BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

IN RE: PETITION FOR INCREASE IN RATES BY GULF POWER COMPANY. / DOCKET NO. 110138-EI

VOLUME 10

Pages 1738 through 1965

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PROCEEDINGS:	HEARING
COMMISSIONERS PARTICIPATING:	CHAIRMAN ART GRAHAM COMMISSIONER LISA POLAK EDGAR COMMISSIONER RONALD A. BRISÉ COMMISSIONER EDUARDO E. BALBIS COMMISSIONER JULIE I. BROWN
DATE:	Wednesday, December 14, 2011
TIME:	Recommenced at 9:30 a.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	MARY ALLEN NEEL, RPR, FPR
APPEARANCES:	(As heretofore stated.)

I N D E X

WITNESSES

INDEX TO EXHIBITS

PROCEEDINGS

(Transcript continues in sequence from Volume 9.)

CHAIRMAN GRAHAM: Okay. I've got 35 after.

MR. SAYLER: Mr. Chairman, on behalf of the Office of Public Counsel, would it be possible for the remainder of our witnesses to be excused, Ms. Donna Ramas and Dr. Woolridge?

CHAIRMAN GRAHAM: Is there any objection to excusing the rest of OPC's witnesses? Staff?

MS. KLANCKE: No objection.

CHAIRMAN GRAHAM: Okay.

MR. SAYLER: Thank you, Mr. Chairman.

MAJOR THOMPSON: Mr. Chairman, also, with Mr. Gorman, I would like to get him excused.

CHAIRMAN GRAHAM: One more time.

MAJOR THOMPSON: Mr. Gorman, I would like to get him excused.

CHAIRMAN GRAHAM: Sure.

MAJOR THOMPSON: Proceed?

CHAIRMAN GRAHAM: Yes.

Thereupon,

GREG R. MEYER

was called as a witness and, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MAJOR THOMPSON:

Q. Can you state your name and business address?

A. Greg Meyer. My business address is 16690 Swingley Ridge Road, Chesterfield, Missouri, 63017.

Q. And your occupation?

A. I'm a senior consultant for Brubaker & Associates.

Q. Did you file direct testimony in this hearing?

A. Yes, I did.

Q. Do you have any changes or corrections?

A. No, I do not.

Q. If you were asked the same questions today, would your answers be the same?

A. Yes, they would.

MAJOR THOMPSON: Mr. Chairman, I would like to insert Mr. Meyer's prefiled testimony into the record.

CHAIRMAN GRAHAM: We will enter Mr. Meyer's prefiled direct testimony into the record as though read.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

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

Direct Testimony of Greg R. Meyer

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Greg R. Meyer. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a Senior Consultant in the field of public utility regulation with the firm of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

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

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing in this proceeding on behalf of the Federal Executive Agencies ("FEA"). The FEA purchases substantial amounts of electricity from Gulf Power Company ("Gulf" or "Company") and the outcome of this proceeding will have an impact on their cost of electricity.

Introduction

Q WHAT AMOUNT OF INCREASE HAS GULF REQUESTED?

A The overall increase requested by Gulf is $93.5 million in base revenues.

Q PLEASE IDENTIFY THE WITNESSES PRESENTING TESTIMONY ON BEHALF OF THE FEA AND BRIEFLY DESCRIBE THE AREAS THAT EACH WILL ADDRESS.

A The following witnesses will present testimony on behalf of the FEA:

- Mr. Michael Gorman will present testimony on cost of capital.
- Mr. David Stowe will present testimony on class cost of service.
- My testimony will address various revenue requirement issues.

Q DO YOU BELIEVE THAT GULF HAS JUSTIFIED THE PROPOSED OVERALL INCREASE OF $93.5 MILLION?

A No. Based on my testimony and the testimony of Mr. Gorman, I believe that Gulf's claimed revenue requirement and revenue increase are significantly overstated.

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A I am providing testimony regarding several adjustments to Gulf's revenue requirement. I am proposing:

1. An adjustment to increase Gulf's Sales for Resale revenues;
2. An adjustment to Gulf's amortization expense for the replacement of AMI meters;

3. An adjustment to Gulf's labor expense to reflect actual employee levels as of June 30, 2011;
4. The disallowance of Gulf's Supplemental Pension expense;
5. An adjustment to Gulf's annual storm recovery allowance;
6. An adjustment to disallow Gulf's proposed adjustment for land held for future use; and
7. The disallowance of the rate base component of Gulf's rate case expense.

In addition to the adjustments described above, I will discuss a problem with the beginning book number Gulf used in its case for accumulated deferred income taxes.

I have prepared a table which lists each of the revenue requirement adjustments the FEA is proposing in Gulf's filed case, and the value of each adjustment. Following Table 1 is a short description of the adjustments.

TABLE 1

Revenue Requirement Adjustments

Description	Value ($000)
1. Return on Equity	$19,875
2. Gulf's Capital Structure	1,828
3. Sales for Resale	1,825
4. AMI Amortization	1,299
5. Labor Expense	5,065
6. Supplemental Pension Expense	1,744
7. Storm Recovery Allowance	1,764
8. Land Held for Future Use	2,240
9. Rate Case Expense	205
Total Reduction	$35,845

1. Return on Equity – Mr. Gorman is proposing a 9.75% return on equity as compared to Gulf's requested 11.7% return on equity
2. Capital Structure – Mr. Gorman is proposing to adjust Gulf's capital structure to include the proper amount of accumulated deferred income taxes.
3. Sales for Resale – I am proposing to increase revenues from Sales for Resale to reflect a normalized level of revenues.
4. AMI Amortization – I am proposing to amortize the meters being replaced with AMI meters over the expected life of the new meters.
5. Labor Expense – I am proposing to adjust Gulf's labor expense to reflect actual employees at June 30, 2011.

6. Supplemental Pension Expense – I am proposing to disallow all expenses associated with Gulf's Supplemental Pension expense.
7. Storm Recovery Allowance – I am proposing that the proper level of the annual storm recovery allowance should be no more than $5.0 million.
8. Land Held for Future Use – I am proposing to disallow rate base treatment for Gulf's proposed adjustment of $27.7 million to land held for future use.
9. Rate Case Expense – I am proposing to disallow the rate base component for the unrecovered rate case expense.

The fact that I do not address a specific revenue requirement issue should not be interpreted as approval or acceptance by the FEA of any position taken by Gulf unless I state otherwise.

Sales for Resale

Q WHAT LEVELS OF SALES FOR RESALE REVENUES DID GULF PROPOSE TO INCLUDE IN ITS COST OF SERVICE?

A Gulf has proposed to include $16.3 million of Sales for Resale margin revenues for the projected test year ending December 31, 2012.

Q WHAT IS THE TOTAL REVENUE LEVEL THAT PRODUCED THE $16.3 MILLION MARGIN PROJECTION FOR 2012?

A For 2012, the total Sales for Resale revenues projected by Gulf to produce $16.3 million of margin revenues was $188.3 million.

Q PLEASE RECONCILE THE TOTAL SALES REVENUES OF $188.3 MILLION TO THE $16.3 MARGIN REVENUES PROPOSED BY GULF.

A Gulf made four adjustments to the total revenues of $188.3 to derive the $16.3 million of margin revenues. I have listed the four adjustments below and have calculated how the $16.3 million was derived in Table 2.

a. Gulf deducted $106.1 million of Sales for Resale revenues to reflect the fuel expense needed to make those sales;

b. Gulf deducted $0.3 million of Purchase Power Capacity Costs ("PPCC");

c. Gulf deducted $5.9 million of revenues because those revenues are related to Gulf's Environmental Cost Recovery Clause ("ECRC"); and

d. Gulf deducted $59.7 million related to Unit Power Sales ("UPS") from the Scherer plant.

TABLE 2

Reconciliation of Gulf's
2012 Sales for Resale Revenues

Description	Amount ($/Millions)
2012 Budgeted Sales for Resale Revenues	$188.3
Less:	
Fuel	106.1
PPCC	0.3
ECRC	5.9
UPS	59.7
Margin Revenues	$ 16.3

Q DID GULF PROJECT WHAT THE LEVEL OF MARGIN REVENUES WOULD BE FOR 2011?

A Yes. Gulf projected that in 2011 there would be $16.3 million margin revenues from total Sales for Resale revenues of $190.4 million.

Q DO YOU BELIEVE THE LEVEL OF MARGIN REVENUES PROPOSED BY GULF FOR 2012 IS REASONABLE?

A No. I believe the level of margin revenues proposed by Gulf is too low.

Q WHAT IS THE BASIS FOR YOUR ARGUMENT?

A Based on the level of total revenues from Sales for Resale for calendar years 2006-2010, and current 12-months data for March and June 2011, I contend the level of margin revenues proposed by Gulf for 2012 is low.

I have based this conclusion on my analysis of total revenues from Sales for Resale. I have submitted discovery to determine the proper adjustments to total revenues to derive margin revenues, but have not received the information from Gulf. However, based on analysis of the historical revenue levels, it is apparent that Gulf has understated Sales for Resale margin revenues.

Q WHAT LEVEL OF SALES FOR RESALE REVENUES HAS GULF RECORDED IN THE PAST?

A For calendar years 2006-2010, the Sales for Resale revenues were:

TABLE 3

Historic Levels of
Sales for Resale Revenues

Year	Amount ($000)
2006	$205,239
2007	196, 691
2008	199,910
2009	130,368
2010	219,300

Q YOU ALSO MENTIONED THAT YOU HAD CURRENT INFORMATION FOR 2011. COULD YOU PROVIDE THAT INFORMATION?

A Yes. The level of Sales for Resale revenues for the 12 months ended March 31, 2011 and June 30, 2011 are $217.2 million and $211.0 million, respectively. These current levels of revenues are significantly greater than what Gulf projected for 2011 ($190.4 million) and 2012 ($188.3 million). Furthermore, the budgeted level of revenues for 2011 and 2012 listed above are significantly less than the annual revenues Gulf has recorded as depicted in Table 3.

Based on this analysis, it is clear that Gulf has understated the margin revenues for 2012.

Q WHAT ADJUSTMENT ARE YOU PROPOSING FOR SALES FOR RESALE MARGIN REVENUES?

A I am proposing to increase margin revenues by approximately $1.9 million.

Q HOW DID YOU CALCULATE THE $1.9 MILLION ADJUSTMENT?

A To derive the $1.9 million adjustment, I calculated what the percentage of margin revenues were from Gulf's budgeted 2011 and 2012 Sales for Resale totals. I found that on average, 8.6% of total revenues are margin revenues. I applied the 8.6% to the total revenues recorded by Gulf for the 12 months ended June 30, 2011 ($211.0 million). This produced estimated total company margin revenues of $18.1 million. Subtracting the $16.3 million total company margin revenues proposed by Gulf from the $18.1 million, produces a total company $1.9 million adjustment.

Q DO YOU HAVE ANY FURTHER COMMENTS ON THIS ISSUE?

A Yes. It is my understanding that certain parties may propose that the revenues of $5.9 million recorded in the ECRC be included in Gulf's base rates in an upcoming ECRC proceeding (Docket No. 110007-EI). If the Commission agrees with this position, then my proposed margin adjustment should be increased to $7.8 million on a total company basis.

As I noted earlier, I have submitted discovery to determine the historic margin revenues Gulf has collected. If the responses to this discovery changes my adjustment, I will update it.

Advanced Metering Infrastructure ("AMI") Amortization

Q HAS GULF PROPOSED AN ADJUSTMENT RELATED TO AMI?

A Yes. Gulf has accelerated the implementation schedule related to AMI meters. As a result, Gulf is proposing to amortize over a four-year period the unrecovered net investment of approximately $7.1 million on a total company basis.

Q DO YOU AGREE WITH GULF'S PROPOSAL TO AMORTIZE THE UNRECOVERED NET INVESTMENT OF APPROXIMATELY $7.1 MILLION OVER FOUR YEARS?

A No, I do not for two reasons. First, the proposal to amortize the unrecovered net investment over four years results in the uneconomical replacement of these meters for ratepayers. Second, the four-year amortization period is too short. For these reasons, I propose that Gulf's proposal be rejected.

Q PLEASE EXPLAIN YOUR BELIEF THAT THE REPLACEMENT OF THESE AMI METERS IS UNECONOMICAL TO GULF RATEPAYERS.

A Gulf identified in its direct testimony projected savings from the AMI project. Specifically, Gulf stated that there would be savings from reduced full-time employees needed previously to read meters, a reduction in transportation costs for meter reading activities and an estimated increase in revenues related to improved meter accuracy. In the following table, I have listed the activity and estimated savings proposed by Gulf for the installation of AMI meters.

TABLE 4

Gulf's Savings from AMI Meters

Description	Savings
Reduced Labor Force (18 FTE's)	$ 466,963
Reduced Transportation Costs	235,000
Increased Revenues	575,000
Total Savings	$1,276,963

However, those cost savings are depleted when one recognizes the increase in expense for the four-year amortization of the unrecovered net investment of $1,772,000 ($7,088,000 ÷ 4). When matching the $1,772,000 against the savings of $1,276,963, ratepayers are being asked to pay in rates an additional $495,037 for the installation of AMI meters. This increased cost does not even include the return "on" and "of" the new AMI meters. Clearly, this proposal by Gulf is an uneconomical choice for Gulf's ratepayers.

Q PLEASE DESCRIBE YOUR CONCERNS WHY THIS FOUR-YEAR AMORTIZATION IS TOO SHORT.

A I have previously discussed that the proposal by Gulf is an uneconomical choice for ratepayers. The main reason for that is Gulf's proposal to amortize the unrecovered investment of $7.1 million over four years.

In its direct testimony, Gulf proposes that the new AMI meters should be depreciated over 15 years. Using a mass property accounting approach, the unrecovered investment in the old meters would be collected over the remaining life of the meters currently installed. In this case, that would be the new AMI meters.

Q PLEASE DESCRIBE YOUR PROPOSED ADJUSTMENT.

A I would propose that unrecovered investment be amortized over 15 years consistent with the life of the new AMI meters. This adjustment reduces Gulf's revenue requirement by $1.3 million.

Labor Expense

Q DID GULF ANNUALIZE PAYROLL EXPENSE FOR 2012?

A Yes. Gulf annualized payroll and fringe benefits for 2012. Gulf has projected that total company payroll and fringe benefits will be approximately $150.9 million.

Q DO YOU BELIEVE GULF'S ANNUALIZED PAYROLL SHOULD BE ADJUSTED?

A Yes. I believe Gulf's annualized payroll (including benefits) should be reduced by approximately $5.2 million.

Q WHAT LEVEL OF EMPLOYEES IS GULF'S PROPOSED TOTAL PAYROLL BASED ON?

A The total number of employees budgeted for 2012 is 1,489. This is an increase of 159 employees since the end of 2010 when Gulf had 1,330 employees. The increase of 159 employees is broken down in Mr. McMillan's testimony, Schedule 20. I have provided a summary of the increase in employees by function below.

TABLE 5

Analysis of Increased Employees

Function	Number of Employees
Recovery Clauses	31
Capital / Construction	42
Operation and Maintenance ("O&M")	86
Total	159

Therefore, Gulf is projecting to increase its employee levels by 12% from the end of 2010 to 2012.

Q WHAT IS GULF'S HISTORY WHEN COMPARING BUDGETED EMPLOYEES TO ACTUAL EMPLOYEES?

A Gulf has historically operated with fewer employees than budgeted. I have included a table below which compares actual versus budgeted employees for the years 2004-2010.

TABLE 6

Gulf's Budgeted Employees vs. Actual Employees

Year	Actual	Budget	Variance
2004	1,340	1,355	15
2005	1,338	1,413	75
2006	1,322	1,426	104
2007	1,341	1,415	74
2008	1,339	1,412	73
2009	1,365	1,443	78
2010	1,330	1,442	112
2011	---	1,489	
2012	---	1,489	

As can be seen from the table above, Gulf has continuously over-budgeted employees, and many times by a substantial amount.

Q IN GULF'S LAST RATE CASE, WHAT LEVEL OF EMPLOYEES WERE INCLUDED IN GULF'S CASE?

A In the last rate case, Gulf requested a total of 1,367 full-time equivalents ("FTEs"). Gulf has indicated that the Commission did not disallow any positions. Referring back to Table 6 above, it should be noted that since Gulf's last rate case, Gulf has not operated at 1,367 employees for any year.

Q YOU STATED EARLIER THAT AT THE END OF DECEMBER 2010, GULF EMPLOYED 1,330 EMPLOYEES. DO YOU HAVE ANY MORE CURRENT EMPLOYEE LEVELS?

A Yes. At the end of March 31, 2011, Gulf employed 1,334 employees. At the end of June 30, 2011, Gulf employed 1,365 employees.

Q PLEASE DESCRIBE HOW YOU CALCULATED YOUR PROPOSED $5.2 MILLION LABOR ADJUSTMENT?

A I believe Gulf's annualized payroll expense should be based on Gulf's latest known level of employees. As discussed previously, Gulf has consistently over-budgeted employee levels. Therefore, I propose that Gulf's annualized payroll be based on 1,365 employees, which is the level of employees at June 30, 2011.

Q HOW DID YOU DETERMINE THE BREAKDOWN OF THE EMPLOYEES BETWEEN CAPITAL, RECOVERY CLAUSES AND O&M?

A I assumed all growth from December 31, 2010 (1,330 employees) to June 30, 2011 (1,365 employees) was employees that would be assigned to the O&M

function. Therefore, my adjustment takes the 86 employees who were budgeted increases from December 31, 2010 and reduces that level by 35 employees. The estimated 51 unfilled O&M employees at June 30, 2011 was multiplied by Gulf's 2012 average employee budgeted wage and benefit level. This calculation derives my proposed labor adjustment of $5.2 million.

Supplemental Pension Expense

Q DID GULF INCLUDE IN ITS COST OF SERVICE AMOUNTS FOR SUPPLEMENTAL PENSION EXPENSE?

A Yes. In Gulf's Minimum Filing Requirements, Schedule C-35, page 1 of 2, line 12, Gulf has included $1,780,000 of Supplemental Pension expense in its cost of service.

Q DO YOU AGREE THAT THE EXPENSE SHOULD BE INCLUDED IN GULF'S COST OF SERVICE?

A No. I believe the approximately $1.8 million should be disallowed for determining Gulf's revenue requirement.

Q WHAT IS YOUR UNDERSTANDING OF SUPPLEMENTAL PENSION EXPENSE?

A Supplemental Pension expense is additional pension benefits usually offered to certain executives of the utility beyond what is offered in the pension plan to all employees.

Q WHY ARE YOU PROPOSING TO DISALLOW THE EXPENSE?

A I believe the regular pension plan offered to all employees should be sufficient for the executives of Gulf. Executives are paid many times more than the average employee of the utility. The executive's pension plan provides substantially greater benefits than the average employee. The amount of pension benefits offered to executives should be sufficient for ratepayers to fund. Any supplemental pension expense, if deemed necessary, should be paid for by the shareholders of Gulf.

Q DO YOU HAVE ANY FURTHER COMMENTS REGARDING THIS ISSUE?

A Yes. There is a possibility that even the IRS may not allow the recognition of supplemental pension expense for tax purposes. In addition, I am aware of one utility that has no plans to continue their plan in the future.

I have submitted discovery to address this issue, but I do not believe Gulf's ratepayers should pay in rates the costs of Supplemental Pension expenses for Gulf executives. Therefore, I propose to disallow the approximate $1.8 million from Gulf's cost of service.

Storm Recovery Allowance

Q WHAT EXPENSE ACCRUAL HAS GULF PROPOSED FOR PROPERTY DAMAGES IN THE RATE CASE?

A Gulf has proposed an annual accrual of $6.8 million for property damages resulting from storms.

Q WHAT EXPENSE ACCRUAL IS CURRENTLY APPROVED IN GULF'S RATES?

A Gulf currently accrues $3.5 million.

Q DO YOU AGREE WITH THE $6.8 MILLION AS AN ANNUAL ACCRUAL?

A No. I believe the $6.8 million accrual is excessive. I propose that if the Commission decides to increase the annual accrual, the annual accrual be increased to no more than $5.0 million per year.

Q WHAT IS THE BASIS FOR YOUR RECOMMENDATION OF A LIMIT OF $5.0 MILLION ACCRUAL PER YEAR?

A Gulf witness Constance J. Erickson testified on page 29 of her direct testimony that escalating the $3.5 million annual expense allowed in Gulf's last rate case by the CPI and accounting for customer growth would create an approximate $5.0 million accrual currently. I believe that no more than $5.0 million is an appropriate level for the annual accrual for this case. The increase in the accrual would recognize an increase in storm recovery costs over that level of expense approved by this Commission in Gulf's last rate case.

Q DID YOU REVIEW GULF'S 2011 HURRICANE LOSS AND RESERVE PERFORMANCE ANALYSIS ("STORM STUDY")?

A Yes, I did.

Q DO YOU HAVE ANY COMMENTS AS A RESULT OF THAT REVIEW?

A Yes. The Storm Study focuses on the results on a storm reserve from the funding level for property damages that was established in the last case of $3.5 million. I found some of the results from that analysis noteworthy. First, let me clarify that I am proposing to increase the annual accrual from $3.5 million to no more than $5.0 million.

The results of the Storm Study provide some helpful information for determining what level of annual funding should be used in this rate case. Figure 5-1 of the Storm Study shows that if a storm occurred every year for five years at an annual expected loss of $6.8 million, Gulf would still have a reserve of approximately $11 million. In addition, if no storms occurred in the five-year period, the reserve balance would grow to approximately $51 million.

Figure 5-1 also revealed that there was an 89% probability that the fund balance would be greater than $25 million after five years. The $25 million level is within the current target level approved by the Commission.

Similarly, Figure 5-1 identified that there is a 29% chance the storm reserve balance will be negative at the end of five years. Although it may be argued that a 29% probability is very high, one must remember that the Florida Commission has authorized ratepayer surcharges when storm costs have exceeded what was in the storm reserve. This proactive action by the Florida Commission cannot be ignored and must be considered when establishing a proper annual accrual.

It is not my intention to suggest that prudently incurred storm damage expenses should not be recovered from Gulf's ratepayers. I am proposing an annual accrual of no more than $5.0 million for purposes of this rate case.

Q WHAT WOULD BE THE RESULTS AS OUTLINED ON FIGURE 5-1 FROM AN ANNUAL ACCRUAL OF $5.0 MILLION?

A I have submitted discovery to obtain those results, but I have not received the responses at the time I drafted this testimony. However, I do have some preliminary observations of the results if $5.0 million were the annual accrual amount.

First, the storm reserve would be substantially greater ($19 million) than the approximate $11 million on Figure 5-1 if Gulf experienced a storm every year for the five-year period.

Second, the storm reserve would also be substantially greater ($59 million) than the approximate $51 million on Figure 5-1 if Gulf experiences no storms over the five-year period.

In addition, the percentage of likelihood that the storm reserve would be greater than $25 million will exceed 90%. Finally, the percentage of likelihood that the storm reserve will be less than zero will be less than 29%.

In summary, with an accrual of $5.0 million, all of the metrics reported on Figure 5-1 will most likely improve significantly from those listed with an annual accrual funding of $3.5 million.

Q PAGE 31 OF GULF WITNESS ERICKSON'S DIRECT TESTIMONY LISTS THREE PARTS WHICH CONSIST OF A FRAMEWORK FOR STORM RESTORATION COSTS. HOW ARE THESE PARTS AFFECTED WITH YOUR PROPOSED $5.0 MILLION ANNUAL FUNDING LEVEL CAP?

A I will first list the three parts as described by Gulf.

a. An annual property damage accrual adjusted over time as circumstances change;

b. A reserve adequate to accommodate most but not all storm years; and

c. A provision for utilities to seek recovery of costs that exceed the reserve.

In response to part 'a', I believe I have acknowledged that the storm accrual should change and I am recommending that the annual accrual be increased from $3.5 million to no more than $5.0 million.

In response to part 'b', I believe that the reserves I have estimated are substantially greater than the ones listed in Figure 5-1. This part of the framework is the one which will be the most debated among the parties in this case. What level of ratepayer funds should be in a reserve account held by Gulf to fund future storms? I have testified earlier that at an annual accrual of $5.0 million, there will be a greater than 90% chance the reserve will be over $25 million. In these economic times, the storm reserve should be maintained at what the Commission feels is a reasonable level. Some parties may argue that because the Commission has allowed surcharges in the past, no reserve amount should be maintained. Gulf witness Erickson has testified that the Commission has previously found that a target reserve between $25.1 million to $36 million is reasonable. With an annual accrual of $5.0 million, I believe this standard will be achieved. However, if the reserve is depleted, part 'c' of the framework applies.

In part 'c', the utility is allowed to seek recovery of costs which exceed the reserve. As I stated earlier, I am not advocating that the utility be required to

absorb storm costs. To the extent the Commission continues to support this position, the necessity to have large reserves is diminished.

Q PLEASE SUMMARIZE YOUR POSITION REGARDING THIS ISSUE.

A I am recommending that Gulf's proposed $6.8 annual accrual for storm recovery costs be reduced to no more than $5.0 million. I have demonstrated that the storm reserves will be adequately funded. I have discussed how the $5.0 million will satisfy the three parts of the framework the Commission adopted. Finally, if the $5.0 million is not sufficient, the Commission has an established procedure to allow the utility to recover its costs.

Land Held for Future Use

Q IS GULF PROPOSING AN ADJUSTMENT TO ITS RATE BASE FOR LAND HELD FOR FUTURE USE?

A Yes. Gulf is proposing to increase its rate base by $27,687,000 for land purchased for the potential future construction of a nuclear generating station. It should be noted that Gulf admits that it will not need new additional generation until 2022.

Q WHICH GULF WITNESSES ADDRESSED THIS ISSUE?

A Gulf witnesses Richard J. McMillan and Michael L. Burroughs filed direct testimony addressing this issue.

Q DO YOU AGREE WITH GULF'S PROPOSAL TO INCLUDE THESE COSTS IN RATE BASE?

A No, I do not. Gulf witness McMillan testifies on page 6 of his direct testimony that the carrying charges on this investment cease once the site selection costs are placed in rate base. Mr. McMillan references Florida Statute 366.93 as the source for his statement. I have reviewed Florida Statute 366.93 and would argue that Gulf has not obtained the necessary approvals to include this land in rate base. The portion of Florida Statues which I relied on states the following:

> "(3) After a petition for determination of need is granted, a utility may petition the commission for cost recovery as permitted by this section and commission rules."

Neither Mr. McMillan nor Mr. Burroughs provided any testimony that said the Florida Commission had granted Gulf a petition for determination of need. Therefore, I believe Gulf is premature in seeking to include this investment in land in its regulated rate base as provided for by Florida Statute 366.93.

Q DO YOU HAVE ANYTHING FURTHER REGARDING THIS ISSUE?

A Yes. Based on my review of the Commission rules, it is unclear whether Gulf is permitted to accumulate carrying charges prior to the Commission making a determination of need for the power plant. Therefore, any accumulated carrying charges recorded by Gulf prior to the granting of a determination of need by this Commission should be disallowed as well.

Rate Case Expense

Q HAS GULF REQUESTED RATE BASE RECOGNITION FOR RATE CASE EXPENSE?

A Yes. Gulf has requested that the unamortized balance of rate case expense, $2,450,000, be included in rate base for purposes of this rate case.

Q DO YOU AGREE WITH GULF'S PROPOSED ACCOUNTING TREATMENT OF RATE CASE EXPENSE IN THIS RATE CASE?

A No. First, I want to make clear that I am not proposing to reduce the $2.8 million Gulf requested for rate case expense. However, I am recommending that the $2.8 million be treated as a normalized expense. Therefore, I recommend that Gulf's cost of service include a normalized level of rate case expense of $700,000 on an annual basis.

Since I am not proposing an amortization of rate case expense, no deferral of rate case expense is recognized and thus the rate base inclusion as proposed by Gulf is unnecessary.

Q WHEN WILL THE RATE CASE EXPENSES BE INCURRED BY GULF?

A Gulf has indicated in its Minimum Filing Requirements that the entire $2.8 million will be incurred in 2011 which is outside the test year in this case. The proposed adjustment I am sponsoring would normalize this cost over a period of time that the parties believe is reasonable before Gulf will file another rate case. Based on Gulf's filing, Gulf has defined that period to be four years. Therefore, I am proposing a normalized level of rate case for purposes of the 2012 test year be

$700,000. Although these expenses were incurred in 2011, I have included a normalized ongoing level of $700,000 in Gulf's cost of service.

Q BECAUSE YOU HAVE PROPOSED A NORMALIZED LEVEL OF RATE CASE EXPENSE, THE NECESSITY FOR RATE BASE TREATMENT OF RATE CASE EXPENSE IS NEGATED. IS THIS CORRECT?

A Yes. As I have previously stated, since I have determined that on an ongoing basis Gulf's cost of service should include $700,000 for rate case expense, no rate base treatment needs to be recognized for rate case expenses. I, therefore, would recommend rejecting Gulf's proposal to include deferred rate case expense of approximately $2.4 million in rate base. The revenue requirement effect of this adjustment is $205,000.

Deferred Taxes Included in Capital Structure

Q HAVE YOU REVIEWED THE CAPITAL STRUCTURE PRESENTED BY GULF IN THIS RATE CASE?

A Yes. I have verified each component of the Capital Structure included as Schedule 12, page 2 of 5, in Mr. McMillan's direct testimony. I checked the totals on Schedule 12 to the balance listed in Gulf's Minimum Filing Requirements, Section B – Rate Base Schedules, Schedule B-3.

Q DO YOU HAVE ANY CONCERNS WITH THE CAPITAL STRUCTURE AS PRESENTED ON SCHEDULE 12 OF MR. MCMILLAN'S TESTIMONY?

A Yes. I was not able to verify the Deferred Taxes balance of ($492.1 million). I obtained the following 13-month balances from Rate Base Schedule B-3:

Account 190 – Accumulated Deferred Income Tax	$ 70.4 million
Account 281 – Accelerated Deferred Income Tax	($ 90.5 million)
Account 282 - Accelerated Deferred Income Tax	($470.0 million)
Account 283 - Accelerated Deferred Income Tax	($ 46.5 million)
Total	($536.6 million)

I also checked Schedule B-22 of Gulf's Rate Base Minimum Fling Requirements and found the following end-of-year balances for Accumulated Deferred Income Taxes:

2011	($472.0 million)
2012	($601.2 million)

By averaging these two balances, I got an average deferred income tax balance of ($536.6 million) which is almost identical to the balance I calculated.

Q CAN YOU RECONCILE THE DIFFERENCE BETWEEN THE COMPANY'S NUMBER OF ($492.1 MILLION) AND THE ($536.6 MILLION) YOU CALCULATED?

A No. I have submitted discovery to Gulf to determine how they quantified their number, but I have not yet received the response to that discovery.

Q HOW HAVE YOU TREATED THE ($536.6 MILLION) BALANCE IN YOUR CASE?

A FEA witness Michael Gorman has included this balance in his recommended capital structure.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes, it does.

Qualifications of Greg R. Meyer

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Greg R. Meyer. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q PLEASE STATE YOUR OCCUPATION.

A I am a Senior Consultant in the field of public utility regulation with the firm of Brubaker & Associates, Inc. (BAI), energy, economic and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A I graduated from the University of Missouri in 1979 with a Bachelor of Science Degree in Business Administration, with a major in Accounting. Subsequent to graduation I was employed by the Missouri Public Service Commission. I was employed with the Commission from July 1, 1979 until May 31, 2008.

