedule 9, pages 3 and 4, of the exhibit to my direct testimony.

Additionally, electric utility stocks have detached themselves from the market since regulatory restructuring concerns surfaced in 1993.

Electric utility stocks have moved sideways as selling pressures overwhelmed buying and caused the stocks to dramatically under-perform the market on a risk adjusted basis. The resulting lower beta does not reflect lower risk, but the adjustment for higher risk. This can be viewed on Schedule 22 to my rebuttal exhibit. This is confirmed by the rising risk assessment for single A utility bonds shown on Schedule 3, page 2 of the exhibit to my direct testimony.

Therefore, the beta used by Mr. Rothschild understates the relative risk of the list of companies comparable to Gulf Power compared to the market, and therefore understates the indicated investor required market return.

<u>The Credit Suisse First Boston Report Does Not Support Mr. Rothschild's Claim that the Market's Expected Equity Risk Premium is 3.7%.</u>

Q. Mr. Rothschild cites a Credit Suisse First Boston (CSFB) report to investors that shows an equity risk premium relative to government bonds of 3.7%. Please comment.

A. The CSFB report identifies a current market risk premium of 5.3%. The 3.7% figure cited by Mr. Rothschild is based on a CSFB "stress test" which assumes that earnings per share growth returns to the post 1948 trend, which is described as a conservative assumption. CSFB does not state whether or not it has adjusted for the flight to quality and Treasury buy-back premiums in the yields for Treasury securities at this time, or the unprecedented efforts by the Federal Reserve to mitigate the recession in the U.S. economy through lower interest rates.

Accordingly, insufficient information is available from the study to assess whether or not the 5.3% market equity risk premium is representative of reasonable investor expectations. Other issues that are important to assessing the reasonableness of the 5.3% estimate is CSFB's use of the earnings yield as part of the estimation process, an input that CSFB describes in another section of its report as a flawed model, and their assumption that earnings per share will grow after five years at only a 5% rate. This is roughly one-half the rate over the last economic cycle, and investor expectations for the next five years.

Q. Mr. Rothschild also notes that Federal Reserve Chairman Greenspan expects the equity risk premium to decline. Please comment.

A. Because the equity risk premium is volatile from year to year, it is reasonable to consider that Chairman Greenspan may have been thinking of an average of several years. For example, if one thought of the equity risk premium as the average over the last five years, and then moved backward in time adding one year to each new measurement period (5 years, then 6 years, etc.), the results show an equity risk premium for the last five years of about 11%. This method of measurement gives the most recent data more weight than earlier data. It is also clear from the chart showing this method for calculating the equity risk premium that the equity risk premium has been sharply increasing in the 1990s. Perhaps Chairman Greenspan's reference was to these equity risk premiums. Supporting data is shown in Schedule 18 of my rebuttal exhibit.

Nonetheless, had he been referring to the equity risk premiums for

1998 or 1999 (his comments were made in 1999 according to Mr. Rothschild), the Ibbotson equity risk premium for 1999 was 30.0% and for 1998 was 15.5%. I agree that equity risk premiums were likely to decline, and that is why I have used a much lower level to reflect reasonable investor expectations in my testimony.

Q. What equity risk premium do you believe investors are using at this time?

A. Based on Value Line projections for the Value Line Composite of about 1,700 common stocks, the projected total return is 16.9%. Using three different investor growth rate estimates, the expected total return for the S&P 500 is 14.4%. The normalized yield on long-term governments is currently 6.2%. These inputs indicate an expected equity risk premium that averages 9.5%. Supporting data is shown on Schedules 31 and 33 of my rebuttal exhibit.

Q. If Mr. Rothschild had used Ibbotson's long-term, arithmetic equity risk premiums using both the total return and income return, as well as the projected market returns you noted, what would his CAPM test show the investor required return to be for the list of companies comparable to Gulf Power Company?

A. The standard CAPM result would be 10.6% before flotation costs and transformation. It would also be necessary to consider the disconnect of electric stocks from the market which I referenced earlier, and the empirical research that shows beta understates risk for low beta stocks and stocks of small companies.

Accordingly, it is appropriate to use the empirical CAPM shown in my testimony that indicates a required market return by investors of 11.6%, before flotation costs and transformation. Supporting data for the CAPM results are shown on Schedule 33 of my rebuttal exhibit.

CAPM CONCLUSIONS

Q. Please state your conclusions about Mr. Rothschild's CAPM analyses.

A. As stated earlier, Mr. Rothschild's CAPM Version One is seriously flawed and, as presented, does not provide useful guidance for determining the investor required return for Gulf Power Company. His CAPM Version Two is biased downward for the reasons previously stated. When corrected to show representative investor expectations, the standard CAPM shows an investor required market return of 10.6% before consideration of the understatement by beta of risk for low beta stocks and stocks of small companies, both of which apply to Gulf Power Company. The empirical CAPM, which partially adjusts for the beta understatement, shows an investor required return of 11.6% before consideration of flotation costs and transformation.

Q. What regulatory return is necessary to produce the average return of 11.1% shown by the standard and empirical CAPMs in your updated testimony?

A. The necessary regulatory return to yield or produce an 11.1% market return to investors is 13.5%. Supporting data is shown in Schedule 19 of

my rebuttal exhibit.

OVERALL CONCLUSIONS ABOUT THE RESULTS OF MR. ROTHSCHILD'S DCF AND CAPM RESULTS

Q. What are your overall conclusions about the results of Mr. Rothschild's DCF and CAPM analyses for Gulf Power Company?

DCF and CAPM Conclusion

A. Mr. Rothschild's DCF and CAPM analyses are flawed from an investor perspective for the reasons noted in the foregoing analysis. Using investor expected returns on common stock equity, his single-stage DCF analysis shows an investor required market return of 11.5%. His two-stage DCF model, with appropriate modifications, shows the investor required market return using Value Line's expected return on common stock equity is 11.4%, and Zacks' 12.0%. My updated DCF analysis for Gulf Power Company using the investor projected five-year growth rate shows an investor required market return of 12.1%. These estimates are before flotation costs and transformation.

In order for investors to have a reasonable opportunity to earn the range midpoint of his two DCF model results shown above, or 11.7%, the necessary regulatory return is 14.2%, as shown on Schedule 16 of my rebuttal exhibit.

Mr. Rothschild's CAPM Version One has serious fundamental flaws. Therefore, I recommend it not be considered for determining the

cost of common stock for Gulf Power Company. His CAPM Version Two when corrected for its infirmities shows an investor required market return of 11.1% before flotation costs and transformation. The necessary regulatory return to produce an 11.1% market return for investors is 13.5% as shown on Schedule 19 of my rebuttal exhibit.

Overall, Mr. Rothschild's testimony when amended to reflect reasonable investor expectations, supports an allowed regulatory return for Gulf Power Company of 13.5% to 14.2%, or an average of 13.9%.

RESPONSE TO MR. ROTHSCHILD'S COMMENTS ON MY DIRECT TESTIMONY

Transformation, or the Process of Providing Investors with an Opportunity to Earn Their Required Return so that Capital Attraction and Reliable Customer Service Can Reasonably Occur

Q. Do you agree with the rationale stated in FERC and FCC decisions cited by Mr. Rothschild at page 17 of his testimony for rejecting the use of transformation in setting regulatory returns?

A. No. FERC's argument assumes an ability to control the price-to-book value ratio, and that doing so is in the customers' interest. Controlling the price-to-book ratio would be difficult, and would require frequent rate adjustments and administrative costs.

More importantly with respect to capital access, when interest rates decline, it reduces the cost of capital not only for electric power companies like Gulf Power Company, but for all securities. This causes prices for all securities to rise. If investors were confronted with two investment

opportunities -- one that was going to rise because interest rates are declining, while the other would not because the return and earnings would be reduced in response to the lower cost of capital - - it is clear what the investors' response would be. They would buy the stock expected to rise and reject the stock that is expected to decline in price to its book value. Since declines in interest rates can span several years, capital attraction for regulated utilities could be jeopardized for a considerable period of time.

From an investor perspective, this is not an attractive investment proposition. If interest rates are flat, the investor can earn the expected return and is not disadvantaged relative to other stocks. However, interest rates are seldom flat. If interest rates decline, the utility can seek rate relief, and after regulatory lag, presumably increase rates to compensate for the increase in the cost of common stock. Conversely, non-regulated companies can presumably raise prices to offset capital cost increases. On the other hand, if the cost of capital declines, the utility investor will suffer an opportunity cost loss because other common stocks benefit from the decline in interest rates, while it is taken away from investors in utility stocks. Utility stock investors could even experience negative returns if the price decline to book value exceeds the stock's yield.

Therefore, there is a serious capital attraction issue with FERC's argument. Because of the indispensable nature of electric service to commerce, jobs, and the quality of life for Gulf Power Company's customers, I believe it is important for the utility to have continuing access to the capital markets in both easy and difficult conditions. This is, I

believe, a prerequisite for reliable customer service at reasonable rates in the future. Setting rates at levels that would potentially repel rather than attract investor capital does not in my view serve the public interest.

Q. Mr. Rothschild's testimony indicates that when stocks are trading above book value, it is reasonable to drive the stocks downward in price to book value? Do you agree?

A. Definitely not. He notes on page 19 of his testimony that "If the stock price exceeds book value, a reasonable result of the new rate determination could be for the stock price to decline." Based on three decades of working with investors, I can safely report that investors will not buy a stock that is expected to decline in price.

Q. Do investors expect regulated utility stock prices to drop in price or to their book values?

A. No. If they did, the stocks would already be selling at the lower expected price, or at a price-to-book ratio of 1.0 times.

Q. Mr. Rothschild also cites a FCC decision on the same issue. Please comment.

A. The FCC decision cited by Mr. Rothschild essentially makes the same argument as FERC, and concludes that even though the price of the stock declines, that the Bluefield/Hope criteria are still met. Since interest rates can decline over a considerable period of time when investors would be attracted to stocks other than regulated companies, capital access could

be jeopardized which would be adverse to customer interests.

As noted in my response to the FERC order, denying investors an opportunity to earn a prospective return comparable to companies of similar risk will repel rather than attract investors, and jeopardize the ability of Gulf Power Company to attract capital and fulfill its customer responsibilities.

Q. Mr. Rothschild also quotes from the U.S. Supreme Court's Hope decision and notes that the common stock price is the end product of the rate making process, not the front end, and therefore, a reduction in value does not invalidate regulation. Please comment.

A. I do not believe the U.S. Supreme Court would sanction a method that would deprive investors on a prospective basis of a reasonable opportunity to earn their required return. To do so would impede the utility's ability to attract capital, ultimately harming the customers it serves.

Q. What has been the response of regulators to the argument presented by Mr. Rothschild?

A. As price-to-book value ratios have risen from about parity in 1985, regulators have been allowing higher returns on common stock equity than indicated by strict application of market-based models, as shown in Schedule 5 of the exhibit to my direct testimony. Over the last several years, the allowed regulatory returns have exceeded the DCF indicated return by 1 to 3 percentage points using the earnings-per-share growth rate version of the model. Regulatory commissions, by allowing higher

returns than indicated by market based models, do not appear to have followed Mr. Rothschild's recommendation to deny investors an opportunity to earn a fair market return on their investment by setting rates designed to drive stock prices down toward book value.

Q. Mr. Rothschild's remaining comments on your testimony begin with a summary on page 63. There he notes that your DCF analysis using the investor expected five-year growth rate is valid only if the growth rate for book value, earnings and dividends are constant. Please comment.

