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GULF POWER
A SOUTHERN COMPANY

June 21, 2002

Ms. Blanca S. Bayo, Director
Division of the Commission Clerk and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee FL 32399-0870

Dear Ms. Bayo:

RE: Docket No. 011605-EI

Enclosed are an original and fifteen copies of the testimony and exhibit of William N. McKenzie on behalf of Gulf Power Company to be filed in the above docket.

Sincerely,

Susan D. Ritenour

Susan D. Ritenour
Assistant Secretary and Assistant Treasurer

lw

cc: Beggs and Lane
Jeffrey A. Stone, Esquire

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Review of investor-owned electric utilities' risk management policies and procedures	))))	Docket No. 011605-EI

Certificate of Service

I HEREBY CERTIFY that a true copy of the foregoing was furnished by hand delivery or the U. S. Mail this 21st day of June 2002 on the following:

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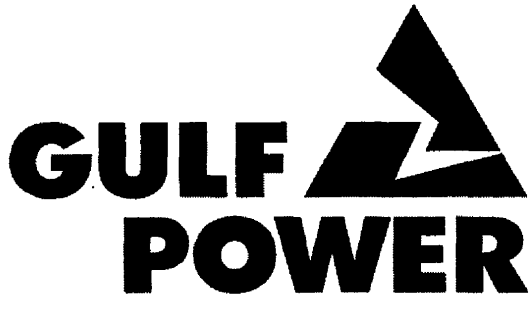
Before the Florida Public Service Commission
Prepared Direct Testimony & Exhibit of
William N. McKenzie
Docket No. 011605-EI
Date of Filing: June 24, 2002



A **SOUTHERN COMPANY**

GULF POWER COMPANY

Before the Florida Public Service Commission
Prepared Direct Testimony and Exhibit of
William N. McKenzie
Docket No. 011605-EI
Date of Filing: June 24, 2002

Q. Please state your name and business address.

A. My name is William N. McKenzie and my business address is Southern Company Services, 600 North 18th Street , Birmingham, Alabama 35291-8162.

Q. What is your occupation?

A. I am General Manager Gas Procurement for Southern Company Services (SCS), Gulf Power Company's fuel procurement agent.

Q. Please describe your educational background and professional experience.

A. I am a 1981 Mechanical Engineering graduate of the Georgia Institute of Technology. I have 21 years experience in the natural gas industry, the initial portion with Sonat, a major interstate pipeline, exploration, and natural gas marketing company. I held various positions in all three divisions, both in Birmingham and Houston. I was involved in all areas of risk management, including hedging purchases and sales, storage arbitrage, basis management, and customer tailored product offerings. Since 1999 I have led Southern electric system's (SES) growing gas procurement operations with 2001 purchases of over 150 billion cubic feet (BCF) and over 1 BCF/day of interstate transportation and over 10 BCF of storage capacity under contract.

Q. What are your duties as General Manager Gas Procurement for Southern Company Services?

A. I am responsible for all natural gas procurement for the electric generating plants of the SES, including those of Gulf Power Company, Georgia Power Company, Alabama Power Company (APC), Mississippi Power Company (MPC), Savannah Electric Power Company (SAV), and Southern Power Company. In addition, I am responsible for the risk management activities of APC, MPC, and SAV, which have hedging programs approved by their respective state commissions.

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

A. My testimony addresses issues relating to fuel risk management of electric utility companies. Included in my testimony are Gulf Power Company's proposal for its Gas/Oil Price Hedging Program and hedging examples.

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

A. Yes. I have prepared an exhibit consisting of two schedules. The first schedule is a basic outline of the plan. The second schedule contains an example of how Gulf's proposed fuel-hedging plan will work.

Counsel: We ask that Mr. McKenzie's exhibit consisting of two schedules be marked as Exhibit No. ___ (WNM-1).

Q. Why should the Florida Public Service Commission (FPSC) authorize Gulf Power to hedge its fuel price risk?

A. It can be persuasively argued that purchasing fuel at the prevailing market price is the lowest cost option over time. However purchasing fuel at market prices means one must absorb high prices when supplies are tight. A buyer has to exercise patience and expend extraordinary resources until the market corrects. This often presents an economic hardship if financial resources are insufficient to sustain the buyer through a peak cycle. Theoretically, hedging provides insurance against adverse outcomes and therefore can cost more than simply paying market prices. An effective hedging program reduces price volatility and improves supply reliability. For these reasons and with the recent change in Gulf's fuel mix, Gulf should actively pursue hedging, but only with the concurrence of this Commission.