I began my employment at the Missouri Public Service Commission as a Junior Auditor. During my employment at the Commission, I was promoted to higher auditing classifications. My final position at the Commission was an Auditor V, which I held for approximately ten years.

As an Auditor V, I conducted audits and examinations of the accounts, books, records and reports of jurisdictional utilities. I also aided in the planning of audits and investigations, including staffing decisions, and in the development of staff positions in which the Auditing Department was assigned. I served as Lead Auditor and/or Case Supervisor as assigned. I assisted in the technical training of other auditors, which included the preparation of auditors' workpapers, oral and written testimony.

During my career at the Missouri Public Service Commission, I presented testimony in nine electric rate cases, nine gas rate cases, seven telephone rate cases and several water and sewer rate cases. In addition, I was involved in cases regarding service territory transfers. In the context of those cases listed above, I presented testimony on all conventional ratemaking principles related to a utility's revenue requirement. During the last three years of my employment with the Commission, I was involved in developing transmission policy for the Southwest Power Pool as a member of the Cost Allocation Working Group.

In June of 2008, I joined the firm of Brubaker & Associates, Inc. as a Consultant. The firm Brubaker & Associates, Inc. provides consulting services in the field of energy procurement and public utility regulation to many clients including industrial and institutional customers, some utilities and, on occasion, state regulatory agencies.

More specifically, we provide analysis of energy procurement options based on consideration of prices and reliability as related to the needs of the client; prepare rate, feasibility, economic, and cost of service studies relating to energy and utility services; prepare depreciation and feasibility studies relating to utility service; assist in contract negotiations for utility services, and provide technical support to legislative activities.

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

BY MAJOR THOMPSON:

Q. Can you provide a brief summary of your testimony?

A. Yes. Good morning, Commissioners. In this proceeding I've proposed seven adjustments in my direct testimony. After discussions with Gulf, two of my issues were settled or stipulated, so I have five remaining issues. Some of these have been discussed extensively with you before, so I'll go through them quickly.

I have an issue with land held for future use or plant held for future use regarding the North Escambia generation site. The FEA opposes including this investment in rate base at this time because there has not been a determination of need issued from this Commission. In addition, the FEA questions whether AFUDC should be allowed on those dollars invested at this time.

Rate case expense, the FEA is proposing a normalization methodology for rate case expense, where we would propose that $700,000 be included in rate case expense over a four-year period. By normalizing rate case expense, you do not have to include an unamortized balance in rate base.

Storm recovery allowance, the FEA has proposed

that the storm recovery allowance be no more than $5 million a year. And the 5 million was, as indicated in my testimony, derived from the 3.5 million that this Commission found in Gulf's last rate case, adjusted for inflation. Again, though, I want to iterate that that's a ceiling and not the -- that should go no more than that. Obviously, the Commission has the discretion to reduce that amount.

In labor expense, you've heard extensive testimony throughout the week on this. The FEA has proposed that the labor expense be adjusted for the last known level of actual employees on Gulf's payroll. At the time of this testimony, the payroll levels included -- or the employee levels included at Gulf were 1,360 employees. That was as of June -- 1,365, excuse me.

Actual employee levels should be -- it's our position that actual employee levels should be used to the extent that those levels of employees can be shown to be needed to provide safe and adequate service.

Finally, my last issue is the margins on sales for resale. We believe that the level included in the case, the margin level included in this case is understated when you compare it to the actual results that Gulf reported in 2010, the 12 months ending

June 30th of 2011, and the results that are now available for September 30th of 2011.

This concludes my summary. Thank you.

MAJOR THOMPSON: I would like to make Mr. Meyer available for cross. And his button was still green.

CHAIRMAN GRAHAM: Intervenors? Staff?

MS. KLANCKE: No questions.

CHAIRMAN GRAHAM: Commissioners?

Redirect.

MAJOR THOMPSON: Can Mr. Meyer be excused for the remainder of the case?

CHAIRMAN GRAHAM: Mr. Meyer can be excused.

Major Thompson, you have David Stowe. You need to move his.

MAJOR THOMPSON: I believe all his prefiled testimony has already been stipulated and is in the record.

CHAIRMAN GRAHAM: It has already been moved into the record?

MAJOR THOMPSON: I believe so.

MS. KLANCKE: That is correct.

CHAIRMAN GRAHAM: Okay.

MAJOR THOMPSON: And I do not believe he had exhibits.

CHAIRMAN GRAHAM: And, Staff, your two witnesses, has all their stuff been moved? It *has in order?

MS. KLANCKE: That's correct, pursuant to stipulation.

CHAIRMAN GRAHAM: I don't have that 84 and 85 have been moved into the record.

MS. KLANCKE: It was my understanding that it was done when we did our recitation, but just to be on the safe side, we can address those now. They were -- both staff witnesses were stipulated by all witnesses, and pursuant to that stipulation, Numbers 84 and 85 were stipulated.

CHAIRMAN GRAHAM: Do you have any objections to 84 and 85 going into the record?

We'll move those two into the record.

(Exhibit Numbers 84 and 85 were admitted into the record.)

MR. MELSON: Mr. Chairman, just so I can be clear, I don't recall any of those three pieces of testimony, Mr. Stowe's or the two staff, the testimony having been inserted. I may be recalling wrong, but in an abundance of caution, you might want to insert it at this time.

CHAIRMAN GRAHAM: You're talking about the two

staff witnesses?

MR. MELSON: The two staff witnesses and FEA's witness Stowe.

CHAIRMAN GRAHAM: We will move their prefiled direct testimony into the record as though read.

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

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

Direct Testimony of David L. Stowe

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A David L. Stowe. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

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

Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

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

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

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

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A The purpose of my testimony is to describe my review of Gulf Power's embedded cost of service ("ECOS") study, and to address certain of Gulf Power's allocation methods.

Company ECOS Discussion

Q HAVE YOU REVIEWED THE ECOS STUDY PROVIDED BY GULF POWER?

A Yes.

Q PLEASE DESCRIBE WHAT YOU DETERMINED FROM YOUR REVIEW.

A The ECOS study presented in Gulf Power's direct testimony is similar to the ECOS study that was approved by the Florida Public Service Commission ("Commission") in Gulf Power's 2002 case (Docket No. 010949-EI). Specifically, Gulf Power's ECOS uses the 12 MCP & 1/13th kWh allocation for generation costs, a 12 MCP allocation of transmission costs and non-coincident peak ("NCP") demand allocation factors for primary and secondary distribution costs.

Gulf Power's ECOS study also recognizes the concept of the minimum distribution system ("MDS") and relies on the zero intercept ("ZI") method to classify customer-related distribution costs in Federal Energy Regulatory Commission ("FERC") Accounts 364-368. I support Gulf Power's recognition of the MDS concept, and also support its use of the ZI method to estimate the percentage of costs that should be allocated based on the number of customers. Gulf Power's use of the ZI could be improved, but nevertheless provides a reasonable estimate of the customer-related portion of distribution costs.

Q DOES GULF POWER ATTEMPT TO FOLLOW GENERALLY ACCEPTED COST OF SERVICE PRACTICES?

A Yes. Gulf Power witness Mr. O'Sheasy correctly states:

> "The overall objective of a cost-of-service study is to assign or allocate costs fairly and equitably to all customers. This objective is accomplished when the resulting cost-of-service study reflects "cost causation," i.e., those customers who caused a particular cost to be incurred by the Company in providing them service should be responsible for that cost... Joint or common costs must be allocated to customer groups based on the nature (i.e., drivers) of the costs incurred, and the aggregate requirements and service characteristics of the customers that caused the costs to be incurred. By adhering to this fundamental and essential principle of cost causation, the results of the cost-of-service study will be fair and equitable to all customers." (Direct Testimony of M. T. O'Sheasy, page 6, lines 3-8 and 16-21).

This portion of Mr. O'Sheasy's testimony indicates Gulf Power's commitment to identifying the cost-causative factors that influence the Company's investments, and its desire to allocate its costs in a manner that appropriately reflects these causative factors.

Q HOW DO THE COST OF SERVICE METHODS PRESENTED IN GULF POWER'S DIRECT TESTIMONY COMPARE TO THE METHODOLOGY APPROVED BY THE COMMISSION IN ITS LAST RATE CASE?

A The cost of service methods Gulf Power uses in this case differ from those approved by the Commission in Gulf Power's last rate case only to the extent that Gulf Power is again proposing the use of the MDS to identify and allocate customer-related distribution system costs. To a large degree, Gulf Power's presentation of its ECOS study is in accordance with its stated commitment to cost causation. Nevertheless, there is one instance where Gulf Power has used a particular allocation method simply because this method was approved in past cases, even though Gulf Power witness O'Sheasy believes a better method exists.

Gulf Power's Use of 12 MCP & 1/13th kWh Allocation

Q TO WHICH PARTICULAR ALLOCATION METHOD DO YOU REFER?

A I refer to the 12 MCP & 1/13th kWh allocation of generation costs. In his direct testimony, Mr. O'Sheasy states:

> "Although the Company does not agree that the use of 12-MCP & 1/13 kWh is a better allocator of generation level costs than a pure 12-MCP allocator would be, Gulf nevertheless prepared its study in this case using the Commission-approved methodology. Gulf continues to believe that a pure 12 MCP factor for generation results in a more accurate cost allocation. However, using the Commission's preferred method does not result in major variances in cost allocation from the pure 12-MCP approach and does not

significantly impair Gulf in designing efficient rates." (Direct Testimony of M. T. O'Sheasy, page 16, lines 11-18).

Q DO YOU AGREE WITH MR. O'SHEASY THAT THE COMMISSION'S APPROVED 12 MCP & 1/13th KWH METHOD IS NOT THE BEST ALLOCATOR OF GENERATION LEVEL COSTS?

A Yes. The 12 MCP & 1/13th kWh allocator does not reflect cost-causative factors that exist during Gulf Power's peak load periods, but instead reflect a system load that is far below the Company's actual peak load. As such, this method over-allocates generation costs to customer classes that use an above average proportion of their electricity during off-peak periods, and therefore bear less responsibility for the peak demand. Simultaneously, the 12 MCP & 1/13th allocation *understates* the generation facility cost responsibility of customer classes that contribute significantly to Gulf Power's system peak, and therefore bear greater responsibility for the Company's investment in generation facilities.

I concur with Mr. O'Sheasy that the pure 12 MCP factor, when compared to the 12 MCP & 1/13th kWh factor, results in a more accurate allocation of generation costs.

Gulf Power's Use of MDS

Q DOES GULF POWER USE COST-OF-SERVICE METHODS TO IDENTIFY A PORTION OF PRIMARY AND SECONDARY DISTRIBUTION COSTS AS CUSTOMER-RELATED?

A Yes. In its allocation of distribution system costs, Gulf Power uses the ZI method[1] to estimate the amount of, and separately allocate, distribution system costs that are incurred in proportion to the number of customers, from costs incurred to serve the maximum load of those customers. Gulf Power's ECOS study witness, Mr. O'Sheasy, states:

> "The Minimum Distribution System (MDS) methodology is necessary to accurately determine and allocate these customer-related distribution costs. The misclassification of costs that results from not using the MDS methodology sends misleading price signals to customers. This misclassification also results in different customer rate classes bearing more or less costs than their cost-causative share of distribution costs. It is therefore important to examine these customer-related costs and classify them appropriately, which the MDS methodology enables us to do." (Direct Testimony of M. T. O'Sheasy, page 16, line 24 – page 17, line 7).

[1]The two most widely recognized methods that are used to estimate the customer-related portion of costs are the ZI method, and the minimum system method. The National Association of Regulatory Utility Commissioners' 1992 publication of the Electric Utility Cost Allocation Manual ("NARUC Manual") includes both methods among those that are commonly used by utilities and approved by Commissioners. Throughout this testimony, I will use the term MDS in a broad sense to refer to the concept of the minimum distribution system in general, but will specify the ZI or minimum system when discussing a particular method that is used to estimate the cost of the MDS.

The Commission's Past Acceptance of MDS

Q IS RECOGNITION OF MINIMUM COSTS A NEW COST OF SERVICE CONCEPT?

A No. Such costs are often recognized in the concept known as the MDS, which represents a collection of costs that must be incurred to extend distribution service to the customers. The MDS has been accepted as valid by numerous state public utility commissions for decades. It has also been presented in the NARUC Manual.[2]

The central idea behind the MDS concept is that there is a cost incurred by a utility when it extends its primary and secondary distribution system, or replaces a component on those systems, that is caused by the utility's obligation to connect customers to its distribution system. This extension of the distribution system is how the utility was built up over decades. By definition, the MDS represents a portion of the cost of every distribution component necessary to provide service, (i.e., meters, services, secondary and primary wires, poles, substations, etc.) The cost included in the MDS, however, is only that portion of the total distribution cost the utility *must* incur to provide service to customers; it does not include costs specifically incurred to meet the peak demand requirements of the customers.

[2]See Chapter 6, Section II, pages 90-96 of the NARUC Manual.

Q HAS THE COMMISSION ADOPTED AN ECOS STUDY BY AN INVESTOR-OWNED UTILITY ("IOU") THAT INCLUDED THE USE OF AN MDS METHOD?

A No. In Order No. PSC-02-0787-FOF-EI, issued in Gulf Power's previous rate case (Docket No. 010949-EI), the Commission stated:

> "The Company and staff have proposed the use of a theoretical minimum distribution cost as part of the customer cost . . . . While we agree that sound regulatory practice should provide for a customer charge to defray otherwise fixed costs, as proposed by the Company and Staff, we do not agree that a theoretical cost of a minimum distribution system is appropriate... *The installation of the distribution system is made in anticipation of a projected level of actual use. The system does not contain a basic theoretical minimum distribution system.* Reliance on such a mechanism is speculative at best. Instead, we believe the appropriate customer charge should be based on the cost of the meter, service drop, meter reading and basic customer service costs (not including uncollectibles)." (Order No. PSC-02-0787-FOF-EI, issued June 10, 2002 in Docket No. 010949-EI, page 76, emphasis added).

Although it is widely agreed that distribution systems are installed in anticipation of a projected level of peak load, this load is not the only cost-causative factor affecting the cost of the distribution system. Safety and reliability standards, as mandated in the Florida Administrative Code ("F.A.C."), also have a cost-causative impact on the installation of Gulf Power's distribution system. Furthermore, these cost-causative factors have a clearly identifiable "minimum"

requirement that is directly related to the number of customers on the system. For example, F.A.C. Rule 25-6.034 – Standard of Construction, states:

> "Each utility shall, *at a minimum,* comply with the National Electrical Safety Code [ANSI C-2] [NESC], incorporated by reference in Rule 25-6.0345, F.A.C.[3]" (F.A.C. Rule 25-6.034, subpart (2), emphasis added).

This rule, in and of itself, clearly shows that the requirements of the National Electrical Safety Code ("NESC") serve as the basis of the smallest distribution system that every Florida utility must construct.

However, other F.A.C. rules mandate that certain facilities be constructed to NESC standards that are significantly higher than the minimum NESC requirements. For example, F.A.C. Rule 25-6.0342 – Electric Infrastructure Storm Hardening states:

> "...This rule is intended to ensure the provision of safe, adequate, and reliable electric transmission and distribution service for operational as well as emergency purposes; *require the cost-effective strengthening of critical electric infrastructure to increase the ability of transmission and distribution facilities to withstand extreme weather conditions;* and reduce restoration costs and outage times to end-use customers associated with extreme

[3]F.A.C Rule 25-6.0345 – Safety Standards for Construction of New Transmission and Distribution Facilities states:

> "(1) The Commission adopts and incorporates by reference the 2002 edition of the National Electrical Safety Code (ANSI C-2) [NESC], as the applicable safety standards for transmission and distribution facilities subject to the Commission's safety jurisdiction. For electrical facilities constructed on or after February 1, 2007, the 2007 NESC shall apply..."

weather conditions. This rule applies to all investor-owned electric utilities." (F.A.C. Rule 25-6.0342, subpart (1), emphasis added).

This rule mandates that the storm hardening plans adopt the extreme wind loading standards, specified in the 2007 version of the NESC, for new construction, major planned expansions, rebuilds, or relocations of existing facilities, and critical infrastructure facilities. Such F.A.C. rules cause Florida's electric utilities to incur costs in a manner that is, in no way whatsoever, related to the peak load of the customers, but is directly related to the existence of customers on the system.

Q DOES EMPIRICAL EVIDENCE EXIST THAT SUGGESTS THESE DISTRIBUTION COSTS ARE CUSTOMER-RELATED AND SHOULD BE ALLOCATED ON THE BASIS OF THE NUMBER OF CUSTOMERS?

A Yes. In October 2002, the Department of Energy's National Renewable Energy Laboratory ("NREL") published a Subcontractor Report entitled *"State Electricity Regulatory Policy and Distributed Resources: Distribution System Cost Methodologies for Distributed Generation."* This report, which describes the research and findings of the Regulatory Assistance Project ("RAP"), analyzed the embedded and marginal cost drivers for 124 U.S. utilities during the time period 1995-1999. With respect to the embedded cost drivers, which are most relevant to the Gulf Power costs identified and analyzed in this case, the RAP very clearly stated:

> "What drives distribution plant investment? We reviewed the relationship of investment in transformers and substations and lines and feeders to system peak, system sales, number of

customers, and to overall system size. Using the 5-year average investment, system peak, system sales, and number of customer data, it becomes clear that the investment in transformers and substations and in lines and feeders are highly correlated with system peak and number of customers and somewhat less correlated with system sales…

> "The R^2 for transformers and substation plant investment and system peak is 0.89, indicating a very strong correlation. Similarly, lines and feeders and system peak also exhibit a strong correlation with an R^2 of .89. *Correlations of investment with the customers show even higher R^2 values of 0.96 and 0.97, for transformers and substations and lines and feeders, respectively.* When compared to system energy, the R^2 drops significantly to only .49 and .42 for transformers and substations and for lines and feeders, respectively." (NREL Subcontractor Report, *State Electricity Regulatory Policy and Distributed Resources: Distribution System Cost Methodologies for Distributed Generation*, page 7, emphasis added).

The NREL report discussed above does *not* suggest that number of customers should replace or supersede peak load as the only cost driver. However, the empirical evidence provided in the NREL report clearly shows that both the number of customers and peak load contribute to a utility's investment in substations and transformers, and in overhead and underground circuits. It is reasonable to conclude, then, that any ECOS study that is designed to classify and allocate costs in accordance with how

those costs were incurred, will use a method that recognizes both the number of customers and peak load as cost-causative factors with regard to these primary and secondary voltage facilities.

ECOS studies that only recognize the costs of services and meters as customer-related costs, significantly understate the costs of connecting customers to the distribution system.

Q WHAT OTHER EVIDENCE EXISTS THAT SUGGESTS THESE DISTRIBUTION COSTS ARE DIRECTLY RELATED TO THE NUMBER OF CUSTOMERS ON THE SYSTEM?

A As I have already stated, F.A.C. Rule 25-6.0342 requires that planned expansions, upgrades, or relocations of facilities be constructed to "extreme weather conditions." F.A.C. Rule 25-6.064 describes how financial contributions from customers (i.e., Contributions-in-Aid-of-Construction or "CIAC"), that are collected to pay for a portion of the costs of these new or upgraded facilities, should be treated. This rule states:

> "All CIAC calculations under this rule shall be based on estimated work order job costs. In addition, each utility shall use its best judgment in estimating the total amount of annual revenues which the new or upgraded facilities are expected to produce.
>
> (a) ...
>
> (b) *In cases where more customers than the initial applicant are expected to be served by the new or upgraded facilities,* ***the utility shall prorate the total CIAC over the number of end-use customers***

> *expected to be served by the new or upgraded facilities* within a period not to exceed 3 years, commencing with the in-service date of the new or upgraded facilities." (F.A.C.. Rule 25-6.064, subpart (6), emphasis added).

The language in this F.A.C. rule provides unequivocal support for the idea that the costs associated with providing service to customers – which is what the CIAC is intended to offset – is directly proportional to the number of customers being served. It is a small step to recognize that the costs that are not offset by CIAC payments, i.e., costs that are recorded in FERC Accounts 364 through 368, are also incurred in direct proportion to the number of customers.

Commission's Acceptance of MDS for Choctawhatchee Electric Cooperative, Inc. ("CHELCO")

Q HAS THE COMMISSION EVER ADOPTED AN ECOS STUDY THAT INCLUDED THE USE OF AN MDS METHOD BY ANY FLORIDA UTILITY?

A Yes. In Order No. PSC-02-1169-TRF-EC, issued in Docket No. 020537-EC on August 26, 2002, the Commission approved rates for CHELCO that were based on an ECOS study which used the ZI method to estimate the MDS costs, and allocate them based on the number of customers.

Q WHY DID THE COMMISSION APPROVE THE USE OF AN MDS METHOD FOR CHELCO WHEN IT HAS NOT ALLOWED SUCH USE FOR IOUS?

A In Order No. PSC-02-1169-TRF-EC, the Commission stated:

> "In the past 20 years, we have consistently rejected the use of the MDS classification methodology by investor-owned utilities ... In this

case, however, we find that CHELCO has four unique characteristics that justify the use of the MDS classification methodology in its cost of service study." (Choctawhatchee Electric Cooperative, Inc., Order No. PSC-02-1169-TRF-EC, issued August 26, 2002 in Docket No. 020537-EC, page 3).

The first unique characteristic identified by the Commission was that "CHELCO has a density of ten customers per mile, while most investor-owned utilities have a density of fifty-five customers per mile or greater." (*Id.*). The Commission's Order also states:

> "In a high-density service territory, several customers may be served by a single transformer, while in a sparsely populated rural area there is usually one transformer for each residential account. Thus, the significant costs of constructing and maintaining a mile of line in a rural service territory are spread to a significantly fewer number of customers." (*Id.* page 4).

There are a couple of problems with using relatively low customer densities as a basis for approving an MDS. First, it is counterintuitive. The customer densities of the IOUs identified by Staff clearly show that, on average, "most" IOUs will incur the cost of connecting an additional customer five and a half times more frequently than CHELCO. This strongly implies that the customer-related costs incurred to connect customers to the system will be much higher for the IOUs than for CHELCO. In other words, most IOUs will incur the costs of transformers and secondary voltage circuits five times as often as CHELCO does. It is unclear, therefore, why CHELCO's relatively low customer density justifies its use of MDS methods, but the much more frequent incurrence

of customer-related costs of "most" IOUs does not.

More importantly, it is unprecedented to base adoption of the MDS method on the customer density of one utility relative to another. Indeed, the Commission's allowance of the MDS method in the case of CHELCO demonstrates – at the very least – that the Commission is aware that some portion of the primary and secondary distribution system costs, other than those related to services and meters, is customer-related. Furthermore, the Commission's acceptance of CHELCO's ZI analysis shows that it also recognizes the usefulness of such analyses to estimate this customer-related portion.

Q WHAT IS THE SECOND UNIQUE CHARACTERISTIC OF CHELCO THAT THE COMMISSION IDENTIFIED?

A The second unique characteristic identified by the Commission was that "CHELCO's rural service territory is quite different from an urban investor-owned utility." The Commission explains in its order:

> "Urban areas are normally occupied throughout the year, and customers usually consume a large amount of electricity that varies seasonally with their heating and cooling load. By contrast, CHELCO provides service to a significant number of barns, stock tanks, electric fences, hunting cabins, and vacation homes. These types of customers consume small amounts of electricity during the course of the year, and their usage is sporadic. A rate design with a relatively low customer charge and a high energy charge for these customers may not recover the costs of investment necessary to serve their load." (*Id.*).

This explanation is surprising in that it begins by describing how perceived differences between rural and urban service territories pertain to the MDS method, yet then draws a conclusion about rate design. Nothing is said to address how urban/rural territory differences negate the importance of the MDS in one case, or increase the importance of the MDS in the other. Furthermore, the comments regarding rate design appear out of place, since the MDS is specific to the ECOS study and therefore precedes, but is otherwise unrelated to the rate design process.

Reasons for Commission's Past Rejections of MDS

Q GIVEN THAT THE COMMISSION HAS APPROVED THE USE OF MDS METHODS FOR AN ELECTRIC COOPERATIVE, WHAT REASONS HAS THE COMMISSION GIVEN IN REJECTING THE USE OF MDS METHODS FOR IOUS IN PAST CASES?

A The Commission objections to the MDS have been numerous and varied. In its June 10, 2002 order (Order No. PSC-02-0787-FOF-E1) issued in regard to Gulf Power's 2002 rate case (Docket No. 010949-E1), the Commission rejected the use of the MDS after providing the following explanations:

1. Although utility and intervenor witnesses relied on the NARUC Manual to support the use of MDS, the NARUC Manual's stated purpose shows it was designed to educate regarding various cost allocation methods, not mandate any particular method.
2. Gulf Power provided no evidence on the specific circumstances that made it choose the MDS methodology over the method approved by the Commission in Gulf Power's previous rate case.

3. The MDS methodology requires construction of a hypothetical system consisting of equipment that is designed to carry zero load. Therefore, no real equipment equates to the costs identified by the ZI methodology. The Commission has rejected MDS in the past for this very reason.
4. Prior orders by the Commission show that it was the MDS's theoretical construct with which the Commission disagreed, not the end result of ECOS studies that use MDS methods.
5. The MDS is internally inconsistent in that it separates out distribution facilities for different treatment than transmission lines.

These are just a subset of the arguments against the MDS that the Commission has accepted over the last 30 years. Indeed, the Commission has not only rejected MDS proposals from Gulf Power, but has also rejected MDS proposals from the Commission Staff, Florida Power & Light Company, Florida Industrial Power Users Group, South Florida Hospital and Healthcare Association, Tampa Electric Company, and Florida Power Corporation.

Q DOES THE MDS METHODOLOGY REQUIRE CONSTRUCTION OF A HYPOTHETICAL SYSTEM CONSISTING OF EQUIPMENT THAT IS DESIGNED TO CARRY ZERO LOAD?

A No. The notion that the MDS is designed to carry no load is an over-simplification, and is also something of a straw-man argument. A better description of the MDS is that it reflects the smallest, lowest cost distribution system that *must be installed for the utility to meet its obligation to provide service to its customers*, but does not contain costs incurred to meet the customer's peak load. Therefore, the MDS methodology only requires the

analyst to identify the electric system components that must be installed to meet whatever construction, safety and/or reliability standards are enforced by the governing authorities at the time the line is installed.

The most realistic and accurate concept of the MDS is that it consists of the network of electric lines that conform to the NESC requirements described in the F.A.C.

Q IS THE MDS INTERNALLY INCONSISTENT IN THAT IT SEPARATES OUT DISTRIBUTION FACILITIES FOR DIFFERENT TREATMENT THAN TRANSMISSION LINES?

A No. It is universally understood that any electric system that carries electricity from the generator to the customer must contain transmission, sub-transmission, and distribution components. However, it is also widely recognized that the customer-related portion of costs steadily decreases as one moves away from the end-use customer toward the generator. At the transmission level, the customer-related portion of costs is generally low.

For example, at the meter, the customer-related portion of costs is 100%. Likewise, the customer-related portion of service costs is also 100%. However, the customer portion of costs drops significantly at the level of primary and secondary distribution lines. According to Gulf Power's analysis, the customer-related portion of its primary and secondary line costs, based on Gulf Power's own analysis of its distribution system, is slightly more than 27%.[4] If Gulf Power's MDS analysis method were applied to costs recorded in the

[4]Percentage found by dividing the customer-related costs identified for FERC Accounts 364-368 by total cost recorded in these FERC accounts.

transmission line accounts (FERC Accounts 354 through 358) it is reasonable to expect the customer-related portion to be far below 27%.

In-Depth Discussion of MDS

Q YOU HAVE DESCRIBED THE MDS PROCESS AS AN ESTIMATE OF COSTS. IS IT A MAJOR PROBLEM THAT GULF POWER HAS ESTIMATED THE AMOUNT OF CUSTOMER AND DEMAND-RELATED COSTS USING ITS PLANT RECORDS?

A No. In fact, utilities commonly rely on engineering and/or operations data to develop percentage estimates that are then used as a proxy for cost data. This is precisely the method that Gulf Power uses when it estimates the primary and secondary portions of its distribution system.

Q DO YOU AGREE WITH GULF POWER WITNESS O'SHEASY'S USE OF THE ZI METHOD TO ALLOCATE DISTRIBUTION COSTS?

A Yes. Mr. O'Sheasy's use of the ZI method is reasonable and appropriate given the overwhelming evidence available today which indicates that the costs Gulf Power incurs to install and maintain its primary and secondary distribution systems are caused by both the number of customers on the system and the peak demand of those customers.

This is not to say that the specific method used by Mr. O'Sheasy to estimate the MDS could not be improved. It certainly could. However, all of the improvements of Mr. O'Sheasy's analysis that I could propose, would result in a larger share of the distribution costs being allocated on the number of customers. Therefore, Mr. O'Sheasy's estimate of the MDS is conservative in the sense that

it understates the amount of costs that are actually caused by the number of customers.

Q DOES THE COMMISSION'S REQUIREMENT THAT ALL UTILITIES COMPLY WITH THE NESC, SUPPORT THE CONCEPT OF THE MDS?

A Yes. The Commission's requirement that all Florida utilities comply with the NESC (F.A.C. Rule: 25-6.0345), and its infrastructure hardening requirement entitled "Electric Infrastructure Storm Hardening (F.A.C. Rule 25-6.0342), establish the specific NESC standards with which the Florida utilities must comply whenever a new customer is connected to the system. Given that the cost of nearly every major primary and secondary distribution system component (FERC Accounts 364 through 368) is affected by these NESC requirements, all Florida utilities will incur costs in direct proportion to the number of customers they serve.

The same cannot be said with respect to demand. If the demand of an existing customer increases or decreases, the cost of meeting the NESC standards remains fixed.

Q DO YOU AGREE THAT CUSTOMER ELECTRICAL DEMAND IS AN IMPORTANT CRITERION WHEN DESIGNING A DISTRIBUTION SYSTEM?

A Yes, the demand requirements that must be met are important factors in system design. Distribution engineers rely on load forecasts and load flow studies to identify and design distribution system upgrades or to project load growth. Local peak demand of a circuit is a vital component of these forecasts and studies. Further, some segments of the delivery system (but not all) will vary with

expected demand. However, when developing an ECOS study, other criteria can be important as well. Gulf Power's ECOS study uses the ZI method to determine a customer-related portion of costs associated with the Company's primary and secondary distribution facilities. Therefore, it is capable of recognizing the cost-causative impact of the F.A.C. rules on these facilities. Absent an MDS method, a significant portion of Gulf Power's distribution costs, which are caused by the number of customers on the system, will nevertheless be inappropriately allocated on the basis of customer demand.

Q PLEASE EXPLAIN WHAT YOU MEAN.

A As I said previously, the fundamental premise of a proper ECOS study is the concept of *cost-causation* which is, in many cases, directly related to electrical parameters like voltage level or peak demand. This is particularly true when planning for maximum conditions or "worst case" scenarios. Yet, there are factors besides voltage level and peak demand that can significantly affect cost. A properly conducted ECOS study must consider all cost-causing factors.

When distribution engineers *design* the enhancement, upgrade or extension of an electric system, they must be constantly aware of the operating parameters of the system. But, it is in the construction of the distribution system that the *true cause* of many distribution costs is clearly seen. Surprisingly, that cause is frequently *not* demand.

An illustration helps make this point clear. Consider a customer who intends to build a home on a new lot, one that does not already have electrical service. This customer is cost and energy conscious and thus chooses to use as many energy efficiency techniques and appliances as possible. After

considerable research and consultation with experts, the customer calls the utility and informs it that he will require service capable of providing a maximum peak demand of 2,000 watts (2 kW).