A. Mr. Rothschild assumes a degree of specificity that is beyond the normal scope of investor practice. Based on my experience, investors typically use a five-year earnings growth rate in assessing expected market returns.

The use of earnings versus dividends is confirmed by a survey of investor practices cited on page 6 of Schedule 7 of the exhibit to my direct testimony. The survey shows that earnings was the top choice among cash flow, book value, earnings, and dividends for the most important variable in valuing a security. Of 297 respondents, only three respondents chose dividends, and only five chose book value. Both dividends and book value were at the bottom of the list among the four choices. If constancy of book value and dividend growth was important to investors in their valuation process one would expect them to be as important as earnings to investors.

Moreover, if investors ignored the five-year earnings growth rate because of the lack of growth constancy, and relied instead on the

sustainable growth rate favored by Mr. Rothschild, one would reasonably expect that First Call, I/B/E/S, Value Line, and Zacks would all provide sustainable rates of growth. The fact of the matter is that they all supply five-year earnings growth rates. Only Value Line provides a sustainable growth rate, which is based on year-to-year data, and is, therefore, not meant to be applicable to the long-term future.

Based on my experience, the sustainable growth rate method, which in its simplest form, consists of just two variables, does not provide investors with the detail they require for making investment decisions.

Nonetheless, the difference between using the investor practice, or five-year earnings growth rate, versus the sustainable growth rate preferred by Mr. Rothschild using investor expected returns on common stock equity, is not substantial enough in my view to justify his objection to investor practice.

Q. If Mr. Rothschild had used the same method as investors for determining expected total return, or investor five-year earnings growth expectations plus the yield, what would the analysis show the investor required market return to be?

A. The indicated investor required return would be 12.1%, as shown in my updated DCF analysis on Schedule 27 of my rebuttal exhibit. This result is not substantially different from the 11.5% shown by Mr. Rothschild's single-stage DCF analysis using investor expected returns on common stock equity rather than his, and 11.4% to 12.0% for his two-stage DCF analysis when again using investor return on common stock equity

expectations.

Q. Mr. Rothschild states that use of the five-year growth rate can lead to ever increasing returns on common stock equity. Please comment.

A. Mr. Rothschild states that if the earnings per share grow more rapidly than book value, the return on common stock equity will increase. This is true, but the reverse is also true. Further, after determining the investor expected market return, I have used the sustainable growth rate method for the transformation process. Therefore, Mr. Rothschild's concern that the return on common stock equity would continually rise if earnings grow more rapidly than book value, and fall when earnings grow less rapidly than book value is not relevant. Moreover, when using a number of companies instead of just one, as Mr. Rothschild did, there is a chance for offsetting outcomes regarding this issue, since more rapid growth in earnings than book value by one company may be offset by the reverse in another company.

From still another perspective, the DCF model results using either the investor return on common stock equity expectation (11.5% using his single-stage DCF, and 11.4% to 12.0% using his two-stage DCF results), or the investor five year earnings growth rate expectation (12.1% shown in the update on Schedule 27 to my rebuttal exhibit) are similar.

Q. Mr. Rothschild alleges that you failed to take into account a downward trend in risk premiums. Please comment.

A. Whether or not one finds a downward trend in risk premiums depends on

the data one chooses to examine. The 1926-2000 Ibbotson data shows that equity risk premiums have been rising from about 4 percentage points in the early 1970s to about 11% for the most recent five years ending in 2000. Supporting data is charted in Schedule 18 of my rebuttal exhibit. Mr. Rothschild, on the other hand, uses a 30-year moving average as shown in Schedule 17 of my rebuttal exhibit. The latter shows for the most recent 30 years an equity risk premium about 4% in the mid-1990s.

Overall, it is best to use the long-term, arithmetic equity risk premium results for the stock market versus long-term governments, which is 7.3% using total returns, and 7.8% using income returns. This is a less arbitrary method than Mr. Rothschild uses. The data go back in time as far as quality inputs are available, and includes many event types that could be considered by investors to the extent that they use long-term, historical data to determine expected equity risk premiums.

Q. Please respond to Mr. Rothschild's comments on the process that you call transformation in your testimony.

A. The problem with Mr. Rothschild's objection is that he does not recognize the difference between book and market returns and improperly equates the investor required market return to the return that the Commission should allow for regulatory purposes. The investor return is a market return and the regulatory return is a book return. When stock prices are materially above book value, as they now are, using the investor required market return as the book regulatory return will not produce the investor required market return. Accordingly, investor expectations will not be

fulfilled, and knowledgeable investors will invest their capital elsewhere. This in turn will jeopardize the ability of Gulf Power Company to attract capital and fulfill its customer responsibilities.

In fact, Mr. Rothschild is not true to his own analysis of investor required returns. For example, he determined that the investor required market return was 10.0%, but as shown on Schedule 12 of my rebuttal exhibit, a 10.0% return on common stock equity will produce only a 7.3% achievable market return to investors. Therefore, his recommendation contradicts his analysis, since the return he recommends for Gulf Power Company will not enable investors to have an opportunity to earn the return he testifies they require. This is explained in greater detail along with a mathematical example on pages 13-20 of my direct testimony.

Q. Do you agree with Mr. Rothschild's claim that when transformation is used the higher the stock price, the higher the return on common stock equity that would be recommended?

A. No. Mr. Rothschild's claim is wrong, and illustrates that he either does not understand the transformation process, or is unwilling to provide investors with an opportunity to earn their required market return. This is clearly shown in the side-by-side example on Schedule 20 of my rebuttal exhibit, which shows why transformation is necessary. In the first of two examples, or "Price Up-Constant ROE," the expected market return is 10.7% based on a return on common stock equity expectation of 13.0%, a price of $35 for the stock, and a book value of $25, as shown in Column A.

If the price of the stock rises from $35 to $40, the investor required

market return declines to 10.0% as shown in Column B. The investor expected return on common stock equity in this example does not change, and the required regulatory return continues at 13.0%, instead of increasing as indicated by Mr. Rothschild.

Concurrently, if the investor expected return on common stock equity declines to 12.5% from 13.0% in the second example in Column F, while the price also rises from $35 to $40, the investor expected market return becomes 9.5% and is consistent with the lower expected return on common stock equity of 12.5% as shown in Column H.

Q. Are earnings necessarily excessive when prices are above book value?

A. No. Mr. Rothschild assumes that earnings are excessive when prices are above book value, and that transformation perpetuates excessive earnings. Mr. Rothschild may think that earnings are excessive, but investors do not, or they would not pay more than book value for regulated utility stocks. Based on investor expectations, the stocks are fairly valued and fairly reflect future cash flows. Cutting the return and earning power, such that common stock prices are driven down to book value would damage investor confidence, repel rather than attract investors, and hurt Gulf Power Company's financial integrity and ability to serve its customers.

Q. Does transformation protect investors from stock price declines?

A. No, transformation does not insulate investors from market risks, but simply provides them with an opportunity to earn their required return.

Transformation avoids driving stock prices to book value, thereby enhancing the ability of investors to earn their required return, so that Gulf Power can attract the capital necessary to continue providing reliable electric service in the future.

CAPM Analysis

Q. On page 79, Mr. Rothschild raises five objections to your CAPM analysis. Please respond.

A. I have previously responded to all but one of these objections earlier in this rebuttal testimony. With regard to the appropriate bond return to use in the CAPM, Mr. Rothschild prefers to use Treasury bills rather than Treasury bonds. However, his CAPM analysis using the Treasury bill results in a return below that of single A utility bonds, which is an untenable conclusion. Investors favor the use of long-term not short-term debt for investment purposes. In my judgment, this is because the long-term Treasury bond better matches the perpetuity term of common stocks, is much more stable than Treasury bill yields, and is much less controlled by the Federal Reserve. The latter point is particularly relevant at this time. Treasury bill yields are very low at this time because of unprecedented rate reductions by the Federal Reserve to mitigate the recession underway in the U.S. economy.

Q. Mr. Rothschild objects to the use of a five year growth rate in the CAPM because he claims that the base year for establishing the growth rate was a recession year when earnings would be depressed. Please comment.

A. Mr. Rothschild fails to recognize that the year 2000 was not a recession year.

Q. Mr. Rothschild on page 90 reiterates his position that equity risk premiums have been declining using the 30 moving average of Ibbotson's 1926-1999 returns, and that your historic equity risk premium is too high. Please comment.

A. Equity risk premiums have been rising as previously noted in my testimony. Comparisons of one method versus that used by Mr. Rothschild are provided on Schedules 17 and 18 of my rebuttal exhibit, both of which employ the same data. Relevant to this issue is the investor expected, market equity risk premiums shown in the update to my testimony on Schedule 33. Investor expected equity risk premiums based on projected market returns for the Value Line Composite and S&P 500 (using three different growth rate estimates) average 9.5%, which is almost double the equity risk premium that Mr. Rothschild believes investors expect.

Q. On page 91, Mr. Rothschild states that Treasury bonds are not risk free since they do not have a zero beta. Do you agree?

A. Mr. Rothschild is correct that longer-term investments such as Treasury bonds have more risk than Treasury bills, or higher than a zero beta -- that is, if one can believe that there is no reinvestment risk for Treasury bill investors. Bill versus bond investors must continually roll over their investments, and when interest rates are declining so are bill rates.

Meanwhile, the value of the bond is rising as investor required returns decline. The reverse is also true.

Even if one assumes that Treasury bonds have more risk than Treasury bills, it is long-term bonds not short-term Treasury bills that investors primarily use. This is because investors prefer comparisons with long-term not short-term bonds because they better match the duration risk of stocks than short-term investments such as Treasury bills. Treasury bill yields are primarily controlled by the Federal Reserve and not investors, and therefore, are not always indicative of investor expectations. For example, not many months ago bill yields were 6% compared to less than 2% currently. Bill yields are also much more volatile than Treasury bond yields. From an investor perspective, therefore, Mr. Rothschild's criticism is without merit.

Q. Mr. Rothschild's next concern is that your CAPM analysis using a 5.4% yield on long-term Treasury bonds would show an investor expected market return of 9.3% to 10.2%. Do you agree?

A. I do not agree that the 9.3% to 10.2% is representative of investor expectations because of the flight to quality and scarcity premiums now present in long-term Treasury bond yields. This is covered in Schedule 8, pages 3 to 6 of the exhibit to my direct testimony.

Mr. Rothschild appears to agree. He notes on page 14 and 15 of his testimony:

> While I normally have made a specific adjustment to the lower the indicated cost of equity for risk specific reasons, in the current

marketplace the yields on long-term bonds already reflect the flight to quality caused by uncertain economic times and stimulating effects of the Federal Reserve Board.

Again, due to current economic conditions, there are temporarily problems with using treasury securities in a risk premium analysis based upon historic risk premium relationships. Therefore, I have only summarized the results of a risk premium analysis based upon long-term corporate bonds.

Comparable Earnings

Q. Mr. Rothschild states that you used higher risk industrial companies for your comparable earnings analysis. Do you agree?

A. No. Schedule 10, page 6, of the exhibit to my direct testimony clearly shows that this is not so.

Q. Please respond to Mr. Rothschild's suggestion that the comparable earnings method does not provide useful information to the Commission.

A. As previously noted in Schedule 10 of my direct testimony, and in my comments about transformation in this testimony, the growth rate used by investors is fundamentally tied to their return on common stock equity expectation. When denying the validity of comparable earnings, therefore, one is also denying the growth rate in the DCF model, or the results of the DCF model. Mr. Rothschild should not expect to have it both ways – using the investor expected return on common stock equity, or "r" in his "br+sv" method for his DCF analysis while denying its validity in the

comparable earnings method. It is necessary for Gulf Power Company to have a regulatory return comparable to investor expectations so that its common stock can provide investors with the market return they require.