Q. Has Gulf Power hedged fuel price risk in the past?

A. Yes. Gulf's fuel program historically has focused on coal because the Company's generation mix has, until recently, been dominated by coal-fired generation. Gulf's coal procurement program includes both long-term contracts and spot purchases, providing a physical hedge that has resulted in relatively stable prices over the years. Past gas requirements at Gulf have been primarily peaking in nature and have not had a significant impact on overall fuel costs. Although Gulf did participate in a pilot fixed-price gas purchase program a few years ago that resulted in savings, the program was discontinued because of the risk associated with fixed-priced physical purchases. This is discussed further below. Gulf Power, to date, has not

hedged with financial derivatives. With the addition of Smith Unit 3, Gulf's generation mix now has a significant amount of gas generation.

Q. What do you consider to be the key components of an appropriate hedging plan for Gulf?

A. Each electric utility's operations are unique and therefore a "one size fits all" hedging program is not appropriate. Hedging programs should be tailored to meet the specific needs of individual electric utilities. Gulf's proposed program includes specific parameters outlining levels of risk and reward appropriate for the Company and its customers. Such parameters outline acceptable volumes, tenure, and above-market exposure limits. The volume limits prohibit speculation while allowing the Company to protect against a high demand season in which fuel consumption is greater than normal. The length of the forward period that can be hedged, or tenure, will be limited such that the Company does not put the customer at risk of paying above-market for an unacceptable period of time. Lastly, the customers above-market exposure will be limited. The Company will assume risks in limiting such above-market exposure in return for the potential to share any below-market savings realized in the hedging program.

Q. What is the appropriate regulatory treatment for (1) gains and losses an investor-owned electric utility incurs from hedging fuel transactions through futures contracts; (2) the premiums an investor-owned electric utility receives and pays for hedging fuel transactions through options contracts;

and (3) the transaction costs an investor-owned electric utility incurs from hedging its fuel transactions through futures and options contracts?

A. Under the risk management plan that Gulf is proposing, it is appropriate that all these costs should be borne by the customer and passed through the fuel clause as prudently incurred fuel expenses.

Q. Should a hedging program provide incentives to the utility for managing fuel price risks?

A. Yes. Under certain circumstances the Commission should use incentive based regulatory mechanisms. An incentive, if structured properly, can create additional customer value. Gulf's program is structured to encourage cautious hedging in a downward market and aggressive hedging in an upward market. Disincentives or penalties, on the other hand, are not appropriate in a hedging program. If a utility is put at financial risk for hedging on behalf of its customers, the utility will tend to be inactive, thus rendering the program ineffective.

Q. Will hedging result in lower fuel prices?

A. Not necessarily. The term "hedging" is often confused with the term "trading." Trading is the business of buying and selling commodities. The underlying assumption of trading is that success is defined by buying low and selling high for a profit. By contrast, hedging is a means of protection or defense, especially against potential financial losses. It is an incorrect assumption that hedging automatically results in lower costs. Although effective hedging may result in lower costs, that is not the primary purpose.

The purpose of a hedging program is to reduce risk -- to protect an existing or anticipated physical market exposure from unexpected or adverse price fluctuations.

Q. Should Gulf hedge price risk with physical fuel contracts, financial derivatives, or a combination of the two?

A. It depends on the fuel. For example, there is not a liquid financial derivatives market for coal. As a result, to manage the price risk of coal a utility must use physical contracts. However, there is a mature, liquid, financial derivatives market for gas and oil. Therefore, managing the price risk of gas and oil with financial derivatives provides many advantages. If an electric utility company attempted to manage gas price risk with physical purchases, it would struggle with the physical commitment to take delivery of gas during periods when its plants were not dispatched. Unlike coal, gas cannot be economically stockpiled in order to burn it later. Gas storage is useful for managing electric generating plants' gas requirements (for reliability and swings in demand) but it is not an economic alternative for gas price management. However, since a financial derivatives market exists, price risk can and should be managed separately from physical procurement. In addition, managing price risk separately from physical procurement 1) provides system operational benefits, 2) enhances supplier reliability, and 3) provides better credit management.

