DEPARTMENT OF THE AIR FORCE
HEADQUARTERS AIR FORCE LEGAL OPERATIONS AGENCY

October 16, 2013

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

Ms. Ann Cole, Director
Office of Commission Clerk
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

REDACTED

Re: Docket No. 130140-EI

Dear Ms. Cole,

Enclosed please find an original and 15 copies for each of the pre-filed testimony of Mr. Greg Meyer and Mr. Mike Gorman, consultants at Brubaker and Associates, Inc., representing Federal Executive Agencies (FEA).

Additionally, FEA is filing a notice of intent to file confidential information in Mr. Meyer's testimony. The confidential information was obtained via Citizen's Request For Production of Documents #162. I have included the documents in a separate enclosure and labeled them "CONFIDENTIAL". Please let me know if you have any questions or concerns.

Sincerely,

s/cct
CHRISTOPHER THOMPSON, Maj, USAF
Staff Attorney

COM 5
AFD 4
APA 1
ECO 1
ENG 1
GCL 1
IDM
TEL
CLK 1 Ct.Rep
DET 1

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition for Rate Increase by Gulf Power Company	Docket No. 130140-EI

Direct Testimony and Schedules of

Greg R. Meyer

On behalf of

Federal Executive Agencies

PUBLIC VERSION

Denotes Redacted Information

October 16, 2013

BAI

BRUBAKER & ASSOCIATES, INC.

1   BEFORE THE

2   FLORIDA PUBLIC SERVICE COMMISSION

3   _____
)
4   **In Re: Petition for Rate Increase**   )   Docket No. 130140-EI
     by Gulf Power Company   )
5   _____)

6   **Direct Testimony of Greg R. Meyer**

7   Q   PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

9   Chesterfield, MO 63017.

10

11   Q   WHAT IS YOUR OCCUPATION?

12   A   I am a consultant in the field of public utility regulation and an Associate with the

13   firm of Brubaker & Associates, Inc., energy, economic and regulatory

14   consultants.

15

16   Q   PLEASE   DESCRIBE   YOUR   EDUCATIONAL   BACKGROUND   AND

17   EXPERIENCE.

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

19

20   Q   ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

21   A   I am appearing in this proceeding on behalf of the Federal Executive Agencies

22   ("FEA"). The FEA purchases substantial amounts of electricity from Gulf Power

23   Company ("Gulf Power" or "Company") and the outcome of this proceeding will

24   have an impact on their cost of electricity.

1 ## Introduction

2 Q WHAT AMOUNT OF INCREASE HAS GULF POWER REQUESTED?

3 A The overall increase requested by Gulf Power is $74.4 million in base revenues.

4

5 Q PLEASE IDENTIFY THE WITNESSES PRESENTING TESTIMONY ON

6   BEHALF OF THE FEA AND BRIEFLY DESCRIBE THE AREAS THAT EACH

7   WILL ADDRESS.

8 A The FEA will sponsor two witnesses, Mr. Michael Gorman and myself. Mr.

9   Gorman will present testimony on cost of capital. I will address other revenue

10   requirement issues.

11

12 Q DO YOU BELIEVE THAT GULF POWER'S PROPOSED OVERALL INCREASE

13   OF $74.4 MILLION IS REASONABLE?

14 A No. Based on the testimony of Mr. Gorman and myself, I believe that Gulf

15   Power's claimed revenue requirement and revenue deficiency are significantly

16   overstated.

17

18 Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?

19 A I am providing testimony which will address several adjustments to Gulf Power's

20   revenue requirement. I am proposing:

21   1. An adjustment to Gulf Power's residential revenues;

22   2. An adjustment to Gulf Power's level of Production O&M expense;

23
24   3. An adjustment to Gulf Power's proposed annual accrual for property damage
    (storms); and

25   4. A discussion of Gulf Power's proposed level of rent expense.

1   I have prepared a table which lists each of the revenue requirement adjustments

2   the FEA is proposing in Gulf Power's filed case and the value of each

3   adjustment. Following Table 1 is a short description of the adjustments.

4

5

6

7

8

9

10

11

TABLE 1	
Revenue Requirement Adjustments	
Description	Value ($/Million)
1. Return on Equity	$24.0
2. Gulf Power's Capital Structure	25.5
3. Residential Revenues	1.8
4. Production O&M Expenses	5.7
5. Storms	5.5
6. Total Reduction	$62.5

12   1. Return on Equity – Mr. Gorman is proposing a 9.45% return on equity
13   ("ROE") as compared to Gulf Power's requested 11.50% ROE.

14   2. Capital Structure – Mr. Gorman is proposing adjustments to Gulf Power's
15   capital structure to properly reflect the inclusion of no-cost capital amounts.

16   3. Residential Revenues – I am proposing to increase the usage per customer
17   for the 2014 forecasted test year.

18   4. Production O&M Expenses – I am proposing to reduce the level of Production
19   O&M expenses for the forecasted test year.

20   5. Storms – I am proposing to continue the current accrual level for property
21   damages as a result of storms.

22   The fact that I do not address a specific revenue requirement issue

23   should not be interpreted as approval or acceptance by the FEA of any position

24   taken by Gulf Power unless I state otherwise.

25

1   <u>Residential Revenues</u>

2   **Q   PLEASE EXPLAIN THIS ISSUE.**

3   A   Gulf Power has used its forecast of the 2014 kWh sales as the basis for

4   developing residential revenues for the test year in this case. As part of this

5   process, Gulf Power has developed a monthly forecasted usage per customer

6   per billing day, which it multiplies by its forecasted level of customers and the

7   billing cycle days per month.

8

9   **Q   DO YOU AGREE WITH GULF POWER'S FORECAST OF MONTHLY**

10   **RESIDENTIAL USAGE PER CUSTOMER PER BILLING DAY?**

11   A   No I believe the monthly levels are understated. The usage per residential

12   customer does not reflect Gulf Power's expectation regarding the economic

13   recovery of its service territory.

14

15   **Q   WHAT IS GULF POWER'S EXPECTATION REGARDING THE ECONOMIC**

16   **RECOVERY?**

17   A   On page 3 of Schedule F-8 of Gulf Power's Minimum Filing Requirements, the

18   Company states that it projects that the economy in its service area will begin

19   recovery in 2013 and continue until economic indicators either return to or

20   exceed 2006 pre-recession levels by the end of 2015.

21

22

23

24

25

1 Q DOES GULF POWER'S FORECAST OF MONTHLY RESIDENTIAL USAGE

2   PER CUSTOMER PER BILLING DAY REFLECT THIS CONTINUED

3   RECOVERY?

4 A No. The monthly residential usage per customer for 2014 shows an increase

5   over 2013 levels for January through April. However, the 2014 monthly

6   residential usage per customer per billing day for May through December of 2014

7   is less than the 2013 values for the same period.

8

9 Q HOW DO THE 2013 MONTHLY KWH SALES PER CUSTOMER PER BILLING

10   DAY COMPARE TO THE 2014 VALUES?

11 A Schedule GRM-1 shows the monthly residential usage per customer per billing

12   day for 2013 and 2014, the difference and the percentage difference.

13

14 Q WHAT AFFECT DOES THE FORECASTED DECLINE FROM 2013 TO 2014 IN

15   RESIDENTIAL MONTHLY USAGE PER CUSTOMER PER BILLING DAY

16   HAVE ON KWH SALES AND REVENUES?

17 A Although the monthly differences appear small, the affect on annual revenue is

18   significant. The decline in April through December residential monthly usage per

19   customer per billing day from 2013 to 2014 results in a reduction in revenue of

20   over $1.8 million.

21

22 Q ARE YOU PROPOSING AN ADJUSTMENT TO THE 2014 CUSTOMER

23   USAGE FORECAST?

24 A Yes. In line with Gulf Power's own expectations about the economic recovery of

25   its service territory, the 2014 monthly customer usage amounts for May through

1 December should at least equal the 2013 level s for the same period. Therefore, I

2 recommend substituting the 2013 May through December customer usage

3 amounts for the forecasted 2014 levels. This adjustment increases the 2014 test

4 year residential sales by 41,866,372 kWh.

5

6 **Q** HOW DOES THIS AFFECT TEST YEAR MARGINAL REVENUES?

7 A The current marginal residential energy rate, as shown on page 1 of

8 Schedule A-2 is 4.313¢/kWh. As a result of my recommended adjustment,

9 residential revenues increase by $1,805,670. The effect on revenue requirement

10 in this case is a decrease of $1,805,670 as a result of my adjustment.

11

12 ## Production O&M Expenses

13 **Q** HAS GULF POWER PROPOSED TO INCREASE ITS PRODUCTION

14 EXPENSES FROM THE LEVEL INCURRED IN THE HISTORICAL YEAR

15 ENDED 2012?

16 A Yes. Gulf Power's witness, Raymond W. Grove, prepared direct testimony which

17 proposes to increase pro duction expenses by approximately $5.5 million.

18

19 **Q** WHAT WAS THE LEVEL OF PRODUCTION EXPENSE INCURRED IN 2012

20 AND FORECASTED FOR THE PROJECTED TEST YEAR OF 2014?

21 A The actual amount of production expense incurred in 2012 was $101.2 million.

22 The 2014 projected test year amount is $106.7 million.

23

24

25

1 Q DO YOU BELIEVE THE $5.5 MILLION INCREASE PRODUCES A

2   REASONABLE LEVEL OF PRODUCTION EXPENSE?

3 A No. I believe Gulf Power's proposed increase is excessive. Therefore, I am

4   proposing that the level of production expense proposed by Gulf Power be

5   reduced by $5.7 million.