Q. Does your comparable earnings method overlook the capital attraction standard?

A. No. Mr. Rothschild argues that capital is raised at the price of common stock and not its book value, which is correct. However, the price of the stock reflects investor expectations of the cash flows (using the DCF model) they expect to receive. As Mr. Rothschild's testimony clearly shows, these cash flow expectations are driven by the return on common stock equity and the retention rate in the simple form of the sustainable growth rate model. This is clearly shown on Mr. Rothschild's Exhibit JAR 5.

Q. What is the linkage between the return on common stock equity and the growth rate in the DCF model?

A. Each of the transformation schedules accompanying my market based models show the relationship between the return on common stock equity and the growth rate ("br" growth rate, where "b" is the retention rate and "r" the return on common stock equity). The connection or interrelationship is also shown on Mr. Rothschild's JAR 5. Mr. Rothschild states that in implementing his two-stage DCF model on page 46 of his testimony, he "determined future earnings in the second stage of the non-constant DCF model by multiplying the future book value per share by the future

expected earned return on book equity." This statement is itself evidence of the linkage that he later claims does not exist.

Flotation Costs

Q. Mr. Rothschild states that any flotation costs are more than offset by the accretion to book value from the sale of common stock above book value. Do you agree?

A. No. The companies on the list of Gulf Power's comparable companies have not always sold above book value. Furthermore, the accretion to book value is part of the growth rate expected by investors according to the testimony of Mr. Rothschild, who uses the "br+sv" form of the sustainable growth rate method. Clearly, if it is part of growth rate expectations it cannot also be flotation costs.

Q. Do you agree that a 0.2% allowance for flotation cost must be excessive?

A. No. Mr. Rothschild develops an exaggerated example in an attempt to show that financing costs are almost 50% of the new equity raised. His example is flawed because his $984,000 relates to all previous stock issuances. The flotation cost for a $2 million new issuance at 3% would be only $60,000.

MODEL UPDATE

Q. Mr. Rothschild's testimony makes reference to a number of reports and sources of data that are more recent than those you relied on in your

direct testimony. Have you updated your analysis?

A. Yes. In response to Staff's Production of Documents Request No. 55, I have updated my DCF results, equity risk premium analysis, CAPM model and comparative earnings model using the most recent information on stock prices, bond yields, Value Line earnings and dividends projections and other data. Updated schedules reflecting this information are attached as Schedules 21 through 35 of my rebuttal exhibit.

Q. Did you make any other changes when you updated your schedules?

A. Yes. It came to my attention that the bond ratings provided by C.A.Turner in two instances were incorrect at the time my testimony was prepared. The senior, utility debt rating for Progress Energy by S&P is "BBB+" and for TECO Energy "A." The relevance of the incorrect bond ratings is that Progress Energy with a "BBB+" bond rating would not have met the selection criteria noted on Schedule 6, page 6, of the exhibit to my direct testimony for inclusion on the list of comparable companies. Further, the indicated risk of the comparable companies relative to Gulf Power Company, based on the bond rating comparison, would have been understated. My updated exhibits, therefore, exclude Progress Energy from the comparable company group.

Q. What was the impact of the change to your analysis?

A. There was a slight increase in the indicated cost of common stock when deleting Progress Energy from the comparable company group. This increase would be mitigated by the higher than previously acknowledged

risk of the comparable companies relative to Gulf Power Company based on a bond rating comparison.

Q. Do you believe that the change to your comparable group of companies, therefore, would have a meaningful impact on the cost of common stock estimate for Gulf Power Company?

A. No.

Q. What are the updated results of your recommended return on common stock equity for Gulf Power Company?

A. The updated results show a moderate increase in the cost of common stock for Gulf Power Company. The average of the four tests used show an average cost of common stock of 13.6%, and the midpoint of the 13.2% to 14.2% range is 13.7%. Supporting data is summarized on Schedule 21 and detailed supporting data appears on Schedules 22-35 of the exhibit to my rebuttal testimony. Recognizing the slightly higher risk difference between Gulf Power Company and its comparable companies than apparent in my direct testimony, its lower financial risk, all electric revenue derivation, higher regulatory ranking, and its relatively small size, it is my judgment that Gulf Power's cost of common stock is slightly higher than the 13.0% previously recommended. Nonetheless, basing my recommendation on the nearest one-quarter of a percentage point, the updated cost of common stock for Gulf Power Company continues to be at least 13.0%.

Q. Does that conclude your rebuttal testimony?

A. Yes, it does.

CHAIRMAN JABER: Yes. The prefiled rebuttal testimony of Mr. Benore shall be inserted into the record as though read.

MR. MELSON: And, Commissioner, there was a corrected version of the testimony that was filed several days after the original. I believe for the testimony it involved changes on several pages that are indicated as revised. It was filed on January 28th, so it is the revised rebuttal that we would want to have inserted.

CHAIRMAN JABER: Okay. It is the revised rebuttal testimony of Mr. Benore that was filed January 28th shall be inserted into the record as though read. I'm assuming you all are in agreement on this, and there are no objections.

MR. BURGESS: Madam Chairman, on a separate note you are correct in your assumption with regard to me on what you just said. I have just looked through this exhibit, and I would object to it being used. The agreement that I had was that each of our witnesses would provide a summary and would offer the testimony, and there would be no cross. And I realize this is excerpts from it, but nevertheless it is a document that I had not anticipated, and I had not agreed to, and it is a tool that was used that I think is something that is not part of the agreement. So I would object to it being used as he explains his summary.

CHAIRMAN JABER: Okay. Well, we are not there. Hold

onto that thought, but I have noted your objection.

MR. BURGESS: Thank you.

CHAIRMAN JABER: Okay. We have handled inserting the testimony. Mr. Melson.

BY MR. MELSON:

Q Mr. Benore, you had one exhibit identified as CAB-2 consisting of schedules numbered 12 to 15, is that correct?

A I'm sorry, 12 to --

Q I'm sorry, 12 to 35.

A Yes.

Q And, again, a revised set of exhibits was filed with the revised testimony on January 28th. Do you have any changes or corrections to the January 28th version of that exhibit?

A No, sir.

MR. MELSON: Chairman, I would ask that Exhibit CAB-2 be identified as Exhibit 29.

CHAIRMAN JABER: The Revised Composite Exhibit CAB-2 shall be identified as Composite Exhibit 29.

(Composite Exhibit 29 marked for identification.)

BY MR. MELSON:

Q Mr. Benore, would you please summarize your rebuttal testimony.

CHAIRMAN JABER: Okay. Before we do that, Mr. Melson, there has been an objection to the use, even the use of the handout that you passed out to the Commissioners. Why

don't you go ahead and address that objection.

MR. MELSON: Commissioner Jaber, Mr. Burgess is correct insofar as we did not discuss specifically the use of a handout. We did discuss a summary of testimony. Mr. Benore would essentially use this as notes to present his summary. Every page in the document can be referenced directly back to a page in his testimony or as an existing schedule to his testimony. We just thought the summary would be easier to follow along if the Commissioners and the other parties had in front of them the specific pieces of the testimony that were being summarized.

CHAIRMAN JABER: Mr. Burgess.

MR. BURGESS: Commissioners, again, I just think it is improper, it is counter to the agreement. We didn't put together anything, we didn't agree on it. We had a specific agreement and it did not include an additional exhibit with an exhibit number that is going to be brought in. I just think it is something that was not contemplated, and I do not consider it to be part of our agreement.

CHAIRMAN JABER: Mr. Melson, I'm going to go ahead and sustain the objection, recognizing I'm not really sure what the objection is, other than you all didn't have a meeting of the minds on the use of the exhibit. So we are not going to refer to the exhibit. And to the degree that puts Mr. Benore in the position of pointing out to us in testimony and on his

prefiled exhibits where he would like us to look, I will allow that leeway.

MR. MELSON: All right.

BY MR. MELSON:

Q Mr. Benore, can you summarize your rebuttal testimony, please.

A Yes, I would be pleased to. I found a number of concerns about Mr. Rothchild's recommended 10 percent return on common stock equity. Among the very most important of these is that he ignored investor return on equity expectations. They range from 13.5 to 14.85 percent, but he employed 12 to 13.5 percent in his DCF models. The rationale he used is that investors are too optimistic. They overestimate. And furthermore historical returns on equity in recent years were not as high as those that investors now expect.

There are two problems, I believe, with that analysis. One, investors invest on the basis of expectations, not on after-the-fact results. And the second problem that I have is that whatever historical guidance can be found in historical data is already imparted into or part of their expectations for the future. So I think he made a serious fundamental mistake when he abandoned investor expectations of 13.5 to 14.85 percent on common stock equity and instead used his own.

Fundamentally, neither I nor Mr. Rothchild have the

capital to sustain the electric power industry or Gulf Power's necessary investments. Therefore, I do not think that rate of return experts like myself, and I would include others as well, should impart their own expectations in their analysis when there are very clear and obvious investor expectations about the issues that they are overwriting.

A second major problem, and it is a serious one, I calculated, amounts to about three-quarters to a full percentage point error in his approach, is that in his two-stage DCF model he starts the second stage with the dividend policy in the first stage. I think it was a 41.33 percent retention rate.

What he should have done, in light of progression in time and investor expectations, is to use a terminal rate that investors had put in place for the year 2005, which was 47.39 percent. Using the 41.33 percent instead of the 47.39 percent and a simple sustainable growth rate model, the return on equity times the retention rate and the various runs that he made generally fallout to diminish or reduce the investor expected return by three-quarters to one percentage point. That is a haircut that clearly should not be pushed onto investors.

The very latest data shows what the dividend policy expectations are that run through the year 2005. He should not go back in time and find some other lower number that gives the

growth rate, gives a lower growth rate. I don't think that is proper, and I would seriously, from an investor perspective, object to that.

He also ignored the very small size of Gulf Power. And I don't mean that in a demeaning way for the people of Gulf Power in any sense, it is just a fact. And we think in the marketplace and have credible evidence to show that smaller companies don't have the same resources to work with to guide their company as do larger companies. And that imparts more uncertainty and more volatility to their results. That means to the investment community that business risk is higher.

And this factor in and of itself according to Ibbotson Associates' study on size premia would increase the cost of common stock equity based on their data by three-quarters of a percentage point. I believe that to be inappropriate in light of the constructive regulatory environment in this state, especially the use of adjustment clauses. And on a net basis, factoring in the constructive nature of regulatory policy in Florida, I have allowed only a quarter for that in my judgment, but it is something I still think should not be ignored.

He also ignored flotation costs. And I think I heard Mr. Rothchild say that they are small. FERC calculates them to be 2/100ths of a percentage point, if I have that correct. Therefore, they are inconsequential. I don't think they are

inconsequential at all, and I think they are on the order of about 20 basis points. He explains when stocks are selling above book value, you can sort of ignore it. But what he does is to incorporate that into the growth rate, and he shouldn't double count it by using it in the growth rate as well as saying, well, because of it I can also ignore flotation costs. It just doesn't add up and make sense to me.

But most importantly, most importantly, Mr. Rothchild's recommendation of 10.0 percent will only yield a 7.3 percent market return to investors. This is less than the yield of 7.7 percent on Moody's Single A utility bonds, which is the same rating of Gulf Power Company.