Q. How does managing price risk separately from physical procurement provide operational benefits?

A. Gulf, as a member of the integrated Southern electric system (SES), economically dispatches its units in order to provide the lowest costs to its customers. Gulf purchases power from other SES companies when lower cost generation is available. If gas procurement is conducted utilizing physical gas contracts at fixed prices, Gulf might be forced to sell gas at a significant loss or burn it uneconomically in order to liquidate the physical purchase obligation. Purchasing natural gas at market based prices allows the SES to dispatch its gas generating assets in a manner that produces the greatest economic benefit for its customers. This is consistent with the dispatch philosophy of the Southern electric system.

Q. How does managing price risk separately from physical procurement enhance supplier reliability?

A. If a fixed-price contract with a gas supplier is lower than market, the supplier may fail to deliver and divert the supply to a higher priced market. This contract non-performance is known as "price majeure". Keeping physical contracts at prevailing market prices mitigates price majeure because a supplier cannot obtain a higher price from a different purchaser. This in effect enhances security of supply.

Q. Please describe the benefit related to credit management associated with managing price risk separately from physical procurement.

A. When a hedge results in a price below market, the counter party owes you that value of the difference. For example, if the Company has locked in a price of $3.50 on one BCF of natural gas with a counterparty and the

current price of that future delivery is $4.50, then you have a $1 million credit exposure with that counterparty. This credit exposure is managed much more easily with higher credit rated banks than with natural gas producers or marketing companies. The strategy of purchasing physical gas at market and hedging with financial derivatives has proven to be a prudent strategy for Southern operating companies as energy-marketing companies have undergone significant credit downgrades in the past year. In addition, several large producing companies market their production through marketing affiliates with lower credit ratings, limiting a buyer's ability to effectively manage credit exposure. There are a limited number of creditworthy physical suppliers.

Q. Please describe the hedging program proposed by Gulf Power in this docket.

A. As shown in Schedule 1 of my exhibit, Gulf is proposing a simple program that hedges the commodity component of natural gas and oil requirements. Since Gulf Power has contracted for firm gas transportation to its combined cycle plant at a fixed price, the transportation component for the majority of Gulf's gas requirements is effectively hedged. Although the program addresses oil, Gulf's oil requirement is minimal. The primary objectives of this program are as follows: 1) reduce gas price volatility to customers, 2) protect against adverse price movements (price spikes), and 3) limit the level of above-market gas price exposure. In order to accomplish these objectives, Gulf proposes that all physical purchases be priced at the prevailing market value at the time of delivery. All commodity

price hedging will be managed through use of financial derivatives. The proposal has the following limits:

Volume: Fixed priced hedging is limited to 100% of Gulf Power's projected annual volume. In other words, Gulf Power will not hedge with fixed prices more than the volume projected to be burned. This prohibits speculation. Further, to hedge against higher than normal demand, Gulf Power's proposal allows option price hedging up to 110% of the projection. This allows for hedging against abnormally high demand conditions, without exposing the customer to potential losses associated with fixed-prices if demand does not materialize.

Tenure: Forward hedging is limited to 42 months. This period allows Gulf Power to take advantage of market cycles and to hedge up to 3 summer seasons out at any point in time. However, it mitigates the risk of being above-market for an extremely long period of time (greater than 3 ½ years).

Above-market Exposure: As part of the total program, which includes the potential for Gulf to earn an incentive if savings are achieved, Gulf proposes to limit the customers' above-market exposure. Gulf will limit the customers' annual above-market exposure for natural gas and oil to 10% of the current year cost projection. For example, if Gulf's gas/oil projection for 2003 is 25 BCF @ $4.00, or $100 million, then Gulf guarantees its hedging activity will not cost more than $10 million. If Gulf hedges and the market for gas declines such that Gulf physically purchases 25 BCF at $3.00 ($75 million),