During the installation of the primary and secondary distribution extension to the customer's home, he notices that the linemen are using conductors, poles, cross-arms, and components identical to those serving the much larger, and less efficient, home down the street. After more investigation, the customer learns that the distribution extension to his home is capable of carrying far greater demand than his home was designed to use. When he informs the utility of this "error," the utility explains that it cannot install wires smaller than a certain size or hang them below a certain height. In short, there are specified minimum standards that the utility must meet that are wholly unrelated to the new home's reduced demand.

This illustration demonstrates that although utilities design and install distribution equipment to satisfy their customers' need for electricity, there are factors other than electrical demand that force them to incur costs. Safety and reliability are as critical to every phase of design and construction as demand. As one reviews the cost of the distribution system nearest the customer (that portion from the distribution system that includes primary voltage radial lines, line transformers and the network of secondary voltage lines), the cost incurred to comply with safety and reliability standards begins to outweigh the cost of meeting electrical demand.

Q HAS THE COMMISSION ADOPTED THE NESC STANDARDS IN THE F.A.C.?

A Yes. F.A.C. Rule 25-6.0345 – Safety Standards for Construction of New Transmission and Distribution Facilities states:

> "The Commission adopts and incorporates by reference the 2002 edition of the National Electrical Safety Code (ANSI C-2) [NESC], as the applicable safety standards for transmission and distribution facilities subject to the Commission's safety jurisdiction. For electrical facilities constructed on or after February 1, 2007, the 2007 NESC shall apply. Electrical facilities constructed prior to February 1, 2007, shall be governed by the edition of the NESC specified by subsections 013.B.1, 013.B.2, and 013.B.3 of the 2007 NESC. *Each investor-owned electric utility, rural electric cooperative, and municipal electric system shall, at a minimum, comply with the standards in these provisions*." (F.A.C. Rule 25-6.0345, subpart (1), emphasis added).

Q WHAT IS THE PURPOSE OF THE NESC?

A Section 1, Part 010, of the NESC states:

> "The purpose of these rules is the practical safeguarding of persons during the installation, operation, or maintenance of electric supply and communication lines and their associated equipment. They contain *minimum provisions considered necessary* for the safety of employees and the public. They are not intended as a design specification or an instruction manual." (Emphasis added).

Q DOES THE NESC ALSO ESTABLISH STANDARDS FOR THE ELECTRICAL DEMAND EACH COMPONENT MUST BE CAPABLE OF CARRYING?

A Not directly. To my knowledge, the only situation where the NESC covers something like this is in the case of grounding wires where the NESC sets the "short time ampacity adequate for a fault current."[5] Yet even here, the purpose of the grounding wire is to provide safety or enhance reliability rather than to serve electrical load.

Q ARE MDS METHODS USED FOR ALLOCATING DISTRIBUTION COSTS IN OTHER STATES?

A Yes, it is not uncommon outside of Florida. My research indicates MDS methods are currently, or have been approved by at least 17 state commissions.

[5]Section 9, Subsection 93.C., Ampacity and Strength.

Q WHAT DO YOU RECOMMEND?

A The Commission should accept Gulf Power's use of the ZI method to estimate the customer-related costs associated with the Company's primary and secondary distribution system. By recognizing the MDS in its ECOS study, Gulf Power has obtained a reasonable, yet understated, estimate of costs associated with the MDS. The Commission should also accept Gulf Power's classification of the costs identified by its ZI analysis as customer-related, and its allocation of these costs based on the number of customers in each class.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes, it does.

Qualifications of David L. Stowe

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A David L. Stowe. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q PLEASE STATE YOUR OCCUPATION.

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

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A I was graduated from the Kansas State University's College of Electrical and Computer Engineering in 1987, with a Bachelor of Science degree in Electrical Engineering. Following my graduation, I worked with the Kansas Corporation Commission ("KCC") as a Utilities Engineer. My responsibilities included the review and engineering analysis of utility filings, investigations of compliance with the Commission's Orders and State laws, and filing and defending testimony regarding those filings. In addition, I served as Geographic Information Systems Coordinator as the KCC digitized and automated its utility facilities and territory maps from the original velum sheets.

In April of 1993, I accepted a position with the Missouri Public Service Commission where, again in the capacity of a Utilities Engineer, focused primarily on depreciation, jurisdictional allocations, and production cost modeling. My employment with the Commission also allowed me to complete the requirements for Professional Engineer registration. I acquired my certificate for

Professional Engineering registration in 1996.

From October 1995 until January 2002, I developed my expertise in computer engineering and communications; first acting as a Unix System Administrator and Oracle DBA with Kansas City Power and Light, and later offering both hardware and software consulting services to corporations with enterprise-wide application requirements with Digital Equipment Corporation and Compaq. During this time, I was also the president and owner of a company that installed analog and digital communication systems in cellular phone towers.

In January of 2002, I joined the Analytic Services Department of Aquila, Inc. as a Senior Regulatory Analyst where I was primarily responsible for developing and maintaining cost of service models for each of Aquila's electrical territories. In addition, I was solely responsible for completing associated engineering studies to determine the P/S portions of each subsidiary's distribution systems, calculating the zero intercept values for the subsidiaries' poles, conductors, conduits, and transformers, performing customer impact analyses, and assisting in rate design.

In October of 2007, I joined Brubaker & Associates, Inc. as a consultant. Since that time, I have assisted on cost of service, revenue requirement, and tariff issues in Colorado, Illinois, Kansas, Michigan, Missouri, Montana, New York, Oklahoma, Wisconsin and Wyoming.

I have testified before the State Commissions of Colorado, Illinois, Kansas, Michigan and Missouri.

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

DIRECT TESTIMONY OF DEBRA M. DOBIAC

Q. Please state your name and business address.

A. My name is Debra M. Dobiac, and my business address is 2540 Shumard Oak Boulevard, Tallahassee, Florida, 32399.

Q. By whom are you presently employed and in what capacity?

A. I am employed by the Florida Public Service Commission as a Regulatory Analyst II in the Office of Auditing and Performance Analysis.

Q. How long have you been employed by the Commission?

A. I have been employed by the Commission since January 2008.

Q. Briefly review your educational and professional background.

A. I graduated with honors from Lakeland College in 1993 and have a Bachelor of Arts degree in accounting. Prior to my work at the Commission, I worked for 6 years in internal auditing at the Kohler Company and First American Title Insurance Company. I also have approximately 12 years of experience as an accounting manager and controller.

Q. Please describe your current responsibilities.

A. Currently, I am a Regulatory Analyst II with the responsibilities of managing regulated utility financial audits. I am also responsible for creating audit work programs to meet a specific audit purpose.

Q. Have you presented testimony before this Commission?

A. Yes. I testified in the Aqua Utilities Florida, Inc. Rate Case, Docket No. 080121-WS and the Water Management Services, Inc. Rate Case, Docket No. 100104-WU.

Q. What is the purpose of your testimony today?

A. The purpose of my testimony is to sponsor the staff audit report of Gulf Power Company (Utility or GPC) which addresses the Utility's application for a rate increase. This audit report is filed with my testimony and is identified as Exhibit DMD-1.

Q. Was this audit prepared by you or under your direction?

A. Yes, it was prepared under my direction and supervision.

Q. What was the test year you audited?

A. The historical year ended December 31, 2010 is the period we audited unless otherwise specified.

Q. Please describe the work you performed in this audit.

A. We performed the following procedures:

Utility Books and Records

We developed a 13-month trial balance from the Utility's general ledger and reconciled it to the Minimum Filing Requirements (MFRs) for rate base, net operating income, and capital structure. No variances were noted.

We verified that the Utility's adjustments to rate base and net operating income for the audit period were consistent with the Commission's findings in the Utility's last rate case. We reconciled these adjustments to the general ledger or other supporting documentation. We verified that all necessary adjustments were made and that they were correctly calculated based on the Utility's last rate case.

Rate Base:

Utility Plant in Service and Accumulated Depreciation

We verified the 13-month average plant balances, reserve balances, and depreciation expense for each plant account for the audit period. In addition, we verified the plant additions, retirements, and adjustments from the last rate case date through the most recent actual data.

For our beginning balances, we used the Utility's December 31, 2000 plant and reserve balances from the last rate case audit in Docket No. 010949-EI as adjusted by Commission Orders. We scheduled the plant and reserve balances from the monthly

operating reports through December 31, 2010 and traced the ending balance to the general ledger and the MFRs. We judgmentally selected work orders added since the last rate case and tested additions to supporting documentation. No exceptions were noted.

Property Held for Future Use

We obtained a list of all property held for future use and the corresponding deeds, closing statements, and property tax bills. We traced the land balances to the monthly operating reports, the general ledger, and the MFRs.

Construction Work in Progress

We obtained a list of projects included in Construction Work In Progress (CWIP) and determined which projects were eligible for Allowance for Funds Used During Construction (AFUDC) pursuant to Rule 25-6.0141, Florida Administrative Code (F.A.C.). We recalculated AFUDC for the work orders tested. We noted that the Utility is not requesting AFUDC-eligible CWIP in rate base.

Working Capital

We reviewed the accounts included in working capital for items that may earn interest. We verified that the balance sheet accounts associated with the interest income and interest expense were excluded from working capital.

We reviewed transactions in clearing accounts, stores expense, prepayments, deferred debits, deferred credits, and accrued liabilities to determine if they were utility in nature, and that expenses were not overstated. We also reviewed materials and supplies and other accounts receivable for non-utility items. We determined which of these accounts were included in working capital, and then selected accounts with material balances. Audit staff judgmentally sampled these accounts, traced items to source documentation, verified if utility-related, and included appropriately in working capital. No exceptions were noted.

We judgmentally sampled accounts 228.1 – Accumulated Provision for Property Insurance, 228.2 – Accumulated Provision for Injuries and Damages, and 228.4 – Accumulated Miscellaneous Operating Provisions to determine whether the Utility complies with the provisions of Rule 25-6.0143, F.A.C. We traced these items selected in our samples to source documentation, verified if utility-related, and determined if they were appropriately included in working capital. No exceptions were noted.

Net Operating Income:

Operating Revenue

We recalculated the unbilled revenue for the audit period and traced it to the MFRs and the general ledger. We recalculated a judgmental sample of customer bills and traced the rates to the appropriate clause factors and tariffs. No exceptions were noted.

Operation and Maintenance Expense

We prepared an analytical review of the Utility's expenses. We compared the expenses from 2006 to 2010 noting any large increases in accounts. We selected a judgmental sample based on the analytical review and tested as per the criteria listed above. No exceptions were noted.

We selected a judgmental sample from the advertising account and reviewed the advertisements to determine if they were image enhancing in nature, promotional, related to non-utility operations or one of the recovery clauses. No advertisements sampled met these criteria.

We selected a judgmental sample of legal fees, other outside service expenses, sales expenses, customer service expenses, office supplies and expense, and miscellaneous general expenses and tested them to see that they were reasonable, adequately supported, and recorded in compliance with the Uniform System of Accounts (USOA). No exceptions were noted.

We reviewed the liability, health, and life insurance expense accounts during and subsequent to the audit period to determine if the Utility received refunds based on loss experience. We also requested information from the Utility concerning refunds it had received based on loss experience.

Depreciation Expense

We obtained depreciation schedules for the audit period and reconciled them to the general ledger and the MFRs. We compared the rates used with those approved in Order No. PSC-10-0458-PAA-EI issued July 19, 2010 in Docket No. 090319-EI. No exceptions were noted.

Taxes Other than Income

We traced the property taxes, gross receipts tax and regulatory assessment fees reported in the MFRs to the applicable tax returns and recalculated these taxes as necessary. We obtained the sales tax reports and compared them to the sales tax accounts to verify that sales tax collection discounts are recorded above the line. We recalculated sales tax collection discounts for the year 2010, and traced the discounts from the general ledger to sales and use tax returns and utility payment vouchers. No exceptions were noted.

Income Taxes

The Utility's 2010 federal and state tax returns were filed on September 15, 2011. We attempted to reconcile the federal and state income taxes to the MFRs and the general ledger, and to verify that deferred income tax expense and deferred tax balances include proper bonus depreciation treatment of property additions.

Capital Structure:

We obtained the rate base/capital structure reconciliation and determined that the non-utility adjustments removed in rate base were removed in the capital structure. We

developed a 13-month average trial balance from the Utility's general ledger and reconciled it to the cost of capital MFRs. Audit staff reconciled the cost of capital cost rates for the audit period to the debt documentation. We obtained a reconciliation of the rate base adjustments in the capital structure and traced it to the MFRs and the general ledger. No exceptions were noted.

Other:

Affiliate Transactions

Audit staff reviewed the Utility's policies and procedures relating to the recording of affiliate transactions and the cost/allocation manual for employees to determine if an appropriate amount of costs were allocated pursuant to Rule 25-6.1351, F.A.C. During the review of rate base and net operating income, we examined items that were allocated as per the Utility's policies and procedures. No exceptions were noted.

Federal Energy Regulatory Commission Audit

We read the Federal Energy Regulatory Commission (FERC) audit, dated May 4, 2004, pertaining to the industry-wide audit of Account 154, Plant Materials and Operating Supplies, and Account 163, Stores Expenses Undistributed, and determined that no corrective action was required.

Internal and External Audits

We reviewed the internal and external audits to determine if any adjustments materially affected the audit period. We noted that the Utility had performed any required corrective action in the applicable follow-up audit.

Budget Analysis

We requested comparisons of actual to budget capital expenditures and variance explanations for each month from January 2010 to June 2011. Audit staff scheduled the actual to budget capital expenditures noting significant variances and traced them to the

Utility's explanations. All variances were explained to audit staff's satisfaction.

We requested comparisons of actual to budget O&M expenditures and variance explanations for each month from January 2010 to June 2011. We scheduled the actual to budget O&M expenditures noting significant variances and traced them to the Utility's explanations. All variances were explained to audit staff's satisfaction.

Audit staff requested a breakdown of the Production O&M budget for Special Projects for the Historical Year Ended December 31, 2010, the Prior Year Ended December 31, 2011, and the Projected Test Year Ended December 31, 2012. We reviewed the data for any atypical projects and any significant variances from year to year. All variances were explained to audit staff's satisfaction.

We requested copies of any internal, external, quality review, or industry peer reviews conducted during the past five years relating to the budget function. The Utility provided one internal audit that reported no significant findings.

Q. Please review the audit findings in this audit report, DMD-1, which address the Gulf Power Company's rate case filing.

A. There were four findings in this audit.

Audit Finding 1

Audit Finding 1 concerns land that was classified as Property Held for Future Use (PHFU) but has been occupied by a substation since 2003. In April 2011, the Utility transferred $85,464 of land for the substation from PHFU to Plant in Service. The PHFU and Plant in Service 13-month averages on MFR Schedule B-1 do not reflect this transfer for 2010, 2011 and 2012. Audit staff did not adjust the MFRs because the amount was immaterial compared to the balance of PHFU or Plant in Service. Since PHFU and Plant in Service are components of rate base, this Finding has no net effect on the total of rate base for 2010, 2011 and 2012.

Audit Finding 2

Audit Finding 2 involves income generated by PHFU. In 2008, the Utility sold timber located on PHFU in Mossy Head for $55,320. The accounting for the sale of the Mossy Head timber was based on the internal procedures for land held less than 15 years. The Mossy Head land was acquired in 1998 and 1999, and the weighted age of the land was ten years, based on the purchased acreage. As the land was held less than fifteen years, a .667 revenue multiplier was calculated based on the Utility's internal procedure. This multiplier was then applied to the $55,020 received for the timber harvested and yielded $36,680 that was booked to revenue account 456-00700. The remaining proceeds of $18,340 were booked as a reduction to the Mossy Head PHFU investment, account 105.

Audit Finding 3

Audit Finding 3 relates to insurance premium refunds. We reviewed liability, health, and life insurance expense during and subsequent to the audit period, and requested information from the Utility concerning refunds it had received based on loss experience. The Utility disclosed that no insurance refunds were received during 2010. However, a refund for overpayments of $4,791 was received from the health insurance in 2011. Overpayments of $853 were incurred originally in 1999 and 2000. Refunds of $3,938 were received in 2011 for overpayments incurred earlier in 2011. A refund of $255,500 was received in 2011 from Workman's Compensation Insurance for an incident that occurred prior to the 2010 test year. These amounts received do not affect the 2010 test year. Audit staff did not determine the effect on 2011 and 2012, if any.

Audit Finding 4

Audit Finding 4 addresses income taxes. The Utility informed us that the tax returns were scheduled to be filed on September 15, 2011, and promptly provided access

to copies of the tax returns after the filing date. We noted significant variances between the MFRs, the general ledger, and the tax returns with respect to taxable income per books, temporary and permanent differences, state taxable income, and federal taxable income, for which we requested a reconciliation. The reconciliation was not completed as of the date of the audit report, and audit staff was unable to determine what effect the variances would have on deferred taxes.

Q. Does that conclude your testimony?

A. Yes.

DIRECT TESTIMONY OF RHONDA L. HICKS

Q. Please state your name and address.

A. My name is Rhonda L. Hicks. My address is 2540 Shumard Oak Boulevard; Tallahassee, Florida; 32399-0850.

Q. By whom are you employed and in what capacity?

A. I am employed by the Florida Public Service Commission (FPSC or Commission) as Chief of the Bureau of Consumer Assistance in the Division of Service, Safety, and Consumer Assistance.

Q. Please give a brief description of your educational background and professional experience.

A. I graduated from Florida A&M University in 1986 with a Bachelor of Science degree in Accounting. I have worked for the FPSC for 23 years. I have varied experience in the electric, gas, telephone, and water and wastewater industries. My work experience includes rate cases, cost recovery clauses, depreciation studies, tax, audit, consumer outreach and consumer complaints. I currently work in the Bureau of Consumer Assistance within the Division of Safety, Reliability, and Consumer Assistance where I manage consumer complaints and inquiries.

Q. What is the function of the Bureau of Consumer Assistance?

A. The bureau's function is to resolve disputes between regulated companies and their customers as quickly, effectively, and inexpensively as possible.

Q. Do all consumers, who have disputes with their regulated company, contact the Bureau of Consumer Assistance?

A. No. Consumers may initially file their complaint with the regulated company and reach resolution without the bureau's intervention. In fact, consumers are encouraged to allow the regulated company the opportunity to resolve the dispute prior to any

Commission involvement.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to advise the Commission of the number of consumer complaints logged against Gulf Power Company under Rule 25-22.032, Florida Administrative Code, Consumer Complaints, from January 1, 2009, through September 30, 2011. My testimony will also provide information on the type of complaints logged and those complaints that appear to be rule violations.

Q. What do your records indicate concerning the number of complaints logged against Gulf Power Company?

A. From January 1, 2009, through September 30, 2011, the FPSC logged 1,520 complaints against Gulf Power Company. During 2009 and 2010, the FPSC logged 593 and 602 complaints against Gulf Power Company, respectively. In 2011, from January 1, 2011, through September 30, 2011, the FPSC logged 325 complaints against Gulf Power Company. Of the 1,520 complaints, 1,394 were transferred directly to the company for resolution and required no further action from the Commission.

Q. What have been the most common types of complaints received by the Commission?

A. During the specified time period, the majority of complaints logged against Gulf Power Company involved billing.

Q. Do you have any exhibits attached to your testimony?

A. Yes. I am sponsoring Exhibit RLH-1.

Q. Would you explain Exhibit RLH-1?

A. Yes. Exhibit RLH-1 is a summary listing of complaints logged against Gulf Power Company under Rule 25-22.032, Florida Administrative Code. The complaints,

received January 1, 2009 through September 30, 2011, were captured in the Commission's Consumer Activity Tracking System (CATS). The summary groups the complaints by Close Type and within each Close Type, the complaints are segregated by Pre-Close Type. The first grouping is Pre-Close types that are still pending. The remaining groupings are categorized by Close Type codes such as EB-49, GI-02, GI-05, GI-25, etc.

Q. What is a Pre-Close Type?

A. A Pre-Close Type is an internal categorization code that is applied to each complaint upon receipt. A complaint is assigned a Pre-Close Type based solely on the initial information provided by the consumer.

Q. What is a Close Type?

A. A Close Type is also an internal categorization code. It is assigned to each complaint once staff completes its investigation and a proposed resolution is provided to the consumer. In some instances, the Pre-Close Type will differ from the Close Type because staff's investigation reveals facts that were not available upon receipt of the complaint.

Q. A great majority of complaints were resolved as Close Type GI-02, Courtesy Call/Warm Transfer. Can you explain this Close Type?

A. Yes. Gulf Power Company participates in the Commission's Transfer-Connect (Warm Transfer) System. This system allows the Commission to directly transfer a customer to the company's customer service personnel. Once the call is transferred to Gulf Power Company, it provides the customer with a proposed resolution. Customers who are not satisfied with the company's proposed resolution have the option of recontacting the Commission. While the Commission is able to assign a Pre-Close Type to each of the complaints in this category, a specific Close Type is not assigned

because the proposed resolution is provided by Gulf Power Company. Consequently, the assigned Close Type allows staff to monitor the number of complaints resolved via the Commission's Transfer-Connect System.

Q. How many of the complaints summarized on your exhibit has staff determined may be a violation of Commission rules?

A. Of the 1,520 complaints, staff determined that one may be violation of Commission rules.

Q. What was the nature of the possible rule violation?

A. The possible rule violation was failure to respond to the Commission in a timely manner.

Q. Does this conclude your testimony?

A. Yes, it does.

MS. KLANCKE: In addition, just to be on the safe side, Stowe's deposition, pursuant to stipulation, was reflected as having been stipulated, but just in case, let's ensure for complete necessary that it has been moved into the record.

CHAIRMAN GRAHAM: We'll show it moved into the record.

We're at rebuttal? Okay.

MR. MELSON: We call Dr. Vander Weide.

Mr. Chairman, before we start with Dr. Vander Weide, our rebuttal witness Thompson was presenting rebuttal on only one issue, and that issue has now been stipulated. This is just to announce to the Chair that we are going to withdraw that testimony and will not be presenting his rebuttal. He's listed as the very last witness, so we don't save any time until later this afternoon.

CHAIRMAN GRAHAM: Okay. I'll strike anybody as soon as you want them struck.

MR. MELSON: And with that, we ask that he be excused so he can return to work.

CHAIRMAN GRAHAM: Is there no need for Mr. Thompson to stay, no objections? We will excuse him. So be it.

Thereupon,

JAMES H. VANDER WEIDE

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

DIRECT EXAMINATION

BY MR. MELSON:

Q. Dr. Vander Weide, let me remind you you're still under oath. Would you please state your name and business address.

A. Yes. My name is James H. Vander Weide, and my business address is 3606 Stoneybrook Drive, Durham, North Carolina.

Q. And what is your occupation or profession?

A. I am Research Professor of Finance and Economics at Duke University and president of Financial Strategy Associates.

Q. And did you prefile rebuttal testimony in this docket dated November 4th consisting of 76 pages?

A. Yes, I did.

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

A. Yes. I have two that are both on page 66.

Q. Page 66?

A. Yes, of my rebuttal testimony. On lines 13

and 14, there are the letters TB and AB that are definitions of the terms that are in the equation that is just above that. That should be a T_B and A_B. And then on line 24, after the comma, I say, "I obtain a risk of 5.78 percent." That should be, "I obtain a risk premium of 5.78 percent." So the word "premium" should be inserted after the word risk.

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. MELSON: Mr. Chairman, I would ask that Dr. Vander Weide's rebuttal testimony be inserted into the record as though read.

CHAIRMAN GRAHAM: We will insert Dr. Vander Weide's rebuttal testimony into the record as though read.

REBUTTAL TESTIMONY AND EXHIBIT OF

JAMES H. VANDER WEIDE, PH.D.

ON BEHALF OF GULF POWER COMPANY

DOCKET NO. 110138-EI

November 4, 2011

I. INTRODUCTION AND PURPOSE

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

A. My name is James H. Vander Weide. I am Research Professor of Finance and Economics at Duke University, The Fuqua School of Business. I am also President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to business clients. My business address is 3606 Stoneybrook Drive, Durham, North Carolina 27705.

Q. Are you the same James H. Vander Weide who provided direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your testimony?

A. I have been asked by Gulf Power Company ("Gulf Power" or "the Company") to review the direct testimonies and cost of capital recommendations of Dr. J. Randall Woolridge and Mr. Michael P. Gorman. Dr. Woolridge's testimony is presented on behalf of the Florida Office of Public Counsel ("OPC"), and Mr. Gorman is appearing on behalf of the Federal Executive Agencies ("FEA").

Q. Is there anything in the testimonies of Dr. Woolridge and Mr. Gorman that causes you to change your recommended cost of equity for Gulf Power?

A. No, there is not. I continue to recommend that Gulf Power be allowed to earn an 11.7 percent rate of return on equity.

II. REBUTTAL OF DR. WOOLRIDGE

Q. What is Dr. Woolridge's recommended rate of return on equity for Gulf Power?

A. Dr. Woolridge recommends that Gulf Power be allowed to earn a rate of return on equity equal to 9.25 percent.

Q. What areas of Dr. Woolridge's testimony will you address in your rebuttal testimony?

A. I will address Dr. Woolridge's: (1) proxy companies; (2) discounted cash flow ("DCF") analysis; (3) rejection of analysts' growth forecasts; (4) Capital Asset Pricing Model ("CAPM") analysis; (5) comments on the relationship between utility rates of return on equity and their market-to-book ratios; and (6) comments on my direct testimony.

A. Dr. Woolridge's Proxy Companies

Q. What criteria does Dr. Woolridge use to select his proxy company group?

A. Dr. Woolridge selects companies that are listed as electric utilities or combination electric and gas companies in both AUS Utility Reports and The Value Line Investment Survey, have at least 50 percent of revenues from regulated electric utility services, pay a cash dividend, have an investment-grade bond rating as

reported by AUS Utility Reports, are not involved in an acquisition, and have EPS growth rate forecasts available from Yahoo, Reuters, and Zacks [Woolridge at 8–9].

Q. Do you agree with Dr. Woolridge's proxy selection criteria?

A. No. I disagree with Dr. Woolridge's criteria that: (1) a proxy company must be followed by AUS Utility Reports; (2) must have at least fifty percent of revenues from regulated electric utility services; and (3) must have an investment-grade bond rating as reported by AUS Utility Reports.

Q. Why do you disagree with Dr. Woolridge's criterion that a proxy company must be followed by AUS Utility Reports?

A. I disagree with this criterion because, in my opinion, the average investor does not rely on AUS Utility Reports as an important or widely used source of information for investment decisions. The average investor is more likely to rely on information from investment information companies such as Value Line, Standard & Poor's, and Internet sources such as Yahoo Finance and Reuters.

Q. Why do you disagree with Dr. Woolridge's criterion that a proxy company must have at least fifty percent of revenues from regulated electric utility services?

A. I disagree with this criterion for three reasons. First, the fair rate of return standard set forth in the *Hope* and *Bluefield* decisions requires that investors have an opportunity to earn a return on their investment in Gulf Power that is commensurate with returns they expect to earn on other investments of similar risk.

The *Hope* and *Bluefield* decisions do not require that a proxy company must have a specific percentage of revenues from electric utility service. Second, the companies in the Value Line electric utility industry that fail Dr. Woolridge's criterion requiring greater than fifty percent revenues from electric utility services generally fail this criterion because they are combination utilities that have both electric and gas utility operations. Since electric and natural gas utility operations are widely considered to be of relatively similar risk, there is no need to eliminate combination utilities from a proxy company group to estimate the cost of equity for an electric utility such as Gulf Power. Third, it is not clear that revenues is a primary indicator of a company's involvement in electric utility operations.

Q. What Value Line electric utilities does Dr. Woolridge eliminate because he believes they have less than fifty percent revenues from electric utility operations?

A. It appears that Dr. Woolridge eliminates Black Hills, CenterPoint Energy, Dominion Resources, Integrys Energy, Sempra Energy, UIL Holdings, and Vectren for this reason.

Q. Are these companies combination utilities, with both electric utility and natural gas utility operations?

A. Yes.

Q. Why do you disagree with Dr. Woolridge's criterion that a company must have an investment-grade bond rating as reported by AUS Utility Reports?

A. Although I generally agree that a proxy company should have an investment-grade bond rating, I disagree with Dr. Woolridge's reliance on AUS Utility Reports as a source for information on a company's bond rating. In my experience, AUS Utility Reports is an unreliable source of bond rating information. For example, AUS Utility Reports shows a BBB+ Standard & Poor's bond rating for UniSource and "NR" from Moody's, when, in fact, UniSource has a below-investment grade bond rating from both Standard & Poor's and Moody's, as shown directly on the web sites of Standard & Poor's and Moody's. (*See* http://www.standardandpoors.com/prot/ratings/entity-ratings/en/us/?entityID=269542&sectorCode=UTIL and http://www.moodys.com/credit-ratings/UniSource-Energy-Corporation-credit-rating-806919894.) Furthermore, a company's current bond rating by Standard & Poor's or Moody's is freely available to anyone from Standard & Poor's or Moody's.

B. Dr. Woolridge's DCF Model

Q. Does Dr. Woolridge use the DCF model to estimate Gulf Power's cost of equity?

A. Yes, he does.

Q. What cost of equity result does Dr. Woolridge obtain from his application of his DCF model?

A. Dr. Woolridge obtains a cost of equity result of 9.3 percent for his proxy group [Woolridge Exhibit ___JRW-10, page 1 of 6].

Q. What DCF model does Dr. Woolridge use to estimate Gulf Power's cost of equity?

A. Dr. Woolridge uses an annual DCF model of the form, $k = D_0(1+.5g)/P_0 + g$, where k is the cost of equity, D_0 is the first period dividend, P_0 is the current stock price, and g is the average expected future growth in the company's earnings and dividends.

Q. What are the basic assumptions of Dr. Woolridge's annual DCF model?

A. Dr. Woolridge's annual DCF model is based on the assumptions that: (1) a company's stock price is equal to the present value of the future dividends investors expect to receive from their investment in the company; (2) dividends are paid annually; (3) dividends, earnings, and book values are expected to grow at the same constant rate forever; and (4) the first dividend is received one year from the date of the analysis.

Q. Do you agree with Dr. Woolridge's use of an annual DCF model to estimate Gulf Power's cost of equity?

A. No. Dr. Woolridge's annual DCF model is based on the assumption that companies pay dividends only at the end of each year. Since Dr. Woolridge's proxy companies all pay dividends quarterly, Dr. Woolridge should have used the quarterly DCF model to estimate Gulf Power's cost of equity.

Q. Why is it unreasonable to use an annual DCF model to estimate the cost of equity for companies that pay dividends quarterly?

A. It is unreasonable to apply an annual DCF model to companies that pay dividends quarterly because: (1) the DCF model is based on the assumption that a company's stock price is equal to the present value of the expected future dividends associated with investing in the company's stock; and (2) the annual DCF model cannot be derived from this assumption when dividends are paid quarterly. (I note that this Commission also uses a quarterly DCF model when estimating the cost of equity for water and wastewater utilities. *See* Order No. PSC-11-0287-PAA-WS issued July 5, 2011, in Docket No. 110006-WS, regarding the annual reestablishment of authorized range of return on common equity for water and wastewater utilities.)

Q. Does Dr. Woolridge acknowledge that one must recognize the assumptions of the DCF model when estimating the model's inputs?

A. Yes. Dr. Woolridge states, "In general, one must recognize the assumptions under which the DCF model was developed in estimating its components (the dividend yield and expected growth rate)." [Woolridge at 21.]

Q. Recognizing your disagreement with Dr. Woolridge's use of an annual DCF model, did Dr. Woolridge apply the annual DCF model correctly?