And turning to the exhibits now that I need to progress in that way, I show on my Schedule 12 the mathematics where a 10 percent regulatory return will only produce a 7.3 percent return to the investor. And I show in the lower table on that very same exhibit that in order for investors to have an opportunity to earn the 10.0 percent that he recommends, that a 12.7 percent return on common stock equity is necessary.

I also found it very interesting in Mr. Rothchild's comments on my testimony, which I respect, and they were delivered in a constructive way for which I am grateful, but I do politely disagree. For him to say that I'm trying to overthrow Hope Bluefield, Permian, Basin and Duquesne is simply certainly not meant, and I believe to be fallacious. What

transformation does simply, and please note, he did not refute the example. He mentioned the example, and it is on Page 5 of the original handout, if that is still an exhibit and available to you. If it was not allowed, it is in my direct testimony. And perhaps someone will help me find the citation of that so that I don't waste your time. But please note that he did not refute that if this Commission allows 10 percent on common stock equity, that the return that the investor can reasonably expect to achieve in the marketplace will be substantially less.

And the example that was shown on Page 5 of the original handout, which is close to what the market looks like today, shows that when a 10 percent return is allowed only a 7.0 percent will be realized. So I would have to say I don't believe that Hope Bluefield really said you should not provide investors with an opportunity to earn their realized return. And that is all, in fact, that transformation attempts to do.

Moving further along in my summary to his CAPM, it is based effectively on a 4 percent equity risk premium or a market return over the return on long-term U.S. Government Bonds. That is very, very low. In fact, you will find in my rebuttal testimony on page -- you will find a graph there. And what the graph shows is that if you plot the 30-year moving average of equity risk premiums from 1926 to the year 2000 for the Ibbotson data, the 4 percentage points is about as low a

number as you will be able to find for that entire period of time. And I believe that on its face it is unrepresentative of reasonable investor expectations. I finally found that, it is Schedule 17. If you just run your eye there you will see that the range has been from about 14 to 3 percent, and 4 is about as low as you can go. And I think that is unrepresentative.

And if you turn to Schedule 18 of the same exhibit, this shows the equity risk premium formated in a different way. It starts off in the year 2000 with the last five years, which was an average of about 11 percent. And for each successive year that you go backward in time it adds a year. So the first data point in 2000 is five years, the next one in 1999 is six years, seven years, eight years, et cetera.

And what you can see there is that the equity risk premium recently has certainly been much higher than 4 percentage points. Again, 4 is about as low as it has ever been in history by this measure. And, in fact, the equity risk premium has been rising, not falling. So I believe Mr. Rothchild has erred in terms of using a equity risk premium for his CAPM model that is severely low and unrepresentative of investor expectations.

One last thing, if I may, that I would like to refer to is that Mr. Rothchild said in his testimony that the error with transformation, and this isn't a pure quote, but it's pretty close, the error with transformation is at best

illustrated -- I take that to mean his best shot -- by noting that the higher the stock price, the higher the ROE that Benore would recommend. This is not true as shown in the two examples on this page, which is in your documents a table that is shown on Page 20. And that table really has two parts. And the first part shows that when the price goes up, presumably because interest rates have declined, the ROE can remain constant.

What happens here, contrary to what Mr. Rothchild said and apparently believes, is that the ROE doesn't have to go up. What happens is that the investor return goes down. That is shown in Column B, Line 10, where it dropped to 10 percent when the price went to 40 from 35. That is shown in A and B, row one. The investor required return dropped from 10.71, in Column A, row 10, to 10.0 percent.

And, furthermore, I have tried to make a more complex example to incorporate another objection that Mr. Rothchild presumably could have made, and that is that when the price goes up there is no way the ROE can go down. Well, this shows that that would be not true, as well. Here in the next example to the right of the long vertical line, the price goes up from 35 to 40 and the investor expected return goes down from 13 to 12.5 percent. And, again, the investor required return is the adjustment process, not the return on common stock equity. So when prices go up, it doesn't necessarily follow as he says

that the ROE that transformation would suggest would go up. I think this demonstrates that that is not true.

And, finally, I would like to thank you for your patience, and for your patience especially as I stumbled around here trying to find these exhibits which I had not anticipated the need to do. And for the opportunity, again, to express my views about the cost of common stock for Gulf Power Company, which I continue to believe is 13.0 percent. Thank you. If you have any questions, I would be pleased to try to respond to them.

CHAIRMAN JABER: Thank you, Mr. Benore. I have one. We have heard a lot about the Hope case with your testimony and with Mr. Rothchild's testimony. Is it your position that your recommendation is consistent with the Hope case, or is it your position that Hope is inapplicable to what you recommend?

THE WITNESS: I believe it is applicable and that my testimony is consistent for this very fundamental reason. Investors, as even Mr. Rothchild notes in his testimony, should have an opportunity to earn their cost of capital. He defines the cost of capital differently than I do, but I think the point is still a valid one; that is that investors should have an opportunity to earn their cost of capital. And as I showed in, I believe it was on Page 5 of the first handout, that is a practical impossibility to do under current market circumstances. And that is an example that neither Mr.

Rothchild, or any other intervenor, or staff, or Commission to the best of my knowledge has refuted.

I am aware of no refutation of that mathematical example that I also believe is representative of today's situation in the marketplace. So I believe my testimony to be compliant with Hope and Bluefield, that is, to give a company financial integrity, which I think presumes the ability to provide investors with their required return so that in turn they can attract capital and be in a position to provide reliable and continued service to their customers.

CHAIRMAN JABER: Commissioners, any questions?

COMMISSIONER DEASON: Yes, I have just a few questions. You indicated that you consider there needs to be a 25 basis point -- I believe it is 25 basis points --

THE WITNESS: No, 20.

COMMISSIONER DEASON: No, 25. You're anticipating my question again.

THE WITNESS: I'm sorry.

COMMISSIONER DEASON: 25 basis point adjustment for the size of Gulf Power, is that correct?

THE WITNESS: Yes.

COMMISSIONER DEASON: Okay. I suppose Gulf is a small company in relation to other Florida investor-owned utilities, but Gulf is also part of a much larger company, being the Southern System. And it is, in fact, Southern which

actually issues the stock. So why is it that Gulf needs a small company premium?

THE WITNESS: Yes. I believe that each company should stand on its own feet, and there should be no cross-subsidization. And because small companies do have higher returns that have been returned in the marketplace over time, it is evident that investors require of them higher returns. This would be applicable based on the Ibbotson risk premia studies, and I believe that it is an appropriate cost attributable to Gulf Power Company because of its small size.

It would be my judgment that that is a cost that is a real cost, but one that should not be passed on to the other customers of the Southern Company system, that is Alabama Power, Georgia Power, Savannah. That cost should be recognized, I believe, and borne by its source or the cost should follow causation. And I believe in this case because of the small size of Gulf Power, that higher return should be borne by this company.

COMMISSIONER DEASON: I don't follow when you say that we should not have Alabama or Georgia subsidizing Gulf. You recommend that they --

THE WITNESS: Well, if you --

COMMISSIONER DEASON: Let me ask my question.

THE WITNESS: I'm sorry.

COMMISSIONER DEASON: If you were testifying on

behalf of Georgia Power, would then you indicate that they need a lower ROE than what you recommend for Gulf Power?

THE WITNESS: They were at a sufficient size where the risk premia study would show that they don't require a higher return.

COMMISSIONER DEASON: You're playing games. They don't require higher, does that mean that they require a lower ROE than Gulf Power?

THE WITNESS: All other things being equal, yes, they would require a lower ROE than Gulf Power.

COMMISSIONER DEASON: Have you testified on behalf of Georgia Power?

THE WITNESS: I did.

COMMISSIONER DEASON: And did you testify to that to the Georgia Commission?

THE WITNESS: It was certainly part of my testimony that a risk premia was not required of them.

COMMISSIONER DEASON: Not a risk premium, but a risk negative adjustment. In other words, they should have a lower ROE because they are larger.

THE WITNESS: Right. There are risk differences between Georgia and Gulf, and when I made my recommendation I was mindful of those differences. In making a judgmental difference between their cost of capital and that of the comparable companies, I did consider the size. Their size was

such that a premia, or an additional compensation or addition to their return was unnecessary. When I made that same analysis for Gulf Power Company and compared them -- I think it is 640 or 630 million of market capitalization versus approximately 5 billion for its comparable companies, it was obvious that this was a much smaller company relative to the comparable group against which its costs was being measured. Because of that, an increase in the return of Gulf relative to its comparable companies was required, and I am recommending that that be a quarter of a percentage point.

COMMISSIONER DEASON: Is that the same as saying that we should deny Florida ratepayers the efficiencies and benefits of Gulf being part of a larger company?

THE WITNESS: I'm not addressing that issue at all, sir. I am just addressing the cost of common stock equity as it relates to the size of the company.

COMMISSIONER DEASON: Okay. I have a question. And just for ease of reference, I don't know if this is going to be an exhibit or not, but it was your handout, which is Page 3 of that handout.

THE WITNESS: Yes.

COMMISSIONER DEASON: And here you are indicating that the actual return of a -- a regulatory return of 10 percent is actually 7.33 percent.

CHAIRMAN JABER: Commissioner Deason, let me

interrupt you for just a minute, because I think actually the objection went to even using this, but Mr. Melson represented that this same page could be found in an exhibit, so --

MR. MELSON: Schedule 12.

MR. BURGESS: Commissioner, my comments went to the first page of the bullets that set out -- changed language a little bit and set out -- otherwise I have no problems at all with it. That was the only concern I had.

CHAIRMAN JABER: Then for the sake of ease, we are going to look at Page 3 of the handout.

COMMISSIONER DEASON: Very good. I'm trying to understand the dynamics of this analysis, and tell me if I'm wrong. It appears to me that if for purposes of this calculation, if the price of 34.80 were actually $22.76, that the investor return and the regulatory return would be the same?

THE WITNESS: Yes, sir.

COMMISSIONER DEASON: Okay. So why is it that because investors are willing to bid up the price of the stock above its book value, that that means that they require a higher return?

THE WITNESS: The $34.80 is the average price for the comparable companies from Mr. Rothchild's testimony. That price represents investor risk and return valuations relative to other investment opportunities in the marketplace. So when

they look forward and estimate what they expect this company will be, or these companies, the comparable companies will be able to earn in the future, and place a value on those earnings, they believe their worth of $34.80 a share, and that is what they are willing to pay for them in the marketplace today. So that is how that valuation gets to be what it is.

COMMISSIONER DEASON: So explain to me again what the 34.80 represents? That is the price of comparable companies?

THE WITNESS: The average price, yes, sir.

COMMISSIONER DEASON: And then what relation does that have, then, to the -- the book value of 22.76, is that also the book value of the comparable companies?

THE WITNESS: Yes, sir.

COMMISSIONER DEASON: And what are the comparable companies, are they regulated or unregulated?

THE WITNESS: They are regulated electric power companies, and they are the same -- Mr. Rothchild used the same comparable companies that I did in my testimony, and he -- I'm just opening his testimony JAR-5, Page 7. They are Allegheny Energy, Alliant --

COMMISSIONER DEASON: That's fine. There is a list within your testimony?

THE WITNESS: Yes, I think you will find a list in both of our testimonies. The only difference that I would note for your consideration is that in one of his DCF tests he also

used Southern Company. I did not use Southern Company in any of the analyses in my testimony.

COMMISSIONER DEASON: Well, I guess what I'm trying to understand is it appears that the dynamics of this is that if investors are willing to bid up the price of a company or a group of comparable companies higher than its book value, that the more they bid that up they are saying they are demanding a higher return than what the regulatory return would be.