6

7 Q WHAT IS THE BASIS FOR YOUR PROPOSED ADJUSTMENTS?

8 A I have reviewed the historic cost data provided by Mr. Grove and attached as

9   Schedule 7 to his direct testimony. Based on that review, I believe Gulf Power's

10 proposed production expense level of $106.7 million is overstated. Schedule 7

11 breaks out the level of production expense by baseline expenses and outage

12 expenses. Both of these categories of expense have large increases for the

13 2014 test year compared to the historical actual level of expenses. Furthermore,

14 a review of Gulf Power's projected level by production expenses from its last rate

15 case reveals that Gulf Power has historically over-forecasted these expenses.

16

17 Q PLEASE DESCRIBE WHAT IS INCLUDED IN THE BASELINE OF

18 PRODUCTION EXPENSES.

19 A As Mr. Grove stated on page 14 of his direct testimony:

20   Baseline expenses are costs required to conduct the day-to-day
21   operation and maintenance of the generating equipment and
22   auxiliary equipment and facilities. Baseline expenses include all
23   labor, material and other expenses, such as contracts for
24   maintaining grounds, janitorial services, and other services.

25

1   Q   WHAT ARE THE HISTORIC AND FORECASTED LEVELS OF BASELINE

2   PRODUCTION EXPENSES?

3   A   I have prepared Schedule GRM-2 which shows the historic and forecasted levels

4   of baseline production expenses. As this schedule shows, the 2013 and 2014

5   levels of Baseline Materials and Baseline Other expenses has been significantly

6   increased from the actual levels experienced by Gulf Power dating back to 2008.

7   The forecasted level of Baseline Materials expense reflects increases

8   from 17.5% to 56.9% above the actual 2008 through 2012 levels. The Baseline

9   Materials expenses do not exhibit a steady increase in the level of expense, but

10   instead have both increased and decreased from year to year during the 2008

11   through 2012 historical period. However, in no year has the level of expenses

12   changed as much as the forecasted increase from 2012 to 2013. In fact, the

13   level of change forecasted from 2012 to either 2013 or 2014 is more than the

14   difference between the lowest and highest levels of expenses that occurred

15   during the 2008 through 2012 historical period (2009 compared to 2011).

16   The Baseline Other expenses increase by $5.6 and $6.8 million from the

17   actual amount recorded in 2012 to the levels forecast in 2013 and 2014,

18   respectively. An annual increase of the magnitude forecasted by the Company

19   has only occurred once during the 2008 through 2012 historical period (2009 to

20   2010). Baseline Other expenses also do not exhibit a steady increase in the total

21   level of expense. Like Baseline Materials expenses, Baseline Other expenses

22   have both increased and decreased from year to year during the 2008 through

23   2012 historical period.

24   In summary, I believe the level of Baseline Materials and Baseline Other

25   expenses forecasted for 2014 is overstated.

1   Q   DID YOU REVIEW GULF POWER'S FORECASTED LEVEL OF BASELINE

2   EXPENSES FROM ITS LAST RATE CASE?

3   A   Yes. I reviewed Mr. Grove's direct testimony from the last case (Docket

4   No. 110138-EI). In that case, Mr. Grove forecasted the following levels of

5   baseline production expenses. I have prepared Table 2 which compares Gulf

6   Power's forecasted level of expense to the actual levels recorded on Gulf

7   Power's books for 2011 and 2012.

8

9

10

11

TABLE 2				
Forecasted Levels vs. Actual Levels				
Description	Budget 2011	Actual 2011	Budget 2012	Actual 2012
Baseline Materials	$ 9,526	$ 8,514	$ 8,734	$ 7,843
Baseline Other	47,485	47,393	47,544	44,846
Baseline Labor	30,077	27,779	30,828	28,150
Total Baseline	$87,088	$83,686	$87,106	$80,839
Source: Docket No. 110138-EI, Exhibit No. ____ (RWG-1), Schedule 7				

16   The above table reveals that Gulf Power over-forecasted the baseline

17   production expenses in its previous case for years 2011 and 2012. Including

18   over-forecasted expenses in rates provides a benefit to shareholders as it

19   provides more certainty that the authorized rate of return will be achieved.

20

21   Q   PLEASE DESCRIBE YOUR REVIEW OF THE OUTAGE EXPENSES.

22   A   I reviewed the level of outage expenses from 2008 through the forecast test year

23   of 2014. As expected, the level of outage expense fluctuates each year. This

24   review also revealed that different units exhibit different outage expenses and the

25   number of days that a unit is offline for maintenance will also vary. However, I

1   did notice that the level of outage expenses for 2013 is drastically lower than the

2   actual levels or the amount forecasted for 2014. I am concerned that the level of

3   2014 may be inflated due to the extremely low level of expenses forecasted for

4   2013. I have included Table 3 to show the levels of outage expense. The level

5   of expense fluctuations shown in this table suggest that significantly higher

6   maintenance expenses in 2011 and 2012 may have allowed a drastically lower

7   level to be realized in 2013. This drastically low level of maintenance in 2013

8   would likely result in inflated levels in 2014.

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

TABLE 3

Levels of Outage Expense

Year	Outage Expense
2008 (A)	$ 13,014
2009 (A)	$ 14,183
2010 (A)	$ 10,871
2011 (A)	$ 26,206
2012 (A)	$ 20,109
2013 (F)	$ 2,420*
2014 (F)	$17,221*

(A) = Actual
(F) = Forecasted

*Adjusted for Scholz excluded.

Source: Docket No. 130140-EI
Exhibit No. _____ (RWG-1), Schedule 7

1 Q PLEASE DESCRIBE HOW YOU DERIVED YOUR ADJUSTED LEVEL OF

2   BASELINE PRODUCTION EXPENSE OF $100.9 MILLION.

3 A I reflected the highest historic levels of Baseline Materials and Baseline Other

4   expenses incurred in 2011. I then added the forecasted 2014 level of Baseline

5   Labor to those totals to arrive at the level of baseline production expenses.

6   Table 4 shows the breakdown of the level of baseline expenses.

7

8

9

10

11

TABLE 4	
Breakdown of the	
Level of Baseline Expenses	
Description	FEA Proposed Baseline Production Expense
Baseline Materials	$ 8,514
Baseline Other	47,393
Baseline Labor	29,476
Total Baseline	$85,383

Source: Schedule GRM-2

12

13

14

15

16   To this baseline's total, I propose to add the 2014 forecasted level of

17   outage expense as adjusted ($17,221). I also propose to add the expenses for

18   special projects and reflect the adjustments for Scholz, Perdido and Wholesale.

19   After summing all of these amounts, I propose a total production O&M level of

20     $101.0 million.

21   I believe this to be a conservative total as I have not proposed to adjust

22   the forecasted level of outage expenses. I contend that the significant volatility

23   exhibited during the 2008 through 2012 historical and 2013 forecasted periods

24   would support a normalized level rather than the 2014 forecasted level. I have

1   not proposed such an adjustment for outage expenses, but believe the

2   Commission could justifiably reduce my proposed level even further.

3

4   ## Storms

5   **Q**   **IN ITS DIRECT TESTIMONY, GULF POWER HAS REQUESTED AN**

6   **INCREASE OF $5.5 MILLION IN THE PROPERTY DAMAGE ANNUAL**

7   **ACCRUAL. DO YOU AGREE THAT AN ANNUAL PROPERTY DAMAGE**

8   **ACCRUAL OF $9 MILLION IS REASONABLE?**

9   **A**   No. I am proposing that Gulf Power's annual property damage accrual should

10   remain at the current level of $3.5 million.

11

12   **Q**   **WHAT IS THE BASIS FOR YOUR POSITION?**

13   **A**   On page 29 of the Report and Order in Gulf Power's last rate case, Docket

14   No. 110138-EI (Order No. PSC-12-0179-FIF-EI), the Commission had the

15   following conclusion:

16   On balance, we find that the record supports maintaining the existing
17   annual accrual at $3.5 million. No pressing need has been identified to
18   warrant an increase in the accrual at this time. As such, we find that a
19        $3.5 million accrual coupled with the 2011 year-end reserve level of
20   approximately $31 million will be sufficient to cover the costs of most, but
21   not all storms. If circumstances change, it will be appropriate to revisit
22   this decision in a future proceeding.

23   In that rate case, the Commission also determined that target reserve

24   levels should be increased to $48 to $55 million. Since the Commission decision

25

1   in Docket No. 110138-EI, the circumstances have not changed and this

2   Commission should continue the annual accrual of $3.5 million.

3   In 2012, Gulf Power did not record storm charges which were greater

4   than the $3.5 million annual accrual. Thus, the reserve level grew to a 2012 year

5   ending balance of $32 million. Gulf Power has projected that at the end of 2014,

6   the reserve level will be approximately **************** Therefore, the reserve

7   level will have ***************************** from the end of 2011 through

8   December 2014. In Gulf Power's last rate case, the Commission's finding that a

9   reserve level of $31 million will be sufficient to cover the costs of most, but not all

10   storms is still valid today. ***

11   **

12   continues to support the Commission's previous finding that $3.5 million is an

13   appropriate level for the property damage annual accrual.