A. No. Dr. Woolridge's annual DCF model is based on the assumption that dividends will grow at the same constant rate forever. Under the assumption that dividends will grow at the same constant rate forever, the cost of equity is given by the equation, $k = D_0 (1 + g) / P_0 + g$, where D_0 is the current annualized dividend, P_0 is the stock price, and g is the expected constant annual growth rate. Thus, the correct first period dividend in the annual DCF model is the current annualized dividend multiplied by the factor, (1 + growth rate). Instead, Dr. Woolridge uses the current

annualized dividend multiplied by the factor (1 + 0.5 times growth rate) as the first period dividend in his DCF model. This incorrect procedure, apart from other errors in his methods, causes him to underestimate Gulf Power's cost of equity.

Q. How does Dr. Woolridge estimate the expected future growth component of the DCF cost of equity?

A. Dr. Woolridge considers Value Line data on historical growth rates in earnings, dividends, and book value, as well as Value Line data on projected growth rates in earnings, dividends, and book value. For most of his proxy companies, Value Line's average historical growth rates are significantly less than its projected growth rates. Dr. Woolridge also considers analysts' forecasts of future growth provided by First Call, Reuters, and Zacks, and internal growth estimates based on Value Line's estimates of retention ratios and rates of return on book equity. Dr. Woolridge's final estimate of the growth rate that investors expect for his proxy companies is an approximate average of Value Line's historical growth rates, Value Line's projected growth rates, Dr. Woolridge's internal growth rates, and his reported analysts' growth rates [Woolridge at 31].

Q. Do you agree with Dr. Woolridge's use of historical growth rates to estimate investors' expectation of future growth in the DCF model?

A. No. Historical growth rates are inherently inferior to analysts' forecasts because analysts' forecasts already incorporate all relevant information regarding historical growth rates and also incorporate the analysts' knowledge about current conditions and expectations regarding the future. My studies, described in my direct testimony at pp. 24 – 26, indicate that investors use analysts' earnings growth

forecasts in making stock buy and sell decisions rather than historical or internal growth rates such as those presented by Dr. Woolridge.

Q. How do Value Line's projected growth rates for Dr. Woolridge's proxy group of electric utilities compare to Value Line's historical growth rates for these companies?

A. Value Line's projected growth rates are approximately one hundred basis points higher than its historical growth rates for Dr. Woolridge's proxy companies (see Woolridge Exhibit__JRW-10, pp. 3, 4 and 6).

Q. What is the internal growth method of estimating the growth component for the DCF method?

A. The internal growth method estimates expected future growth by multiplying a company's retention ratio, "b," times its expected rate of return on equity, "r." Thus, "g = b x r," where "b" is the percentage of earnings that are retained in the business and "r" is the expected rate of return on equity.

Q. Do you agree with the use of the internal growth method to estimate growth in the DCF model?

A. No. The internal growth method is logically circular because it requires an estimate of the expected rate of return on equity, "r," in order to estimate the cost of equity using the DCF model. Yet, for regulated companies such as Gulf Power, the allowed rate of return on equity is set equal to the cost of equity.

Q. How does Dr. Woolridge estimate the expected rate of return on equity for each proxy company in his sustainable growth analysis?

A. Dr. Woolridge uses Value Line's forecast of each company's rate of return on equity for the period 2014 – 2016 as his estimate of the expected rate of return on equity for each company.

Q. Are there any errors in Dr. Woolridge's calculation of sustainable growth?

A. Yes. Dr. Woolridge mistakenly uses a zero percent projected rate of return on equity for Xcel Energy, whereas Value Line actually projects that Xcel's rate of return on equity for the period 2014 – 2016 will be ten percent. (*See* Value Line Investment Survey, Xcel Energy report, August 5, 2011.)

Q. What impact does Dr. Woolridge's use of an incorrect zero percent forecast for Xcel Energy have on the average return on equity forecast for his proxy company group?

A. If Dr. Woolridge had correctly used a ten percent forecast of Xcel Energy's return on equity in his internal growth calculation, the average return on equity for his proxy company group would have been fifty basis points higher, 10.3 percent rather than 9.8 percent.

Q. What rate of return on equity would Dr. Woolridge have assumed in his calculation of expected growth using his internal growth method if he had used the correct Value Line return on equity for Xcel Energy?

A. Dr. Woolridge would likely have used a rate of return on equity equal to 10.3 percent.

Q. Is it reasonable to assume that Dr. Woolridge's proxy companies will earn a rate of return on equity equal to 10.3 percent when he is recommending that they be allowed to earn only a return of 9.25 percent?

A. No. Investors are well aware that electric utilities are regulated by rate of return regulation. If investors truly believed that the utilities' cost of equity were equal to Dr. Woolridge's recommended 9.25 percent, they would forecast that the utilities would earn 9.25 percent on equity. Thus, Dr. Woolridge's recommended 9.25 percent rate of return on equity is inconsistent with an assumed 10.3 percent earned rate of return on equity for his proxy companies.

Q. Does Dr. Woolridge's internal growth method recognize that, in addition to growth from retained earnings, the companies in his proxy group can also grow by issuing new equity at prices above book value?

A. No. Dr. Woolridge's internal growth method underestimates the expected future growth of his proxy companies because it neglects the possibility that the companies can also grow by issuing new equity at prices above book value. Since many of the proxy companies are selling at prices in excess of book value, and Value Line forecasts that many of them will issue new equity over the next several years, Dr. Woolridge's failure to recognize the "external" component of future growth causes to him to underestimate his proxy companies' expected future growth even more.

Q. Does Dr. Woolridge's internal growth method recognize that Value Line's reported rates of return on equity generally understate each company's average rate of return on equity for the year?

A. No. Dr. Woolridge fails to recognize that Value Line calculates its reported rates of return on equity by dividing a company's net income by end of year equity, whereas most financial analysts calculate a company's rate of return on equity by dividing net income by the average equity for the year. In the general case where a company's equity is increasing, Value Line's reported ROEs will understate the average ROE for the year. Thus Dr. Woolridge's failure to recognize that Value Line's reported ROEs understate each company's average ROE for the year is an additional factor causing him to underestimate Gulf Power's cost of equity.

Q. Do you agree with Dr. Woolridge's use of analysts' growth forecasts to estimate the expected growth component of his DCF model?

A. Yes. As discussed in my direct testimony, I recommend the use of analysts' growth forecasts for the purpose of estimating the expected growth component of the DCF model. I have conducted extensive studies that demonstrate that stock prices are more highly correlated with analysts' growth rates than with either historical growth rates or the internal growth rates considered by Dr. Woolridge.

Q. What sources of analysts' growth rate data does Dr. Woolridge use in his DCF calculations?

A. Dr. Woolridge uses analysts' growth rate data provided by Yahoo First Call, Zacks, and Reuters.

Q. What DCF result would Dr. Woolridge have obtained for his proxy companies if he had correctly used the quarterly DCF model, incorporated an allowance

for flotation costs, and relied on the analysts' growth forecasts to estimate the growth component of his DCF model?

A. Dr. Woolridge would have obtained an average DCF result equal to 10.3 percent, a median result equal to 10.5 percent, and a midpoint result (average of high and low results) equal to 10.9 percent based on three-month average stock prices through September 30, 2011 (see Exhibit___(JVW-3), Rebuttal Schedule 1). I note that the Florida Commission included an adjustment for flotation costs in its 2009 TECO Order. The Commission states, "We have traditionally recognized a reasonable adjustment for flotation costs in the determination of the investor-required ROE. ... such adjustments have typically been on the order of 25 to 50 basis points." Order No. PSC-09-0283-FOF-EI, Docket No. 080317-EI, April 30, 2009, at 44. In addition, I note that this Commission typically uses a flotation cost of allowance of four percent in both DCF and CAPM models to estimate the cost of equity for water utilities in Florida. *See* Order No. PSC-11-0287-PAA-WS, issued July 5, 2011in Docket No. 110006-WS, regarding the annual reestablishment of authorized range of return on common equity for water and wastewater utilities.

Q. Have you updated your DCF calculations?

A. Yes. My updated DCF calculations produce an average result equal to 10.7 percent, a median result equal to 10.8 percent, and a midpoint result equal to 11.5 percent (*see* Exhibit___(JVW-3), Rebuttal Schedule 2).

C. Dr. Woolridge's Rejection of Analysts' Growth Forecasts

Q. How do you recommend estimating the future growth component in the DCF model?

A. As described in my direct testimony, I recommend using the analysts' forecasts published by I/B/E/S Thomson Reuters.

Q. Why do you believe that the analysts' forecasts of earnings growth are more accurate indicators of investors' growth expectations than the historical and internal growth data provided by Dr. Woolridge?

A. Security analysts analyze the prospects of companies and forecast earnings. They take into account all available historical and current data plus any additional information that is available, such as changes in projected capital expenditures, regulatory climate, industry restructuring, regulatory rulings, or changes in the competitive environment. The performance of security analysts is measured against their ability to weigh the above factors, to predict earnings growth, and to communicate their views to investors. Financial research indicates that securities analysts are influential, their forecasts are more accurate than simple extrapolation of past growth, and, most importantly, the consensus of their forecasts is impounded in the current structure of market prices. This is a key result, since a proper application of the DCF model requires the matching of stock prices and investors' growth expectations.

Q. Are analysts' forecasts readily available?

A. Yes. An important part of the analysts' job is getting their views across to investors. Major investment firms send out monthly reports with their earnings forecasts, and institutional investors have direct access to analysts. Individual investors can get the same forecasts through their investment advisors or online. Studies reported in the academic literature indicate that recommendations based on

these forecasts are relied on by investors. Indeed, because analysts' forecasts are perceived by investors as being useful, there are services which offer analysts' forecasts on all major stocks. I/B/E/S and Zack's are some of the providers of these data. I recommend use of the I/B/E/S growth rates because they have been: (1) shown to be highly correlated with stock prices; (2) widely studied in the finance literature; and (3) widely available to investors for many years.

Q. Is it your contention that analysts make perfectly accurate predictions of future earnings growth?

A. No. Forecasting earnings growth, for either the short-term or long-term, is very difficult. This statement is consistent with the fact that stocks, unlike high-quality bonds, are risky investments whose returns are highly uncertain. Though analysts' forecasts are not perfectly accurate, they are better than either retention growth rates or historical growth in predicting stock prices. One would expect this result, given that analysts have all the past data plus current information. The important consideration is: what growth rates do investors use to value a stock? Financial research suggests that the analysts' growth forecasts are used by investors and therefore are most related to stock prices.

Q. Does the observation that analysts' growth forecasts are inherently uncertain imply that investors should ignore analysts' growth forecasts in making stock buy and sell decisions?

A. No. Because growth forecasts have a significant influence on a company's stock price, investors have a great incentive to use the best available forecasts of a company's growth prospects, even if these growth forecasts are inherently

uncertain. In this regard, the investor's situation is similar to the situation of a pilot who is flying across the country. Although the pilot recognizes that weather forecasts are inherently uncertain, he or she has a strong incentive to obtain the best available forecasts of cross-country weather patterns before taking off.

Q. Have you done research on the appropriate use of analysts' forecasts in the DCF model?

A. Yes. As described in my direct testimony, I prepared a study in conjunction with Willard T. Carleton, Professor of Finance Emeritus at the University of Arizona, on why analysts' forecasts are the best estimate of investors' expectations of future long-term growth. This study is described in a paper entitled "Investor Growth Expectations and Stock Prices: the Analysts versus History," published in the Spring 1988 edition of The Journal of Portfolio Management. My studies indicate that the analysts' forecasts of future growth are superior to historically-oriented growth measures and retention growth measures in predicting a firm's stock price.

Q. Please summarize the results of your study.

A. First, we performed a correlation analysis to identify the historically oriented growth rates which best described a firm's stock price. Then we did a regression study comparing the historical and retention growth rates to the consensus analysts' forecasts. In every case, the regression equations containing the average of analysts' forecasts statistically outperformed the regression equations containing the historical and retention growth estimates. These results are consistent with those found by Cragg and Malkiel, the early major research in this area (John G. Cragg and Burton G. Malkiel, Expectations and the Structure of Share Prices,

University of Chicago Press, 1982). These results are also consistent with the hypothesis that investors use analysts' forecasts, rather than historically oriented growth calculations, in making stock buy and sell decisions. They provide overwhelming evidence that the analysts' forecasts of future growth are superior to historically oriented growth measures in predicting a firm's stock price.

Q. Has your study been updated to include more recent data?

A. Yes. Researchers at State Street Financial Advisors updated my study using data through year-end 2003. Their results continue to confirm that analysts' growth forecasts are superior to historical and retention growth measures in predicting a firm's stock price.

Q. Does Dr. Woolridge agree with your assessment that analysts' growth forecasts should be used to estimate the future growth component of the DCF model?

A. No. Dr. Woolridge argues that analysts' growth forecasts should not be used to estimate the future growth component of the DCF model because, in his opinion, it is well known that analysts' growth forecasts are overly optimistic [Woolridge at 25].

Q. Have you reviewed the research literature on the properties of analysts' growth forecasts?

A. Yes, I have reviewed the articles identified (*see* Exhibit___(JVW-3), Rebuttal Schedule 3).

Q. What basic questions does the research literature on analysts' forecasts address?

A. The research literature on analysts' growth forecasts addresses three basic questions: (1) Are analysts' forecasts superior to historical growth extrapolations in their ability to forecast future earnings per share? (2) Is the correlation between changes in analysts' EPS growth forecasts and stock prices greater than the correlation between historical earnings growth rates and stock prices? and (3) Are analysts' growth forecasts overly optimistic?

Q. How do researchers test whether analysts' growth forecasts are more accurate than forecasts based on historical growth extrapolations?

A. I have identified at least eight published research studies dating from 1972 to 2006 that compare the accuracy of analysts' growth forecasts to the accuracy of forecasts based on historical extrapolations. Typically, these research studies follow several basic steps: (1) gather data on historical earnings per share for a large sample of firms over a reasonably long historical period of time; (2) gather data on actual earnings per share growth rates for the same firms over a subsequent future time period; (3) apply statistical forecasting techniques to determine the best model for forecasting future earnings growth based on historical growth data; (4) gather data on analysts' growth forecasts for the study period; (5) calculate the difference between the actual growth rate and the forecasted growth rate for both the best statistical forecasting model and the analysts' forecasts; (6) determine whether there is a significant difference between the forecasting errors of the statistical forecasting model and the forecasting errors of analysts' EPS growth forecasts; and (7) if the errors from the analysts' EPS growth forecasts are less than the errors

from the statistical forecasting techniques and the difference is statistically significant, conclude that analysts provide superior forecasts to the forecasts obtained by statistical forecasting techniques. The main differences between the studies reported in the literature relate to the time period studied, the size of the database, and the statistical techniques used to forecast future earnings growth based on historical earnings data.

Q. What are the general conclusions of the research literature regarding the accuracy of analysts' growth forecasts compared to the accuracy of growth forecasts based on historical growth extrapolations?

A. Seven of the eight articles strongly support the hypothesis that analysts' forecasts provide better predictions of future earnings growth than statistical models based on historical earnings, and one of the articles neither supports nor rejects this hypothesis (see Table 1 below). These articles strongly support the conclusion that analysts' EPS growth forecasts are better proxies for investor growth expectations than historical growth rates.

TABLE 1

ARTICLES THAT STUDY WHETHER ANALYSTS' FORECASTS OR HISTORICAL GROWTH EXTRAPOLATIONS ARE BETTER PREDICTORS OF EPS GROWTH

Author (Date)	*Support Historical*	*Support Analysts*
Elton and Gruber (1972)	Neutral	Neutral
Brown and Rozeff (1978)	No	Yes
Crichfield, Dyckman, and Lakonishok (1978)	No	Yes
Givoly and Lakonishok (1984)	No	Yes
Brown, Hagerman, Griffin, and Zmijewski (1987)	No	Yes
Newbold, Zumwalt, and Kannan (1987)	No	Yes
Brown, Richardson, and Schwager (1987)	No	Yes
Banker and Chen (2006)	No	Yes

Q. Why is the correlation between analysts' EPS growth forecasts and stock prices a significant issue in the research literature on analysts' growth forecasts?

A. If analysts' EPS growth forecasts are good proxies for investor growth expectations, one would expect that changes in analysts' growth forecasts would have a significant impact on stock prices. The impact of changes in analysts' growth expectations on stock prices can be estimated using standard statistical regression techniques.

Q. What are the general conclusions of the research literature regarding the correlation between changes in analysts' EPS forecasts and stock prices?

A. I have identified at least seven published research studies that use regression techniques to test whether the impact of changes in analysts' growth forecasts on stock prices is sufficiently strong to justify the conclusion that analysts' EPS growth forecasts are good proxies for investor growth expectations. All these studies find that changes in analysts' growth forecasts have a large and statistically significant impact on changes in stock prices. Five of these studies also test whether the impact of analysts' growth forecasts on stock prices is stronger than the impact of historical and/or retention growth rates on stock prices. These studies find that changes in analysts' growth forecasts have a significantly stronger impact on stock prices than changes in historical and/or retention earnings growth rates. In summary, financial research strongly supports the conclusion that analysts' growth forecasts are the best proxies for investor growth expectations.

TABLE 2

ARTICLES THAT STUDY THE RELATIONSHIP

BETWEEN ANALYSTS' GROWTH FORECASTS AND STOCK PRICES

Author (Date)	*Support Historical*	*Support Analysts*
Malkiel (1970)	No	Yes
Malkiel and Cragg (1970)	No	Yes
Elton, Gruber, and Gultekin (1981)		Yes
Fried and Givoly (1982)		Yes
Vander Weide and Carleton (1988)	No	Yes
Gordon, Gordon, and Gould (1989)	No	Yes
Timme and Eisemann (1989)	No	Yes

Q. What are the general conclusions of the research literature regarding the claim that analysts' forecasts are overly optimistic?

A. A review of available research evidence strongly supports the hypothesis that analysts' growth forecasts are not optimistic. I have reviewed nine articles that address whether analysts' growth forecasts are overly optimistic. At least seven of the nine articles reviewed find no evidence that analysts' growth forecasts are overly optimistic. Two articles find evidence of optimism, but also conclude that optimism is declining significantly over time. Of these two studies, one finds that analysts' forecasts for the Standard & Poor's 500 are pessimistic for the last four years of the study.

TABLE 3

ARTICLES THAT STUDY WHETHER ANALYSTS' FORECASTS ARE BIASED TOWARD OPTIMISM

Author (Date)	*Conclusion*
Crichfield, Dyckman, and Lakonishok (1978)	Unbiased
Elton, Gruber, and Gultekin (1984)	Unbiased
Givoly and Lakonishok (1984)	Unbiased
Brown (1997)	Declining optimism
Keane and Runkle (1998)	Unbiased
Abarbanell and Lehavy (2003)	Unbiased
Ciccone (2005)	Pessimistic
Clarke, Ferris, Jayaraman, and Lee (2006)	Unbiased
Yang and Mensah (2006)	Unbiased

Q. What is the most important contribution of the more recent research literature on the accuracy of analysts' forecasts?

A. The most important contribution of more recent research is to identify substantial statistical difficulties in earlier research studies that caused some of these studies to unwittingly accept the hypothesis of optimism when no optimism was present. For example, recent studies recognize that the results of earlier studies are heavily influenced by the presence of large unexpected accounting write-offs and special accounting charges at a small number of sample companies. Unexpected accounting write-offs and special charges have a potentially dramatic impact on conclusions concerning analysts' bias because analysts' forecasts intentionally exclude the impact of accounting write-offs and special charges, whereas actual earnings include these items. Thus, a comparison of analysts' forecasts premised on normalized earnings (that is, earnings that exclude the impact of accounting write-offs and special charges) to reported earnings that include the negative effect of accounting write-offs and special charges will bias the results in favor of concluding that analysts are optimistic. Recent studies demonstrate that, once the distorting effect of unexpected accounting write-offs and special charges are removed from the analysis, there is no evidence that analysts' EPS growth forecasts are optimistic.

Recent research also highlights the potential impact of high correlation in analysts' forecast errors on study conclusions. Analysts' forecast errors tend to be highly correlated because unexpected industry and economy-wide shocks, such as unexpected increases in oil prices or terrorist attacks, have similar effects on all firms in the same industry. However, the relevant statistical tests of optimism are based on the assumption that analysts' forecast errors are independent, that is, the

tests assume that the correlation of the analyst errors is zero. Once the statistical tests of optimism are adjusted to account for the high correlation in forecast errors that generally characterize the data, evidence supports the hypothesis that analysts' EPS growth forecasts are unbiased, and hence not optimistic.

Q. Dr. Woolridge argues that analysts face potential conflicts of interest between their companies' research operations and underwriting operations. Have the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") addressed the issue of analysts' potential conflicts of interest?

A. Yes. Beginning in the early 2000s, the NYSE and NASD implemented a series of rule changes that address potential conflicts of interest. Specifically, they:

- Imposed structural reforms to increase analyst independence, including prohibiting investment banking personnel from supervising analysts or approving research reports;
- Prohibited offering favorable research to induce investment banking business;
- Prohibited research analysts from receiving compensation based on a specific investment banking transaction;
- Required disclosure of financial interests in covered companies by the analyst and the firm;
- Imposed quiet periods for the issuance of research reports after securities offerings managed or co-managed by a member;
- Restricted personal trading by analysts;
- Required disclosure in research reports of data and price charts

that help investors track the correlation between an analyst's rating and the stock's price movements; and

- Required disclosure in research reports of the distribution of buy/hold/sell ratings and the percentage of investment banking clients in each category. [*See* "Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules," December 2005, p. 5.]

Q. What is your overall conclusion regarding the use of analysts' growth forecasts as proxies for investors' growth expectations?

A. Contrary to Dr. Woolridge's assessment that analysts' growth forecasts should not be used in the DCF model because they are well known to be optimistic, I find that the research literature provides strong support for the conclusion that: (1) analysts' EPS growth forecasts are not optimistic; and (2) analysts' EPS growth forecasts are reasonable proxies for investor growth expectations, while the historical growth extrapolations and retention growth rates used by Dr. Woolridge are not. Furthermore, Dr. Woolridge's concerns regarding analysts' potential conflicts of interest have been fully addressed by rule changes implemented by the NYSE and NASD in the early 2000s. In addition, Dr. Woolridge fails to recognize that the DCF model requires the growth forecasts of investors, whether accurate or not. In this regard, it is helpful to keep in mind that investors would not pay for analysts' growth forecasts if they did not find them to be helpful in making stock buy and sell decisions. Similarly, the NYSE and NASD would not have taken steps to address conflicts of interest if investors did not rely on analysts' forecasts in making investment decisions.

D. Dr. Woolridge's Capital Asset Pricing Model

Q. What is the CAPM?

A. The CAPM is an equilibrium model of expected returns on risky securities in which the expected or required return on a given risky security is equal to the risk-free rate of interest plus the security's "beta" times the market risk premium:

Expected return = Risk-free rate + (Security beta x Market risk premium).

The risk-free rate in this equation is the expected rate of return on a risk-free government security, the security beta is a measure of the company's risk relative to the market as a whole, and the market risk premium is the premium investors require to invest in the market basket of all securities compared to the risk-free security.

Q. How does Dr. Woolridge use the CAPM to estimate Gulf Power's cost of equity?

A. The CAPM requires estimates of the risk-free rate, the company-specific risk factor, or beta, and either the required return on an investment in the market portfolio, or the risk premium on the market portfolio compared to an investment in risk-free government securities. For the risk-free rate, Dr. Woolridge uses an average 4.0 percent yield on 30-year Treasury bonds [Woolridge at 34]; for the company-specific risk factor or beta, Dr. Woolridge uses the current Value Line beta for each company [Woolridge at 35]; and for the required return or risk premium on the market portfolio, Dr. Woolridge employs an average 5.10 percent risk premium he obtains from his review of the risk premium literature [Woolridge at 43].

Q. What CAPM result does Dr. Woolridge obtain for his proxy companies?

A. Dr. Woolridge obtains a CAPM result of 7.6 percent for his proxy group [Woolridge at 45].

Q. Does Dr. Woolridge recognize that the result of his CAPM analysis is unreasonably low?

A. Yes. Dr. Woolridge reports a result equal to 9.3 percent for his DCF studies and a result equal to 7.6 percent for his CAPM studies [Woolridge at 45]. From these results, Dr. Woolridge concludes that Gulf Power's cost of equity is equal to 9.25 percent. Since Dr. Woolridge's CAPM results are approximately 170 basis points lower than his recommended cost of equity, Dr. Woolridge must agree that a CAPM result of 7.6 percent is unreasonably low.

Q. Do you agree with Dr. Woolridge's application of the CAPM?

A. No, but I do agree with Dr. Woolridge that his CAPM results are below a reasonable range of estimates of Gulf Power's cost of equity.

Q. Why do you believe that the CAPM produces unreasonably low cost of equity results for electric utilities at this time?

A. I believe there are two reasons why the CAPM produces unreasonably low cost of equity results for electric utilities at this time. First, as a result of the economic crisis, the U.S. Treasury has kept interest rates on Treasury securities unusually low as part of its effort to stimulate the economy. Economists are forecasting that interest rates on Treasury securities will increase significantly once the economy

begins to recover. In addition, the betas of utilities are currently approximately 0.70, and the CAPM tends to underestimate the cost of equity for companies whose equity beta is less than 1.0 and to overestimate the cost of equity for companies whose equity beta is greater than 1.0.

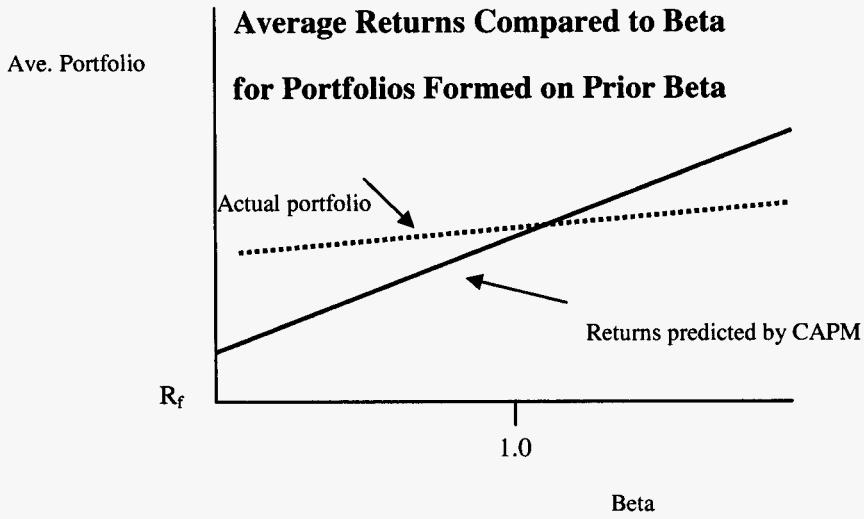
Q. Can you briefly summarize the evidence that the CAPM underestimates the required returns for securities or portfolios with betas less than 1.0 and overestimates required returns for securities or portfolios with betas greater than 1.0?

A. Yes. The CAPM conjectures that security returns increase with increases in security betas in line with the equation

$$ER_i = R_f + \beta_i \left[ER_m - R_f\right],$$

where ER_i is the expected return on security or portfolio i, R_f is the risk-free rate, $ER_m - R_f$ is the expected risk premium on the market portfolio, and β_i is a measure of the risk of investing in security or portfolio i. If the CAPM correctly predicts the relationship between risk and return in the marketplace, then the realized returns on portfolios of securities and the corresponding portfolio betas should lie on the solid straight line with intercept R_f and slope $[R_m - R_f]$ shown below.

Figure 1



Financial scholars have found that the relationship between realized returns and betas is inconsistent with the relationship posited by the CAPM. As described in Fama and French (1992) and Fama and French (2004), the actual relationship between portfolio betas and returns is shown by the dotted line in the figure above. Although financial scholars disagree on the reasons why the return/beta relationship looks more like the dotted line in the figure than the solid line, they generally agree that the dotted line lies above the solid line for portfolios with betas less than 1.0 and below the solid line for portfolios with betas greater than 1.0. Thus, in practice, scholars generally agree that the CAPM underestimates portfolio returns for companies with betas less than 1.0, and overestimates portfolio returns for portfolios with betas greater than 1.0.

Q. What conclusions do you reach from your review of the literature on the CAPM to predict the relationship between risk and return in the marketplace?

A. I conclude that the financial literature strongly supports the proposition that the CAPM underestimates the cost of equity for companies such as public utilities with betas less than 1.0. Since the CAPM significantly underestimates the cost of equity for companies with betas less than 1.0, and both Dr. Woolridge's and my proxy companies have betas that are significantly less than 1.0, I further conclude that the Commission should give little or no weight to the results of the CAPM at this time.

E. Dr. Woolridge's Comments on the Relationship between Utilities' Rates of Return on Equity and their Market-to-Book Ratios

Q. Does Dr. Woolridge discuss the relationship between rates of return equity, the cost of equity, and market-to-book ratios in his testimony?

A. Yes. Dr. Woolridge asserts that a market-to-book ratio above 1.0 indicates that a company is earning more than its cost of equity:

> As such, the relationship between a firm's return on equity, cost of equity, and market-to-book ratio is relatively straightforward. A firm that earns a return on equity above its cost of equity will see its common stock sell at a price above its book value. Conversely, a firm that earns a return on equity below its cost of equity will see its common stock sell at a price below its book value. [Woolridge at 13.]

Q. Dr. Woolridge reports the results of three regression analyses that he believes support his claim that: (1) companies with market-to-book ratios greater than 1.0 are earning more than their costs of equity; (2) companies with market-to-book ratios equal to 1.0 are earning their costs of equity; and (3) companies with market-to-book ratios less than 1.0 are earning less than their costs of equity [Woolridge at 13]. Does Dr. Woolridge's regression analysis for his electric utilities provide any support for this claim?

A. No. Dr. Woolridge's regression analysis for his electric utilities does not support his claim. Dr. Woolridge claims that the cost of equity for electric utilities like Gulf Power is 9.25 percent. Of the fifty-four electric utilities in his market-to-book study, twenty-five companies have ROEs less than 9.25 percent. However, only seven of these twenty-five companies with ROEs less than Dr. Woolridge's recommended 9.25 percent cost of equity have market-to-book ratios less than 1.0 [Woolridge work papers]. The average ROE for these twenty-five companies is 7.1 percent, and their average market-to-book ratio is 1.23. These data clearly contradict Dr. Woolridge's claim that companies earning less than their cost of equity will have market-to-book ratios of less than 1.0.

Q. What is the date of Dr. Woolridge's market-to-book study?

A. According to his work papers, Dr. Woolridge's market-to-book study is dated January 2009.

Q. Have you updated Dr. Woolridge's market-to-book study using current market data?

A. Yes. Using current Value Line data at October 2011, I find that of the fifty-three electric utilities followed by Value Line, nineteen have ROEs below Dr. Woolridge's recommended 9.25 percent rate of return on equity; however, contrary to Dr. Woolridge's hypothesis, only four of these nineteen electric utilities have market-to-book ratios less than 1.0. With regard to the Value Line natural gas utilities, only two of the twelve companies have ROEs less than 9.25 percent, and no natural gas utility has a market-to-book ratio less than 1.0. Similarly, for the six water utilities followed by Value Line, there are two companies that have estimated ROEs less than Dr. Woolridge's 9.25 percent recommended return on equity, and no water utility has a market-to-book ratio less than 1.0. These data provided strong evidence that Dr. Woolridge's hypothesis regarding the relationship between ROEs and market-to-book ratios is incorrect.