THE WITNESS: I guess I can't follow the logic, if I may put it that way, of relating it to the regulatory environment and the like. What it does represent is their valuation of the future earnings of the company. And as Mr. Rothchild points out, investors expect a 13.5 to 14.85 percent return on equity for those comparable companies. So that expectation to a large extent is what is driving the price that they are willing to pay for that stock.

CHAIRMAN JABER: Commissioners, any other questions?

Mr. Benore, on the other side of the equation, if we were to consider the size of Gulf Power, shouldn't we also consider the fact that the customer base will increase according to Mr. Bowden's testimony, number one; and, number two, shouldn't we factor in the fact that electric companies can take advantage of various clauses?

THE WITNESS: I believe growth is important to the investment community, and there is probably more growth for

this company than there is for the typical electric power company. But I believe that that is something that would already be factored into their expectations.

Furthermore, with regard to the adjustment clauses, as I previously indicated, and I apologize if I have overlooked it, the risk premia studies using Ibbotson data would indicate a cost of common stock equity higher than the comparable companies by about three-quarters of a percentage point. I firmly believe that because of the fuel, the purchased power, the environmental and capacity clauses that is afforded to Gulf Power Company by this constructive regulatory jurisdiction mitigates that risk. And, therefore, I would recommend with respect to the size issue or higher risk caused by the company's smaller size to be substantially mitigated by these constructive practices, and use only a quarter instead of a three-quarter point higher return increment.

CHAIRMAN JABER: Thank you.

Redirect, Mr. Melson.

MR. MELSON: No redirect. And we would move Exhibit 29.

CHAIRMAN JABER: Okay. Composite Exhibit 29 is admitted into the record without objection.

(Composite Exhibit 29 admitted into evidence.)

CHAIRMAN JABER: Thank you, Mr. Benore.

THE WITNESS: You're welcome.

MR. MELSON: And may Mr. Benore now be excused?

CHAIRMAN JABER: Yes. And that brings us, Gulf Power, to Mr. Saxon.

MR. BADDERS: Yes, ma'am. He is taking the stand at this time. We are ready to proceed.

CHAIRMAN JABER: Okay.

- - - - -

R. MICHAEL SAXON

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

DIRECT EXAMINATION

BY MR. BADDERS:

Q Mr. Saxon, have you been sworn this morning?

A Yes, I have.

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

A Yes. My name is Michael Saxon, my address is One Energy Place, Pensacola, Florida.

Q And by whom are you employed and in what capacity?

A I'm employed by Gulf Power Company as Manager of Corporate Planning.

Q Have you prefiled direct testimony consisting of 16 pages?

A I have.

Q Do you have any changes or corrections to that

testimony?

A I do. On Page 7, Lines 4 and 5, and on Page 16, Line 8 --

CHAIRMAN JABER: Let's take them one at a time.

THE WITNESS: I'm sorry. Okay.

CHAIRMAN JABER: That's okay. Page 7.

THE WITNESS: Page 7, Lines 4 and 5, change 2.1 million to 1.8 million. Page 16, Line 8, change 2.1 million to 1.8 million.

BY MR. BADDERS:

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

A Yes, they would.

MR. BADDERS: We ask that the prefiled direct testimony of Michael Saxon be inserted into the record as though read.

CHAIRMAN JABER: Yes. The prefiled direct testimony of Mr. Saxon shall be inserted into the record as though read.

BY MR. BADDERS:

Q Mr. Saxon, do you have one exhibit labeled RMS-1 attached to your testimony consisting of seven schedules?

A Yes, I do.

Q Are you also sponsoring a section of the MFRs which are identified on Schedule 7 of that exhibit?

A Yes, I do.

Q Do you have any changes or corrections to that exhibit, or to your portion of the MFRs?

A I do not.

MR. BADDERS: We ask that that exhibit, RMS-1 be identified as the next exhibit.

CHAIRMAN JABER: Yes. Exhibit 30 shall be RMS-1.

(Exhibit 30 marked for identification.)

GULF POWER COMPANY

Before the Florida Public Service Commission
Prepared Direct Testimony & Exhibit of
R. Michael Saxon
Docket No. 010949-EI
In Support of Rate Relief
Date of Filing: September 10, 2001

Q. Please state your name and business address.

A. My name is R. Michael Saxon, and my business address is One Energy Place, Pensacola FL 32520-0761. I am the Manager of Corporate Planning for Gulf Power Company.

Q. Please describe your educational and professional background.

A. I have a Master of Science Degree in Management from Troy State University and a Bachelor of Science Degree in Marketing from the University of West Florida. My employment with Gulf Power began in 1976. I have served in various capacities of increasing responsibility including the Pensacola District Manager. In that position, I was responsible for the daily customer and field service activities of the Pensacola District. I have been in my position as Manager of Corporate Planning since March of 2001.

Q. Please describe your responsibilities and duties as the Manager of Corporate Planning.

A. My primary responsibility is to ensure that Gulf's budgeting, forecasting, and performance measurements are effective and consistent. I

coordinate the overall planning effort, and I am responsible for the production of the Company's financial forecast. My responsibilities also include the ongoing development and maintenance of the Operation and Maintenance (O & M) and Construction Budgeting System and the development of the O & M and Construction budgets and forecasts. I am responsible for coordinating the Strategic Business Plan and the development of goals and measurements for the Company. The Corporate Planning Department provides financial analysis and maintains expertise in the use of available support tools for decision making.

Q. Have you prepared an exhibit that contains information to which you will refer in your testimony?

A. Yes.

Counsel: We ask that Mr. Saxon's Exhibit (RMS-1), comprised of seven schedules, be marked for identification as Exhibit___.

Q. Were all of the schedules in this exhibit prepared under your supervision?

A. Yes. Each schedule of this exhibit was prepared under my supervision and direction.

Q. Are you the sponsor of certain minimum filing requirements (MFRs)?

A. Yes. The MFRs that I am sponsoring, in part or in whole, are listed on Schedule 7 of my exhibit. To the best of my knowledge, the information in all of the listed MFRs is true and correct.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide an overview of the planning process that results in the production of Gulf's financial forecast. The financial forecast is the basis for Gulf's projected data for the test year used in this rate case. Specifically, I will present an overview of Gulf's planning and budgeting process, outline the assumptions used in developing Gulf's financial forecast, and describe both the Construction Budget process and the O & M budget process. I will also sponsor a portion of Gulf's Construction Budget related to General Plant. Because of my prior position with the Company, I will also support the service fees requested by the Company and the level of Customer Accounts dollars requested in the test year. My testimony will also address the Customer Accounts expenses in the O & M Benchmark analysis.

Q. Please describe Schedule 1 of your exhibit.

A. Schedule 1 is a flow chart of Gulf's annual planning and budgeting process. This is an ongoing process intended to develop a financial forecast for use by management as a tool for making decisions affecting the future direction of the Company. There are eight component budgets that are incorporated into Gulf's financial forecast. The Company's Leadership Team, consisting of Gulf's executive officers, reviews and approves these budgets.

Q. Who will testify on the preparation of the eight component budgets in Gulf's financial forecast?

A. The Customer, Energy, Peak Demand, and Revenue Budgets are the responsibility of Mr. McGee; the Fuel Budget is the responsibility of Mr. Moore; the Interchange Budget is the responsibility of Mr. Howell; and the Construction Budget is the responsibility of Mr. Moore, Mr. Howell, Mr. Fisher, and me. Mr. Moore, Mr. Fisher, Mr. McMillan, Ms. Neyman, Mr. Howell, and I will discuss the O & M Budget. Mr. Labrato addresses the interface of the component budgets with the financial model in his testimony.

Q. Has Gulf Power filed a list of the assumptions used in developing Gulf's financial forecast?

A. Yes. MFR F-17 lists the assumptions used in developing Gulf's financial forecast and the supporting basis for each assumption. Gulf's management believes the assumptions used in this financial forecast, as outlined on MFR F-17, to be reasonable in light of our experiences and the circumstances known at the time the assumptions were developed.

Q. Who administers the financial planning process?

A. As the Manager of Corporate Planning, I ensure that all involved with the process are kept informed of the key assumptions, goals, and any strategic issues facing the Company. Our Chief Financial Officer, Mr. Labrato, is responsible for ensuring the Company's Leadership Team reviews and approves the eight component budgets of the planning process.

Q. Schedule 1 shows Corporate Planning's involvement in producing Gulf's financial forecast. Would you describe your department's involvement?

A. Primarily, Corporate Planning is responsible for coordinating the Construction Budget and O & M Budget processes. The department is also responsible for assimilating the information that is produced in the approved Revenue, Fuel, Interchange, Construction and O & M Budgets for use in the financial model. Corporate Planning is responsible for the ongoing process of analyzing and updating the financial model logic to ensure accurate forecasts of the Company's financial performance.

Q. Please describe Gulf's Construction Budget.

A. The Construction Budget consists of Plant Expenditures (PE's) for additional property covering a period of ten years. PE's are categorized as Major Generation, Other Production, Transmission, Distribution, and General Plant. The PE's are further identified as Specific PE's and Blanket PE's. Specific PE's are generally individual projects costing $50,000 or more that may require expenditures in one or more years. Blanket PE's include repetitive type plant additions that are not easily defined or distinguished as individual or separate projects at the time the budget is prepared.

Q. Who is responsible for developing PE's?

A. Individuals within the functional operating area are responsible for developing the PE's in that area. The appropriate Vice President reviews and approves the PE's prior to their being submitted to Corporate

Planning. The majority of the PE's are prepared under the direction of Mr. Moore, Mr. Fisher, and Mr. Howell.

Q. Who is responsible for reviewing and approving the overall Construction Budget?

A. Gulf's Leadership Team reviews all Construction Budget requests. Corporate Planning provides the Leadership Team with any necessary summaries, comparisons, or other information that may be requested. After review and approval by the Leadership Team, the Construction Budget is approved annually by the Company's Board of Directors.

Q. Does Gulf monitor the actual construction expenditures against its approved budget?

A. Yes. Quarterly, Corporate Planning does a comparison of Actual to Budget expenditures. Any variance over or under a set threshold is researched and explained by the appropriate functional area. Variance explanations, by project, are prepared and an estimate of the budget status at year-end or at completion of the project is shared with the Chief Financial Officer. Supervision of this control mechanism is the responsibility of Corporate Planning.

Q. What is the amount of Gulf's test year Construction Budget?

A. Gulf's June 2002 through May 2003 Construction Budget is $64.9 million. Schedule 2 of my exhibit shows Gulf's test year Construction Budget by category.

Q. Are you sponsoring a portion of the General Plant Construction Budget for the test year?

A. Yes. I am testifying to the portion of General Plant that relates to telecommunications, computer, and other equipment, which is ~~$2.1~~ $1.8 million in the test year. This ~~$2.1~~ $1.8 million is well within the range of normal expenditures for what Gulf has been spending for this portion of General Plant for the last three years and for the period January 1, 2001 through May 31, 2002.

Q. Would you please state the purpose of your testimony as it relates to the O & M Budget?

A. I will describe the preparation process and provide an overview of the assumptions used to prepare the test year O & M Budget. The following individuals are responsible for and are prepared to address the specific assumptions, details, and explanations related to the test year O & M Budget for the indicated functions: Production is the responsibility of Mr. Moore; Transmission is the responsibility of Mr. Howell; Distribution will be addressed by Mr. Fisher; I will sponsor Customer Accounts; Customer Service & Information, Sales, and Advertising is the responsibility of Ms. Neyman; and Administrative & General expenses will be addressed by Mr. McMillan. The assumptions and their supporting basis for the test year O & M Budget are outlined in MFR F-17.