14

15 Q   IS THE $3.5 MILLION ANNUAL ACCRUAL A SUFFICIENT LEVEL OF

16   FUNDING TO COVER MOST STORM CHARGES WHICH HAVE

17   HISTORICALLY OCCURRED DURING A YEAR?

18 A   Yes. In response to Citizens' Interrogatory 162, the history of storm charges was

19   presented back to 1985. The current level of $3.5 million annual accrual would

20   ***

21   ***

22   **************************

23

24

25

| 1 | Q | HAS THE COMMISSION ESTABLISHED ANY GUIDELINES RELATED TO |

1   Q   HAS THE COMMISSION ESTABLISHED ANY GUIDELINES RELATED TO

2   STORM RESTORATION COSTS?

3   A   Yes. The Commission has established the following three guidelines for storm

4   restoration costs:

5   1. An annual property damage accrual adjusted over time as
6   circumstances change;

7   2. A reserve adequate to accommodate most, but not all, storm years.

8   3. A provision for utilities to receive surcharges for the recovery of costs
9   that exceed the reserve.

10

11   Q   PLEASE COMMENT ON EACH GUIDELINE.

12   A   The current annual funding level of $3.5 million is a sufficient funding level. In

13   Docket No. 010949-EI, the Commission found that the level of the accrual be

14   sufficient to cover annual damages and promote growth in the reserve. Since the

15   annual accrual level has been $3.5 million beginning in 1997, Gulf Power has

16   ***

17   ***

18   Therefore, Guideline 1 has been satisfied with the annual funding of $3.5 million.

19   The reserve level is projected to *************************** from Gulf

20   Power's last rate case through December 2014. The current storm reserve level

21   would **

22   ***

23   ***

24   ***

25   ************************************** the existing $3.5 million level is an adequate

1   ongoing annual accrual. Furthermore, the **

2   ** the Commission's reserve

3   range of $48 to $55 million that is supported by the current level of annual

4   accrual.

5   Finally, the Commission has authorized ratepayer surcharges when storm

6   costs have exceeded what was in the storm reserve. This proactive action by the

7   Commission demonstrates that it intends to provide timely rate recovery of storm

8   costs to utilities in Florida. In addition, Gulf Power can also use proceeds from

9   insurance claims to offset its storm costs.

10

11 **Q**   **PLEASE SUMMARIZE YOUR POSITION.**

12 **A**   I recommend that the Commission continue the $3.5 million annual accrual. This

13   level **

14   **

15   *********** Finally, the Commission has taken a proactive approach to

16   extraordinary storm cost recovery through the use of surcharges.

17

18 **Transmission Rent Expense**

19 **Q**   **DO YOU SUPPORT THE LEVEL OF TRANSMISSION RENT GULF POWER**

20   **HAS INCLUDED IN THE 2014 TEST YEAR?**

21 **A**   No. The level of transmission rent expense is significantly higher than the

22   amount experienced during 2012.

23

24

25

1   Q   **HOW DO THE 2013 AND 2014 FORECASTED LEVELS OF TRANSMISSION**

2   **RENT EXPENSE COMPARE TO THE HISTORIC LEVELS EXPERIENCED BY**

3   **GULF POWER?**

4   A   Table 5 illustrates the significant growth in transmission rent expense from 2008

5   through the 2012. Gulf Power has forecasted this expense to increase by $4.3

6   million in 2013 and $7.9 million in 2014.

7

8

9

10

11

12

13

14

15
16

TABLE 5
Significant Growth in Transmission Rent Expense

Year	Outage Expense
2008	$ 319,000
2009	$ 1,487,000
2010	$ 2,531,000
2011	$ 2,497,000
2012	$ 5,508,000
2013	$ 9,812,000
2014	$13,386,000

17

18   Q   **HAS GULF POWER PROVIDED ANY EXPLANATION FOR THE SIGNIFICANT**

19   **INCREASE IN TRANSMISSION RENT EXPENSE?**

20   A   In its Minimum Filling Requirements at page 1 of Schedule C-8, Gulf Power

21   provided the following "detail of changes in expenses" regarding transmission

22   rent expense.

23

24

25

| Acct No. | Account | Test Year Ended 12/31/14 | Prior Year Ended 12/31/13 | Increase/(Decrease) | | Reason(s) for Changes |
				Dollars (000s)	Percent %	
567	Trans. Rent	$13,386	$9,812	$3,574	36.42%	See Note 7

Note 7: $3,574,000 increase in new projects within Transmission Rent 115KV. Certain transmission costs are recovered through the purchased power capacity cost recovery clause.

5   Schedule C-8 also lists Company witnesses Grove, Erickson, McQuagge

6   and Caldwell as responsible for this portion of the Minimum Filing Requirements.

7

8   Q   DO ANY OF THE GULF POWER WITNESSES LISTED ON SCHEDULE C-8

9   PROVIDE AN EXPLANATION FOR THE SIGNIFICANT INCREASES IN

10   TRANSMISSION RENT EXPENSE, EITHER HISTORICALLY OF AS

11   FORECASTED?

12   A   No.

13

14   Q   WHAT ARE YOU RECOMMENDING WITH REGARD TRANSMISSION RENT

15   EXPENSE?

16   A   I recommend that the Commission require Gulf Power to provide a detailed

17   explanation and supporting documentation that justifies the significant increase in

18   transmission rent. Forecasted increases in expense of such magnitude must not

19   be included in rates without adequate justification.

20

21   Q   DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

22   A   Yes, it does.

23

24

1   <u>Qualifications of Greg R. Meyer</u>

2   Q   PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

4   Chesterfield, MO 63017.

5

6   Q   PLEASE STATE YOUR OCCUPATION.

7   A   I am an Associate in the field of public utility regulation with the firm of Brubaker

8   & Associates, Inc. ("BAI"), energy, economic and regulatory consultants.

9

10 Q   PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND

11   EXPERIENCE.

12 A   I graduated from the University of Missouri in 1979 with a Bachelor of Science

13   Degree in Business Administration, with a major in Accounting. Subsequent to

14   graduation I was employed by the Missouri Public Service Commission. I was

15   employed with the Commission from July 1, 1979 until May 31, 2008.

16   I began my employment at the Missouri Public Service Commission as a

17   Junior Auditor. During my employment at the Commission, I was promoted to

18   higher auditing classifications. My final position at the Commission was an

19   Auditor V, which I held for approximately ten years.

20   As an Auditor V, I conducted audits and examinations of the accounts,

21   books, records and reports of jurisdictional utilities. I also aided in the planning of

22   audits and investigations, including staffing decisions, and in the development of

23   staff positions in which the Auditing Department was assigned. I served as Lead

24   Auditor and/or Case Supervisor as assigned. I assisted in the technical training

1   of other auditors, which included the preparation of auditors' workpapers, oral

2   and written testimony.

3   During my career at the Missouri Public Service Commission, I presented

4   testimony in numerous electric, gas, telephone and water and sewer rate cases.

5   In addition, I was involved in cases regarding service territory transfers. In the

6   context of those cases listed above, I presented testimony on all conventional

7   ratemaking principles related to a utility's revenue requirement. During the last

8   three years of my employment with the Commission, I was involved in developing

9   transmission policy for the Southwest Power Pool as a member of the Cost

10   Allocation Working Group.

11   In June of 2008, I joined the firm of Brubaker & Associates, Inc. as a

12   Consultant. Since joining the firm, I have presented testimony and/or testified in

13   the state jurisdictions of Florida, Idaho, Illinois, Indiana, Maryland, Missouri and

14   Washington. I have also appeared and presented testimony in Alberta and Nova

15   Scotia, Canada. These cases involved addressing conventional ratemaking

16   principles focusing on the utility's revenue requirement. The firm Brubaker &

17   Associates, Inc. provides consulting services in the field of energy procurement

18   and public utility regulation to many clients including industrial and institutional

19   customers, some utilities and, on occasion, state regulatory agencies.

20   More specifically, we provide analysis of energy procurement options

21   based on consideration of prices and reliability as related to the needs of the

22   client; prepare rate, feasibility, economic, and cost of service studies relating to

23   energy and utility services; prepare depreciation and feasibility studies relating to

24   utility service; assist in contract negotiations for utility services, and provide

25   technical support to legislative activities.