then Gulf guarantees that the customer will not pay more than $85 million net for the gas, including any hedging financial losses. This requires the Company to actively monitor and manage its hedged positions rather than passively letting hedges expire regardless of the cost to the customer. In addition, Gulf proposes to manage the 42-month forward mark-to-market position such that it will limit any negative mark-to-market (MTM) to 5% of the forward 42-month projection. For example, if Gulf's projected oil/gas is $100 million per year for the next 4 years, Gulf will manage hedges such that the MTM will not exceed negative $17.5 million ($100 X 3.5 years X 5%). These two limits encourage Gulf to be a cautious hedger in a down market, which is in the best interest of our customers. In exchange for aggressively managing the above-market risk for the customer and accepting the risk of managing this exposure within the limits proposed, Gulf will retain an incentive of 25% of any below-market savings achieved through its hedging activity. The savings will be calculated annually netting gains, losses, and option premiums required to manage the program. Gulf's program is unique in that no incentive or risk premium is earned or retained unless Gulf's hedging activity achieves savings for the customer.

These limits, along with the associated incentive, align Gulf Power's hedging activity goals and the customers' interest to protect against adverse price movements and minimize fuel costs.

Q. Does Gulf Power possess the experience required to implement this proposed hedging program?

A. Yes. As mentioned earlier in my testimony, SCS, Gulf Power's fuel procurement agent, currently manages hedging programs for Alabama Power Company, Mississippi Power Company, and Savannah Electric Power Company that have been approved by their respective state commissions. Gulf can expeditiously implement the program using the experience and systems at SCS.

Q. Does SCS have adequate controls and systems in place for managing a financial derivative hedging program for Gulf Power?

A. Yes. SCS has the necessary segregation of authority to ensure proper controls for executing financial derivatives, including a separate Risk Oversight Group which monitors, evaluates, and reports all hedging activity to management.

Q. Will Gulf Power incur additional administrative costs due to this hedging program?

A. Yes. Gulf can implement this program utilizing existing staff, but additional man-hours will be required. As Southern Company's gas requirement has grown over the past 3 years, SCS's gas procurement team has grown from 5 to 9 persons. The team will add staff as necessary to manage the physical and financial gas procurement as needed. Gulf Power's allocated cost of this team will increase somewhat to manage its gas and hedging portfolio. Gulf seeks to recover the incremental administrative costs

associated with the hedging program through the fuel clause. Gulf's portion of such costs will be minor compared to the benefits.

Q. What benefits will this program provide Gulf Power's customers?

A. Gulf Power will have the opportunity to provide more rate stability by hedging its gas/oil price risk. The customer will benefit from the opportunity to protect against short-term natural gas price run-ups and is guaranteed a limit on above-market exposure. In addition, this program is designed to encourage and incent below market savings.

Q. What benefits will this program provide Gulf Power?

A. Gulf Power will benefit from the authority to use financial derivatives to manage fuel costs in ways that increase customer satisfaction. In addition, Gulf will have the opportunity to earn an incentive. However, Gulf will assume the financial risks of managing the program to keep costs within the above-market and mark-to-market limits prescribed.

Q. Please provide a hedging example under this program.

A. Attached as Schedule 2 to my exhibit is an example of a hedging scenario for both a rising and a declining market. As shown in these examples, hedging results in savings versus market in a rising market and above-market costs in a declining market. This example also demonstrates the effect of hedging to reduce volatility.

Q. What specific approvals is Gulf seeking from the Commission in order to implement its hedging program?

A. Gulf is seeking the Commission's approval to implement a financial hedging program and recover the costs associated with it. Gulf is also seeking the Commission's concurrence that the parameters and limits of the program are appropriate, prudent and in the best interest of its customers.

Q. Why is Commission approval necessary in order to implement a financial hedging program?

A. Over the years, especially in the gas industry, it has been a normal practice for local distribution companies and electric utilities to buy gas at market and pass the costs to their customers through their respective fuel clauses. Buying gas at market was traditionally deemed prudent by Commissions and questions were only raised if purchases resulted in above-market prices. Hedging, on the other hand, inherently places above-market pricing risks directly into a utility's purchasing program. Therefore, an electric utility should pursue the approval of its commission before incurring such price risk on behalf of the utility's customers.

Q. If the Commission approves Gulf's hedging program, what is the Commission's ongoing role in that program?

A. The Commission's role should simply be one of oversight and ensuring that Gulf's risk management plan continues to be prudent and in the best interests of its customers. On an ongoing basis, the Commission should periodically monitor the Company's performance to ensure that the hedging

program objectives are being met.