Q. What is the amount of Gulf's test year O & M Budget?

A. The test year O & M Budget exclusive of all related Net Operating Income

(NOI) adjustments is $186.4 million. Schedule 3 of my exhibit summarizes the test year O & M Budget by major functional category. This schedule ties with Mr. Labrato's Schedule 8 and the adjusted 2000 actual O & M that is shown in MFR C-2. The witnesses responsible for O & M expenses by function will be addressing the increases from the adjusted 2000 O & M to the test year O & M.

Q. Please describe Corporate Planning's role in preparing Gulf's O & M Budget.

A. Corporate Planning is responsible for establishing a logical process for the preparation of the budget; for administering the process under the direction of the Chief Financial Officer; and for preparing the necessary summaries, comparisons, or other information that may be requested. The Leadership Team reviews and approves the O & M Budget. Schedule 4 of my exhibit is a flow chart outlining the O & M Budget process.

Q. Would you describe the process of preparing Gulf's O & M budget?

A. Referring to my Schedule 4, the first step in Gulf's O & M Budget process is to develop a list of strategic issues facing the Company. These issues are then integrated into the Company's Strategic Business Plan. Each Planning Unit within the Company prepares objectives and goals that address its direction and major emphasis for the coming year. These goals and objectives support specific issues identified in the Company's Strategic Business Plan. The Chief Financial Officer then reviews the

budgeted revenues forecasted for the period and communicates a Budget Message that outlines the goals and objectives of the Company and gives specific guidelines to the Planning Units for development of their budgets and forecasts.

Q. Please describe the O & M Budget process after the issuance of the Budget Message.

A. Upon receipt of the Budget Message each Planning Unit prepares a detailed budget that supports its approved goals and objectives for the budget year. The budget represents the funds required to accomplish its goals and objectives. The Vice President for each function approves the function's budget prior to its submission to Corporate Planning. Corporate Planning reviews submittals for compliance with the Budget Message and compiles the data for review by the Chief Financial Officer and the Leadership Team. Any changes are documented and the approved budget is then sent to the Planning Units. A signature page is maintained with the Chief Financial Officer and the President signifying final approval of the O & M Budget.

Q. What rate of inflation is used by Gulf in the preparation of its O & M Budget?

A. The Budget Message issued by the Chief Financial Officer includes the inflation rate to be used by the Planning Units in preparing the O & M Budget. The rate of inflation for 2002 and 2003 used in preparing the O & M Budget was 2.43 percent and 2.40 percent, respectively. These

rates of inflation are developed by Southern Company Services utilizing forecast data obtained from Regional Financial Associates (RFA), now known as Economy.com, Inc.

Q. How are salary increases budgeted?

A. Corporate Planning sends a letter to the Planning Unit Managers with an appropriate rate, furnished annually by Human Resources, to be used for salary increases. A suggested amount for promotions is also stated.

Q. What is the value of the O & M budgeting process used by Gulf Power Company?

A. Gulf uses the budgeting process as a comprehensive management tool both to plan and to control the Company's operations. Goals, objectives, priorities, and appropriate expenditure levels are established through the budgeting process.

Q. How do Planning Unit Managers monitor monthly budget variances?

A. Our on-line accounting and reporting system allows each user to produce monthly budget to actual comparison reports. Each quarter, the departments are required to submit reports that include explanations of variances that are plus or minus 10 percent and greater than $25,000. Any variance amount that exceeds plus or minus $500,000, regardless of the percentage, must be explained. Projections for year-end expenditures are also submitted quarterly. The Chief Financial Officer reviews these reports and year-end projections and informs the Leadership Team as the

need arises.

Q. Please describe any new initiatives Gulf has undertaken to improve the Construction and O & M budget process.

A. Gulf is using a proprietary budget system called BUDWORKS for electronic submittal of Construction and O & M budgets and forecasts. This system, developed in 1997 and enhanced each year, has greatly reduced the time spent in the development, reporting and submittal of budget requests.

Q. Mr. Saxon, are you familiar with the development of the costs for Gulf's service fees?

A. Yes. Because of my experience in district operations, I am familiar with the job functions associated with providing these services. I am also familiar with the cost components of these job functions.

Q. Does the Company propose any changes to these fees?

A. Yes. Based on our analysis of current costs, Gulf has developed new fees for the connection of initial service, existing service, and temporary service; restoration of service (after violation of rules); premise visit; investigation of unauthorized use; and returned item charges.

Q. How have these fees changed?

A. My Schedule 5 shows a summary of the proposed changes to the service fees. Supporting details are included in MFR E-10.

Q, How long have these service fees been in effect?

A. The fees for connection of existing service, restoration of service (after violation of rules) and premise visit have been in effect since 1983. The fees for connection of initial service, connection of temporary service, and investigation of unauthorized use became effective with Gulf's last rate case in 1990. The Company proposes to increase these fees to more closely reflect the cost of providing these customer-requested or customer-driven services. The returned item fee has been in effect since 1993 and the proposed increase is in accordance with Florida law.

Q. Please describe the methodology used to calculate the proposed level requested for these service fees.

A. The steps required to provide each service were identified, and the cost associated with each step was determined. Gulf then adjusted these fees in $5.00 increments for ease of administration. The total cost for each service, prior to being adjusted, is listed in column 2 of my Schedule 5. All of the proposed fees are cost-based, except for the returned item charge. Gulf proposes a returned item charge that varies by item amount in accordance with Florida law.

Q. Are any of the requested service fees new to the customers?

A. No. Gulf currently has a fee for each of these services. However, Gulf is subdividing the fee for restoration of service (after violation of rules) into three different categories. The three categories are restoration of service, restoration of service after hours, and restoration of service at the pole.

Each category has different cost components that justify a different charge.

Q. Are you sponsoring the level of Customer Accounts O & M expenses in the test year?

A. Yes. In my previous position as Pensacola District Manager, I was involved in the day-to-day activities of our customer accounting function. The Company's request of $16.6 million dollars for the test year Customer Accounts expense is reasonable, prudent, and necessary. Since the addition of Gulf's CSS system, Customer Accounts expenses have averaged $15.8 million dollars per year. Customer Accounts expenses have increased since 2000 by $1.3 million. This increase is due to postage expenses, uncollectible expenses, and Automated Resource Management System (ARMS) expenses. The remaining increase is primarily related to the normal increases in labor and programs due to inflation and customer growth.

Q. Are you sponsoring the Customer Accounts Benchmark analysis variance information?

A. Yes. The total Company O & M expenses are under the Benchmark by $3.7 million; however, the Customer Accounts Benchmark variance is over by $2.5 million. As shown on my Schedule 6, this variance is related to four areas. The first is Information Technology (IT) in the amount of $1.1 million; second is the Customer Service System (CSS) in the amount of $940,000; next is Uncollectible Accounts of $607,000; and ARMS

makes up the remainder.

Q. Please discuss the expense changes that have caused IT costs to exceed the Benchmark.

A. In 1990, the majority of all IT costs were in the A & G function. These IT costs are now charged directly to the Planning Unit wherever it is feasible to do so. With the evolution of computer technology within the workforce over the past 10-12 years, there has been a decrease in the need for support personnel to handle correspondence, presentations, reports, etc., for other professional job classifications. Computer technology has enabled the general workforce to do more with automated processes, thus increasing productivity.

Q. Please discuss CSS and why this is an increase over the Benchmark in Customer Accounts.

A. Mr. Fisher's testimony includes a discussion of the reasons why Gulf implemented CSS. As described in Mr. Fisher's testimony, CSS is a powerful tool that is critical to Gulf's future. In 1997, this system replaced the General On-line System (GOLS) which had been in use since 1972. CSS helps Gulf meet the expectations of our customers for outstanding service while controlling costs and providing the flexibility to respond to opportunities that arise in the marketplace. Purchasing a standard system and making enhancements was the most cost-effective way to satisfy Southern Company's need for a state-of-the-art customer information system across all five operating companies.

Q. Please discuss the Benchmark variance for Uncollectible Accounts.

A. The Benchmark for uncollectibles was established by applying the rate of inflation and customer growth to the 1990 budget of $511,000. Actual uncollectible expense for 1990 was $1,267,283. The average uncollectible expense for 1997, 1998, 1999, and 2000, with the current year-end projection for 2001, is $1,408,000. This supports the reasonableness of Gulf's test year request of $1,543,000. Some of the factors impacting uncollectible expense include national economic conditions, local economic conditions, and weather. During extreme weather conditions, Gulf does not disconnect electric service for non-payment. Gulf's policy is not to disconnect for non-payment when temperatures are forecasted to be 32 degrees or less, 95 degrees or greater, or when the heat index is forecasted to be 105 degrees or greater. These extreme weather conditions, in effect, increase arrears and, consequently, uncollectibles.

Q. Please discuss the Benchmark variance for ARMS.

A. Mr. Fisher's testimony includes a summary of the benefits of ARMS. ARMS is a very valuable tool for managing the daily work schedules of Field Service Representatives and Service Technicians engaged in service work orders. This new system has increased productivity and efficiency.

Q. Mr. Saxon, would you please summarize your testimony?

A. Gulf utilizes a very straightforward, logical, and comprehensive process in

developing the eight component budgets that are incorporated into the model, which results in Gulf's financial forecast. This budgeting process is performed annually and results in a forecast that management uses as a tool in planning and decision making. We believe the assumptions contained in each budget are reasonable and that they have been obtained from the best sources available at the time the budgets were developed.

The ~~$2.1~~ $1.8 million of General Plant expenditures in the test year that relate to telecommunications, computer, and other equipment are reasonable and well within the range of normal expenditures for the last three years. The requested level of O & M Customer Accounts expenses in the test year are reasonable, prudent, and necessary. Our current service fees have been in effect for over ten years, some as long as 18 years, and do not adequately recover our costs of performing these activities. The proposed changes to these fees more closely reflect the current cost of these activities.

Q. Does this conclude your testimony?

A. Yes, it does.

BY MR. BADDERS:

Q Mr. Saxon, would you please summarize your testimony.

A Yes, I will. Thank you. I will provide an overview of the planning and budgeting process which results in the development of a financial forecast which is comprised of eight component budgets. These budgets are reviewed and approved by Gulf's leadership team, which is comprised of Gulf's executive officers. I will address the involvement of corporate planning in producing Gulf's financial forecast.

An overview of the construction budget process is also provided in my direct testimony. The construction budget consists of plant expenditures referred to as PEs for additional assets covering a period of ten years. These budgeted PEs are reviewed and approved by the appropriate vice-president prior to being submitted to corporate planning. Final approval is given by the leadership team and subsequently ratified annually by the company's board of directors.

Of the 64.9 million construction budget being requested in this case, I am directly supporting $1.8 million of general plant PEs which relate to telecommunications, computer, and other equipment. I have described the preparation process and provided an overview of the assumptions used in preparing the operation and maintenance budget. Corporate planning is responsible for administering the process and providing reports as requested by our chief financial

officer and Gulf's leadership team.

The leadership team reviews and approves the O&M budget. Instructions were given to the planning units to zero base budget years 2002 and 2003. Gulf's planning units utilize their experience, knowledge, and expertise to develop their budgets each year. Input from external sources and expected increases or decreases to expenses are taken into account when making these projections. The resulting budget is representative of the needs of the company to provide safe reliable service to our customers in the test year and in the future.