1   In addition to our main office in St. Louis, the firm has branch offices in

2   Phoenix, Arizona and Corpus Christi, Texas.

3

4

5

6

7

8

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25   \\Doc\Shares\ProlawDocs\TSK\9823\Testimony-BAI\247437.docx

GULF POWER COMPANY
Docket No. 130140-EI

kWh Sales/Customer/Billing Day

Line	Description	January (1)	February (2)	March (3)	April (4)	May (5)	June (6)	July (7)	August (8)	September (9)	October (10)	November (11)	December (12)
1	2013	37.60	36.05	30.29	27.65	31.63	43.64	50.90	51.56	47.57	38.28	28.89	31.84
2	2014	38.14	36.47	30.54	27.75	31.58	43.45	50.59	51.17	47.07	37.67	28.19	31.04
3	Difference	0.54	0.42	0.25	0.10	-0.05	-0.19	-0.31	-0.39	-0.50	-0.61	-0.70	-0.80
4	% Difference	1.44%	1.16%	0.83%	0.37%	-0.16%	-0.43%	-0.61%	-0.76%	-1.05%	-1.58%	-2.43%	-2.51%

GULF POWER COMPANY
Docket No. 130140-EI

Historic and Forecasted Levels of Baseline Production Expense

Line	Description	Actual 2008	Actual 2009	Actual 2010	Actual 2011	Actual 2012	Forecasted 2013	Forecasted 2014	2008 - 2012 Average
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	Baseline Materials	$ 7,288	$ 6,376	$ 7,762	$ 8,514	$ 7,843	$ 10,321	$ 10,006	$ 7,557
2	Baseline Other	40,727	37,820	46,923	47,393	44,846	50,381	51,593	43,542
3	Baseline Labor	27,328	25,769	27,237	27,779	28,150	29,009	29,476	27,253
4	Total Baseline	$ 75,343	$ 69,965	$ 81,922	$ 83,686	$ 80,839	$ 89,711	$ 91,075	$ 78,351

Source: Exhibit No. _____ (RWG-1), Schedule 7

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of FEDERAL EXECUTIVE AGENCIES' TESTIMONY has been furnished to the following by electronic mail this 16th day of October, 2013:

J. R. Kelly
Joseph McGlothlin
Office of the Public Counsel
c/o Florida Legislature
111 West Madison Street, Room 812
Tallahassee, FL 32399-1400
mcglothlin.joseph@leg.state.fl.us

Maj Christopher Thompson, USAF
AFLOA/JACE-ULFSC
139 Barnes Drive, Suite 1
Tyndall Air Force Base, FL 32403
christopher.thompson.5@us.af.mil

Robert L. McGee, Jr.
One Energy Place
Pensacola, Florida 32520-0780
rlmcgee@southernco.com

Suzzane Brownless
Martha Barrera/ Martha Brown
Office Of The General Counsel
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850
sbrownle@psc.state.fl.us
mbarrera@psc.state.fl.us
mbrown@psc.state.fl.us

Jon C. Moyle
Karen A. Putnal
Moyle Law Firm
118 North Gadsden Street
Tallahassee, FL 32301
jmoyle@moylelaw.com
kputnal@moylelaw.com

Richard D. Melson
705 Piedmont Drive
Tallahassee, FL 32312
rick@rmelsonlaw.com

Jeffrey A. Stone, jas@beggslane.com
Russell A. Badders, rab@beggslane.com
Steven Griffin, srg@beggslane.com
Beggs & Lane
P.O. Box 12950
Pensacola, FL 32591-2950

Wal-Mart Stores East. L.P. and Sam's East, Inc.
c/o Robert Scheffel Wright
John T. La Via, III
Gardner Bist Law Firm
1300 Thomaswood Drive
Tallahassee, FL 32303
schef@gbwlegal.com
jlavia@gbwlegal.com

s/cct
_____
Major Christopher Thompson
Staff Attorney
USAF Utility Law Field Support Center
AFLOA/JCAE – ULFSC
139 Barnes Drive, Suite 1
Tyndall AFB, FL 32403-5319
Phone: 850-283-6350
Email: Christopher.Thompson.5@us.af.mil

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition for Rate Increase by
Gulf Power Company

Docket No. 130140-EI

Direct Testimony and Exhibits of

Michael P. Gorman

On behalf of

Federal Executive Agencies

October 16, 2013

BAI

BRUBAKER & ASSOCIATES, INC.

1 **Table of Contents to**

2 **the Direct Testimony of Michael P. Gorman**

3 **Page**

20

21

22

23

24

25

1   BEFORE THE

2   FLORIDA PUBLIC SERVICE COMMISSION

3   _____

4   In Re: Petition for Rate Increase by   Docket No. 130140-EI
      Gulf Power Company
5   _____

6

7   **Direct Testimony of Michael P. Gorman**

8   **Q   PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

9   A   Michael P. Gorman.   My business address is 16690 Swingley Ridge Road,

10   Suite 140, Chesterfield, MO 63017.

11

12   **Q   WHAT IS YOUR OCCUPATION?**

13   A   I am a consultant in the field of public utility regulation and a Managing Principal

14   of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

15

16   **Q   PLEASE   DESCRIBE   YOUR   EDUCATIONAL   BACKGROUND   AND**

17   **EXPERIENCE.**

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

19

20   **Q   ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

21   A   I am appearing in this proceeding on behalf of the Federal Executive Agencies

22   ("FEA").

23

24

25

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

2 A My testimony will address Gulf Power Company's ("Gulf Power" or "Company")

3 overall rate of return including return on equity, capital structure and embedded

4 debt cost.

5

6 ## SUMMARY

7 Q **PLEASE SUMMARIZE YOUR RATE OF RETURN RECOMMENDATIONS.**

8 A I recommend the Florida Public Service Commission ("Commission") award Gulf

9 Power a return on common equity of 9.45%, which is at the approximate midpoint

10 of my estimated range of 9.10% to 9.85% (Exhibit MPG-1), and an overall rate of

11 return of 4.74%.

12 My recommended return on equity and proposed capital structure will

13 provide Gulf Power with an opportunity to realize cash flow financial coverages

14 and balance sheet strength that conservatively support Gulf Power's current

15 bond rating. Consequently, my recommended return on equity represents fair

16 compensation for Gulf Power's investment risk, and it will preserve the

17 Company's financial integrity and credit standing.

18 I will also respond to Gulf Power witness Dr. James H. Vander Weide's

19 proposed return on equity of 11.50%. His recommended return includes a

20 leverage adjustment of 70 basis points and flotation cost adder of about 24 basis

21 points. For the reasons discussed below, Dr. Vander Weide's recommended

22 return on equity is excessive and should be rejected.

23

24

25

1 Q HOW DID YOU ESTIMATE GULF POWER'S CURRENT MARKET COST OF

2 EQUITY?

3 A I performed three versions of the Discounted Cash Flow ("DCF") model, Risk

4 Premium ("RP") study, and Capital Asset Pricing Model ("CAPM") to a proxy

5 group of publicly traded companies that have investment risk similar to Gulf

6 Power. Based on these assessments, I estimate Gulf Power's current market

7 cost of equity to be 9.45%.

8

9 ## Electric Utility Industry Market Outlook

10 Q PLEASE DESCRIBE THIS SECTION OF YOUR TESTIMONY.

11 A I begin my estimate of a fair return on equity for Gulf Power by reviewing the

12 market's assessment of electric utility industry investment risk, credit standing,

13 and stock price performance in general. I used this information to gauge the

14 market's perception of the risk characteristics of electric utility investments in

15 general, which is then used to produce a refined estimate of the market's return

16 requirement for assuming investment risk similar to Gulf Power's utility

17 operations.

18 Based on the assessments described below, I find the credit rating

19 outlook of the industry to be strong and supportive of the industry's financial

20 integrity, the industry has ample access to low-cost capital to support rate base

21 investments, and electric utilities' stocks have exhibited strong and stable price

22 performance over the last several years.

23 Moreover, the electric utility industry in general is in a large capital

24 expenditure portion of its cycle, which is creating significant demands for external

25 capital in order to support large capital improvement programs. Credit rating

1   agencies and market participants have embraced the utilities' need for significant

2   amounts of external capital by meeting the capital market demands of electric

3   utilities at near historical low capital market costs. All of this supports my belief

4   that Gulf Power should have sufficient access to capital to support its major

5   capital program, and relatively moderate capital costs are currently available and

6   expected to be available for the next several years.

7   Based on this review of credit outlooks and stock price performance, I

8   conclude that the market continues to embrace the electric utility industry as a

9   safe-haven investment, and views utility equity and debt investments as low-risk

10   securities.

11

12   Q   **PLEASE DESCRIBE ELECTRIC UTILITIES' CREDIT RATING OUTLOOK.**

13   A   Electric utilities' credit rating outlook has improved over the recent past and is

14   stable. Standard & Poor's ("S&P") recently provided an assessment of the credit

15   rating of U.S. electric utilities. S&P's commentary included the following:

16   **Effect on ratings**

17   Notwithstanding the slow economic recovery, credit quality in the

18   domestic utility industry has continued a long shift to greater

19   stability, and even modest improvement in some cases, especially

20   as many companies re-emphasize their core competencies.

21   *   *   *

22   **Industry Ratings Outlook**

23   **Good access to funding expected to continue**

24   Liquidity is adequate for most utilities and investor appetite for

25   utility debt remains healthy, with deals continuing to be

1   oversubscribed at very attractive rates. The amount of medium- to

2   long-term debt and hybrid securities issued through the three

3   months ended March 31, 2013 was about $8.7 billion. <u>Credit</u>

4   <u>fundamentals indicate that most, if not all, utilities should continue</u>

5   <u>to have ample access to funding sources and credit</u>. The relative

6   certainty of financial performance provided by the regulatory

7   framework under which utilities operate, their effective monopoly

8   position, long-lived assets, and the financing necessary to fund

9   these assets are all factors that make the utility sector attractive to

10   investors. These elements have also helped utilities more

11   effectively manage their rate-relief needs and mitigate the effect of

12   sizable rate increases on customers.[1]

13   Similarly, Fitch states:

14   **Rating Outlook**

15   **Flat Growth Base Case:** Fitch Ratings expects overall <u>stable</u>

16   ratings for issuers within the U.S. Power and Gas Utility sector in

17   2013 despite modest deterioration in operating environment.