F. Rebuttal of Dr. Woolridge's Comments on Vander Weide Direct Testimony

Q. What issues does Dr. Woolridge have regarding your estimate of Gulf Power's cost of equity?

A. Dr. Woolridge disagrees with my: (1) quarterly DCF model; (2) reliance on analysts' growth forecasts; (3) risk premium estimates; (4) allowance for flotation costs; and (5) financial leverage adjustment [Woolridge at 48].

1. Quarterly DCF Model

Q. What are Dr. Woolridge's criticisms of your DCF studies?

A. Dr. Woolridge claims that I should: (1) use the annual rather than the quarterly DCF model to estimate Gulf Power's cost of equity; (2) use a combination of

historical and analysts' growth rates to estimate the growth component of the DCF model; and (3) include no adjustment for flotation costs.

Q. What is the major difference between the quarterly DCF model which you use and the annual DCF model employed by Dr. Woolridge?

A. The major difference is that my quarterly DCF model is based on the realistic assumption that dividends are paid quarterly, while Dr. Woolridge's annual DCF model is based on the unrealistic assumption that dividends are paid once at the end of each year.

Q. Why do you use the quarterly rather than the annual DCF model to estimate Gulf Power's cost of equity?

A. As I discuss in my direct testimony, the DCF model assumes that a company's stock price is equal to the present discounted value of all expected future dividends. Since the companies in my proxy group all pay dividends quarterly, the current market price that investors are willing to pay reflects the expected quarterly receipt of dividends. Therefore, a quarterly DCF model must be used to estimate the cost of equity for these firms. The quarterly DCF model differs from the annual DCF model in that it expresses a company's price as the present discounted value of a quarterly stream of dividend payments. The annual DCF model is only a correct expression for the present discounted value of future dividends if dividends are paid once at the end of each year.

Q. Why does Dr. Woolridge disagree with your application of the quarterly DCF model?

A. Dr. Woolridge argues first that an early proponent of the DCF model, Dr. Myron Gordon, stated that "the appropriate dividend yield adjustment for growth in the DCF model is the expected dividend for the next quarter multiplied by four." [Woolridge at 22 and 49.] Second, Dr. Woolridge argues that my quarterly DCF model allows investors to earn more than their required rate of return on equity. [Woolridge at 49.]

Q. Is Dr. Gordon's statement in favor of an annual DCF model a reasonable justification for use of the annual DCF model in this proceeding?

A. No. Although Dr. Gordon was certainly a major early proponent of the DCF model, this does not imply that Dr. Gordon is correct in his arguments regarding the quarterly DCF model. As shown in Appendix 2 of Exhibit ___ (JVW-2) to my direct testimony, there can be no doubt that when dividends are paid quarterly, the quarterly DCF model must be used to estimate the cost of equity.

Q. Do you agree with Dr. Woolridge's assertion that the quarterly DCF model allows investors to earn more than their required return on equity?

A. No. The quarterly DCF model does not allow investors to earn more than their required return on equity; it simply offers a better estimate of investors' required return on equity than an annual DCF model. Whether a company earns more than its cost of equity depends on many factors, including the state of the economy and the demand for electricity, factors which cannot be known at the time the cost of equity is being estimated.

2. Analysts' Growth Forecasts

Q. Dr. Woolridge also criticizes your use of analysts' growth rates in your DCF model. Why do you use analysts' growth rates to estimate the growth component of the DCF model?

A. I use analysts' growth rates because my studies indicate that the analysts' growth rates are highly correlated with stock prices. This evidence provides strong support for the conclusion that investors use analysts' growth rates in making stock buy and sell decisions, and thus the analysts' growth rates should be used to estimate the growth component of the DCF model.

Q. Does Dr. Woolridge agree with your statistical studies of the relationship between analysts' growth rates and stock prices?

A. No. Dr. Woolridge has four criticisms of my statistical studies of the relationship between analysts' growth rates and stock prices. First, he argues that my statistical study is outdated. Second, he argues that my study is misspecified because I used a "linear approximation" to the DCF model rather than a modified version of the DCF model. Third, he argues that I did not use both historical and analysts' forecasted growth rates in the same regression. Fourth, he argues that I did not perform any tests to determine if the difference between historic and projected growth measures is statistically significant. [Woolridge at 60 – 61.]

Q. Do you agree with Dr. Woolridge's assertion that your statistical analysis of the relationship between analysts' growth rates and stock prices is outdated?

A. No. As discussed in my direct testimony, my study was updated in August 2004. The updated study continues to support the conclusion that the analysts' growth

rates are more highly correlated with stock prices than historical measures such as those employed by Dr. Woolridge. Furthermore, Dr. Woolridge ignores other studies that have corroborated my results.

Q. Do you agree with Dr. Woolridge's criticism that your DCF model is misspecified because you used a "linear approximation" to the DCF model rather than a modified version of the DCF model?

A. No. Most regression analyses are based on the assumption that the relationship between the variables being studied is linear. As part of my studies, I tested whether the linear assumption was sufficiently close to provide reliable estimates of the model parameters. Applying a first order Taylor-series approximation to the DCF equation, I found that the first order, or linear, approximation was sufficiently close to the true equation to justify using linear regression analysis to study the relationship between price/earnings ratios and growth rates.

Q. Why did you not use a combination of historical and analysts' growth rates in the same regression?

A. I did not use a combination of historical and analysts' growth rates in the same regression because there are an infinite number of such combinations which could be tested. My studies indicate that the relationship between analysts' forecasts and stock prices is so strong compared to the relationship between historical growth rates and stock prices that there would be little advantage to combining historical growth rates with analysts' forecasts to predict stock prices.

Q. Is there a statistically significant difference between historical and projected growth measures in explaining stock prices in your statistical study?

A. Yes. The difference in performance of historical and projected growth rates is both statistically significant and dramatic.

Q. Dr. Woolridge claims in his testimony, "it is well known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased." [Woolridge at 25.] Is he correct?

A. No. Contrary to Dr. Woolridge's claim, the academic literature presents compelling evidence that analysts' EPS forecasts are unbiased—that is, neither optimistic nor pessimistic. As discussed above, I have reviewed nine articles that address whether analysts' growth forecasts are overly optimistic. At least seven of the nine articles reviewed find no evidence that analysts' growth forecasts are overly optimistic. Two find evidence of optimism, but also conclude that optimism is declining significantly over time. Of these two studies, one finds that analysts' forecasts for the S&P 500 are pessimistic for the last four years of the study.

Q. Does some of the later research explain why some earlier studies in the literature conclude that analysts' EPS growth forecasts are optimistic?

A. Yes. Articles by Abarbanell and Lehavy (2003) and Keane and Runkle (1998) recognize that the results of earlier studies are heavily influenced by: (i) the inclusion of large unexpected accounting write-offs and special accounting charges in reported earnings; and (ii) the impact of high correlation in analysts' forecasts. As discussed above, these articles conclude that once the problems associated with the inclusion of non-recurring earnings in reported earnings per share and

correlations in analysts' forecasts are corrected, the evidence supports the conclusion that analysts' forecasts are unbiased, and hence, not optimistic.

Q. Dr. Woolridge discusses the results of his study of the relationship between analysts' forecasts for utilities and the utilities' subsequent achieved earnings growth rates. Do you have any comments on his study?

A. Yes. First, Dr. Woolridge has misspecified the time frame of his analysts' earnings growth forecasts. In his study, Dr. Woolridge claims that he compares the analysts' forecast made in a particular quarter to the company's realized earnings growth rate in the *same* quarter four years hence. In making this comparison, Dr. Woolridge fails to recognize that: (i) the time frame of the analysts' growth forecast is an indefinite, long-run period that may differ from one analyst to another; (ii) quarterly realized earnings are unaudited; and (iii) quarterly realized earnings are subject to seasonality. Dr. Woolridge has provided no evidence that analysts' growth estimates were intended to forecast actual results for exactly the same quarter four years hence.

Second, Dr. Woolridge has not distinguished between recurring (that is, normalized) and non-recurring (that is, non-normalized) earnings. The analysts' forecasts are intended to be applied only to growth in recurring earnings, meaning that they are forecasts of earnings in the absence of extraordinary events and one-time write-offs. It is likely that the forecast deviations in Dr. Woolridge's sample are due to primarily to the impact of extraordinary events and one-time write-offs rather than to problems with the analysts' forecasts of recurring earnings.

Third, Dr. Woolridge fails to adjust for the high correlation in analysts' forecast across companies. Financial researchers have conclusively demonstrated

that there is no evidence of analysts' optimism in data sets that are properly adjusted for the impact of one-time accounting write-offs and the correlation in analysts' forecasts across companies. (*See* Jeffery Abarbanell and Reuven Lehavy, "Biased Forecasts or Biased Earnings? The Role of Reported Earnings in Explaining Apparent Bias and Over/underreaction in Analysts' Earnings Forecasts," *Journal of Accounting and Economics,* 36 (2003) 105 – 146; Stephen J. Ciccone, "Trends in Analyst Earnings Forecast Properties," *International Review of Financial Analysis*, 14 (2005) 1 – 22.)

Q. Why do analysts exclude non-recurring earnings from earnings growth forecasts?

A. Analysts exclude non-recurring earnings from earnings growth forecasts because stock prices reflect the impact of expected future earnings and, by definition, non-recurring earnings or losses are not expected to recur in the future. Since non-recurring earnings do not, in theory, impact stock prices, analysts do not include them in their earnings per share forecasts. In addition, because accounting adjustments are somewhat discretionary, it is virtually impossible to forecast the timing and magnitude of such adjustments, certainly when the long-term earnings per share forecast is intended to apply to a period three to five years in the future.

Q. Do you have evidence that non-recurring items can have a significant impact on the reported earnings per share for electric utilities?

A. Yes. The impact of non-recurring items on reported earnings per share for electric utilities can be estimated from annual data on aggregate earnings per share for electric utilities, including and excluding non-recurring items, published by The

Edison Electric Institute in its annual financial report on investor-owned electric utilities. As shown in Table 4 below, aggregate EPS including non-recurring items (that is, EPS as reported) is generally less than aggregate EPS excluding non-recurring items; and, in many years, the difference is substantial. Thus, Dr. Woolridge's use of EPS data that include non-recurring items could have had a significant impact on his conclusion that analysts' forecasts are optimistic.

TABLE 4

EARNINGS PER SHARE ("EPS") INCLUDING AND EXCLUDING

NON-RECURRING ITEMS

U.S. INVESTOR-OWNED ELECTRIC UTILITIES

1992 - 2007

Year	EPS Include Non-Recurring	EPS Exclude Non-Recurring	Difference (Exclude – Include)
1992	1.66	1.85	0.19
1993	1.65	1.99	0.34
1994	1.92	1.96	0.04
1995	2.10	2.11	0.01
1996	2.14	2.21	0.07
1997	1.49	2.01	0.52
1998	1.52	1.79	0.27
1999	2.04	2.05	0.01
2000	1.59	2.47	0.88
2001	2.43	2.93	0.50
2002	(0.04)	2.40	2.44
2003	1.45	2.20	0.75
2004	2.23	2.00	(0.23)

2005	2.09	2.28	0.19
2006	2.42	2.37	(0.05)
2007	2.65	2.34	(0.31)

3. Risk Premium

Q. What is the risk premium approach to estimating the cost of equity?

A. The risk premium approach is based on the principle that investors expect to earn a return on an equity investment in Gulf Power that reflects a "premium" over and above the return they expect to earn on an investment in a portfolio of long-term bonds. This equity risk premium compensates equity investors for the additional risk they bear in making equity investments versus bond investments. Using the risk premium approach, the cost of equity is given by the following equation: cost of equity = interest rate plus risk premium.

Q. How do you estimate the interest rate component of the risk premium approach?

A. I estimate the interest rate component of the risk premium approach using the yield to maturity on A-rated utility bonds.

Q. Does Dr. Woolridge have any criticisms of your use of the yield to maturity on A-rated utility bonds to estimate the interest rate component of the risk premium approach?

A. Yes. Dr. Woolridge argues that my use of the yield to maturity on A-rated utility bonds inflates the required return on equity because long-term utility bonds are not

risk free, that is, they are subject to both interest rate risk and credit risk [Woolridge at 62 - 63].

Q. Do you agree with Dr. Woolridge's criticism of your use of the yield to maturity on A-rated utility bonds to estimate the interest rate component of the risk premium approach?

A. No. Dr. Woolridge fails to recognize that the risk premium approach does not require that the interest rate be "risk free." Indeed, the only requirement of the risk premium approach is that the same interest rate be used to estimate the interest rate component as is used to estimate the risk premium component. Since the risk premium approach suggests that the cost of equity equals (the interest rate) plus (the required return on equity minus the interest rate), the cost of equity should be approximately the same in a risk premium analysis, no matter what interest rate is used as the benchmark interest rate. Thus, use of the interest rate on A-rated utility bonds in a risk premium analysis will produce a higher interest rate component than use of a government bond interest rate, but this difference will be offset by the correspondingly lower risk premium. The lower risk premium arises because the difference between the return on equity and yield on A-rated utility bonds is less than the difference between the return on equity and the yield on long-term government bonds.

Q. Why do you use the yield on A-rated utility bonds rather than the yield on Treasury bonds in your risk premium studies?

A. I use the yield on A-rated utility bonds rather than the yield on Treasury bonds in my risk premium studies because I believe that utility bond yields are better

indicators of utilities' cost of equity than Treasury bond yields. First, because the U.S. dollar is the major currency for international trade, foreign governments tend to hold their currency reserves in U.S. Treasury bonds. Indeed, foreign investors now hold approximately 55 percent of U.S. Treasury debt. (*See* Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association, February 4, 2009. http://www.ustreas.gov/press/releases/tg10.htm.) Thus, Treasury bond yields are highly sensitive to changes in international economic conditions, whereas the U.S. utilities' cost of equity is not.

Second, since U.S. Treasuries are considered to be the safest investment in the world, investors across the world tend to flock to investments in U.S. Treasuries at times of widespread global economic turmoil. In such periods of turmoil, the required return on risky investments such as utility bonds and stocks increases while the yield on U.S. Treasury bonds declines. Thus, changes to U.S. Treasury bond yields are poor indicators of changes in a utility's cost of equity.

Third, yields on U.S. Treasury bonds are highly sensitive to efforts by the Federal Reserve to stimulate the economy. Although most Federal Reserve monetary policy operations are conducted using short-term U. S. Treasury bills, yields on long-term Treasury bonds frequently move in the same direction as yields on short-term Treasury bills. In addition, the Federal Reserve has recently begun to purchase long-term Treasury bonds in an effort to further reduce long-term Treasury yields.

Fourth, to the extent that there are economic developments that are specific to the utility industry, such as changes in environmental regulations and energy policy, such factors will be reflected both in utility bond yields and the utility cost

of equity, but not in U.S. Treasury bond yields. Thus, that utility bond yields reflect utility-specific risks is an argument for—not an argument against—the use of utility bond yields to indicate changes in the utility cost of equity.

Q. How do you estimate the risk premium component of the risk premium approach?

A. I estimate the risk premium component of the risk premium approach in two ways. First, I estimate the difference between the DCF cost of equity for a proxy group of companies over the previous 111 months and the concurrent yield to maturity on A-rated utility bonds in those months, and then adjust the average risk premium to account for changes in interest rates. This estimate is my "ex ante risk premium approach." Second, I estimate the risk premium from an historical study of stock and bond returns over the period 1937 to the present. This second risk premium approach is my "ex post risk premium approach."

Q. Why does Dr. Woolridge criticize your ex ante risk premium approach?

A. Dr. Woolridge criticizes my ex ante risk premium approach because it relies on analysts' forecasts to estimate the required return on equity using the DCF model.

Q. Have you addressed Dr. Woolridge's criticisms of your use of analysts' growth forecasts elsewhere in this rebuttal testimony?

A. Yes, I have. (See Section II, F., 3, above.)

Q. Does Dr. Woolridge agree with your use of historical stock and bond returns to estimate the equity risk premium?

A. No. Dr. Woolridge states:

> There are a number of flaws in using historic returns over long time periods to estimate expected equity risk premiums. These issues include: (a) biased historic bond returns; (b) use of the arithmetic versus the geometric mean return; (c) the large error in measuring the equity risk premium using historical returns; (d) unattainable and biased historic stock returns; (e) company survivorship bias; and (f) the "peso problem—U.S. stock market survivorship bias." [Woolridge at 65.]

Q. Why does Dr. Woolridge believe that historical bond returns are biased?

A. Dr. Woolridge states:

> Historic bond returns are biased downward as a measure of expectancy because of capital losses suffered by bondholders in the past. As such, risk premiums derived from this data are biased upwards. [Woolridge at 65.]

Q. Do you agree with Dr. Woolridge's statement that historical bond returns are biased downward because of capital losses suffered by past bond investors?

A. No. Because of capital gains and losses, historical bond returns may be higher or lower than what investors expected at the time they purchased the bonds. During the period since 1982, for example, historical bond returns have been biased upward as a measure of expectancy because of the large capital gains achieved by bondholders over this period. However, over the entire period considered in my ex post risk premium study (from 1937 to the present), capital gains and losses on

bonds have approximately offset each other, and consequently there is no significant bias as a result from either capital gains or losses.

Q. What is the difference between an arithmetic and a geometric mean return?

A. An arithmetic mean return is an additive return that is calculated by summing the achieved return in each time period and dividing the total by the number of periods. In contrast, the geometric mean return is a multiplicative return that is calculated in two steps. First, one calculates the product of (1 plus the return) in each period of the study. Second, one calculates the n^{th} root of this product and subtracts 1 from the result. Thus, if there are two periods, and r_1 and r_2 are the returns in periods one and two, respectively, the arithmetic mean is calculated from the equation: $a_m = (r_1 + r_2) \div 2$. The geometric mean is calculated from the equation,

$$a_g = [(1 + r_1) \times (1 + r_2)]^{.5} - 1.$$

Q. Please describe Dr. Woolridge's concern regarding the use of geometric versus arithmetic mean returns.

A. Dr. Woolridge believes that my ex post risk premium study is biased because I calculate the expected risk premium using the arithmetic mean of past returns, whereas he believes I should have calculated the expected risk premium using the geometric mean of past returns.

Q. Is Dr. Woolridge's criticism valid?

A. No. As explained in Ibbotson® SBBI® Valuation Edition 2011 Yearbook (SBBI®), the arithmetic mean return is the best approach for calculating the return investors expect to receive in the future:

> 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. [SBBI® at 56.]

A discussion of the importance of using arithmetic mean returns in the context of CAPM or risk premium studies is contained in my direct testimony, Schedule 5 of Exhibit ___ (JVW-1), "Using the Arithmetic Mean to Estimate the Cost of Equity Capital."

Q. Dr. Woolridge claims that "the SEC requires equity mutual funds to report historical return performance using geometric mean and not arithmetic mean returns." [Woolridge at 67.] Does this observation demonstrate that the risk premium should be estimated using geometric mean returns rather than arithmetic mean returns?

A. No. As discuss above, I agree that historical performance should be measured using the geometric mean rather than the arithmetic mean. However, as I demonstrate in Schedule 5 of Exhibit ___ (JVW-1), in estimating the cost of equity,

it is essential to use the arithmetic mean return because it is only the arithmetic mean return that will make an initial investment grow to the expected value of the investment at the end of the investment horizon. Thus, for an investment with an uncertain outcome, the arithmetic mean is the best measure of the forward looking expected risk premium.

Q. Dr. Woolridge also criticizes your ex post risk premium study because it is based on "unattainable and biased historic stock returns." [Woolridge at 68 - 69.] Is he correct?

A. No. Dr. Woolridge bases his allegation on the assumption that stock index returns such as those reported by Ibbotson® SBBI® are "unattainable to investors." Dr. Woolridge's assumption is false: investors, in fact, can attain the returns achieved by stock indices simply by purchasing the stock index.

Q. Do you agree with Dr. Woolridge's criticism that your ex post risk premium study is characterized by "survivorship bias"? [Woolridge 69.]

A. No. Survivorship bias refers to problems that might arise when data for companies that have failed are excluded from the sample. However, with regard to the U.S. markets that I study, survivorship bias is not a major issue. First, over the period 1937 to the present, there have been relatively few companies in the S&P 500 and the S&P Utilities that have failed. Second, the S&P 500 includes the return on a stock until the day it is dropped from the index, and the effect of a company being dropped from the S&P 500 is generally anticipated by the market well in advance of the delisting. Thus, survivorship is not a material issue with respect to U.S. stocks.

Q. What does Dr. Woolridge mean when he refers to the "peso problem"? [Woolridge at 70.]

A. Dr. Woolridge uses the term "peso problem" to refer to the fact that U.S. investors have earned higher returns on stock investments than investors in other countries because the U.S. economy has not suffered many of the same economic calamities as the economies of other countries. This criticism of the use of U. S. stock returns in risk premium studies might be appropriate if one were attempting to estimate the expected rates of return on non-U. S. stocks. However, for U. S. stocks, since there is no indication that the U. S. will suffer the economic calamities of other countries, such as hyper-inflation or military invasion, there is no reason why the returns on U. S. stocks would be biased upward. As Morningstar states with respect to "survivorship bias" and the closely-related "peso problem":

> While the survivorship bias evidence may be compelling on a worldwide basis, one can question its relevance to a purely U.S. analysis. If the entity being valued is a U.S. company, then the relevant data set should be the performance of equities in the U.S. market. [SBBI® at 62.]

Q. Dr. Woolridge claims that his market risk premium estimate is reasonable because it is consistent with the 7.37 percent long-term forecasted return on the S&P 500 published by the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters [Woolridge at 44]. Is the Survey of Professional Forecasters a reliable source of cost of equity estimates?

A. No. The economists included in the survey are macro economists who are primarily concerned with forecasting factors such as GDP growth, inflation rates,

unemployment rates, job growth, and other macro-economic indicators. They are not experts in forecasting the rate of return on the S&P 500.

Q. Dr. Woolridge also claims that his risk premium estimate is reasonable because it is consistent with the risk premium estimate found in the Graham Harvey survey of Chief Financial Officers in September 2011 [Woolridge at 44]. Do you agree that surveys of business managers provide useful information on the expected market risk premium?

A. No. Surveys of business managers provide little or no information on the expected market risk premium because: (1) managers have no incentive to take the survey seriously; (2) their responses are not typically based on market transactions or actual investment decisions; (3) their responses may reflect what they think the investigator wants to hear; and (4) the response rate is frequently low. In addition, Dr. Woolridge fails to recognize that Graham and Harvey comment that their survey responders frequently use hurdle rates for making investment decisions that exceed their estimates of excess returns on the S&P 500. (Graham and Harvey confirm that CEO responses to their survey are not typically based on market transactions or actual investment decisions when they state, "Often their [the CFO's] 10-year risk premium is supplemented so that the company's hurdle rate exceeds their expected excess return on the S&P 500." John Graham and Campbell Harvey, "The Long-Run Equity Risk Premium," Sep. 9, 2005, p. 6.)

4. Flotation Costs

Q. Why do you include an adjustment for flotation costs in your DCF analysis?

A. I include an adjustment for flotation costs because, without such an adjustment, Gulf Power would not be able to recover all the costs it incurs to finance its investments in electric plant and equipment.

Q. Does Gulf Power issue equity in the capital markets?

A. No. Although Gulf Power does not issue equity in the capital markets, its parent must issue equity to provide Gulf Power the necessary financing to make investments in its electric utility operations in Florida. If the parent is not able to recover its flotation costs through Gulf Power's rates, it will not be able to recover the full cost of issuing equity required to invest in Gulf Power.

Q. Does Dr. Woolridge agree with your flotation cost adjustment?

A. No. Dr. Woolridge claims that a flotation cost adjustment is inappropriate because: (1) the company has not presented any evidence that it actually incurs flotation costs when it issues new equity; and (2) it is frequently asserted that a flotation cost adjustment is required to prevent dilution of the company's existing shareholders, but existing shareholders cannot suffer dilution as long as the company's stock price is above book value.

Q. Do you agree with Dr. Woolridge's assertion that the company did not provide any evidence that it incurs flotation costs when it issues new equity?

A. No. In Appendix 3 of Exhibit ___ (JVW-1) to my direct testimony, I present evidence that all companies incur flotation costs when they issue new equity

securities, that flotation costs represent approximately five percent of the company's pre-issue stock price, and that the company will not be able to earn a fair rate of return on its investment if it does not recover its flotation costs.

Q. Do you justify flotation costs on the grounds that flotation costs are required to prevent dilution of existing shareholders?

A. No. I justify flotation costs on the grounds that the company will not be able to earn a fair rate of return if it does not recover the flotation costs it incurs when it issues new equity. My flotation cost adjustment is unrelated to the company's market-to-book ratio.

5. Financial Risk Adjustment

Q. How do financial market participants measure risk?

A. Under the assumption that the probability distribution of returns is symmetric, *i.e.*, centered on the mean return, financial market participants generally measure risk by the forward-looking variance of return on investment.

Q. Does the forward-looking variance of an investor's return on a stock investment in a company depend on the company's capital structure?

A. Yes. The forward-looking variance of an investor's return depends on the company's debt to equity ratio, where both debt and equity are measured in terms of market values, not book values.

Q. What is the meaning of the term, "financial risk"?

A. Economists use the term, "financial risk" to refer to the contribution of the firm's capital structure, *i.e.*, its debt to equity ratio, to the forward-looking variance of return on the firm's stock.

Q. Does financial risk reflect the market values of debt and equity in a company's capital structure or the book values of debt and equity in a company's capital structure?

A. Financial risk measures the contribution of the company's capital structure to the forward-looking variance of return on the company's stock, and the forward-looking variance depends on the market values of debt and equity in the company's capital structure, not the book values. (*See,* for example, Richard A. Brealey, Stewart C. Myers, and Franklin Allen, Principles of Corporate Finance, 8th ed., McGraw-Hill, 2006.) Thus, financial risk reflects the market values of debt and equity in a company's capital structure, not the book values.

Q. Is Gulf Power recommending that its weighted average cost of capital in this proceeding be calculated based on the market values of debt and equity in its capital structure?

A. No. Consistent with previous regulatory practice, Gulf Power is recommending that its weighted average cost of capital be based on the book values of debt and equity in its capital structure.

Q. Is the financial risk associated with Gulf Power's recommended capital structure measured in the same way as the financial risk associated with the capital structures of your proxy companies?

A. No. The financial risk of my proxy companies is reflected in their market value capital structures, while Gulf Power is recommending that a book value capital structure be used for the purpose of setting rates. Thus, the financial risk of my proxy companies is measured by their market value capital structures, while Gulf Power's financial risk is measured by its book value capital structure.

Q. How do you adjust your cost of equity results for your comparable companies to reflect the difference between the market's perception of the financial risk of your proxy companies and the financial risk reflected in Gulf Power's recommended capital structure?

A. As described in my direct testimony (see pp. 48 – 49), I adjust the cost of equity results for my comparable companies by equating the after-tax weighted average cost of capital of my proxy companies to the after-tax weighted average cost of capital of Gulf Power. In this procedure, I use market-value capital structure weights for my comparable companies because the cost of capital for these companies is based on market values, and I use book value weights for Gulf Power because the recommended cost of capital for Gulf Power in this proceeding is based on book values.

Q. Does Dr. Woolridge agree with your financial risk adjustment?

A. No. Dr. Woolridge claims that my financial risk adjustment is unjustified because: (1) a market-to-book ratio above 1.0 indicates that a company is earning more than

its cost of equity; (2) there is no change in the company's leverage; (3) financial publications report capital structures based on book values; and (4) no other commissions have accepted using a market value capital structure to calculate the allowed rate of return. [Woolridge at 79 - 80.]

Q. Do you agree that a market-to-book ratio greater than 1.0 indicates that a company is earning more than its cost of equity?

A. No. As discussed above, Dr. Woolridge's own study, based on January 2009 data, shows that some 25 of the 54 electric utilities in his market-to-book study have ROEs less than 9.25 percent (Dr. Woolridge's recommended return on equity). However, only 7 of these 25 companies have market-to-book ratios less than 1.0. The average ROE for these companies is 7.1 percent, and the average market-to-book is 1.23. Similar results hold for current data on the market-to-book ratios and expected ROEs for Value Line utilities, as described above. These data clearly contradict Dr. Woolridge's claim that a company's market-to-book ratio is an indicator of whether a company is earning more than its cost of equity.

Q. Does your financial risk adjustment assume a "change" in a company's leverage?

A. No. As discussed above, my financial risk adjustment reflects the difference in the financial risk between the capital structures of the proxy companies and the company's ratemaking capital structure. It is unclear what Dr. Woolridge refers to when he notes a "change" in capital structure.

Q. Does the observation that financial publications report capitalization on a book value basis undermine the validity of your financial risk adjustment?

A. No. The validity of my financial risk adjustment is based on the widely-recognized observation that the variance of an investor's portfolio returns depends on the market values of the securities in the portfolio, not on the book values of the securities in the portfolio. The truth of the statement that variance of return depends on market values is recognized both in academia and the marketplace. In addition, investors have no difficulty in calculating market value capital structures from publicly available information.

Q. Dr. Woolridge claims that in response to OPC interrogatories, you state that you "could not identify any proceeding" in which you have testified "in which the regulatory commission had adopted" your "leverage adjustment." [Woolridge at 80.] Does Dr. Woolridge correctly characterize your response?

A. No. I stated that I do not maintain records of regulatory decisions or a list of all cases in which commissions have accepted my recommendations. However, I noted that I was generally aware that financial adjustments similar to that which I propose have been adopted in Pennsylvania and Canada, and that many states use market value capital structures to determine utility property taxes.

Furthermore, I am also aware that market value capital structures have been used to set allowed rates of return in numerous telecommunications cases in which I have participated since 1996, including the *Virginia Arbitration Proceeding* in which my 12.95 percent overall cost of capital recommendation was accepted, and a Michigan docket in which my 75 percent equity market value capital structure recommendation has been accepted. (Memorandum Opinion and Order, *Petition of*

AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc., 18 FCC Rcd 17722 ¶ 94 (2003) (**"*Virginia Arbitration Order*"**). In this proceeding, the Wireline Competition Bureau of the FCC, accepting Verizon's proposal, finds that the appropriate capital structure component of the weighted average cost of capital should be based on the market values of debt and equity, stating, "we give no weight to the portion of AT&T/WorldCom's proposal that is based on incumbent LECs' book value capital structure." *See* Order at ¶¶ 103-104. See also, Michigan Public Service Commission Order, *In the matter, on the Commission's own motion, to review the total element long run incremental costs and the total service long run incremental costs for Verizon North Inc., and Contel of the South, Inc., D/B/A Verizon North Systems, to provide telecommunications services*, Case No. U-15210, March 18, 2009. "The Commission is not persuaded that Verizon's capital structure should be based on book value. The Commission agrees with the Staff and adopts Verizon's proposed capital structure of 75% equity and 25% debt." Order at 17.)

III. REBUTTAL OF MR. GORMAN

Q. What is Mr. Gorman's recommended cost of equity for Gulf Power?

A. Mr. Gorman recommends a cost of equity for Gulf Power equal to 9.75 percent.

Q. How does Mr. Gorman estimate Gulf Power's cost of equity?

A. Mr. Gorman estimates Gulf Power's cost of equity by applying several cost of equity methodologies to the same groups of electric companies that I present in my

direct testimony. His cost of equity methodologies include: (1) the DCF model; (2) a risk premium method; and (3) a Capital Asset Pricing Model ("CAPM").