I am also supporting the increase of customer accounting O&M expenses in this case. The costs are over the benchmark which this Commission has used as a guide in prior cases by $2.5 million. This variance is due primarily to the increase in four areas. Information technology costs have increased by $1.1 million. In 1990 these costs were in the A&G function, they are now directly charged to the business unit incurring the costs whenever it is feasible to do so.

The customer service system was put into service in October of 1997. This system accounts for $940,000 of the increase in customer accounting. It is a valuable tool that helps us meet the expectations of our customers for outstanding customer service. Our automated resource management system accounts for $58,000, and ARMS is a very valuable tool for

managing the daily work schedules of field service representatives and service technicians engaged in service work. Uncollectible accounts increased by $607,000 over the 1990 benchmark.

In conclusion, the budget submitted in this case is Gulf's plan of operation for the test year period. I believe this budget process along with management's commitment to keep cost low is what has allowed Gulf to historically maintain our operating cost per kilowatt hour as one of the lowest in the southeast.

Thank you for allowing me to summarize my testimony.

MR. BADDERS: We tender Mr. Saxon for cross examination.

CHAIRMAN JABER: Thank you. FEA?

MR. ERICKSON: No questions.

CHAIRMAN JABER: FIPUG?

MR. PERRY: No questions.

MR. BURGESS: No questions.

CHAIRMAN JABER: Staff.

MR. HARRIS: Yes, we have a few questions. Thank you.

CROSS EXAMINATION

BY MR. HARRIS:

Q Mr. Saxon, I have several questions that are of a clarification nature.

A Sure.

Q I'm referring to your deposition exhibit, which I think had been admitted as Exhibit 21. Do you have a copy of that?

A Yes, sir, I believe I do. All right, sir.

Q I wanted to refer to beginning with Page 1 of 5, which is the first page of your late-filed exhibit to your deposition.

A Yes, sir.

Q And the first line lists an average salary of 24,434. What year is that average salary computed on?

A That is based on 2001 salaries escalated by 4 percent to bring it up to the 2002 level.

Q So that is a 2002 level salary?

A Yes, sir, that is correct.

Q Do you know what that number would be if it was escalated to the test year ending in 2003?

A Yes, sir, that number would go to approximately $24,600.

Q And is that the same number that is contained in your minimum filing requirements Schedule C-33, Line 3, do you know?

A No, sir, it is not.

Q Can you explain the difference?

A Yes. The number in MFR C-33 is the average which includes all senior level management, which obviously we don't

have a lot of turnover there in senior level management. And typically we would not include that number and those higher salaries in that number for calculating our hiring lag.

Q So the difference is based on hiring lag?

A The difference would be typically, as I said, there is very little turnover in those higher level positions in the company. And when that occurs, or when there is a vacancy typically there is promotions where someone in the company currently moves up to those positions so that ultimately the vacancy that stays vacant for a period of time is an entry level salary which is reflected in the $24,000, or I guess that adjusted number would be the $24,600 average salary.

Q Thank you. On that same page you list an unbudgeted O&M temporary employee salary of, I believe, $224,065. Could you explain why that amount is so large?

A Those are dollars that are expended by the planning units when they do have a vacancy to cover that vacancy while they are in the process of getting a person hired.

Q Immediately following that you have a $100,000 budgeted hiring lag. Could you explain that number to me?

A Yes, sir. In one of our planning units, and that is specifically customer services where there is a reasonable amount of turnover, in recognition of that turnover that planning unit takes that into account in their budgeting process. And, in essence, reduces their budget by $100,000 in

recognition of that hiring lag each year.

Q On Page 2 of 5, the next page of your exhibit, you show an other category. Could you explain what that is?

A Yes, sir. That is a clearing account. It does include some appliance sales in our stores area, meaning warehousing, et cetera.

Q And then the next line is ENS/capital, could you explain that account?

A Yes, sir. That is engineering and supervision direct, that is capital expenditures.

Q What does that mean?

A Those are dollars that are expended or payroll that is contributed to capital projects as opposed to O&M projects.

Q Are the percentage allocations among the various categories in the test year budget consistent with previous year's allocations?

A Yes, sir, they are.

Q On Page 3 of 5, the third page?

A Yes, sir.

Q You have at the bottom, 11 earned progression vacancies. Could you explain what those are?

A Yes, sir, I can. Those were vacancies in 2001, and Mr. Fisher will expand on these in his testimony, but that is 11 vacancies that will be filled as a class. So these individuals will be hired together, they will come in and train

together in what we refer to as an earned progression program.

Q And on Pages 4 and 5, which I believe are excerpted from your Schedule C-33, I notice that there is a difference in gross payroll from 1998 through the 2003 test year. Could you explain the cause of those differences?

A I'm sorry, Mr. Harris, would you repeat your question.

Q Sure. On Pages 4 and 5 --

A Yes.

Q -- which I think are Schedule C-33 of your MFRs?

A Yes, sir.

Q My understanding is that in gross payroll there is a difference, and I'm wondering if you can explain what the differences in gross payroll for each of those years '98 through the projected test year 2003 are?

A Mr. Harris, are you talking about the changes from one year to next, the actual increases?

Q Yes.

A Okay. Yes, sir. I don't have a complete analysis, but in most cases that would be primarily due to merit increases and promotions, et cetera.

Q Thank you. I wanted to ask you about fringe benefits, which starts with Line Number 4, and my understanding is that the fringe benefits are based on the number of actual employees that are employed at any one time, is that correct?

A That is correct.

Q Is any account taken for employee hiring lag when calculating the fringe benefits amounts?

A Oftentimes the fringe benefits are applied to a number of employees in a year prior to the budget year, so typically in our view you would not consider that in a hiring lag.

Q Would it be appropriate to make an adjustment to the fringe benefits accounts to take account of that hiring lag?

A Yes, sir. I think we could consider an adjustment for fringe benefits.

Q Has Gulf Power Company made any calculations or adjustments for fringe benefits based on that hiring lag?

A Yes, sir. I believe if we were going to make an adjustment to benefits for hiring lag, the appropriate rate of that would be 21.9 percent would be the appropriate rate to apply.

MR. HARRIS: I believe that is all the questions we have. Thank you.

THE WITNESS: Thank you, sir.

CHAIRMAN JABER: Thank you, Mr. Harris.

Commissioners, do you have any questions?

CHAIRMAN JABER: Just a couple for you. I'm trying to understand your allegation that some of these costs have gone up because of the information technology aspect and

because of uncollectible accounts, in particular. I know you brought out four points, but I am concerned with those two.

THE WITNESS: Yes, ma'am.

CHAIRMAN JABER: Information technology, several places in your testimony you say that -- you make it a point to say that those used to be included in the A&G function, and now the company is charging them directly to where the department is that is causing the costs to be incurred, which is the business unit.

THE WITNESS: Yes, ma'am.

CHAIRMAN JABER: It's not your testimony that removing it from A&G and putting it into the business unit is actually creating an increase in the expense?

THE WITNESS: No, ma'am, not at all. That is an explanation of the increase in the benchmark for that business unit itself.

CHAIRMAN JABER: Okay. And with respect to the cost itself, correct me if I'm wrong, but I'm assuming that you have had to purchase the computers, you have had to do the training on the computers. Is there anything else?

THE WITNESS: No, ma'am, that would predominately be it for IT.

CHAIRMAN JABER: Do you have a website?

THE WITNESS: Yes, we do.

CHAIRMAN JABER: So that is where the costs

associated with the website would be?

THE WITNESS: I'm not certain that that is where all the costs of that would be. I do know that part of our new system that our customers have electronic access to billing information and their account information, and that is where that piece of technology would be in there. The website may be in a different part in the company, it may be in corporate communications or what have you. But as far as all the opportunities that customers have to access us electronically for reviewing their accounts, it would be housed here.

CHAIRMAN JABER: Okay. So they can access you electronically via the website. Are you doing on-line billing?

THE WITNESS: Yes, ma'am, we are. On-line billing, it's called e-bill. Customers can view the bill and mail the check, or they can view the bill and actually mail the check or pay electronically through the Internet.

CHAIRMAN JABER: Okay. So all the costs associated with that would be in that expense, too?

THE WITNESS: That is correct.

CHAIRMAN JABER: Okay. Now, you also make the point on that topic that that has created a situation where you don't need as many personnel because so much can be done on-line now, and so much is made more efficient through the use of computers. Should we see the corresponding reduction in your filing to personnel and salaries?

THE WITNESS: I don't think you can, and I will tell you why. Obviously there has been some efficiencies. That particular piece of the business continues to grow, but I'm not sure it has gotten to the size yet where we can really recognize that large a reduction. However, I think it ultimately will allow for some cost containment that maybe then those resources could be more effectively used elsewhere.

CHAIRMAN JABER: So you think long-term there should be a corresponding reduction to salaries and personnel associated expenses?

THE WITNESS: I think over time if we could specifically identify those associated with that, that you would see that.

CHAIRMAN JABER: Okay. On the customer uncollectibles, I had a hard time following why you have such an issue with the uncollectible amounts. I know you cite to weather and your policy of not disconnecting customers during certain situations, but if I am reading your testimony correctly, there is a high percentage and, therefore, a high revenue amount associated with customer uncollectibles. Can you elaborate?

THE WITNESS: Commissioner, over the last five years our uncollectible amount has averaged about $1.6 million. And the amount that I think has been stipulated to in this case for the test year is 1.5 million. With respect to the benchmark,

however, in 1990 the budgeted amount for uncollectibles was 511,000, and actuals for that year were 1.3 million. So we missed the budget in 1990, which has caused it to have an impact on the benchmark calculation.

CHAIRMAN JABER: Well, big picture, though, are you looking at ways to get that amount closer to zero?

THE WITNESS: Yes, ma'am. We work diligently to do that. You have alluded to our policy with respect to weather, however, and we want to stay sensitive to that, because oftentimes weather-related issues are going to impact probably the most vulnerable population within our community, that being the elderly. So we want to say tentative to that issue. But we work diligently to control uncollectibles. We have shortened are collection cycle significantly in order to try to curb uncollectibles. And I think the fact that it was 1.3 million actual in 1990 and averaged only 1.6 million over the last five years is indicative of our ability to at least hold the line on it as revenues have increased.

CHAIRMAN JABER: Thank you, Mr. Saxon.

Redirect.

MR. BADDERS: No redirect.

CHAIRMAN JABER: You're excused. Thank you.

Exhibit 30.

MR. BADDERS: Yes, we would like to move the exhibit.

CHAIRMAN JABER: Is admitted into the record without

objection.

(Exhibit 30 admitted into the record.)

CHAIRMAN JABER: That brings us to Mr. McGee. And, staff, you acknowledge that there is no need to put Mr. McGee on the stand, so let's go ahead and insert the prefiled direct testimony of R.L. McGee --

MR. MELSON: Consisting of 11 pages.

CHAIRMAN JABER: -- consisting of 11 pages into the record as though read. And, Mr. Melson, he has an exhibit?

MR. MELSON: One exhibit, RLM-1, consisting of Schedules 1 through 7.

CHAIRMAN JABER: Okay. Composite Exhibit RLM-1 shall be identified as Composite Exhibit 31, and shall be admitted into the record without objection.

MR. MELSON: Thank you.

(Exhibit 31 marked for identification and admitted into the record.)