18   *   *   *

19   **Stable Regulation but Authorized ROEs Trending Down**

20   <u>Fitch expects the downward pressure on authorized ROEs for</u>

21   <u>regulated utilities to persist in tandem with falling interest rates in</u>

22   <u>the economy.</u> Lower ROEs are also associated with features

23   increasingly common in tariff structures that minimize cash flow

---

[1] *Standard & Poor's Ratings Direct*: "Industry Report Card: Stable-To-Modestly Improved Industry Outlook Supports Ratings For U.S. Regulated Electric, Gas, And Water Utilities," April 19, 2013 at 3-4 and 6-7, emphasis added.

1   volatility. Many state regulators are awarding lower ROEs as an

2   offset to awarding special tariff mechanisms such as revenue

3   decoupling, forward test year, rate-adjustment trackers[,] etc.

4   *   *   *

5   **Strong Liquidity Conditions to Prevail**

6   Fitch expects the power and gas utility sectors to continue to enjoy

7   <u>strong capital market access</u>. Low interest rates due to

8   accommodative monetary policies by the Fed continue to bring

9   down the cost of debt for companies, which represents a

10   significant expense item for the capital-intensive utility sector.

11   <u>Since 2006, interest expense has declined almost 150 bps for the</u>

12   <u>typical utility holding company as financing costs for new debt</u>

13   <u>issuance is at historic lows and these companies have</u>

14   <u>unprecedented access to the capital and bank markets.</u>[2]

15   The Edison Electric Institute ("EEI") also opined as follows:

16   **Steady Industry Fundamentals**

17   Indeed, broad global macroeconomic forces have been the

18   principle [sic] driver of utility stock returns in recent years, relative

19   to other market sectors. Investors now take mostly as a given the

20   industry's reasonably strong business fundamentals. Utilities are

21   undertaking sizeable and wide-ranging capital investment

22   programs that include distribution network upgrades, Smart Grid

23   investments, a significant boost in the pace of transmission

24   investment, rising emissions-related capex driven by the need to

---

[2]*FitchRatings*: "2013 Outlook: Utilities, Power, and Gas," December 7, 2012 at 1, 6-7 and 10, emphasis added.

1   comply with EPA regulations, and generation investments in

2   select power markets.

3   *   *   *

4   <u>Credit analysts are generally positive on the industry's ability to</u>

5   <u>finance an aggressive pace of investment, noting that while it is</u>

6   <u>now cash flow negative on an annual operating basis, its balance</u>

7   <u>sheets are generally strong and utilities have access to a diverse</u>

8   <u>range of funding sources.</u> The industry weathered the storm of

9   the 2008/2009 financial crisis by postponing optional capex

10   projects and finding cost savings where possible without

11   jeopardizing service quality. Today's economic backdrop is much

12   improved from that period, and with interest rates at multi-decade

13   lows and investors of all types hungry for yield, the capital markets

14   are wide open for most economic sectors, including utilities. The

15   execution risk inherent in managing large, complex construction

16   projects in a way that addresses the interests of both shareholders

17   and regulators seems far more pronounced than financing risk.[3]

18

19 **Q**   **PLEASE DESCRIBE ELECTRIC UTILITY STOCK PRICE PERFORMANCE**

20   **OVER THE LAST SEVERAL YEARS.**

21 **A**   As shown in the graph below, the EEI has recorded electric utility stock price

22   performance compared to the market. The EEI data shows that its Electric Utility

23   Index has outperformed the market in downturns and trailed the market during

24   recovery. This supports my conclusion that utility stock investments are

---

[3]*EEI Q3 2012 Financial Update* "Stock Performance" at 5, emphasis added.

1   regarded by market participants as a moderate to low-risk investment.

2

3

4

5

6

7

8

9

10

11

FIGURE 1

Index Comparison

Source: EEI Q2 2013 Stock Performance Financial Update, at Page 1.
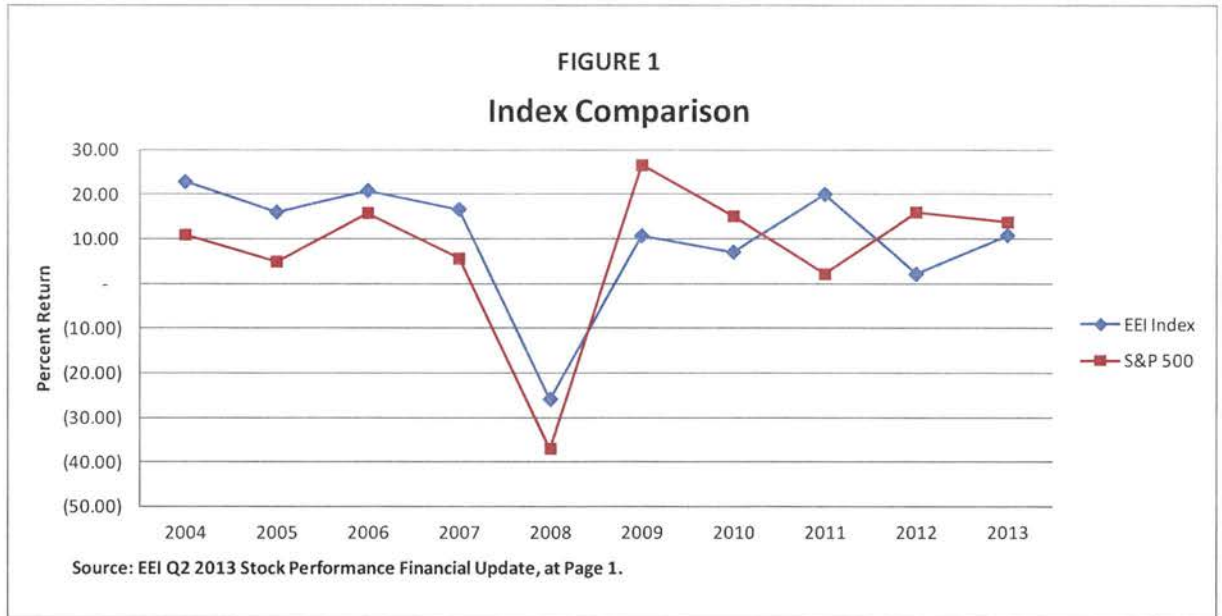
12   EEI describes electric utility stock price/valuation as sustainable:

13   **Mixed Valuation Signals**

14   The broad market's gains during Q3 along with the EEI

15   Index's flat performance removed some of the richness to

16   utility share valuations that several analysts noted at the

17   end of Q2. Indeed, the magnitude of underperformance

18   for the first nine months of 2012 is similar to that which

19   occurred during the same period of 2009, after markets

20   bottomed and then recovered from the losses produced by

21   the financial crisis. As the market recovery continued in

22   2010, with 14% to 17% gains, the staid utility sector's 7%

23   return could not keep pace. Yet when 2011 produced

24   worries of economic slowdown, the worsening of the

25   European debt crisis and the summer's woefully

1   memorable deficit gridlock and S&P downgrade of U.S.

2   Treasury debt in August — along with sharply falling

3   interest rates — the EEI Index powered forward with a

4   20% return against single-digit gains across the broader

5   markets.

6   With the industry business models now set on regulated or

7   mostly regulated structures, and with slow growth in

8   earnings and dividends as the main appeal for investors,

9   such periodic reversals of fortune, driven by changing

10   economic prospects and investor sentiments, seem likely

11   to continue. Interest rates are now at multi-decade lows

12   and while analysts <u>still cite utility price/earnings ratios as</u>

13   <u>above average, 4% dividend yields give utility shares</u>

14   <u>considerable price support relative to the lower yields</u>

15   <u>available from bonds</u>.[4]

16

17 **Q** **WHAT ARE THE IMPORTANT TAKEAWAY POINTS FROM THIS**

18   **ASSESSMENT OF ELECTRIC UTILITY INDUSTRY CREDIT AND**

19   **INVESTMENT RISK OUTLOOKS?**

20 **A** Credit rating agencies consider the electric utility industry to be stable and

21   believe investors will continue to provide an abundance of capital to support

22   utilities' large capital programs and at moderate capital costs. All of this supports

23   the continued belief that electric utility investments are generally regarded as

24   safe-haven or low-risk investments, and the market embraces low-risk

---

[4]*Id.* at 6, emphasis added.

1   investments – like utility investments. The demand for low-risk investments will

2   provide funding for electric utilities in general.

3

4   **Gulf Power's Investment Risk**

5   Q   **PLEASE DESCRIBE THE MARKET'S ASSESSMENT OF GULF POWER'S**

6   **INVESTMENT RISK.**

7   A   The market assessment of Gulf Power's investment risk is described by credit

8   rating analysts' reports. Gulf Power has a "Stable" corporate bond rating from

9   S&P and Moody's and is "A" and "A3," respectively.

10   Specifically, S&P states the following:

11   **Rationale**

12   Business Risk: Excellent

13   • Construction of two new nuclear units at Georgia

14   Power Co. and an integrated gasification combined

15   cycle (IGCC) power plant at Mississippi Power Co.