Q. Does Mr. Gorman give equal weight to his three cost of equity methods?

A. No. Mr. Gorman's recommended 9.75 percent cost of equity is based primarily on the results of his DCF and risk premium analyses:

> My recommended return on common equity of 9.75% is supported by my DCF and risk premium studies. Because Treasury bond yields are currently at abnormally low levels, I am placing minimal weight on the results of my CAPM study at this time

Q. What areas of Mr. Gorman's testimony will you address in your rebuttal testimony?

A. I will address Mr. Gorman's DCF analysis, risk premium analysis, and his comments on my direct testimony.

A. Mr. Gorman's DCF Model

Q. What DCF model does Mr. Gorman use to estimate Gulf Power's cost of equity?

A. Mr. Gorman uses an annual DCF model to estimate Gulf Power's cost of equity.

Q. Do you agree with Mr. Gorman's use of an annual DCF model to estimate Gulf Power's cost of equity?

A. No. As discussed in my rebuttal of Dr. Woolridge, the DCF model is based on the assumption that a company's stock price reflects the present value of the dividends

investors expect to receive from their ownership of the stock. Since the companies in Mr. Gorman's analysis all pay dividends quarterly, these companies' stock prices reflect the present value of a quarterly stream of dividends. Hence, the quarterly DCF model is the only DCF model that is consistent with the basic assumption that stock prices are equal to the expected present value of future dividends.

Q. Does Mr. Gorman include an allowance for flotation costs in his DCF analysis?

A. No.

Q. Do you agree with Mr. Gorman's failure to include flotation costs in his DCF analysis?

A. No. As discussed in my direct testimony, flotation costs are a cost of issuing securities that must be reflected in a cost of equity analysis for investors to earn a return that is commensurate with returns on other investments of the same risk.

Q. How does Mr. Gorman estimate the growth component of his DCF model?

A. Mr. Gorman estimates the growth component of his DCF model by using analyst growth forecasts, a "sustainable" growth forecast, and a three-stage growth forecast.

Q. What DCF result does Mr. Gorman obtain when he uses analysts' growth forecasts in his DCF model?

A. Mr. Gorman obtains a DCF result equal to 10.1 percent.

Q. Do you agree with Mr. Gorman's use of analysts' growth forecasts as a proxy for investors' growth expectations in the DCF model?

A. Yes. Mr. Gorman's use of analysts' growth forecasts is consistent with the results of studies, including my own, that demonstrate that analysts' growth forecasts are more highly correlated with stock prices than are other growth forecasts such as historical growth forecasts and sustainable growth forecasts.

Q. Does Mr. Gorman offer any comments on the use of analysts' growth forecasts as a proxy for investors' growth expectations in the DCF model?

A. Yes. Mr. Gorman claims that analysts' growth forecasts overstate investors' long-run growth expectations because they exceed economists' projections of the long-run growth in the economy:

> The three- to five-year growth rate of the proxy group exceeds the growth rate of the overall U.S. economy. As developed below, the consensus of published economists projects that the U.S. Gross Domestic Product ("GDP") will grow at a rate of no more than 5.1% and 4.7% over the next 5 and 10 years, respectively. A company cannot grow, indefinitely, at a faster rate than the market in which it sells its products. The U.S. economy, or GDP, growth projection represents a ceiling, or high-end, sustainable growth rate for a utility over an indefinite period of time. [Gorman at 19.]

Q. Mr. Gorman seems to believe that investors' growth expectations must be "rational." Are investors' growth expectations always "rational"?

A. No. In hindsight, most economists would agree that investors' growth expectations during the tech stock boom of the late 1990s and early 2000 were irrational. Yet, it was these "irrational" growth expectations that caused stock prices to rise by so much during that time.

Q. Does the DCF Model only require the use of investors' growth expectations when investors' growth expectations are "rational"?

A. No. The DCF model requires the use of investors' growth expectations, whether rational or irrational.

Q. Is it appropriate for Mr. Gorman to adjust the growth term in his DCF model, without also adjusting the stock price term in his model?

A. No. If Mr. Gorman believes that investors' growth expectations are irrational, he should recognize that "irrational" growth expectations are likely to be accompanied by "irrational" stock prices. To be consistent in applying his own definition of "rational," Mr. Gorman would need to adjust not only his growth estimates to reflect the long-run growth in the economy, but also his stock prices to reflect a "rational" estimate of the value of the company.

Q. Do you agree with Mr. Gorman's use of the "sustainable growth" method of estimating investors' growth expectations?

A. No. I have two objections to Mr. Gorman's use of the "sustainable growth" method of estimating investors' growth expectations. First, the DCF model

requires the growth forecasts of investors, and my studies, along with those of others, provide strong evidence that analysts' growth forecasts are a better proxy for investors' growth expectations than the sustainable growth rate used by Mr. Gorman. Second, as discussed in my rebuttal of Dr. Woolridge above, the sustainable growth method is logically circular in that each company's rate of return on equity must be known in order to estimate the sustainable growth rate at the same time that the sustainable growth rate must be known to estimate the rate of return on equity through the DCF model. It is not possible for the rate of return on equity to be known before the sustainable growth rate, and, at the same time, the sustainable growth rate to be known before the rate of return on equity.

Q. What is the basic assumption of Mr. Gorman's three-stage DCF model?

A. Mr. Gorman's three-stage DCF model is based on the assumption that investors believe his proxy companies will grow at the average analyst growth rates for five years, then decline to the long-run growth in the economy in years six through ten, and then beginning in the sixth year grow at the rate of 4.9 percent forever.

Q. Does Mr. Gorman provide any evidence to support this basic assumption?

A. No. He simply assumes that rational investors would make this assumption.

Q. Why does Mr. Gorman prefer the results of his three-stage DCF model over the results of his constant growth DCF Model?

A. As discussed above, Mr. Gorman prefers the results of his three-stage model because, in his opinion, analysts' growth rates generally exceed the projected

growth of the economy, and company's cannot grow forever at a rate in excess of the expected growth of the economy.

Q. Do you agree with Mr. Gorman's opinion that companies cannot grow forever at a rate in excess of the expected growth in the U.S. economy?

A. Yes. As Mr. Gorman implies, if a company grew forever at a rate in excess of the rate of growth of the U.S. economy, it would eventually take over the economy. This is not a reasonable expectation.

Q. Does the opinion that a company cannot grow at a rate greater than the rate of growth in the GNP forever imply that a single-stage DCF model cannot be used to estimate the cost of equity?

A. No. Mr. Gorman fails to recognize that the DCF model requires the growth expectations of investors, not the growth expectations of Mr. Gorman. If investors use analysts' growth rates to value stocks in the marketplace, Mr. Gorman should use analysts' growth rates to estimate the growth component of the DCF model. Mr. Gorman also fails to recognize that companies do not have to grow at the same rate forever for the single-stage DCF Model to be a reasonable approximation of how prices are determined in capital markets.

Q. Have you done any studies on the growth rates that investors use to value stocks in the marketplace?

A. Yes. As discussed in my direct testimony, my studies indicate that investors use analysts' forecasted growth rates to value stocks in the marketplace.

Q. Does the opinion that a company cannot grow at a rate of growth greater than the growth in GNP forever imply that Mr. Gorman's assumption that companies can only grow at rates faster than the economy for five years is correct?

A. No. The opinion that a company's earnings cannot grow at a rate greater than the rate of growth in the GNP forever does not imply that companies can only grow faster than the rate of growth in the economy for five years. Mr. Gorman's assumption that companies must grow at the same rate as the economy after year five is completely arbitrary.

B. Mr. Gorman's Risk Premium Model

Q. How does Mr. Gorman estimate the required risk premium for investing in his electric company proxy group?

A. Mr. Gorman estimates the required risk premium for investing in his proxy electric utilities from data on the average authorized electric utility rates of return on equity for each year from 1986 to June 2010. Mr. Gorman finds that the average authorized rate of return on equity for electric utilities over this period was 5.21 percent higher than the yield to maturity on long-term Treasury bonds and 3.79 percent higher than the yield to maturity on A-rated utility bonds.

Q. Do you agree with Mr. Gorman's method of estimating the required risk premium on electric utility stocks?

A. No. Mr. Gorman fails to recognize that the Commission has a responsibility to make an independent assessment of the required return on equity for Gulf Power in this proceeding. In addition, Mr. Gorman fails to recognize that the indicated risk

premium in his data base tends to increase as interest rates decline. Mr. Gorman should have adjusted his average risk premiums to account for the relationship between the allowed risk premium on equity and the level of interest rates on long-term Treasury bonds and A-rated utility bonds.

Q. Have you studied the relationship between the allowed rates of return on equity by regulatory commissions and the interest rates on long-term Treasury bonds and A-rated utility bonds?

A. Yes. Using the data found in Mr. Gorman's Exhibits MPG-11 and MPG-12, I perform a regression analysis of the relationship between the risk premium implied by the allowed rates of return on equity issued by regulatory commissions and the interest rates on long-term Treasury bonds and A-rated utility bonds. I find that the risk premium implied by allowed rates of return compared to the yield on long-term Treasury bonds is given by the relationship:

$$RP_{AUTHORIZED} = \underset{(21.59)}{7.820} - \underset{(7.41)}{0.418 \times T_B}$$

where:

$RP_{AUTHORIZED}$ = the risk premium implied by utility commission authorized rates of return on equity,

7.82 and 0.418 = estimated regression coefficients with t-statistics shown in parentheses; and

T_B = the yield on long-term Treasury bonds.

Similarly, I find that the risk premium implied by allowed rates of return compared to the yield on A-rated utility bonds is given by the relationship:

$$RP_{AUTHORIZED} = \underset{(16.89)}{6.780} - \underset{(7.59)}{0.390 \times A_B}$$

where:

$RP_{AUTHORIZED}$ = the risk premium implied by utility commission authorized rates of return on equity,

6.78 and 0.39 = estimated regression coefficients with t-statistics shown in parentheses; and

A_B = the yield on Moody's A-rated utility bonds.

Q. Do these regression equations support the conclusion that the risk premium tends to increase when interest rates decline?

A. Yes. The negative coefficients associated with the interest rate variables, ~~TB~~ T_B and ~~AB~~ A_B, indicate that the risk premium moves in the opposite direction as interest rates, thus verifying the conclusion that the risk premium increases when interest rates decline.

Q. What risk premium do you obtain from your statistical analysis of the relationship between allowed rates of return and the interest rate on long-term Treasury bonds?

A. Using Mr. Gorman's forecasted 4.2 percent interest rate on long-term Treasury bonds, I obtain a risk premium of 6.06 percent over the forecasted yield to maturity on long-term Treasury bonds. Using Value Line's forecasted 4.9 percent yield on Treasury bonds, I obtain a risk premium of 5.78 percent over the yield to maturity on 20-year U.S. Treasury bonds. These risk premium estimates are approximately 60 to 90

basis points higher than the average 5.21 percent average risk premium on U. S. Treasury bonds shown on Mr. Gorman's Exhibit MPG-11, page 1 of 1.

Q. Why are the estimated risk premiums from your regression analyses so much higher than the average risk premium over the 1986 – 2010 period that Mr. Gorman uses?

A. The risk premiums from my regression analyses are higher than the average risk premium over the period of Mr. Gorman's study because, as my regression analyses demonstrate, risk premiums generally increase when interest rates decline; and interest rates have declined over the period of Mr. Gorman's study.

Q. What risk premium do you obtain from your statistical analysis of the relationship between allowed rates of return and the interest rate on A-rated utility bonds?

A. Using a forecasted interest rate on A-rated utility bonds equal to 5.89 percent, I obtain a risk premium of 4.48 percent. This risk premium estimate is approximately 70 basis points higher than the average 3.79 percent risk premium shown on Mr. Gorman's Exhibit MPG-12, page 1 of 1.

Q. Why is the estimated risk premium from your regression analysis higher than the average risk premium over the period 1986 – 2010 shown on Mr. Gorman's Exhibit MPG-12?

A. The risk premium from my regression analysis is higher than the average risk premium over the period of Mr. Gorman's study because, as discussed above, risk premiums generally increase when interest rates decline, and interest rates have

declined over the period of Mr. Gorman's study. My regression analyses correctly take into account the inverse relationship between risk premiums and interest rates.

Q. What cost of equity estimates would Mr. Gorman have obtained from his risk premium analyses if he had correctly recognized that risk premiums increase when interest rates decline, as you describe above?

A. Using Value Line's forecasted 4.9 percent yield on long-term Treasury bonds and a forecasted yield of 5.89 percent on A-rated utility bonds, Mr. Gorman would have obtained estimated risk premiums of 6.06 percent over long-term Treasury bonds and 4.48 percent over utility bonds. Adding these risk premium estimates to the forecasted interest rates, Mr. Gorman would have obtained cost of equity estimates of 10.5 percent and 10.7 percent, respectively. These results exceed Mr. Gorman's risk premium estimates of the cost of equity by approximately 70 to 90 basis points and exceed his recommended cost of equity by 95 basis points.

C. Response to Mr. Gorman's Comments on Dr. Vander Weide's Testimony

Q. Does Mr. Gorman agree with your cost of equity estimate for Gulf Power?

A. Mr. Gorman disagrees with my: (i) financial risk adjustment [Gorman at 43 – 47]; (ii) DCF analysis [Gorman at 47 – 53]; and (iii) risk premium analysis [Gorman at 54 – 57].

1. Financial Risk Adjustment

Q. Why do you adjust the cost of equity results for your proxy companies to reflect the average difference between the financial risk of your proxy

companies and the financial risk reflected in Gulf Power's recommended capital structure?

A. As explain in my direct testimony, I adjust my cost of equity results because they reflect a higher degree of financial risk than Gulf Power's recommended capital structure. In making this assessment, I recognize that investors measure the financial risk of investing in the equity of my proxy companies based on these companies' market value capital structures, while Gulf Power is recommending a book value capital structure. Since investors demand a higher return for bearing greater risk, an adjustment is required to the cost of equity result for the proxy companies.

Q. You note that "investors measure the financial risk of investing in the equity of my proxy companies based on these companies' market value capital structures." Why do equity investors measure the financial risk of your proxy companies based on their market value capital structures?

A. Equity investors measure financial risk based on market value capital structures because, from the equity investor's point of view, risk is measured by the forward-looking variance of return on investment; and the variance of return on investment depends on a company's market value capitalization, not its book value capitalization.

Q. How does Mr. Gorman define financial risk?

A. Mr. Gorman defines financial risk as the ability of a company to pay the interest and principal payments on its debt [Gorman at 46].

Q. Does Mr. Gorman's definition of financial risk reflect the point of view of equity investors?

A. No. Mr. Gorman's definition of financial risk reflects the point of view of debt investors, not the point of view of equity investors. Whereas debt investors are justifiably concerned with a company's ability to cover the interest and principal payments on its debt, equity investors are primarily concerned with the forward-looking variance of return on their investment. As noted above, the forward-looking variance of return on investment depends on a company's market value capital structure, not its book value capital structure. Indeed, equity investors generally cannot buy a company's stock at book value.

Q. In summary, do you agree with Mr. Gorman's criticism of your financial risk adjustment?

A. No. Mr. Gorman fails to recognize that equity investors measure financial risk by the forward-looking variance of return on their equity investment in the company, and the forward-looking variance of return on an equity investment in a company reflects the company's market value capital structure. Mr. Gorman's criticism of my financial risk adjustment depends on his incorrect assertion that financial risk reflects book value capitalization ratios rather than market value capitalization ratios. While his assertion may be correct from the bond investor's point of view, it is certainly not correct from the equity investor's point of view. The equity investor's point of view is the only point of view that is relevant for determining the cost of equity.

2. DCF Analysis

Q. What issues does Mr. Gorman have with regard to your DCF analysis?

A. Mr. Gorman addresses my: (i) use of a quarterly DCF model; (ii) flotation cost adjustment; and (iii) reliance on analysts' growth forecasts.

Q. Why does Mr. Gorman disagree with your use of a quarterly DCF model?

A. Mr. Gorman claims that my use of a quarterly DCF model is inappropriate because "the quarterly compounding component of the return is not a cost to the utility" [Gorman at 50].

Q. Does Mr. Gorman attempt to explain his position on the quarterly compounding return through an example?

A. Yes. Mr. Gorman provides an example where he assumes that Gulf Power has issued a bond with a face value of $1,000, at an interest rate of six percent paid in two semi-annual $30 installments. He asserts that Gulf Power's cost of this bond is only six percent, whereas the bond investor expects to earn a 6.1 percent return because of the compounding effect of semi-annual coupon payments. [Gorman at 51.]

Q. Do you agree with Mr. Gorman's assertion that the cost of the bond to Gulf Power in his example is only six percent?

A. No. The cost of the bond to Gulf Power is calculated by solving for the value of the discount rate that equates the present value of the stream of interest and principal payments to the face value of the bond. In Mr. Gorman's example, the cost of the bond is 6.11 percent because:

$$\$1{,}000 = \frac{\$30}{(1.0611)^{.5}} + \frac{\$1{,}030}{(1.0611)}$$

Q. Mr. Gorman claims in his example that the cost of a $1,000 bond with a six percent interest rate is the same when a company makes two semi-annual coupon payments as it is when the company makes a single, end-of-year payment of $60. Is Mr. Gorman correct?

A. No. The cost of a $1,000 bond is greater when the company makes two semi-annual coupon payments of $30 than when it makes a single coupon payment of $60 at the end of the year. It can be easily demonstrated that the cost of the $1,000 bond with a single end-of-year interest payment of $60 is 6.02 percent, whereas, as shown above, the cost of the $1,000 bond with semi-annual interest payments equal to $30 is 6.11 percent.

Q. Why is the company's cost of debt greater when it makes two semi-annual payments than when it makes a single end-of-year payment?

A. The company's cost of debt is greater when it makes two semi-annual interest payments of $30 than it is when it makes a single $60 payment at the end of the year because the interest payments are made sooner on average when interest is paid semi-annually than when the company makes a single payment at the end of the year. Because of the time value of money, earlier payments are more costly to the issuing company than later payments of an equal dollar amount. In Mr. Gorman's discussion, he simply fails to recognize the time value of money.

Q. Does Mr. Gorman attempt to extend his example to investments in stocks?

A. Yes. Mr. Gorman provides a stock example where an investor purchases Gulf Power stock for $100 and expects to receive four quarterly dividends equal to $1.50 each, or six percent per year [Gorman at 52- 53]. In his discussion of this example, Mr. Gorman asserts that the cost of the company's dividend payment is only six percent, whereas the return to the investor would be 6.13 percent.

Q. Do you agree with Mr. Gorman's assertion that the cost to the company of the quarterly dividend payments in his example is only six percent?

A. No. Assuming for simplicity that the value of the investment is the same at the end of the year as it is at the beginning of the year, the cost of the quarterly dividend payments to the company can be calculated by solving for the value of the discount rate that equates the present value of the stream of quarterly dividend payments and capital value at the end of the year to the $100 price of the stock. In Mr. Gorman's example, the cost to the company of the dividend payments is 6.16 percent because:

$$\$100 = \frac{\$1.50}{(1.16)^{.25}} + \frac{1.50}{(1.16)^{.5}} + \frac{1.50}{(1.16)^{.75}} + \frac{\$101.50}{(1.16)}$$

Q. In his stock example, Mr. Gorman claims that the cost of equity to the company is the same when the company makes four quarterly dividend payments equal to $1.50 each as it is when the company makes a single, year-end dividend payment equal to $6. Is he correct?

A. No. The cost of equity is greater when the company makes four quarterly $1.50 dividend payments than when it makes a single six dollar dividend payment at the

end of the year because the quarterly payment of dividends requires the company to make dividend payments sooner on average than the annual payment, and sooner payments are always more costly than later payments.

Q. Are Mr. Gorman's concerns with your use of analysts' forecasts and a flotation cost adjustment similar to the concerns expressed by Dr. Woolridge?

A. Yes, they are.

Q. Have you responded to these concerns in your rebuttal of Dr. Woolridge?

A. Yes, I have.

3. Risk Premium Analysis

Q. What issue does Mr. Gorman have with regard to your risk premium analysis?

A. Mr. Gorman objects to my use of a forecasted, rather than a current interest rate, in my risk premium analysis [Gorman at 54 – 55].

Q. Why do you use a forecasted, rather than a current interest rate, in your risk premium analysis?

A. I use a forecasted interest rate because the fair rate of return standard requires that Gulf Power have an opportunity to earn its cost of equity during the period when rates are in effect, and the rates approved in this case will not come into effect until a time in 2012.

Q. Does Mr. Gorman also use forecasted interest rates in estimating Gulf Power's cost of equity in his risk premium approach?

A. Yes. Mr. Gorman uses forecasted, rather than current interest rates in his risk premium analysis comparing the average allowed return on equity for electric utilities to interest rates on 30- year Treasury bonds [Gorman at 30 – 31].

Q. Does Mr. Gorman attempt to estimate the cost of equity you would have obtained from your ex ante risk premium analysis if you had used current bond yields rather than forecasted bond yields?

A. Yes. Mr. Gorman claims that my ex ante risk premium analysis would have produced a cost of equity equal to 9.82 percent if I were to use a current interest rate on A-rated utility bonds equal to 4.92 percent [Gorman at 54].

Q. Do you agree with Mr. Gorman's claim that your ex ante risk premium analysis would produce a cost of equity result equal to 9.82 percent if you were to use an A-rated utility bond yield equal to 4.92 percent?

A. No. Mr. Gorman obtains his 9.82 percent result by adding my estimated 4.9 percent equity risk premium reported in my direct testimony to the 4.92 percent current yield on A-rated utility bonds. However, Mr. Gorman fails to recognize that my estimated ex ante risk premium depends on the value of the interest rate on A-rated utility bonds through the estimated regression equation described in Appendix 4 of Exhibit ___ (JVW-2) to my direct testimony. Although 4.9 percent is the correct ex ante risk premium estimate when the interest rate is 6.15 percent, the correct ex ante risk premium estimate when the interest rate is 4.92 percent is 5.57 percent (5.57 = 8.17 – 0.5316 x 4.9). Thus, adding the correct 5.57 percent

estimated ex ante risk premium to the interest rate of 4.92 percent produces an ex ante risk premium cost of equity equal to 10.47 percent, not the 9.82 percent incorrectly calculated by Mr. Gorman.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BY MR. MELSON:

Q. And do you have an Exhibit JVW-3 attached to your rebuttal testimony consisting of three schedules; is that correct?

A. Yes, I do.

Q. Do you have any changes or corrections to that exhibit?

A. No, I do not.

MR. MELSON: Mr. Chairman, that has been pre-identified as Exhibit 158.

CHAIRMAN GRAHAM: So noted.

BY MR. MELSON:

Q. Dr. Vander Weide, could you give us a brief summary of your testimony?

A. Yes. My rebuttal testimony responds to the testimonies of Dr. Woolridge and Mr. Gorman, who appeared this morning to summarize their testimonies.

Based on my analysis of Dr. Woolridge's and Mr. Gorman's testimonies, I conclude that they have significantly underestimated Gulf Power's cost of equity. My initial and updated cost of equity estimates continue to -- results continue to demonstrate that my recommended 11.7 percent cost of equity for Gulf Power is reasonable.

I demonstrated in my rebuttal testimony that

Dr. Woolridge and Mr. Gorman rely primarily on the discounted cash flow model to estimate Gulf Power's cost of equity. However, there are several reasons why their DCF results underestimate Gulf Power's cost of equity, including their use of an annual DCF model, even though the companies and their proxy groups all pay dividends quarterly, and their use of historical and sustainable growth rates, even though the financial literature provides overwhelming evidence that utility stock prices reflect analysts' growth rates rather than historical or sustainable growth rates.

Mr. Gorman stated this morning that the DCF model requires sustainable growth rates, and Dr. Woolridge stated this morning that there is evidence that analysts' growth rates are optimistic. I strongly disagree with both of those statements.

The DCF model requires the growth rates of investors, because investors' growth rates are reflected in stock prices. And there is very strong evidence that investors use analysts' growth rates in making stock buy and sell decisions and that analysts' growth rates are reflected in stock prices.

In addition, Dr. Woolridge is undoubtedly incorrect when he states that there is unanimous opinion that analysts' growth rates are optimistic. I cite

numerous articles, approximately 25 or 26, in my rebuttal testimony that demonstrate that analysts' growth rates are not overly optimistic and that analysts' growth rates are the growth rates that are impounded in stock prices.

In contrast to the low DCF results obtained by Dr. Woolridge and Mr. Gorman, my updated DCF application produces a DCF result equal to 10.8 percent.

In addition to my discussions of their DCF results, I also discuss Mr. Gorman's risk premium analysis. He provides a risk premium analysis based on allowed rates of return for electric utilities compared to interest rates on both utility and Treasury bonds.

I demonstrate that he fails to recognize that the allowed risk premium increases when interest rates decline. And if he had correctly recognized the strong inverse relationship, which I demonstrate statistically, he would have obtained a risk premium estimate of Gulf Power's cost of equity in the range of 10.5 to 10.7 percent. This latter range of equity -- cost of equity estimates is also consistent with the evidence that I presented -- that I discussed yesterday that the average allowed rate of return for integrated electric utilities over the first nine months of 2011 is approximately 10 1/2 percent.

Mr. Gorman stated this morning that the average allowed return was 10 percent. That is not only incorrect for all electric utilities -- it's really 10.2 percent for all electric utilities -- but more relevant, it's incorrect for integrated electric utilities such as Gulf Power. Integrated electric utilities are considered to be more risky than distribution-only electric utilities, and hence they have higher allowed -- average allowed rates of return on equity than distribution-only utilities.

With regard to their comments on the financial risk adjustment, I demonstrate that their financial risk adjustment depends on their opinion that investors measure the financial risk of their proxy companies based on book value capital structures. I also disagree with that comment, because investors measure financial risk based on market value capital structures, and financial experts agree on that unanimously.

CHAIRMAN GRAHAM: Dr. Vander Weide, I need you to sum this up in about 30 seconds.

THE WITNESS: Yes. I'm on my summary statement.

In summary, Dr. Woolridge and Mr. Gorman's recommendations are based on flawed analyses. The Commission should reject their recommendations and

grant Gulf Power an authorized return on equity of 11.7 percent.

CHAIRMAN GRAHAM: Thank you, sir.

MR. MELSON: Mr. Chairman, counsel forgot to hand out a late-filed exhibit that had been asked for yesterday from Dr. Vander Weide. The parties have seen it before, but I meant to get it up on your chairs before we brought him to the stand, and we're handing it out now.

MR. YOUNG: Also, with that, Mr. Chairman, Late-filed Exhibit Number 185 that OPC requested is also being handed to you.

CHAIRMAN GRAHAM: Mr. Young, you're saying that this one has already been numbered as 185?

MR. YOUNG: Yes, sir. It has already been entered into the record, is my understanding.

CHAIRMAN GRAHAM: Well, it hadn't been entered into the record, but we gave it a number.

MR. YOUNG: I'm sorry. Can you repeat that?

CHAIRMAN GRAHAM: My understanding was we didn't enter it into the record. We just gave it a number. We were going to allow -- OPC was going to see if they had any objections to it, and then you were going to enter it.

MR. YOUNG: Okay. Yes, correct.

CHAIRMAN GRAHAM: And, Mr. McGlothlin, I take it you don't have any objections to 185.

MR. McGLOTHLIN: I do not.

CHAIRMAN GRAHAM: We will enter 185 into the record.

(Exhibit Number 185 was admitted into the record.)

MR. MELSON: And Dr. Vander Weide is tendered for cross.

CHAIRMAN GRAHAM: Staff, any questions of Dr. Vander Weide?

MR. McGLOTHLIN: I do, if you want to go to the intervenors first.

CHAIRMAN GRAHAM: I thought you wanted to only address the questions that Staff had asked.

MR. McGLOTHLIN: I'm sorry if I misunderstood or you misunderstood me. I did not say that I would limit my cross to that. Once you clarified the limitations on the company, I was satisfied that I had no objection to that process, but I do have some cross of this witness. I suppose we spoke past each other. I'm sorry.

CHAIRMAN GRAHAM: Then I misunderstood. I was looking forward to that. Please go ahead.

MR. McGLOTHLIN: I do not think this will take

a long time.

CROSS-EXAMINATION

BY MR. McGLOTHLIN:

Q. Dr. Vander Weide, I intend to ask you some questions about one area of disagreement between you and Dr. Woolridge. But as starters, you will agree that both you and Dr. Woolridge agree that the appropriate growth rate to be applied in the DCF formula is the long-term growth rate; correct?

A. Not entirely. I agree that it's the long-term growth rate of investors that is reflected in stock prices.

Q. And you defined that in your testimony yesterday as three to five years. That's the basis for your analysis; correct?

A. No, that's incorrect. I suggested that analysts' growth rates generally reflect their estimates of growth for three to five years, but since there are no other long-term growth rates available, investors generally use those three- to five-year growth rates as estimates of long-term growth. And the evidence for that is based on the fact that the analysts' long-term growth rates are reflected in stock prices for utilities, whereas historical and what are sometimes called sustainable growth rates are not.

Q. With respect to the use of analysts' projections, you disagree with Dr. Woolridge's assertion that those projections are upwardly biased; correct?

A. Yes. Not only do I disagree with him in that regard; it doesn't even matter whether they were upwardly biased. It's whether investors use those growth rates when they make stock buy and sell decisions. But to be absolutely clear, there is no evidence whatsoever that they are upwardly biased.

Q. Please turn to page 22 of your rebuttal. Do you see Table 3 there, "Articles that Study Whether Analysts' Forecasts Are Biased Toward Optimism"?

A. Yes.

Q. You list nine articles in that table, do you not?

A. Yes.

Q. Looking at the first one, can you tell me the time frame of analysts' projections that were studied by the authors, Crichfield, Dyckman and Lakonishok?

A. I'm sorry. I missed the last part of your question.

Q. That's because I struggled with this last surname, I believe.

Can you tell me the time frames that were reviewed by the authors of the first article that's

listed there?

A. Those articles -- those would have been prior to the time that the articles were published, which are shown in the schedule.

Q. Well, how long a projection period did those authors consider? Do you know?

A. I don't recall.

Q. Well, sir, I've got those articles. I only have one copy here. And to expedite things, if you need -- I'll ask you to accept some things subject to check, and if you need to see the article to answer the question, we'll find a way to do that.

But would you agree subject to check that this first article looks at forecasts of annual EPS and not three- to five-year growth rate forecasts?

A. I'm sorry. When you say a forecast of annual EPS, you mean one-year forecasts of annual EPS?

Q. Yes.

A. I don't recall what it is. I would accept it subject to check for the purpose of cross-examination, but I don't recall what it is.

Q. The next article is the one by authors Elton, Gruber, and Gultekin. Do you see that?

A. Yes.

Q. Would you accept subject to check that this

also looks at forecasts of -- annual forecasts of EPS and not three to five years?

A. Yes.

MR. MELSON: Mr. Chairman, I've got a concern about accepting these subject to check. I don't know how we're going to check them. If Mr. McGlothlin would like to offer them as exhibits so that they're in the record and the parties can check them, that would alleviate my concern.

MR. McGLOTHLIN: I'm willing to do that. I only have one copy with me. I can make them -- I can have them copied and provided, or if you want to take a timeout and have the witness look at my copy, I'm fine. I had hoped to be able to expedite the process, but to the extent the witness wants to see the articles, I'm fine with that as well.

CHAIRMAN GRAHAM: Well, the next witness is also going to be addressing Issue 37. Are you going to ask the same questions of that witness?

MR. McGLOTHLIN: No, sir.

MR. MELSON: That's not within the scope of the next witness's testimony. His scope is narrower.