GULF POWER COMPANY

Before the Florida Public Service Commission
Prepared Direct Testimony and Exhibit of
Robert L. McGee
Docket No. 010949-EI
In Support of Rate Relief
Date of Filing: September 10, 2001

Q. Please state your name, business address, employer and position.

A. My name is Robert L. McGee and my business address is One Energy Place, Pensacola, Florida, 32520. I am employed by Gulf Power Company as the Marketing Services Manager.

Q. Mr. McGee, please summarize your educational background and professional experience.

A. I attended the University of Maryland and graduated with a B.S. degree in Electrical Engineering in 1984. In 1993, I earned a Masters degree in Business Administration from the University of West Florida. I was a United States Naval Flight Officer until 1994 when I began my career in the electric utility industry at Gulf Power Company. I have held various positions within the company in Marketing and Power Generation. In my present position, I am responsible for Energy Conservation Cost Recovery (ECCR) filings, pricing, economic evaluations, market research, load research, forecasting and marketing services activities.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present the approach, methods and results associated with Gulf's forecast of customers, energy sales, peak

demands and base rate revenues. The forecast is provided to Corporate Planning for use in the budgeting and planning process as discussed by Mr. Saxon. I will also address the Company's cost of service load research results.

Q. Have you prepared an exhibit that contains information to which you will refer in your testimony?

A. Yes. Exhibit (RLM-1) consisting of seven schedules was prepared under my supervision and direction.

Counsel: We ask that Mr. McGee's Exhibit (RLM-1) consisting of seven schedules be marked as Exhibit No. ___.

Q. Are you the sponsor of certain Minimum Filing Requirements (MFR's)?

A. Yes. These are listed on Schedule 7 at the end of my exhibit. To the best of my knowledge, the information contained in these MFRs is true and correct.

Q. Mr. McGee, you indicated you are responsible for the forecasts of Gulf's customers, energy sales, peak demands and base rate revenues. What tabulations have you provided detailing your retail projections for the test year?

A. I have provided four tabulations of test year forecast data: Schedule 1 details retail customers by rate; Schedule 2 details retail energy sales by rate; Schedule 3 details territorial system peak demand by month; and Schedule 4 details retail base rate revenue by rate. Schedules 1, 2 and 4

also provide totals by customer classification.

Q. Please summarize your Schedule 1.

A. Gulf projects that it will have a total of 389,181 retail customers by May 2003, an increase of 7,737 customers over projections for May 2002. This represents an anticipated annual growth rate of 2.0 percent for the test year. By comparison, historical growth rates of 2.5 percent, 2.7 percent and 1.8 percent were experienced in 1998, 1999 and 2000, respectively. Current projections for year-end 2001 and 12 months ended May 2002 indicate annual growth rates of 2.0 percent and 2.1 percent respectively.

Q. Please summarize your Schedule 2.

A. Retail energy sales are expected to total 10,282,958 megawatthours in the test year, representing an increase of 1.4 percent over projections for the twelve months ended May 2002. The retail megawatthour sales forecast by class consists of the following: Residential: 4,778,953 MWH, comprising 46.5 percent of retail; Commercial: 3,309,615 MWH, comprising 32.2 percent; Industrial: 2,173,005 MWH, comprising 21.1 percent; and Street Lighting: 21,315 MWH, comprising 0.2 percent.

Q. Please summarize your Schedule 3.

A. Gulf's territorial system peak demand is projected to be 2,224 MW in the test year, representing an increase of 57 MW or 2.6 percent over projections for the twelve months ended May 2002. This peak is expected

to occur in the summer month of July 2002.

Q. Please summarize your Schedule 4.

A. Retail base rate revenues are expected to total $343,750,000 in the test year. Using current rates, the base rate revenue forecast by class consists of the following: Residential: $196,535,000; Commercial: $104,114,000; Industrial: $41,097,000; and Street Lighting: $2,002,000.

Q. What are the objectives of your forecasting efforts?

A. Gulf has adopted two primary objectives in preparing forecasts: (1) comprehensive coverage of major issues and trends that may impact Gulf and its customers, and (2) effective communication to management and planning functions of the underlying causes and potential implications.

Since the primary focus in this proceeding is on the test year, the short-term forecast will serve as the basis for discussion of forecast results.

Q. What level of accuracy has been achieved in your recent short-term forecasts of retail customers, energy sales and base rate revenues?

A. Employing the same basic methods and approach used for this proceeding, our forecast accuracy has consistently exceeded the standards which we consider appropriate for planning purposes. Schedule 5 provides a summary of our short-term forecast accuracy for the last four budget forecasts issued prior to the test year forecast.

Q. What rate schedules are included in the residential class forecast of customers and energy sales?

A. Gulf's residential class is currently comprised of four rate schedules: RS (residential service) which represents the majority of class energy sales, rate schedule RST (residential service, time-of-use conservation), rate schedule RSVP (residential service variable pricing), and finally rate schedule OS (outdoor service – lighting).

Q. Please describe the methods used to prepare the forecast of residential customers.

A. The short-term forecast (0-2 years) of customers is based primarily on projections prepared by Gulf's district Marketing personnel based upon recent historical trends in customer gains and their knowledge of locally planned construction projects from which they are able to estimate the near-term anticipated customer gains. These projections are then analyzed for consistency and the incorporation of major construction projects and business developments, and reviewed for completeness and accuracy. The end result is a near-term forecast of residential customers.

Q. Please describe the methods used to prepare the residential class energy sales forecast.

A. The short-term (0-2 years) residential energy sales forecast is statistically modeled utilizing multiple regression analyses. Monthly class energy purchases per customer per billing day, the dependent variable, is estimated based upon the following independent variables: recent

historical energy sales, expected normal weather (heating and cooling degree hours), seasonal variations and projected price of electricity. The model output is then multiplied by the projected number of customers and billing days by month to expand to the total residential class. The residential class energy projections are then adjusted to reflect the anticipated incremental impacts of Gulf's Demand Side Management (DSM) plan.

Q. What rate schedules are included in the commercial class forecast of customers and energy sales?

A. Gulf's commercial class represents the most heterogeneous market served by Gulf. Included in this class are customers from the following current rate schedules: GS (general service), GST (general service, time-of-use conservation), GSD (general service demand), GSDT (general service demand, time-of-use conservation), LP (large power service), LPT (large power service, time-of-use conservation), RTP (real time pricing) and OS (outdoor service).

Q. Please describe the method used to prepare the commercial class customer forecast.

A. As in the residential sector, the short-term forecast (0-2 years) of commercial customers is prepared by Gulf's district Marketing personnel utilizing recent historical information concerning increases in the number of customers, knowledge of the local area economies and upcoming construction projects. A review for completeness and accuracy of the

assumptions, techniques and results for each district is undertaken with special attention given to the incorporation of major commercial development projects. The end result is a near-term forecast of commercial customers.

Q. Please describe the methods used to prepare the commercial class energy sales forecast.

A. The short-term (0-2 years) commercial energy sales forecast is also developed utilizing multiple regression analyses. Monthly class energy purchases per customer per billing day are estimated based upon recent historical data, expected normal weather (heating and cooling degree hours), seasonal variations and projected price of electricity. The model output is then multiplied by the projected number of customers and billing days by month to expand to the total commercial class. The commercial class energy projections are then adjusted to reflect the anticipated incremental impacts of Gulf's DSM plan.

Q. What rate schedules are included in the industrial class forecast of customers and energy sales?

A. Gulf's industrial customer class consists of customers billed under the following current rate schedules: GS (general service), GSD (general service demand), GSDT (general service demand, time-of-use conservation), LP (large power service), LPT (large power service, time-of-use conservation), PX (large high load factor power service), SBS (standby and supplementary service), RTP (real time pricing), CIS

(commercial/industrial service optional rider) and OS (outdoor service).

Q. Describe the methods used to prepare the industrial class energy sales forecast.

A. The short-term industrial energy sales forecast is developed using a combination of on-site surveys of major industrial customers, trending techniques, and multiple regression analyses.

Fifty-one of Gulf's largest industrial customers, representing over 91 percent of the industrial class sales, are interviewed to identify load changes due to equipment additions and replacements, or changes in operating characteristics. The short-term forecast of monthly sales to these major industrial customers is a synthesis of this detailed survey information and historical monthly load factor trends.

The forecast of short-term sales to the remaining smaller industrial customers is developed using a combination of trending techniques and multiple regression analysis by rate, as appropriate. The resulting estimates of energy purchases per customer per day are multiplied by the expected number of customers and billing days by month to expand to the rate level totals. These projections are then added to the results for the major industrial customers to sum to the industrial class totals.

Q. How is Gulf's forecast of territorial wholesale energy prepared?

A. The forecast of energy sales to wholesale customers is developed utilizing multiple regression analyses. Monthly energy purchases per day for each of Gulf's wholesale customers are estimated based upon recent historical

data, expected normal weather (heating and cooling degree hours) and seasonal variations. The model output is then multiplied by the projected number of days by month to expand to the customer totals, which are then summed to develop the class totals.

Q. Please describe the methods used to prepare your peak demand forecast.

A. The short-term (0-2 years) peak demand forecast is prepared using average historical monthly territorial load factors and projected monthly territorial supply.

The summer peak month demand projections are based upon the average of the historical summer peak month territorial load factors for the period from 1980 through the summer peak of 2000, excluding the extreme high load factor and extreme low load factor experienced during that period. Gulf's summer peak demand typically occurs in the month of July.

Similarly, the winter peak month demand projections are based upon the average of the historical winter peak month territorial load factors for the period from 1980 through the winter peak of 2000/2001, excluding the extreme high load factor and extreme low load factor experienced during that period. Gulf's winter peak demand typically occurs in the month of January.

The remaining monthly demand projections are developed in similar fashion utilizing the respective historical average monthly load factors, excluding the monthly extreme high and extreme low load factors.

The resulting monthly demand projections are then further refined by taking into account the impact of Gulf's DSM programs.

Q. Please describe the procedure used to develop the test year retail base rate revenue forecast.

A. Appropriate rate schedules are applied to monthly projections of customers, energy sales and billing demands for each customer rate classification. The revenue forecast is based upon rates currently reflected in Gulf's tariff.

Q. You indicated earlier that you were responsible for Gulf's load research activities. What load research data is being used in these proceedings?

A. Gulf's 1999 Cost of Service Load Research Study, filed with the Commission in May 2000 pursuant to Order No. 13026 in Docket No. 820491-EU, is the basis of the cost of service study in this proceeding.

Q. Does Gulf's 1999 Cost of Service Load Research sample design meet the requirements of the Cost of Service Load Research Rule, Docket No. 820491-EU, Order No. 13026?

A. Yes. The sample design does meet the requirements of the referenced rule.

Q. What tabulation have you provided detailing the results of Gulf's 1999 Load Research Study?

A. Schedule 6 provides a summary tabulation of Gulf's 1999 Load Research

Study results.

Q. Does this conclude your testimony?

A. Yes, it does.

CHAIRMAN JABER: Thank you.

That brings us to Mr. Moore.

(The transcript continued in Volume 5.)

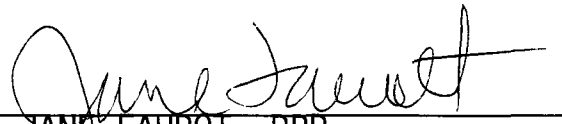
STATE OF FLORIDA)
: CERTIFICATE OF REPORTER
COUNTY OF LEON)

I, JANE FAUROT, RPR, Chief, Office of Hearing Reporter Services, FPSC Division of Commission Clerk and Administrative Services, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 25TH DAY OF FEBRUARY, 2002.



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