16   introduces   significant   construction   risk,   on   a

17   consolidated basis

18   • Regulated utility operations that span four states, serve

19   a large customer base and contribute more than 90%

20   of operating income

21   • Operations in jurisdictions with generally constructive

22   regulatory environments providing for timely investment

23   recovery

24

25

1   •   Prudent and largely conservative financial risk

2   management and generally effective handling of

3   regulatory risk

4   Financial Risk: Significant

5   •   Large capital spending program for system expansion

6   and environmental compliance can pressure financial

7   profile absent timely rate relief

8   •   Ongoing need for external financing

9   •   Generally stable debt leverage

10   •   Dividend payout ratio remains high in light of planned

11   capital spending program[5]

12

13 **Gulf Power's Proposed Capital Structure**

14   Q   **WHAT CAPITAL STRUCTURE IS THE COMPANY REQUESTING TO USE TO**

15   **DEVELOP ITS OVERALL RATE OF RETURN FOR ELECTRIC OPERATIONS**

16   **IN THIS PROCEEDING?**

17   A   Gulf Power's December 2014 forecasted regulatory capital structure, as

18   supported by Gulf Power witness Ms. Susan D. Ritenour, is shown below in

19   Table 1.

20

21

22

23

24

---

[5] *Standard & Poor's RatingsDirect Summary*: "Gulf Power Co.," March 21, 2013 at 2.

1

2

3

4

5

6

7

8

9

10

11

12

13

TABLE 1

Gulf Power's Proposed
Capital Structure

Description	Regulatory Capital Structure (1)	Investors' Capital Structure (2)
Long-Term Debt	36.36%	45.46%
Short-Term Debt	1.47%	1.83%
Preference Stock	4.20%	5.25%
Common Equity	37.96%	47.46%
Customer Deposits	1.11%	---
Deferred Income Taxes	20.17%	---
FASB 109 Deferred Taxes	-1.37%	---
Investment Tax Credit	0.10%	---
Total Capital Structure	100.00%	100.00%

Source: MFR Schedule D-1a.

14

15 Q **IS GULF POWER'S PROPOSED CAPITAL STRUCTURE REASONABLE?**

16 A No. Gulf Power's proposed capital structure misallocates customer-supplied

17 capital in the development of the overall rate of return for jurisdictional

18 operations. In reconciling its jurisdictional rate base with its jurisdictional capital

19 structure, Gulf Power allocates pro forma rate base adjustments to the capital

20 structure by spreading these adjustments equally over both investor-supplied

21 capital and customer-supplied capital.

22 Customer-supplied capital includes deferred taxes and customer

23 deposits. Deferred taxes are a zero-cost capital component, and customer

24 deposits have a relatively low interest rate as prescribed by the Commission.

25 These low-cost customer-supplied capital components should be used

1   exclusively to fund jurisdictional rate base. If they are not, then a portion of the

2   customer-supplied low-cost capital components will be used to benefit investors

3   rather than exclusively jurisdictional customers.

4

5   Q   HOW DO YOU PROPOSE TO ADJUST THE COMPANY'S PROPOSED

6   CAPITAL STRUCTURE?

7   A   The Company develops its proposed capital structure on its Schedule D-1a, page

8   1. On that schedule under column 6, the Company proposes to spread its pro

9   rata adjustments equally over investor capital and customer-supplied capital. I

10   recommend to modify this spread of pro rata adjustments to only investor-

11   supplied capital. All customer-supplied capital should be fully allocated to

12   jurisdictional cost of service to ensure customers get full benefit of the low-cost

13   capital they provide the Company.

14   I developed this revised capital structure on my Exhibit MPG-1. As

15   shown on this exhibit, this revised capital structure mix produces a common

16   equity ratio of total capital of 31.43%. In comparison, the Company's proposed

17   capital structure produces a common equity ratio of 37.96%. Again, the

18   difference in capital structures reflects my recommendation to allocate 100% of

19   the customer-supplied low-cost capital to jurisdictional cost of service.

20

21   Q   WHY SHOULD CUSTOMERS RECEIVE THE FULL BENEFIT OF CUSTOMER-

22   SUPPLIED CAPITAL?

23   A   Customers should receive the full benefit of customer-supplied capital because

24   this is actual cash proceeds provided to the Company from customers that have

25   been retained by the Company to fund its invested cost of utility operations.

1   Accumulated deferred income taxes reflect the Company's collection of

2   income tax expense, from customers that temporarily exceeds its current income

3   tax liability.

4   As the Company's income tax liability comes due over time, the deferred

5   tax collections will ultimately be paid to government taxing authorities. In the

6   interim, the Company is permitted to retain the prepaid tax accruals as zero-cost

7   capital which is used to fund plant and equipment.

8   Since customers provide the deferred tax proceeds, customers should

9   receive the full benefit of the cost savings.

10   Customer deposits are also funds available to the Company to support its

11   investment in utility plant and equipment. These funds do have a prescribed

12   interest rate which is included in Gulf Power's cost of service. Since customers

13   provide this capital, and actually provide a return on the capital by recovery of

14   customer deposit expense in Gulf Power's cost of service, these funds should be

15   fully reflected as a source of capital available to support Gulf Power's invested

16   capital cost.

17

18   Q   **WHAT IS YOUR PROPOSED CAPITAL STRUCTURE IN THIS PROCEEDING?**

19   A   My proposed capital structure is shown below in Table 2.

20

21

22

23

24

25

1

2

3

4

5

6

7

8

9

10

11

12

13

TABLE 1	
Gulf Power's Proposed	
Adjusted Capital Structure	
Description	**Regulatory Capital Structure**
Long-Term Debt	30.11%
Short-Term Debt	1.21%
Preference Stock	3.48%
Common Equity	31.43%
Customer Deposits	1.88%
Deferred Income Taxes	34.03%
FASB 109 Deferred Taxes	-2.30%
Investment Tax Credit	0.16%
Total Capital Structure	100.00%

Source: Exhibit MPG-1.

14 Q **WILL YOUR PROPOSED CAPITAL STRUCTURE SUPPORT GULF POWER'S**

15 **FINANCIAL INTEGRITY AND CREDIT RATING?**

16 A Yes. As I will discuss later in my testimony, my proposed capital structure is

17 consistent with Gulf Power's current credit rating and will support Gulf Power's

18 financial integrity.

19

20 **RETURN ON EQUITY**

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

22 **EQUITY."**

23 A A utility's cost of common equity is the return investors require on an investment

24 in the utility. Investors expect to achieve their return requirement from receiving

25 dividends and stock price appreciation.

1 Q **PLEASE DESCRIBE THE FRAMEWORK FOR DETERMINING A REGULATED**

2 **UTILITY'S COST OF COMMON EQUITY.**

3 A In general, determining a fair cost of common equity for a regulated utility has

4 been framed by two hallmark decisions of the U.S. Supreme Court: Bluefield

5 Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va., 262 U.S. 679

6 (1923) and Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

7 These decisions identify the general standards to be considered in

8 establishing the cost of common equity for a public utility. Those general

9 standards provide that the authorized return should: (1) be sufficient to maintain

10 financial integrity; (2) attract capital under reasonable terms; and (3) be

11 commensurate with returns investors could earn by investing in other enterprises

12 of comparable risk.

13

14 Q **PLEASE DESCRIBE THE METHODS YOU HAVE USED TO ESTIMATE GULF**

15 **POWER'S COST OF COMMON EQUITY.**

16 A I have used several models based on financial theory to estimate Gulf Power's

17 cost of common equity. These models are: (1) a constant growth Discounted

18 Cash Flow ("DCF") model using consensus analysts' growth rate projections; (2)

19 a constant growth DCF using sustainable growth rate estimates; (3) a multi-stage

20 growth DCF model; (4) a Risk Premium model; and (5) a Capital Asset Pricing

21 Model ("CAPM"). I have applied these models to a group of publicly traded

22 utilities that I have determined share investment risk similar to Gulf Power's.

23

24

25

1 **Risk Proxy Group**

2 Q **HOW DID YOU SELECT A UTILITY PROXY GROUP SIMILAR IN**

3 **INVESTMENT RISK TO GULF POWER TO ESTIMATE ITS CURRENT**

4 **MARKET COST OF EQUITY?**

5 A I relied on an electric utility proxy group that I determined to be comparable in

6 investment risk to Gulf Power. My recommended proxy group is the same proxy

7 group used by Gulf Power's witness Dr. Vander Weide to estimate Gulf Power's

8 return on equity. However, I removed Entergy Corp. and TECO Energy because

9 it was involved in merger or acquisition activities. Entergy Corp. has requested

10 regulatory authorization to spin off its transmission assets to ITC Holdings in

11 exchange for stock in ITC Holdings. TECO Energy announced a proposed

12 acquisition of New Mexico Gas on May 28, 2013. Fitch has noted this acquisition

13 to be significant and has placed TECO Energy on Credit Watch.

14

15 Q **PLEASE DESCRIBE WHY YOU BELIEVE YOUR PROXY GROUP IS**

16 **REASONABLY COMPARABLE IN INVESTMENT RISK TO GULF POWER.**

17 A The proxy group is shown in Exhibit MPG-2. This proxy group has an average

18 corporate credit rating from S&P of "BBB+," which is lower than S&P's corporate

19 credit rating for Gulf Power of "A". The proxy group's corporate credit rating from

20 Moody's of "Baa2" is also lower than Gulf Power's corporate credit rating from

21 Moody's of "A3." The bond rating indicates that the proxy group has greater

22 investment risk than Gulf Power.

23 The proxy group has an average common equity ratio of 45.1% (including

24 short-term debt) from SNL Financial ("SNL") and 49.1% (excluding short-term

25 debt) from *The Value Line Investment Survey* ("*Value Line*") in 2012. The proxy

1   group's common equity ratio is comparable to my recommended common equity

2   ratio of 47.5% for Gulf Power.