Q. Does this conclude your testimony?

A. Yes it does.

AFFIDAVIT

STATE OF ALABAMA)
)
COUNTY OF JEFFERSON)

Docket No. 011605-EI

Before me the undersigned authority, personally appeared William Norris McKenzie, who being first duly sworn, deposes, and says that he is the General Manager, Gas Procurement in the Fuel Services Department of Southern Company Services, Inc., an Alabama corporation, that the foregoing is true and correct to the best of his knowledge, information, and belief. He is personally known to me.

William Norris McKenzie
General Manager

Sworn to and subscribed before me this 21st day of June, 2002.

Kimberly S. Thrift
Notary Public, State of Alabama at Large

NOTARY PUBLIC STATE OF ALABAMA AT LARGE
MY COMMISSION EXPIRES: Nov 25, 2004
BONDED THRU NOTARY PUBLIC UNDERWRITERS

Gulf Power Company
Fuel Risk Management Plan

Gas/Oil Price Hedging Proposal

- All physical purchases at market price at the time of delivery.
- Commodity price risk managed through use of financial derivatives (swaps, options etc.).
- Volume that may be hedged using fixed pricing is limited to 100% of projected annual volume.
- Volume that may be hedged using option pricing is limited to 110% of projected annual volume.
- Forward hedging period limited to 42 months out.

Customer Protection and Company Incentive

- Gulf manages above market caps for natural gas and oil in order to limit risk to the customer as follows:
  - Annual above market cap = 10% of current year projection for delivered natural gas and oil.
  - Forward Mark-to-Market negative limit equal to 5% of forward 42 month projection.
- Company Incentive:

  In exchange for managing above-market risk, Gulf earns an incentive equal to 25% of savings achieved. Gulf earns no incentive unless hedging activity generates customer savings.

HEDGING EXAMPLES
RISING & FALLING MARKET PRICES

Scenario:

The Company projects gas burn for July to be 1,000,000 MMBtu (1 BCF).

The Company hedges the price of half of its projected gas requirement (500,000 MMBtu) with a futures contract at the price of $3.50 / MMBtu.

The Company also purchases a call option for the remaining 500,000 MMBtu of its July gas needs with a strike price of $4.00 at a premium cost of $0.30/MMBtu.

RISING MARKET:

Using Futures Contract (fixed price)

July Futures Contract Price	$3.50 / MMBtu
July Settlement Price	$4.50 / MMBtu
Savings	$1.00 / MMBtu
Volume Hedged	500,000 MMBtu
Futures Contract Benefit	$500,000

Using Call Option

July Call Option Strike Price	$4.00 / MMBtu
July Settlement Price	$4.50 / MMBtu
Savings (Cost)	$0.50 / MMBtu
Option Premium	($0.30) / MMBtu
Savings (Cost)	$0.20 / MMBtu
Volume Hedged	500,000 MMBtu
Call Option Benefit	$100,000

Hedged Prices	= $3.50	for 500,000 MMBtu (Futures Contract)
	= $4.30	for 500,000 MMBtu (Call Option)
Avg Paid	= $3.90	
Market Price	= $4.50	
Savings	= $0.60/MMBtu = $600,000	

Company Retained Incentive @ 25% = $150,000
Net Customer Benefit @ 75% = $450,000

FALLING MARKET:

Using Futures Contract (fixed price)

July Futures Contract Price	$3.50 / MMBtu
July Settlement Price	$2.50 / MMBtu
Savings (Cost)	($1.00) / MMBtu
Volume Hedged	500,000 MMBtu
Futures Contract Net Cost	$500,000

Using Call Option

July Call Option Strike Price	$4.00 / MMBtu
July Settlement Price	$2.50 / MMBtu
Savings (Cost)	$0 (not exercised)
Option Option	($0.30) / MMBtu
Savings (Cost)	($0.30) / MMBtu
Volume Hedged	500,000 MMBtu
Call Option Net Cost	$150,000

Hedged Prices	= $3.50	for 500,000 MMBtu (Futures Contract)
	= $2.80	for 500,000 MMBtu (Call Option)
Avg Paid	= $3.15	
Market Price	= $2.50	
Above Market	= $0.65 = $650,000	

Company Retained Incentive = $0