CHAIRMAN GRAHAM: Okay. Let's move to the next witness, and then we can generate those

companies so we can come back to Dr. Vander Weide.

MR. MELSON: Gulf calls Dr. Vilbert.

Thereupon,

MICHAEL J. VILBERT

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

DIRECT EXAMINATION

BY MR. MELSON:

Q. Dr. Vilbert, have you been sworn this morning?

A. Yes, I have.

Q. Would you please state your name and business address?

A. My name is Michael J. Vilbert. The last name is spelled with a V as in victor. My business address is 201 Mission Street, Suite 2800, San Francisco, California.

Q. And what is your occupation or profession?

A. I'm a principal of the Brattle Group, which is an economic consulting firm.

Q. Did you prefile rebuttal testimony in this docket dated November 4, 2011, consisting of 16 pages?

A. Yes, I did.

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

A. No, I do not.

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

A. Yes, they would.

MR. MELSON: Mr. Chairman, I would ask that Dr. Vilbert's rebuttal testimony be inserted into the record as though read.

CHAIRMAN GRAHAM: We will insert Dr. Vilbert's direct -- I'm sorry rebuttal testimony into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony of
Michael J. Vilbert
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 4, 2011

Q. Please state your name and address for the record.

A. My name is Michael J. Vilbert. My business address is *The Brattle Group*, 201 Mission Street, Suite 2800, San Francisco, CA 94105, USA.

Q. Please summarize your background and experience.

A. I am a Principal of *The Brattle Group*, ("*Brattle*"), an economic, environmental and management consulting firm with offices in Cambridge, Washington, London, San Francisco, Brussels, Madrid and Rome.

Brattle's specialties include financial economics, regulatory economics, and the gas and electric industries. My work concentrates on financial and regulatory economics. I hold a B.S. from the U.S. Air Force Academy and a Ph.D. in finance from the Wharton School of Business at the University of Pennsylvania. I have worked in the areas of cost of capital, investment risk and related matters for many industries, regulated and unregulated alike, in many forums. I have testified before the U.S. Federal Energy Regulatory Commission ("FERC"), Canadian National Energy Board ("NEB"), and before many state/provincial regulatory commissions in the U.S. and Canada. I have previously filed testimony and testified

before the Florida Public Service Commission. Appendix A to this rebuttal testimony is a more complete description of my professional qualifications.

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

A. I have been asked by Gulf Power Company to respond to written testimony by Dr. J. Randall Woolridge and Mr. Michael P. Gorman in the current proceeding on the measurement of financial leverage and its impact on a regulated utility's allowed return on equity.

Q. What portions of their respective testimonies are you addressing?

A. The relevant section in Dr. Woolridge's testimony is Section VII.E, Leverage Adjustment, as well as Exhibit JRW-6. Mr. Gorman's discussion of financial leverage is between pages 43 and 47 of his testimony.

Q. What are their main arguments?

A. On behalf of Gulf Power Company, Dr. James H. Vander Weide proposed to add a 90 basis point (0.9 percent) adjustment to the cost of equity estimated from the proxy group to reflect the fact that Gulf Power's capital structure for rate making purposes (53.74 percent debt) has more financial risk than the market value capital structure of the proxy group (44.92 percent debt). Dr. Woolridge and Mr. Gorman rejected Dr. Vander Weide's leverage adjustment based on two principal reasons: (Woolridge at pp.79-81, Gorman p.45)

a. Financial leverage should be measured on a book value basis. Hence, there is no need for the leverage adjustment.

b. Dr. Vander Weide's leverage adjustment would reward equity investors in regulated utilities with above-market risk-adjusted cost of equity.

Q. What evidence do Dr. Woolridge and Mr. Gorman offer to reject the financial risk adjustment proposed by Dr. Vander Weide?

A. Although both Dr. Woolridge and Mr. Gorman acknowledged that financial leverage increases risk to equity investors and increases the cost of equity, they dispute the notion that financial risks are measured on a market value basis. Instead, Dr. Woolridge argues that "financial publications and investment firms report capitalizations on a book value and not a market value basis" and "[T]here is no need for a leverage adjustment since there is no change in leverage." (Woolridge testimony, p.80) Mr. Gorman similarly argues that Gulf Power's financial risk concerns the availability of operating cash flows to meet its book value financial obligations, and "is tied to both its book value capitalization which in turn drives its market value capitalization." (Gorman testimony, pp.44-46)

Q. What is the fundamental flaw in their arguments?

A. The disregard of market value capitalization in measuring a company's financial leverage and risk is a fundamental flaw in Dr. Woolridge's and Mr. Gorman's arguments. As I will explain below, the cost of equity estimated from capital markets reflects both the business risk of the

company and its financial risk which is properly measured by the market value capital structure.

Q. Does the use of an estimated ROE based upon market value information conflict with the use of a book value rate base to set rates?

A. No. In Florida, as well as in most U.S. utility regulation, rates are set using the regulated company's rate base which is measured on the basis of the original costs or book value. The book value capital structure embedded in the depreciated rate base is generally different from the market value capital structures of the sample companies used to estimate the cost of equity. The estimated (market derived) ROEs are applied to the book value rate base, but financial risk inherent in the rate base may differ from the financial risk of the sample used to estimate the ROE. To account properly for the difference in financial risk between the ROE estimated from market data and the capital structure of the regulated firm, I agree with Dr. Vander Weide that the allowed return on equity should be adjusted to reflect the difference in financial leverage, so that equity investors will be given a fair opportunity to earn their cost of equity. The leverage adjustment should not be confused with the market-to-book ratio adjustment ("MV/BV") referred to by Mr. Gorman.[1]

[1] The Gorman Testimony at p. 45 argues that the leverage adjustment is "nothing more than a flawed market-to-book ratio adjustment."

Q. How does Mr. Gorman confuse the two concepts?

A. Consider first a situation in which the book value and market value for all sample companies are equal. The estimated cost of equity from the sample will reflect the business risk and the financial risk of the sample companies as before. Further assume that the rate base capital structure of the regulated entity differs from the average capital structure of the sample companies. I believe that Dr. Woolridge and Mr. Gorman would agree with me and Dr. Vander Weide that an adjustment would be warranted for the allowed ROE for the regulated company, although Dr. Woolridge and Mr. Gorman may or may not agree with the exact adjustment recommended by Dr. Vander Weide.

Q. Why is the situation different if the MV/BV ratio is not equal to 1.0?

A. This is the essence of the disagreement between us. Dr. Woolridge and Mr. Gorman assert that financial risk is properly measured by the book value capital structure so there is no need for the leverage adjustment. This is incorrect. It is the market value capital structure that matters for measuring financial risk, and a leverage adjustment is required if the rate base capital structure is different from the market value capital structure embedded in the sample companies' estimates of the cost of equity. More importantly, except for the difference between current cost of debt and embedded cost of debt, the after-tax weighted-average cost of capital ("ATWACC") is the same under either 11.7 percent ROE with 44.92 percent book value capital structure or 10.8 percent ROE with 53.74 percent market value capital structure.

The notion that financial leverage is and should be measured on a market value basis, shared by Dr. Vander Weide and me, is supported in every textbook on corporate finance of which I am aware.[2] Further, the view is not just an ivory-tower creation. Professional valuation books and guidance advocate the use of market value capital structure.[3] Morningstar, an off-the-shelf cost of capital provider, also uses market-value capital structure in the cost of capital estimates.[4] Even Professor Woolridge's text, "Applied Principles of Finance", uses market values to illustrate the computation of the overall cost of capital.[5] Similar views were also endorsed by legal decisions on bankruptcy proceedings.[6]

Q. Isn't it true that credit rating agencies measure financial risk with reference to book values?

A. Yes and no. Credit rating agencies are concerned with the credit worthiness of debt issuing entities; their ability to pay interest and repay debt. They are only indirectly concerned with the cost of equity capital.

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2 See, *e.g.*, Richard A. Brealey, Stewart C. Myers, and Franklin Allen, 2011, *Principles of Corporate Finance*, 10th edition, McGraw-Hill Irwin, at p. 472; Stephen A. Ross, Randolph W. Westerfield, and Jeffrey Jaffe, 2002, *Corporate Finance*, 6th edition, McGraw-Hill Irwin, at p.386; and Mark Grinblatt and Sheridan Titman, 1998, *Financial Markets and Corporate Strategy*, 1st edition, Irwin/McGraw-Hill, at p. 464.

3 See, *e.g.*, Tom Copeland, Tim Koller, and Jack Murrin, 2000, *Valuation: Measuring and managing the value of companies*, 3rd edition John Wiley & Sons, p. 204; and Shannon P. Pratt and Alina V. Niculita, 2008, *Valuation a business: The analysis and appraisal of closely held companies*, 5th edition, McGraw-Hill, at pp. 216 – 217.

4 See, *e.g.*, Morningstar, *Ibbotson Cost of Capital 2010 Yearbook*, at p. 10.

5 J. Randall Woolridge and Gary Gray, *Applied Principles of Finance*, Preliminary Edition, Penn State University, 2006, pp. 127-129.

6 See, *e.g.*, Bernstein, Stan, Susan H. Seabury, and Jack F. Williams, 2008, "Squaring bankruptcy valuation practice with *Daubert* Demands," *ABI Law Review*, at p. 190.

To ensure credit worthiness, credit rating agencies rely upon accounting information to calculate financial ratios to measure the financial health of a company. Historically, accounting information is based primarily on historical costs, *i.e.*, book value information. Accounting information is used by the rating agencies partly because it follows the Generally Accepted Accounting Principles ("GAAP") and is audited by third-party auditors. This allows for consistency between companies when comparing financial performance and to evaluate the credit worthiness of a company. Another rationale for the rating agencies' use of accounting information is the stability of accounting information, which is generally not updated more frequently than quarterly. Only the annual statements are fully audited. On the other hand, market value information changes daily. Any credit report based upon market information would be out of date very quickly. Use of accounting data avoids this problem.

Stability is both a virtue and a flaw (not timely) in historical-cost based financial accounting and credit analysis. Since Statement of Financial Accounting Standard No. 157 "Fair Value Measurements" took effect on and after 2008,[7] financial statements have incorporated more and more market value information about a company's assets and liabilities. Similarly, credit rating agencies such as Moody's also used market value information in their assessment of credit risk. For example, Moody's

[7] See http://www.fasb.org/summary/stsum157.shtml, last accessed October 29, 2011.

stated that some of its measures of corporate default risk are "updated continuously" and "extracted from the equity markets."[8]

Q. Can you explain why financial leverage is and should be measured on a market value basis?

A. The impact of financial leverage on cost of equity has been developed since the 1958 paper by Prof. Franco Modigliani and Merton Miller ("MM"), two economists who eventually won Nobel Prizes in part for their body of work on the effects of debt on firm value.[9] One key corollary of the MM theorems and their various extensions is that cost of equity increases as financial leverage increases. Although the exact speed of increase in cost of equity differs by models of capital structure, it is universally accepted that as a firm adds debt, its cost of equity increases as a result.

Both Dr. Woolridge and Mr. Gorman acknowledge that the cost of equity increases with financial leverage; however, they assert that financial risk is measured on a book value basis. This belief is wrong for two reasons. First, in MM's classic paper and subsequent extensions of their original paper, financial leverage has been consistently measured on a market value basis. This is because MM's basic insight is that, under perfect market conditions, financial leverage does not increase the *market value*

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[8] See brochure of Moody Analytics, http://www.moodysanalytics.com/~/media/Brochures/Credit-Research-Risk-Measurement/Quantative-Insight/CreditEdge/CreditEdge-Plus-Brochure.ashx, last accessed October 29, 2011.

[9] Franco Modigliani and Merton H. Miller (1958), "The cost of capital, corporation finance and the theory of investment," *American Economic Review*, 48, pp. 261-297. For a modern textbook exposition of the capital structure theories, see Brealey, Myers, and Allen, *op cit.*, Chapter 17.

to a firm as long as different combinations of debt and equity can be selected by the investors themselves.[10] To implement such a self-help financial engineering, investors have to be able to buy and sell debt and equity to achieve their desired combination. The prices at which they transact are, by definition, *market prices.* Second, as a more practical matter, economists generally prefer to use market values because they convey timely information, rather than historical data, about the assets. Business decisions on investment, capital budgeting, and financing are all based on real time market value information.

Q. Could you provide a numerical example to illustrate the impact of debt on cost of equity?

A. As a simple example, think of an investor who takes money out of her savings and invests $100,000 in real estate. The future value of the real estate is uncertain. If the real estate market booms, she wins. If the real estate market goes down, she loses. Figure 1 below illustrates this.

[10] In developing the theory, MM assume that investors can adjust the capital structures of their portfolios at no cost.

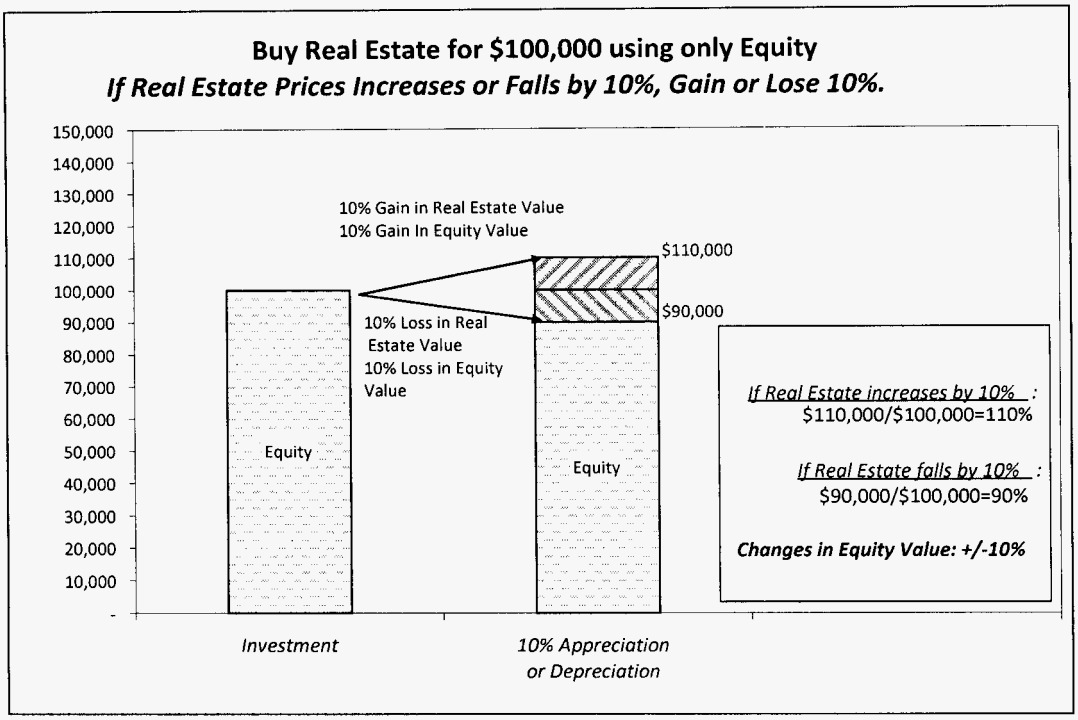


Figure 1

In Figure 2 where the investor financed the purchase using 50 percent equity and 50 percent mortgage, the variability in the investor's equity return is two times greater than that of Figure 1. The entire fluctuation of 10 percent from rising or falling real estate prices falls on the investor's $50,000 equity investment. The lesson from the example is obvious, debt adds risk to equity.

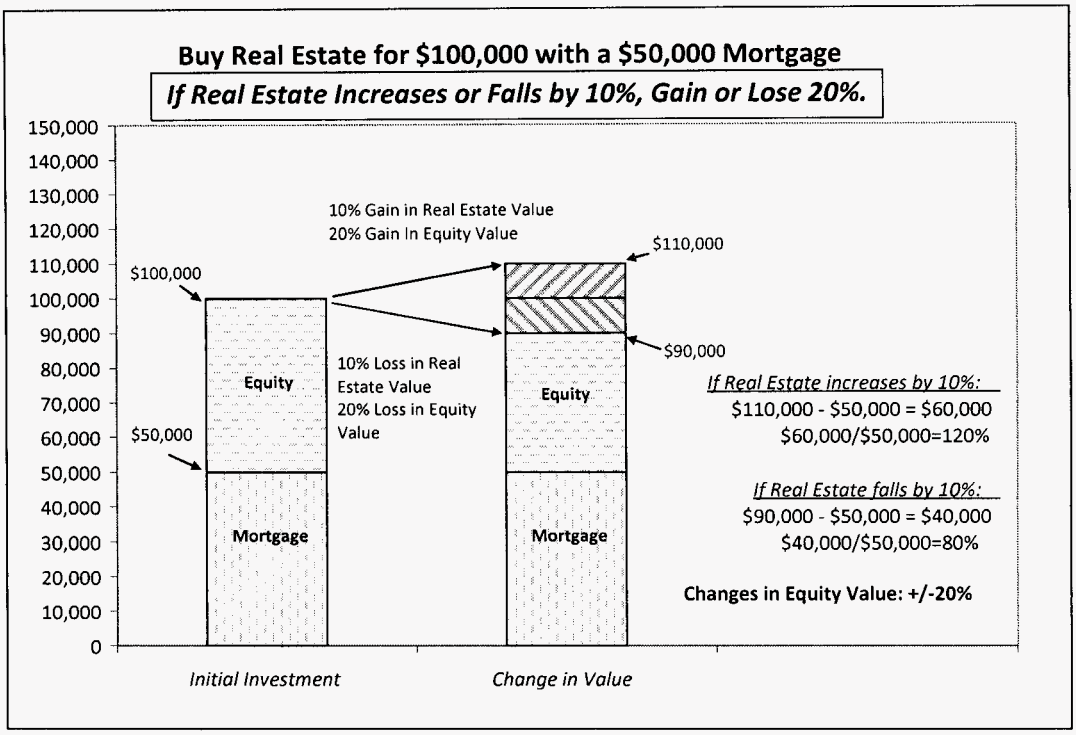


Figure 2

Q. Please provide an example that illustrates why market values are relevant.

A. Suppose in the above example that the investor has invested in real estate 10 years ago. Further assume that accounting depreciation has reduced the book value of the real estate from $100,000 to $75,000, and assume the investor has paid off 40 percent of his $50,000 mortgage. Thus, the investor has a remaining mortgage of $30,000 (= 60% X $50,000). The *book value* of the investor's equity investment is therefore $45,000 (= $75,000 - $30,000). To calculate the return on equity if real estate prices rise or fall 20 percent, one needs to know how real estate prices have developed over the past 10 years. For example, if the market value of the real estate now is $200,000, then a 20 percent decrease in the price of real estate ($40,000) is almost equal to the investor's book value equity. However, his *market value* equity (or net

worth) is equal to the value of the real estate minus what he owes on the mortgage. If we assume that the market value of the mortgage equals the unpaid balance of $30,000, then the investor's net worth is $170,000 (= $200,000 - $30,000). Therefore, the market return on equity due to a 20 percent decline in real estate prices is -23.5% (= -40,000 / 170,000).

Q. How do you respond to Mr. Gorman's claim that financial leverage is measured by the sufficiency of the firm's operating cash flows to meet the contractual book value obligations?

A. While it is true that a firm's debt obligations are typically defined in book value terms, and a firm's internally-generated operating cash flows are the primary source of debt repayment, market value of the firm is also a key determinant of a firm's debt capacity and borrowing cost. Anyone with mortgage borrowing experience knows that, in financing a purchase or refinance an existing mortgage, the amount of mortgage relative to a house's market value ("loan-to-value ratios") is critical for the lenders. The same observation applies to corporate lending and borrowing as well.

Q. Dr. Woolridge argues that "the reason that market values exceed book values is that the company is earning a return on equity in excess of its cost of equity," and presents evidence demonstrating that "there is a strong positive relationship between expected returns on common equity and market-to-book ratios for public utilities." Do you agree?

A. I do not. Mathematically, all else equal, a higher return on equity gives rise to a higher market value of equity, and a higher market to book ratio.

However, all else is not equal in real life. Dr. Woolridge provides very little information on how Exhibit JRW-6 is created, but if Dr. Woolridge intends for Exhibit JRW-6, which graphically shows positive correlation between a utility's estimated returns on equity ("ROE") and its market-to-book ratio, to support his contention, the empirical evidence falls short. From basic statistics, correlation does not mean a cause-and-effect relationship. There are a number of economic issues with Dr. Woolridge's graphical demonstration. First, Dr. Woolridge's estimated ROEs do not measure the cost of capital. They appear to be accounting returns on book value of equity, which reflect accounting convention. In addition, accounting ROEs do not measure the change in stock value, which is also part of economic returns in owning a stock. Second, lack of time dimension in the graphs does not permit one to interpret the relationship between the two variables as to whether higher ROEs lead to higher market-to-book ratios, or higher market-to-book ratios imply higher business risks and hence higher returns on equity. Third, even if economic causality could be established, the bilateral correlation in Exhibit JRW-6 fails to control for other reasons that could contribute to a positive relationship between high ROEs and high market-to-book ratios. Lastly, due to the flaws identified above, the positive correlation simply shows that the price/earnings ("P/E") ratio is positive for the utility companies. To see this, one can multiply book value of equity by the market-to-book ratios and estimated ROEs (which are the ratio of earnings to book value) to obtain the market value of the stock and the company's accounting earnings. In other words, the slope of the scatterplot is an estimate of the sample average P/E ratio. A positive P/E

is not a surprising result, nor does it provide support to Dr. Woolridge's contention that above-market returns on equity, and no other factors, contribute to the utilities' market value exceeding book value.

Q. What are the other factors that could contribute to higher market-to-book ratios?

A. A careful study of the causal relationship between allowed return on equity and market-to-book ratios requires better specification of the regression form, and measurement of the relevant variables. Here I offer a few factors that Dr. Woolridge failed to consider. First, although all the companies in Dr. Woolridge's samples have regulated utility operations, some of the companies have lines of business not subject to regulation. Non-regulated operations could be riskier and have growth options that are typically not present in utilities. Second, utilities are only allowed a fair opportunity to earn their cost of capital. Actual returns on and of capital depend on the factors outside utilities' control, such as fluctuation in consumer demand, supply shocks, weather, regulatory environment, *etc.* Third, investor demand for safe haven investment during the financial crisis and economic downturn could also boost the market-to-book ratios of utilities. (JRW-6 does not specify the time frame of the data.) Fourth, except for accounting artifacts, estimated accounting returns on equity could also be affected by rate freezes, regulatory lags in adjusting the rates or deviation of other rate components (such as depreciation) from economic reality. All these factors could affect a utility's accounting ROE, but they have nothing to do with the utility's cost of capital.

Q. What other comments do you have on Dr. Woolridge's Exhibit JRW-6?

A. Data presented in Exhibit JRW-6 show a number of companies with estimated ROEs below 10 percent, yet with market-to-book ratios above one, some approaching two. If Dr. Woolridge is right, the return on equity on these utilities should be adjusted downward. However, this is inconsistent with Dr. Woolridge's recommended 9.25 percent reasonable cost of equity. Estimated ROEs in excess of 12 percent in the exhibit also raise the red flag that these ROEs are not the correct proxy for utilities' allowed returns on equity. If Dr. Woolridge's hypothesis is correct, the cost of equity for an all equity utility would be in the range of 5 percent or so based upon projecting the intercept of the regression line, which is less than the cost of debt.

Q. How do you respond to Mr. Gorman's comments on disparity in equity returns between a stock repurchase and a utility investment project?

A. Mr. Gorman is mistaken. The objective of Dr. Vander Weide's leverage adjustment is to allow a higher return on equity for a capital structure with higher financial leverage, *i.e.*, 11.7 percent at 53.74 percent debt ratio for ratemaking purposes, as opposed to the financial leverage at a market value debt ratio of 44.92 percent. At 11.7 percent cost of equity and book value capital structure ratios, Gulf Power's ATWACC will be the same as the market value after-tax weighted-average cost of capital from the sample companies. In other words, Dr. Vander Weide is recommending a higher ROE for an investment with 53.74 percent debt than he would for

one with 44.92 percent debt, so Gulf Power is allowed the opportunity to earn its cost of capital. It is not true that the utility would be encouraged to "gold-plate utility plant investment" because it would not be earning an "above-market" return.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BY MR. MELSON:

Q. And did you have one exhibit attached to your direct testimony as Appendix A?

A. I did.

Q. Do you have any changes or corrections to that exhibit?

A. No, I do not.

MR. MELSON: Mr. Chairman, Appendix A is the witness's resumé. Due to an error by counsel, we failed to list that in the Prehearing Order, so it does not appear on the Staff's Composite Exhibit List. I apologize for that. We would like to have it assigned the next number, if we could.

CHAIRMAN GRAHAM: We will assign Number 209 to the witness's Appendix A.

MR. MELSON: Thank you.

(Exhibit Number 209 was marked for identification.)

BY MR. MELSON:

Q. Dr. Vilbert, could you please briefly summarize your testimony?

A. Yes. Good afternoon, Commissioners. My rebuttal testimony in this proceeding addresses the importance of making a leverage adjustment to recognize financial risk when setting the allowed rate of return

on equity for a regulated company.

Dr. Vander Weide adjusts his recommended return on equity for Gulf Power to account for differences in financial risk between his sample companies and Gulf Power. Mr. Gorman and Dr. Woolridge dispute the adjustment on two grounds. First, they claim that financial leverage should be measured on a book value basis rather than a market value basis. Second, Dr. Woolridge asserts that a leverage adjustment would reward investors with an above-market return. Neither of these two claims is valid.

To start, it's important to define financial risk. Financial risk is the additional risk imposed on equity investors by the use of debt in a company's financial structure. Risk to equity investors increases because payments on debt are made before any payments are made to equity investors.

Dr. Vander Weide estimates a return on equity using sample companies of comparable business risk. However, the percentage of equity in Gulf's regulatory capital structure is lower than the percentage of equity in the sample companies. This means that although Gulf has comparable business risk, it has more financial risk than the companies in the sample.

In setting Gulf's return on equity, it is

important that Gulf's overall rate of return be the same as estimated for the sample companies. In order for this to occur, the return on equity must be adjusted to recognize the difference in financial risk. In other words, a financial leverage adjustment is required in order to have an apples-to-apples comparison. The purpose of the adjustment is to ensure that investors receive an overall return comparable to other companies having similar business and financial risk. An adjustment is appropriate whether you start with Dr. Vander Weide's, Dr. Woolridge's, or Mr. Gorman's estimate of the ROE from the sample.

The fundamental flaw in Dr. Woolridge and Mr. Gorman's testimonies is their disregard of market value capitalization in measuring a company's financial leverage. Their suggestion that financial risk is properly measured by book value capital structure and not market value capital structure is incorrect, both theoretically and practically.

On a theoretical basis, it is indisputable that financial risk increases as the percentage of debt in the capital structure increases. Every financial textbook of which I'm aware notes that financial risk is appropriately measured by a company's market value capital structure, not its book value capital structure

as suggested by Mr. Gorman and Dr. Woolridge.

On a practical basis, consider the example of a mortgage lender. If you refinance the mortgage on your home, the lender does not care about the home's book value, that is, what you originally paid for the property, when it evaluates the riskiness of the loan. Instead, the lender is concerned about the relationship between the home's market value and the loan amount. To insist upon looking at the book value as a basis for measuring risk is simply incorrect. Likewise, an investor in equity looks to the market value to measure risk.

The approach used by Dr. Vander Weide does not conflict with any regulatory procedures in Florida, including the use of a book value rate base. Dr. Vander Weide is not making a market-to-book ratio adjustment. In particular, even if the market-to-book value ratio were greater than one, but the regulatory capital structure for Gulf Power had more equity than the sample companies, the approach would reduce the ROE, not increase it, as is appropriate in this proceeding.

The approach does not claim that the financial risk of Gulf Power changes as you move from a book value capital structure to a market value capital structure. The approach simply recognizes that the financial risk

inherent in Gulf Power's regulated rate base is different from the financial risk of the sample companies used to estimate the cost of capital.

In summary, Dr. Vander Weide's financial risk adjustment is based on sound financial theory, is consistent with investors' practical evaluation of risk, and is absolutely appropriate in this proceeding.

MR. MELSON: We tender Dr. Vilbert for cross.

CHAIRMAN GRAHAM: Mr. McGlothlin?

MR. McGLOTHLIN: OPC has no questions of this witness.

MR. MOYLE: We have just a few on behalf of FIPUG.

CROSS-EXAMINATION

BY MR. MOYLE:

Q. What's the percent of debt currently as proposed in the capital structure of Gulf, if you know?

A. It's roughly 54 percent.

Q. In the proxy group, what is it?

A. It's about 45 percent.

Q. And you're aware that Dr. Vander Weide in Iowa had proposed a basis adjustment of 40 basis points and today is proposing a basis adjustment of 90?

A. I don't know what Dr. Vander Weide recommended in Iowa. I know that in this proceeding it's 90 basis

points.

Q. And this is a challenging area, a lot of finance, but as I understand it, the equity that is in Gulf derives from a sole source; is that right?

A. It's my understanding that the equity in Gulf comes from Southern Company.

Q. Okay. And the reason that Gulf is seeking another 10, $12 million related to this financial adjustment, maybe a little less, is because of this difference in the capital structure that we just talked about, right, the 54 percent debt in Gulf versus the 45 in the others?

A. Yes. All the methods used by Dr. Woolridge, Dr. Vander Weide, and Mr. Gorman use market information to estimate the cost of equity, and that cost of equity is a function of the business risk of the companies as well as the financial risk of the companies. And that financial risk, properly measured on a market value basis, is different from the financial risk of the regulated entity capital structure in this case, Gulf Power.

Q. Don't you think the way this is set up with Southern being the sole provider of the equity -- I mean, if somebody wanted to increase their return on equity and could use the capital structure in a way to

do it, you know, why -- it seems to me that Southern Company could reduce their equity further, so rather than having 54 percent debt, they could have 64 or 74, and increase the debt, which would make the company riskier, and then they would increase the ROE even more. Does that logically flow, to your mind?

A. No. This is the key aspect of what Dr. Vander Weide and I are recommending. The cost of capital for a regulated entity, or really any company, is a constant across a broad middle range of capital structures. If that were not true, companies could increase the value of their firm simply by adjusting the capital structure.

Inherent in the question is the belief that if you substitute cheap equity for expensive -- I'm sorry, cheap debt for expensive debt, that you could lower the cost of capital. But companies are already financed. They know that they can substitute debt for equity, and if that would achieve a higher value for their firms, they would do that.

So what is happening when you substitute debt for equity, you increase the cost of equity to offset the savings from the cost of debt so that on a net basis, the overall cost of capital is unchanged by that procedure. You don't gain anything from doing it.

Q. It's not your testimony that the capital structure in Gulf doesn't vary over time, is it?

A. No, that's not my testimony.

Q. And indeed, in businesses, the capital structure -- they vary regularly and routinely; correct?

A. Yes. The point I just made, however, was that the overall cost of capital is not affected by small changes in their capital structure.

Q. But with respect to incentives, wouldn't it be an incentive, to the extent that there is a financial risk adjustment, to increase the amount of debt to the extent that you could then get a higher return on equity?

A. Again, the point is that --

Q. If you can just answer yes or no, I would appreciate it.

A. Certainly. No. The answer is no. The --

MR. MOYLE: That's all I have. That's all I have. Thank you.

CHAIRMAN GRAHAM: Mr. Wright?

MR. WRIGHT: No questions. Thank you, Mr. Chairman.

CHAIRMAN GRAHAM: Staff?

MS. KLANCKE: No questions.

CHAIRMAN GRAHAM: Commissioners?