3   I also compared Gulf Power's business risk to the business risk of the

4   proxy group based on S&P's ranking methodology. Gulf Power has an S&P

5   business risk profile of "Excellent," which is identical to the S&P business risk

6   profile of the proxy group. The S&P business risk profile score indicates that Gulf

7   Power's business risk is comparable to that of the proxy group.[6]

8   Based on total bond rating, financial risk and operating risk, Gulf Power

9   has slightly lower risk than the proxy group. Nevertheless, the parameters are

10   reasonably comparable to the investment risk of Gulf Power, and this proxy

11   group can be used to estimate a fair return on equity for Gulf Power. However,

12   because of Gulf Power's slightly lower investment risk, a return on equity slightly

13   below that which would be appropriate for the proxy group would be a

14   reasonable risk-adjusted return for Gulf Power.

15

16   ## Discounted Cash Flow Model

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

18   A   The DCF model posits that a stock price is valued by summing the present value

19   of expected future cash flows discounted at the investor's required rate of return

20   or cost of capital. This model is expressed mathematically as follows:

---

[9]S&P ranks the business risk of a utility company as part of its corporate credit rating review. S&P considers total investment risk in assigning bond ratings to issuers, including utility companies. In analyzing total investment risk, S&P considers both the business risk and the financial risk of a corporate entity, including a utility company. S&P's business risk profile score is based on a six-notch credit rating starting with "Vulnerable" (highest risk) to "Excellent" (lowest risk). The business risk of most utility companies falls within the lowest risk category, "Excellent," or the category one notch lower (more risk), "Strong." *Standard & Poor's RatingsDirect:* "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

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

P_0 = Current stock price

D = Dividends in periods 1 - ∞

K = Investor's required return

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

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

K = Investor's required return

D_1 = Dividend in first year

P_0 = Current stock price

G = Expected constant dividend growth rate

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

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

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

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

A I relied on the average of the weekly high and low stock prices of the utilities in the proxy group over a 13-week period ending on September 20, 2013. An

1   average stock price is less susceptible to market price variations than a spot

2   price. Therefore, an average stock price is less susceptible to aberrant market

3   price movements, which may not be reflective of the stock's long-term value.

4   A 13-week average stock price reflects a period that is still short enough

5   to contain data that reasonably reflect current market expectations, but the period

6   is not so short as to be susceptible to market price variations that may not reflect

7   the stock's long-term value. In my judgment, a 13-week average stock price is a

8   reasonable balance between the need to reflect current market expectations and

9   the need to capture sufficient data to smooth out aberrant market movements.

10

11   Q   WHAT DIVIDEND DID YOU USE IN YOUR CONSTANT GROWTH DCF

12   MODEL?

13   A   I used the most recently paid quarterly dividend, as reported in *Value Line*.[7] This

14   dividend was annualized (multiplied by 4) and adjusted for next year's growth to

15   produce the D_1 factor for use in Equation 2 above.

16

17   Q   WHAT DIVIDEND GROWTH RATES HAVE YOU USED IN YOUR CONSTANT

18   GROWTH DCF MODEL?

19   A   There are several methods that can be used to estimate the expected growth in

20   dividends. However, regardless of the method, for purposes of determining the

21   market-required return on common equity, one must attempt to estimate

22   investors' consensus about what the dividend or earnings growth rate will be, and

23   not what an individual investor or analyst may use to make individual investment

24   decisions.

---

[7] *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.

1   As predictors of future returns, security analysts' growth estimates have

2   been shown to be more accurate than growth rates derived from historical data.[8]

3   That is, assuming the market generally makes rational investment decisions,

4   analysts' growth projections are more likely to influence observable stock prices

5   than growth rates derived only from historical data.

6   For my constant growth DCF analysis, I have relied on a consensus, or

7   mean, of professional security analysts' earnings growth estimates as a proxy for

8   investor consensus dividend growth rate expectations. I used the average of

9   analysts' growth rate estimates from three sources: Zacks, SNL, and Reuters.

10   All such projections were available on September 24, 2013, and all were reported

11   online.

12   Each consensus growth rate projection is based on a survey of security

13   analysts. There is no clear evidence whether a particular analyst is most

14   influential on general market investors. Therefore, a single analyst's projection

15   does not as reliably predict consensus investor outlooks as does a consensus of

16   market analysts' projections. The consensus estimate is a simple arithmetic

17   average, or mean, of surveyed analysts' earnings growth forecasts. A simple

18   average of the growth forecasts gives equal weight to all surveyed analysts'

19   projections. Therefore, a simple average, or arithmetic mean, of analyst

20   forecasts is a good proxy for market consensus expectations.

21

22

23

24

---

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

1 Q WHAT ARE THE GROWTH RATES YOU USED IN YOUR CONSTANT

2 GROWTH DCF MODEL?

3 A The growth rates I used in my DCF analysis are shown in Exhibit MPG-3. The

4 average growth rate for my proxy group is 5.04%.

5

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

7 A As shown in Exhibit MPG-4, the average and median constant growth DCF

8 returns for my proxy group are 9.09% and 9.12%, respectively.

9

10 Q DO YOU HAVE ANY COMMENTS ON THE RESULTS OF YOUR CONSTANT

11 GROWTH DCF ANALYSIS?

12 A Yes. The constant growth DCF analysis for my proxy group was based on an

13 average long-term sustainable growth rate of 5.04%. This growth rate slightly

14 exceeds my estimate of a maximum long-term sustainable growth rate of 4.9%

15 which I discuss later in this testimony. Hence, I believe the constant growth DCF

16 analysis produces slightly higher but still reasonable return estimates. To

17 enhance the accuracy of my recommended return on equity I have also

18 incorporated two alternative DCF models as discussed below.

19

20 Q WHAT IS YOUR ESTIMATE OF A MAXIMUM LONG-TERM SUSTAINABLE

21 GROWTH RATE?

22 A A long-term sustainable growth rate for the utility stock, or any Company

23 investment, cannot exceed the growth rate of the economy in which it sells its

24 goods and services. Hence, a reasonable proxy for the long-term maximum

25 sustainable growth rate for a utility investment is best proxied by the projected

1   long-term Gross Domestic Product ("GDP"). *The Blue Chip Financial Forecasts*

2   projects that over the next 5 and 10 years, the U.S. nominal GDP will grow in the

3   range of 4.8% to 5.0%. As such, the average growth rate over the next 10 years

4   is around 4.9%, which I believe is a reasonable proxy of long-term sustainable

5   growth.

6   In my multi-stage growth DCF analysis, I discuss academic and

7   investment practitioner evidence that accepts the projected long-term GDP

8   growth outlook as a maximum sustainable growth rate projection. Hence,

9   recognizing the long-term GDP growth rate as a maximum sustainable growth is

10   logical, and generally consistent with academic and economic practitioner

11   accepted practices.

12

13   ## Sustainable Growth DCF

14   **Q   PLEASE DESCRIBE HOW YOU ESTIMATED A SUSTAINABLE LONG-TERM**

15   **GROWTH RATE FOR YOUR SUSTAINABLE GROWTH DCF MODEL.**

16   A   A sustainable growth rate is based on the percentage of the utility's earnings that

17   is retained and reinvested in utility plant and equipment. These reinvested

18   earnings increase the earnings base (rate base). Earnings grow when plant

19   funded by reinvested earnings is put into service, and the utility is allowed to earn

20   its authorized return on such additional rate base investment.

21   The internal growth methodology is tied to the percentage of earnings

22   retained in the company and not paid out as dividends. The earnings retention

23   ratio is 1 minus the dividend payout ratio. As the payout ratio declines, the

24   earnings retention ratio increases. An increased earnings retention ratio will fuel

25

1   stronger growth because the business funds more investments with retained

2   earnings.

3   The payout ratios of the proxy group are shown in my Exhibit MPG-5.

4   These dividend payout ratios and earnings retention ratios then can be used to

5   develop a sustainable long-term earnings retention growth rate. A sustainable

6   long-term earnings retention ratio will help gauge whether analysts' current three-

7   to five-year growth rate projections can be sustained over an indefinite period of

8   time.

9   The data used to estimate the long-term sustainable growth rate is based

10   on the Company's current market to book ratio and on *Value Line's* three- to five-

11   year projections of earnings, dividends, earned returns on book equity, and stock

12   issuances.

13   As shown in Exhibit MPG-6, page 1, the average sustainable growth rate

14   for the proxy group using this internal growth rate model is 5.04%.

15

16   Q   **WHAT IS THE DCF ESTIMATE USING THESE SUSTAINABLE LONG-TERM**

17   **GROWTH RATES?**

18   A   A DCF estimate based on these sustainable growth rates is developed in Exhibit

19   MPG-7. As shown there, a sustainable growth DCF analysis produces proxy

20   group average and median DCF results of 9.10% and 8.72%, respectively.

21

22   **Multi-Stage Growth DCF Model**

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

24   A   Yes. My first constant growth DCF is based on consensus analysts' growth rate

25   projections, so it is a reasonable reflection of rational investment expectations

1   over the next three to five years. The limitation on the constant growth DCF

2   model is that it cannot reflect a rational expectation that a period of high/low

3   short-term growth can be followed by a change in growth to a rate that is more

4   reflective of long-term sustainable growth. Hence, I performed a multi-stage

5   growth DCF analysis to reflect this outlook of changing growth expectations.