REDIRECT EXAMINATION

BY MR. MELSON:

Q. Mr. Moyle asked about capital structures changing from time to time. Do you know whether the capital structure proposed by Gulf in this case is the same as the capital structure approved by the Commission in their last rate case 10 years ago?

A. I don't know.

MR. MELSON: No further questions.

CHAIRMAN GRAHAM: Any exhibits for this witness?

MR. MELSON: Yes, as soon as I can find the number. 209.

CHAIRMAN GRAHAM: We'll enter 209 into the record.

(Exhibit Number 209 was admitted into the record.)

CHAIRMAN GRAHAM: Anything else?

MR. MELSON: And may this witness be excused?

CHAIRMAN GRAHAM: If there's no questions or concerns with this witness, sir, you're excused. Thank you very much.

Mr. McGlothlin, shall we go to the next witness?

MR. McGLOTHLIN: The next witness or the next

party to cross Dr. Vander Weide. We still are in the process of making those copies.

CHAIRMAN GRAHAM: Mr. Moyle, do you want to go ahead with --

MR. MOYLE: Sure.

CHAIRMAN GRAHAM: All right.

Dr. Vander Weide, we're going to call you back up here. Do you feel like a yo-yo yet?

Sir, thank you for your patience.

Thereupon,

JAMES H. VANDER WEIDE

having been previously called as a rebuttal witness on behalf of Gulf Power Company, resumed the stand and testified as follows:

CROSS-EXAMINATION

BY MR. MOYLE:

Q. Good afternoon.

A. Good afternoon.

Q. When we spoke previously, when you were testifying on direct, I asked you whether in your view nuclear generation imposed a greater risk, and I believe you answered the question by saying you couldn't answer the question. Is that your recollection?

MR. MELSON: Objection. This is beyond the scope of his rebuttal testimony. We're here

cross-examining rebuttal.

MR. MOYLE: Maybe a little latitude on this. I'll bring it back.

CHAIRMAN GRAHAM: Okay.

BY MR. MOYLE:

Q. Do utilities that have nuclear generation impose greater risk, in your opinion?

A. As I suggested yesterday, and I still agree that one would have to examine the individual circumstances. They don't -- a universal statement would not be appropriate with regard to nuclear generation or any other type of generation.

Q. And for the purposes of the conversation, we're talking in generalities. You'll accept that; right?

A. Yes, with all the limits of such generalities for this case.

Q. So Fukushima, Chernobyl, Three Mile Island, in your mind, they don't suggest that nuclear generation imposes greater risk than non-nuclear generation?

MR. MELSON: Objection again. This is pretty far afield from anything having to do with an issue in this case.

MR. MOYLE: This is my last question.

CHAIRMAN GRAHAM: I'll allow the witness to

answer the question if he chooses to.

A. Well, first of all, only one of the three incidents that you discussed occurred in the United States, and that one occurred, if I recall, in the early 1980s. I may be wrong on the date, but it certainly was a long time ago.

Right now there are, as I suggested, there are both -- and also, you're not discussing -- you're not presenting a balanced view of the risks. The risks of nuclear, there are risks, but there are risks of all generating facilities. There are risks associated with coal, and that's why society has decided to have some environmental regulations on coal.

Q. Okay.

A. So their relevance is -- the issue is whether the risks, when all things are considered, are greater than other alternatives, and I don't see that they are universally.

Q. What prompted these questions is because you have provided in a late-filed exhibit average return on equities of only integrated utility companies; correct?

A. Yes, because Gulf Power is an integrated utility company.

Q. Okay. But there also is a lot of information about return on equities for non-integrated companies;

correct?

A. Not in that exhibit.

Q. But there is information out there from S&L that would show non-integrated utilities' return on equity; correct?

A. Yes. And what I suggested is that that information is not relevant to Gulf Power, because integrated electric utilities are generally considered more risky than distribution-only electric utilities, and Gulf Power is an integrated electric utility.

Q. So the difference between an integrated and a non-integrated is generation?

A. Well, I would characterize it that the difference is that the distribution-only electric utilities only provide distribution services.

Q. So integrated provides generation and transmission?

A. And distribution.

Q. And I assume the higher return on equity is suggested -- I think you actually made a comment about it in your summary opening statement -- is because it's an integrated company, there's greater risks associated with it; is that right?

A. The investment community -- I was suggesting the investment community views there to be greater risk

associated with being an integrated electric utility, and that the allowed rates of return hence are higher for integrated electric utilities than distribution-only electric utilities.

Q. You answered by saying that's how the investment community views it. Does your view coincide with the investment community?

A. Yes.

Q. Okay. So that would be an answer to my earlier question, which is, integrated utilities that have generation impose greater risk, in your view and in the view of the investment community?

A. Yes, the integrated electric utilities are viewed both by the investment community and by me as being a greater risk than distribution-only electric utilities.

Q. And are there any studies that you can refer me to that support that view?

A. Yes. The schedule that you have in your hands would support that view, that the allowed rates of return for integrated electric utilities exceed the allowed rates of return for distribution-only electric utilities, the difference being about 10.5 versus about 10.2. And if the risk -- and the reason that those allowed rates of return are higher for integrated

electric utilities is that the investment community views them as being of greater risk.

Q. Does the view of the investment community with respect to the risk associated with nuclear generation coincide with your view, that is, that nuclear generation does not impose additional risk, as I understand it, in a general context?

A. I don't believe you characterized my view accurately. My view is that one would have to examine specifically a particular utility with regard to their nuclear or non-nuclear generation, that it wouldn't be possible, in my view, to make a universal statement about a generality, in other words, about the risk of nuclear compared to other options.

Q. The document that is the late-filed exhibit, is that a -- have you used generalities in preparing this document, or have you delved into the specifics of all the utilities represented on this list?

A. I don't -- your statement isn't about the same thing. You're talking about two different things.

Q. I understand.

A. I'm not talking about generalities. I'm talking about the specific numbers that were allowed for these companies. Whether I delved into them or not wouldn't affect the allowed return for those companies.

Q. Okay. Well, just for the purposes of the record, have you delved into the particulars of these companies that are on your exhibit?

A. I'm generally familiar with them. I didn't do so as part of preparing that exhibit, but I'm generally familiar with those companies.

Q. So if I asked you questions about the specifics of these companies, you would be able to answer them?

A. I don't know until I hear the question.

Q. What are the clauses that are available to Avista Corporation in Idaho with respect to recovery of costs?

A. I believe I answered that with regard to the direct testimony that I haven't studied the specific clauses for every electric utility, either in my proxy group or in the country, but that most electric utilities have cost recovery clauses for many of their expenses, and that because those recovery clauses are similar, the group of proxy companies that I have are of similar risk to Gulf Power.

Q. So other than the document that you referred me to, there's no other study that does an analysis that looks at the risks of an integrated electric utility as compared to a non-integrated electric utility; is that a

correct statement?

A. I don't believe it's a correct statement. I already cited the evidence that allowed rates of return for integrated utilities are higher than the allowed rate of returns for distribution-only electric utilities. And since investors demand higher returns for greater risk, that would be evidence in and of itself that the investment community views integrated electric utilities as having higher risk than distribution-only electric utilities.

Q. Okay. So other than return on equity financial analysis, you're not aware of any study that has been done that looks specifically at the relative risk of a wires-only company as compared to a fully integrated utility company; is that correct? If you could answer yes or no, I would appreciate it.

A. I don't think a yes or no would be informative, because --

MR. MOYLE: Mr. Chairman, could I please have a yes or no?

CHAIRMAN GRAHAM: If he doesn't understand the question, he can restate the question.

BY MR. MOYLE:

Q. Do you understand the question?

A. I believe I understood it, but now that a

little bit of time has passed, I would like you to repeat it.

Q. Okay. I'm trying to get you to admit that you're not aware of any study that has been done by a group of engineers or a blue panel committee or anyone that you're aware of that has looked at the relative risk of an integrated electric company, which you've defined as distribution, transmission, and generation, as compared to a wires-only company. And I've asked you that question a few times, and you've referred me to, the proof, in your view, is the return on equities.

And I'm simply trying to ask you, please confirm that you're not aware of any study out there, non-financial return on equity based, that looks at and compares the risk of an integrated electric utility company as compared to a wires-only company. There's no study out there, no study as I described that you can cite me to; correct?

A. Now you're asking a different question. Your first question was was I aware of any, and I have not attempted to find any other studies. Whether there exists such a study, I do not know. But I will say that --

CHAIRMAN GRAHAM: Sir, I think you answered his question. You don't know of any other study.

MR. MOYLE: Thank you.

BY MR. MOYLE:

Q. And with respect to this chart, you did exclude wires-only companies; correct?

A. Yes, as defined by distribution-only companies.

Q. And did you not include 2010 because the distance in time makes those return on equities less probative?

MR. MELSON: Mr. Chairman, this was an exhibit that someone asked him to prepare. I believe the Staff asked for current year data. The Staff asked for integrated electric utilities.

Dr. Vander Weide has simply prepared exactly what was requested.

MR. MOYLE: I can rephrase.

CHAIRMAN GRAHAM: Okay.

BY MR. MOYLE:

Q. Would you agree that having this information that is contained on this exhibit that included 2010 data -- would it be appropriate to include 2010 data, in your professional judgment?

A. Well, as was just discussed, it wouldn't be appropriate in response to the request that was made by the Staff. I will say that the numbers -- there is no

difference, from my recall of the numbers for 2010 as for 2011.

Q. And with respect to probative value, would 2010 be less probative than 2011, in your professional opinion?

A. It depends on what question you're asking. If you're asking what were the allowed returns in 2011, it would not be very probative, and it was my understanding that that was the question.

Q. If you were asking what would be an appropriate return on equity based on a national average?

A. I think both would be informative. I just testified that in my belief, the average allowed return on equity in 2010 was certainly as -- not significantly different from the average allowed return on equity in 2011.

Q. Yes, sir. I thought your answer was going to be no, because when we talked earlier, I thought you said that return on equity was never to try to establish a fair return at a particular point in time in question. And so it followed in my mind that more recent data is more probative than stale data. Am I incorrect in that?

A. All data reflects a sample. Where you cut off the data for the sample is a matter of judgment. I was

responding to a request for average allowed returns for 2011, and that's what that exhibit establishes. And I also suggested that I don't I believe there was any difference between 2010 and 2011, So d I would be happy to discuss either. But all I've done was respond to a request for 2011.

CHAIRMAN GRAHAM: Mr. Moyle, I think we need to move on.

MR. MOYLE: Okay.

BY MR. MOYLE:

Q. Have the returns, the cost of capital in the last six months gone down?

A. I don't see any evidence that they've gone down, no.

Q. Debt costs haven't gone down?

A. Debt costs have gone down, but we're talking -- I'm talking about the cost of equity.

MR. MOYLE: That's all I have.

CHAIRMAN GRAHAM: Thank you. Major Thompson?

MAJOR THOMPSON: No questions.

CHAIRMAN GRAHAM: Mr. Wright?

MR. WRIGHT: No questions, Mr. Chairman. Thank you.

CHAIRMAN GRAHAM: Staff?

MS. KLANCKE: No questions.

MR. McGLOTHLIN: That brings it back to me.

CHAIRMAN GRAHAM: We'll go to the Commissioners, and we'll come back to you.

MR. McGLOTHLIN: Thank you.

CHAIRMAN GRAHAM: Commissioner Balbis.

COMMISSIONER BALBIS: Thank you, Mr. Chairman. I just have two questions. And I believe this was answered by another witness, but do you know what the revenue requirement for 100 basis points for Gulf Power is?

THE WITNESS: No, I do not.

COMMISSIONER BALBIS: Okay. In your rebuttal testimony, you were providing testimony in response to other expert witnesses that have recommended a different return on equity than you recommended; correct?

THE WITNESS: Yes.

COMMISSIONER BALBIS: And we have heard from these witnesses or experts a range of returns, I believe, and one of them was 9.75. Do you recall that?

THE WITNESS: Yes, I do.

COMMISSIONER BALBIS: Okay. And you're recommending 11.70; correct?

THE WITNESS: Yes.

COMMISSIONER BALBIS: What would be the impact to Gulf Power and/or its customers if the Commission were to determine that 9.75 percent is an appropriate ROE?

THE WITNESS: Well, clearly, the revenue requirement would be less with a 9.75 percent return than a 11.2 percent return. However, my understanding is that the obligation of a -- of our investigation is to determine a fair return. And a fair return as defined by the Supreme Court is a return that is commensurate with returns on other investments of the same risk, and I have estimated that to be 11.7 percent.

COMMISSIONER BALBIS: Okay. So would there be any impact on Gulf's ability to attract capital with a 9.75 percent?

THE WITNESS: I believe that except in extreme circumstances, it's generally possible to obtain capital. The question is, what return do you have to offer in order to get that capital?

I believe that if Gulf were not able to -- did not have an opportunity to earn a return that's commensurate with returns on other investments of the same risk, that its risk would increase, which would increase its required return.

COMMISSIONER BALBIS: Okay. Then the last question concerning this Late-filed Exhibit 186, where you have the average returns for 2011 --

THE WITNESS: Yes.

COMMISSIONER BALBIS: The two highest return on equities that are listed on this exhibit are the two Virginia Electric and Power cases of 12.30 percent; is that correct?

THE WITNESS: Yes.

COMMISSIONER BALBIS: Did that 12.30 percent include any basis point performance incentives?

THE WITNESS: I'm not aware that it did, but it was among the listed allowed returns. There were returns that were both above the average and below the average. There are special circumstances. One might suggest there are special circumstances for any one of those companies. This is the average allowed return across the country.

COMMISSIONER BALBIS: Okay. And you would agree that 11.70 percent, according to this exhibit, would be the third highest return on equity listed?

THE WITNESS: I would agree that my recommended 11.7 is above the average allowed return. And I don't have that exhibit with me.

Perhaps it is -- well, maybe I do have it here.

Perhaps it is the third highest, but the 11.7 is still what my recommended return is.

COMMISSIONER BALBIS: Okay. Thank you.

CHAIRMAN GRAHAM: Mr. McGlothlin, do you have any other questions of this witness?

MR. McGLOTHLIN: No, sir. The only line of questions I have relates to Table 3.

CHAIRMAN GRAHAM: All right. We'll just table him and move forward with Mr. Teel and come back to him.

MR. McGLOTHLIN: All right. Thank you.

MR. MELSON: Gulf calls Mr. Teel. And, Commissioner Balbis, I believe Mr. Teel can probably give you an answer to your question about 100 basis points.

Thereupon,

R. SCOTT TEEL

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

DIRECT EXAMINATION

BY MR. MELSON:

Q. Mr. Teel, you understand you're still under oath?

A. Yes, I do.

Q. Would you please state your name and business address again?

A. My name is Scott Teel. I work at One Energy Place, Pensacola, Florida, 32520.

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

A. I'm employed by Gulf Power Company as vice president and chief financial officer.

Q. And did you prefile rebuttal testimony in this docket dated November 4, 2011, consisting of eight pages?

A. I did.

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

A. I do not.

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

A. They would.

MR. MELSON: Mr. Chairman, I ask that Mr. Teel's rebuttal testimony be inserted into the record as though read.

CHAIRMAN GRAHAM: We will insert Mr. Teel's rebuttal testimony into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony and Exhibit of
R. Scott Teel
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 4, 2011

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

A. My name is Scott Teel. My business address is One Energy Place, Pensacola, FL 32520, and I am Vice President and Chief Financial Officer (CFO) of Gulf Power Company (Gulf or the Company).

Q. Did you file direct testimony in this docket?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to demonstrate that the return on equity recommended by Federal Executive Agencies (FEA) witness Gorman is not supportive of Gulf's credit ratings. I also respond to a statement by Office of Public Counsel (OPC) witness Dismukes regarding the benefits non-regulated affiliates of Gulf Power receive from their association with the regulated operating companies.

Q. Are you sponsoring any rebuttal exhibits?

A. Yes. I am sponsoring Exhibit RST-2, consisting of Schedules 1, 2 and 3. Exhibit RST-2 was prepared under my supervision and direction, and the

information contained in that exhibit is true and correct to the best of my knowledge and belief.

Q. Do you agree with Mr. Gorman's evaluation of the effect of his recommended return on equity of 9.75% on Gulf Power's bond ratings?

A. No. Based on his analysis of financial credit metrics utilized by Standard & Poor's, Mr. Gorman concludes that his recommended return on equity would be supportive of an investment grade bond rating and Gulf's "current 'BBB' bond rating." [Gorman at 41] Mr. Gorman uses the wrong credit ratings as the basis of his analysis, and his analysis is too limited to reach any conclusions regarding the effect his recommended return on equity would have on Gulf's credit ratings.

Q. What are investment grade bond ratings?

A. Ratings in the BBB category and higher for Standard & Poor's and Fitch, and ratings in the Baa category and higher for Moody's are considered investment grade. Schedule 5 of Exhibit RST-1 to my direct testimony depicts the ratings scales of each of the three agencies.

Q. What are Gulf's current bond ratings?

A. Contrary to Mr. Gorman's statement, Gulf does not have a BBB rating. Standard & Poor's rates Gulf Power's long-term debt as A, while Fitch and Moody's ratings are A and A3, respectively. Schedule 4 of Exhibit RST-1 to my direct testimony depicts Gulf Power's current credit ratings.

Q. What credit ratings does Gulf target?

A. Gulf targets A ratings for its long-term debt, specifically A ratings by Standard and Poor's and Fitch, and A2 by Moody's. Gulf targets equivalent ratings for its short-term debt, A-1 by Standard & Poor's and F1 by Fitch. Moody's does not rate Gulf Power's short-term debt.

Q. Does an investment grade rating meet Gulf's target?

A. No. The thresholds for an investment grade rating are BBB- for Standard & Poor's and Fitch, and Baa3 for Moody's. These ratings fall well below Gulf's target ratings.

Q. Is it necessary to maintain Gulf's targeted ratings?

A. Yes. As explained in more detail in my direct testimony, maintaining these targeted ratings is critical for Gulf and its customers. Strong credit ratings ensure access to capital even during troubled financial markets and allow Gulf to provide reliable service to its customers at the lowest financing costs possible.

Q. Is Mr. Gorman's evaluation of the potential impact of his recommended rate of return on Gulf's credit ratings complete?

A. No. Mr. Gorman's evaluation is limited to only one of the three credit rating agencies. More importantly, it does not consider all of the qualitative factors which are key drivers of a utility's credit ratings. Most notably, Mr. Gorman does not consider the impact his recommended rate of return

could have on the rating agencies' assessment of the regulatory environment in Florida.

Q. Is the regulatory environment an important consideration of the rating agencies?

A. Yes. All three of the major credit rating agencies place significant importance on a utility's regulatory environment. Moody's credit opinion on Gulf Power dated August 13, 2010, issued when Moody's downgraded Gulf's long-term debt rating from A2 to A3, cites the "recently perceived decline in utility's political and regulatory environment" as a rating driver. See Schedule 7 of Exhibit RST-1 to my direct testimony for a copy of this credit opinion.

In its report on Gulf Power dated October 5, 2010, Fitch states the "continuation of strong regulatory support is important for Gulf to maintain its credit quality and current ratings." See Schedule 8 of Exhibit RST-1 to my direct testimony for a copy of this credit opinion.

Standard & Poor's, in its March 11, 2010 report entitled "Assessing U.S. Utility Regulatory Environments," states:

> [T]he assessment of regulatory risk is perhaps the most important factor in Standard & Poor's Ratings Services' analysis of a U.S. regulated, investor-owned utility's business risk. Each of the other four factors we examine—markets, operations, competitiveness, and management –

can affect the quality of the regulation a utility experiences, but we believe the fundamental regulatory environment in the jurisdictions in which a utility operates often influences credit quality the most.

See Schedule 1 of my rebuttal Exhibit RST-2 for a copy of this report.

Q. How could Mr. Gorman's recommended rate of return affect assessments of the regulatory environment?

A. The rate of return is an important factor in the assessment of the regulatory environment. Fitch explicitly cites "below-average allowed return on equity" in recent decisions in Florida in its report on Gulf Power, dated October 5, 2010. Standard & Poor's, in its report "Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities Industry", issued on November 26, 2008, states the "[E]valuation of regulation focuses on the ability of regulation to provide utilities with the opportunity to generate cash flow and earnings quality and stability adequate to: meet investment needs; service debt and maintain a satisfactory rating profile; and generate a competitive rate of return to investors." See Schedule 8 of Exhibit RST-1 to my direct testimony for a copy of Fitch's credit opinion. A copy of the Standard & Poor's report is attached as Schedule 2 of my rebuttal Exhibit RST-2.

As discussed in my direct testimony, both Moody's and Fitch have expressed concerns about the regulatory environment in Florida. While

Fitch "expects the regulatory climate in Florida to slowly return to normal after this election year and as the state's economy slowly begins to recover," Moody's recognized the "Florida Public Service Commission is entering a period of substantial uncertainty..."

More recently, in its report dated August 12, 2011, Moody's states that "the political and regulatory environment for investor-owned utilities in Florida has largely stabilized"; however, they did not upgrade their score of Baa for Regulatory Framework, the qualitative factor providing 25% of the weighting for their credit ratings. This score was downgraded following recent rate case decisions, citing the state as being "substantially less supportive of credit quality than it had been previously."

Moody's notes that "Gulf Power's base rate case will also be the first one to be addressed by a newly constituted FPSC and may give an indication of the future direction of utility regulation in Florida." Moody's also cites an unsupportive outcome in this case as a factor that could lead to another downgrade. See Schedule 3 of my rebuttal Exhibit RST-2 for a copy of this report.

An authorized rate of return below the return required by investors would increase the concerns of the ratings agencies about the regulatory environment in Florida.

Q. Are you aware of any other assessments of the regulatory environment in Florida?

A. Yes. Regulatory Research Associates (RRA) rates the various states on their regulatory climate. In its August 2011 release, RRA noted that Florida historically had been one of the most stable and constructive state regulatory environments from an investor viewpoint. It cited the recent FP&L and Progress rate decisions in early 2010 as factors that led it to lower its regulatory assessment of the Commission by two steps on its rating scale, from the middle of the "Above Average" range to the top of the "Average" range.

Q. Will Mr. Gorman's recommended return on equity be supportive of Gulf's targeted credit ratings?

A. No. Mr. Gorman's recommended rate of return would be detrimental to the rating agencies' assessment of Gulf Power's regulatory environment, a key factor in determining credit ratings. This could heighten the risk of a downgrade that would adversely affect Gulf's customers by making it more difficult or more costly for Gulf to access the capital markets to support the investment required to continue to provide them with reliable service.

Q. Ms. Dismukes' testimony may be interpreted to state that Southern Company's non-regulated affiliates receive benefits to their credit ratings from being associated with the regulated operating companies. Is this correct?

A. No. Southern Power Company (SPC) is the only non-regulated affiliate of Southern Company that is rated by the credit rating agencies. None of the rating agencies incorporate Southern Company, or its subsidiaries, into their ratings of SPC. SPC is evaluated and rated independently of both the parent company and the core regulated electric utility companies.

Q. Please summarize your rebuttal testimony.

A. Mr. Gorman's conclusion that his recommended rate of return would be supportive of an investment grade bond rating and allow Gulf to maintain "its current BBB utility bond rating" is wrong for several reasons. First, he is mistaken about Gulf's current credit ratings and considers an investment grade rating a sufficient rating. Second, his opinion relies solely on an analysis of financial metrics and considers only one of the three credit rating agencies. Third, and most importantly, he does not consider the qualitative impact on Gulf's credit ratings of a regulatory decision which awarded Gulf only his recommended return on equity.

Additionally, I clarify that the credit rating agencies, in their assessment of Southern Power, Gulf's non-regulated affiliate, do not consider its affiliation with Gulf and its regulated sister companies.

Q. Does that conclude your testimony?

A. Yes.

BY MR. MELSON:

Q. And you had an Exhibit RST-2 to your rebuttal testimony consisting of three schedules; is that correct?

A. I do.

Q. And do you have any changes or corrections to that exhibit?

A. No, I do not.

MR. MELSON: Mr. Chairman, it has been identified in the Prehearing Order or the consolidated exhibit list as number 159.

CHAIRMAN GRAHAM: So noted.

BY MR. MELSON:

Q. Mr. Teel, could you give us a brief summary of your testimony?

A. Yes, I can.

Commissioners, Gulf Power's credit quality is at risk. The purpose of my rebuttal testimony is to address FEA witness Mr. Gorman's assertions that even if granted his recommended return, Gulf will be able to maintain its investment grade rating of BBB and clarify statements made by OPC witness Ms. Dismukes regarding affiliate credit ratings.

Mr. Gorman makes inaccurate assumptions and performs an inadequate assessment in reaching his

conclusions. Mr. Gorman first incorrectly identified Gulf's current credit ratings as BBB. Since, he has acknowledged that mistake and corrected it this morning.

More importantly, he incorrectly assumes that a rating considered investment grade is sufficient. It is not. We target "A" ratings. A rating as low as BBB minus is considered investment grade.

Additionally, Mr. Gorman's credit analysis falls far short of the comprehensive assessment of the credit rating agencies. He makes no mention of key qualitative factors. In fact, an authorization of his recommended rate of return could have an adverse effect on the credit rating agencies' assessment of not only Gulf, but all Florida investor-owned utilities.

Credit rating agencies' opinions are important, because they do influence investors and a company's ability to access capital on reasonable terms. We need access in both stable and turbulent economic environments. Rating downgrades could put that access at risk.

I also address a portion of Ms. Dismukes' testimony, but only to clarify that Gulf's unregulated affiliate credit ratings are not benefited from its association with Gulf or any of its regulated affiliates.

That concludes my summary.

MR. MELSON: We tender Mr. Teel for cross.

MR. McGLOTHLIN: No questions.

CROSS-EXAMINATION

BY MR. MOYLE:

Q. Just a couple following up on a question that was asked from the bench. A hundred basis points, how much does that represent in terms of revenue?

A. That's approximately $10 million, possibly a little bit more with the inclusion of the Crist turbine upgrades.

Q. So the difference between what your witness is suggesting and what the witness from OPC is suggesting is how much?

A. I suppose the difference is approximately 200 basis points, so that would represent about $20 million.

Q. Okay. And the achieved return on equity in 2010 was what?

A. In 2010, we achieved a return on equity of 9 1/2 percent.

Q. And in 2011?

A. And in 2011, through October, we're at about 5.4 percent.

Q. Okay. So if OPC's position to go up to the 9 range was adopted, it would double the return on equity

from 2011; is that right, approximately?

A. It would, approximately.

MR. MOYLE: That's all I have. Thank you.

CHAIRMAN GRAHAM: Major Thompson?

MAJOR THOMPSON: No questions.

CHAIRMAN GRAHAM: Mr. Wright?

MR. WRIGHT: Thank you, Mr. Chairman. Just an quick follow-up on Mr. Moyle's questions.

CROSS-EXAMINATION

BY MR. WRIGHT:

Q. Good afternoon -- yes, it is afternoon. Good afternoon, Mr. Teel.

A. Good afternoon, Mr. Wright.

Q. Mr. Moyle asked you about the difference in revenue requirements as between OPC's position of 9.25 percent and the company's position of 11.7. In your response, I thought you said you thought the differential there was about 200 basis points. It's really closer to 250, is it not?

A. I understood his question to be regarding Mr. Gorman's recommendation, which is what I address in my rebuttal.

Q. Okay. That was what I thought your answer was. So you would agree that -- your answer was with respect to Mr. Gorman's 9.75 percent?

A. That's right.

Q. And with respect to Dr. Woolridge's recommendation, the difference would be about $25 million; correct?

A. Yes.

MR. WRIGHT: Thank you. That's all I have.

CHAIRMAN GRAHAM: Staff?

MS. BARRERA: Just a couple of questions.

CROSS-EXAMINATION

BY MS. BARRERA:

Q. Do you know when Southern Company first issued debt at the parent company level?

A. No, I do not recall that.

Q. And do you know if Southern Company had debt at the parent company level reflected on its books at the time the company filed its last rate case?

A. Yes. My understanding is they did have debt on the books at the time of the last rate case.

MS. BARRERA: Thank you. I have no more questions.

CHAIRMAN GRAHAM: Commissioners? Commissioner Balbis.

COMMISSIONER BALBIS: Thank you, Mr. Chairman. I would like to pose the same questions I asked the previous witness, and I know Mr. Moyle already

clarified the 100 basis point issue.

I'm sure you understand the position we're in. We have several witnesses and experts that are presenting testimony of significant differences in appropriate ROEs, so bear with me as I try and flesh this out.

I would like to pose the same question to you. If this Commission decides that the lower testified appropriate ROE is found appropriate, whether it's 9.25 or 9.75, what impact to Gulf Power would that be?

THE WITNESS: I would tell you that puts us in a -- would put us in a very difficult position with respect to our customers. We are interested in serving the best interests of our customers in the long term. If we are awarded a return on equity less than that required of an investor, that puts us in the position of making a decision as to whether we cut some costs out of our business that are otherwise needed to serve customers in the near term to provide the required rate of return to an investor, or if, in turn, we accept the fact that we're going to provide a return less than that required of an investor, and that in turn puts our access to capital at risk in the long term.

COMMISSIONER BALBIS: So assuming that you now would have a diminished access to capital, what would that result in?

THE WITNESS: The diminished access to capital puts us in a position of not potentially getting the money on reasonable terms to serve the customers. And I would suggest to you that there were utilities who did have that access to capital on reasonable terms at risk during the most recent financial crisis.

COMMISSIONER BALBIS: So would it be true then that you would have to access capital at a higher cost to Gulf, which in turn would be passed on to the ratepayers?

THE WITNESS: Certainly.

COMMISSIONER BALBIS: Okay. Thank you.

CHAIRMAN GRAHAM: Redirect?

MR. MELSON: No redirect. Move Exhibit 159.

CHAIRMAN GRAHAM: We will move Exhibit 159 into the record, which is on page 26.

(Exhibit Number 159 was admitted into the record.)

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

CHAIRMAN GRAHAM: If there are no further questions of Mr. Teel, yes, sir, you can be

excused.

THE WITNESS: Thank you.

CHAIRMAN GRAHAM: Mr. McGlothlin, are you ready to continue with Mr. Vander Weide?

MR. McGLOTHLIN: A moment to check.

CHAIRMAN GRAHAM: Sure.

MR. McGLOTHLIN: We're getting close, I'm told. It's a matter of collating the copies that have been made now.

CHAIRMAN GRAHAM: All right. We'll go on to the next witness, then.

MR. MELSON: Mr. Chairman, would it be inappropriate to hope for a 15-minute-early lunch?

CHAIRMAN GRAHAM: Well, why not? We will reconvene at a quarter till, so that gives you guys an hour.

MR. MELSON: Thank you.

(Proceedings recessed at 12:45 p.m.)

(Transcript continues in sequence in Volume 11.)

CERTIFICATE OF REPORTER

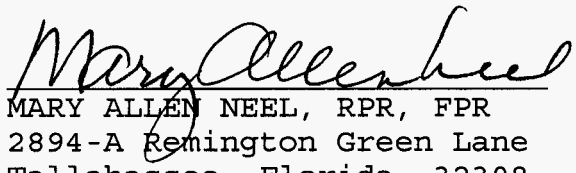
STATE OF FLORIDA:

COUNTY OF LEON:

I, MARY ALLEN NEEL, Registered Professional Reporter, do hereby certify that the foregoing proceedings were taken before me at the time and place therein designated; that my shorthand notes were thereafter translated under my supervision; and the foregoing pages numbered 1737 through 1964 are a true and correct record of the aforesaid proceedings.

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

DATED THIS 18th day of December, 2011.



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