6

7 Q   **WHY DO YOU BELIEVE GROWTH RATES CAN CHANGE OVER TIME?**

8 A   Analyst projected growth rates over the next three to five years will change as

9   utility earnings growth outlooks change. Utility companies go through cycles in

10   making investments in their systems. When utility companies are making large

11   investments, their rate base grows rapidly, which accelerates their earnings

12   growth. Once a major construction cycle is completed or levels off, growth in the

13   utility rate base slows, and its earnings growth slows from an abnormally high

14   three- to five-year rate to a lower sustainable growth rate.

15   As major construction cycles extend over longer periods of time, even

16   with an accelerated construction program, the growth rate of the utility will slow

17   simply because rate base will slow, and the utility has limited human and capital

18   resources available to expand its construction program. Hence, the three- to

19   five-year growth rate projection should be used as a long-term sustainable

20   growth rate but not without making a reasonable informed judgment to determine

21   whether it considers the current market environment, the industry, and whether

22   the three- to five-year growth outlook is sustainable.

23

24

25

1   Q   **IS THE USE OF A MULTI-STAGE DCF MODEL SUPPORTED IN ACADEMIC**

2   **AND INDUSTRY LITERATURE?**

3   A   Yes. In his book *New Regulatory Finance*, Dr. Roger Morin states the following:

4   Dividends need not be, and probably are not, constant from period

5   to period. Moreover, there are circumstances where the standard

6   DCF model cannot be used to assess investor return

7   requirements. For example, if a utility company is in the process

8   of altering its dividend payout policy and dividends are not

9   expected to grow at the same rate as earnings during the

10   transition period, the standard DCF model is inapplicable. This is

11   because the expected growth in stock price has to be different

12   from that of dividends, earnings, and book value if the market

13   price is to converge toward book value.

14   *   *   *

15   A Non-Constant Growth DCF model is appropriate whenever the

16   growth rate is expected to change, and the only way to produce a

17   change in the forecast payout ratio is by introducing an

18   intermediate growth rate that is different from the long-term growth

19   rate, as in the previous example.[9]

20

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

22   A   The multi-stage growth DCF model reflects the possibility of non-constant growth

23   for a company over time. The multi-stage growth DCF model reflects three

24   growth periods: (1) a short-term growth period, which consists of the first five

---

[9]*New Regulatory Finance*, Roger A. Morin, PhD, 2006 Public Utilities Reports, Inc., Vienna, Virginia, pp. 264 and 267.

1   years; (2) a transition period, which consists of the next five years (6 through 10);

2   and (3) a long-term growth period, starting in year 11 through perpetuity.

3   For the short-term growth period, I relied on the consensus analysts'

4   growth projections described above in relationship to my constant growth DCF

5   model. For the transition period, the growth rates were reduced or increased by

6   an equal factor, which reflects the difference between the analysts' growth rates

7   and the long-term sustainable growth rate. For the long-term growth period, I

8   assumed each company's growth would converge to the maximum sustainable

9   long-term growth rate.

10

11   Q   **WHY IS THE GDP GROWTH PROJECTION A REASONABLE PROXY FOR**

12   **THE MAXIMUM SUSTAINABLE LONG-TERM GROWTH RATE?**

13   A   Utilities cannot indefinitely sustain a growth rate that exceeds the growth rate of

14   the economy in which they sell services. Utilities' earnings/dividend growth is

15   created by increased utility investment or rate base. Such investment, in turn, is

16   driven by service area economic growth and demand for utility service. In other

17   words, utilities invest in plant to meet sales demand growth, and sales growth, in

18   turn, is tied to economic growth in their service areas.

19   The Energy Information Administration ("EIA") has observed that utility

20   sales growth tracks, albeit is lower than, the U.S. GDP growth, as shown in

21   Exhibit MPG-8. Utility sales growth has lagged behind GDP growth for more

22   than a decade. As a result, nominal GDP growth is a very conservative proxy for

23   electric utility sales growth, rate base growth, and earnings growth. Therefore,

24   the U.S. GDP nominal growth rate is a conservative proxy for the highest

25   sustainable long-term growth rate of a utility.

1 Q IS THERE RESEARCH THAT SUPPORTS YOUR POSITION THAT, OVER

2   THE LONG TERM, A COMPANY'S EARNINGS AND DIVIDENDS CANNOT

3   GROW AT A RATE GREATER THAN THE GROWTH OF THE U.S. GDP?

4 A Yes. This concept is supported in both published analyst literature and academic

5   work.   Specifically, in a textbook entitled "Fundamentals of Financial

6   Management," published by Eugene Brigham and Joel F. Houston, the authors

7   state as follows:

8   The constant growth model is most appropriate for mature

9   companies with a stable history of growth and stable future

10   expectations.   Expected growth rates vary somewhat among

11   companies, but dividends for mature firms are often expected to

12   grow in the future at about the same rate as nominal gross

13   domestic product (real GDP plus inflation).[10]

14

15 Q IS THERE ANY ACTUAL INVESTMENT HISTORY THAT SUPPORTS THE

16   NOTION THAT THE CAPITAL APPRECIATION FOR STOCK INVESTMENTS

17   WILL NOT EXCEED THE NOMINAL GROWTH OF THE U.S. GDP?

18 A Yes. This is evident by a comparison of the compound annual growth of the U.S.

19   GDP compared to the geometric growth of the U.S. stock market. Morningstar

20   measures the historical geometric growth of the U.S. stock market over the

21   period 1929-2012 to be approximately 5.6% and an inflation rate of 3.0%.[11]

22

23

---

[10]*Fundamentals of Financial Management*, Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation at 298.
[11]*Morningstar 2013 Valuation Yearbook* at 23.

1   During this same time period, the U.S. nominal compound annual growth

2   of the U.S. GDP was approximately 6.3%.[12]

3   As such, the compound geometric growth of the U.S. nominal GDP has

4   been less than the nominal growth of the U.S. stock market capital appreciation.

5   This relationship shows the U.S. GDP is a conservative estimate of long-term

6   sustainable growth.

7

8 Q   HOW DID YOU DETERMINE A SUSTAINABLE LONG-TERM GROWTH RATE

9   THAT REFLECTS THE CONSENSUS OF THE MARKET?

10 A   I relied on the consensus analysts' projections of long-term GDP growth. *The*

11   *Blue Chip Financial Forecasts* publishes consensus economists' GDP growth

12   projections twice a year. These consensus analysts' GDP growth outlooks are

13   the best available measure of the market's assessment of long-term GDP

14   growth. These analyst projections reflect all current outlooks for GDP, as

15   reflected in analyst projections, and are likely the most influential on investors'

16   expectations of future growth outlooks. The consensus economists' published

17   GDP growth rate outlook is 5.0% to 4.8% over the next 10 years.[13]

18   Therefore, I propose to use the consensus economists' projected 5- and

19   10-year average GDP consensus growth rates of 5.0% and 4.8%, respectively,

20   as published by *Blue Chip Financial Forecasts,* as an estimate of long-term

21   sustainable growth. *Blue Chip Financial Forecasts'* projections provide real GDP

22   growth projections of 2.8% and 2.5%, and GDP inflation of 2.1% and 2.2%[14] over

23   the 5-year and 10-year projection periods, respectively. This consensus GDP

---

[12]U.S. Bureau of Economic Analysis, December 2012.
[13]*Blue Chip Financial Forecasts*, June 1, 2013 at 14.
[14]GDP growth is the product of real and inflation GDP growth.

1   growth forecast represents the most likely views of market participants because it

2   is based on published consensus economist projections.

3

4   Q   DO YOU CONSIDER OTHER SOURCES OF PROJECTED LONG-TERM GDP

5   GROWTH?

6   A   Yes, and these sources corroborate my consensus analysts' projections.   The

7   U.S. EIA in its *Annual Energy Outlook* projects real GDP out until 2040.   In its

8   *2013 Annual Report*, the EIA projects real GDP through 2040 to be in the range

9   of 2.0% to 2.9%, with a midpoint or reference case of 2.5%.[15]

10   Also,   the   Congressional   Budget   Office   ("CBO")   makes   long-term

11   economic projections. The CBO is projecting real GDP growth of 2.6% to 2.2%

12   during the next 5 and 10 years, respectively, with GDP price inflation of 2.0%.[16]

13   The CBO's real GDP projections are higher than the consensus, but its GDP

14   inflation is lower than the consensus economists.

15   The real GDP and nominal GDP growth projections made by the U.S. EIA

16   and those made by the CBO support the use of the consensus analyst 5-year

17   and 10-year projected GDP growth outlooks as a reasonable market assessment

18   of long-term prospective GDP growth.

19

20 Q   WHAT STOCK PRICE, DIVIDEND, AND GROWTH RATES DID YOU USE IN

21   YOUR MULTI-STAGE GROWTH DCF ANALYSIS?

22 A   I relied on the same 13-week stock price and the most recent quarterly dividend

23   payment data discussed above. For stage one growth, I used the consensus

---

[15]*DOE/EIA Annual Energy Outlook 2013 With Projections to 2040*, April 2013 at 56.
[16]*CBO: The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, February 2013
at 64.

1   analysts' growth rate projections discussed above in my constant growth DCF

2   model. The transition period begins in year 6 and ends in year 10. For the

3   long-term sustainable growth rate starting in year 11, I used 4.9%, the average of

4   the consensus economists' 5-year and 10-year projected nominal GDP growth

5   rates.

6

7 Q **WHAT ARE THE RESULTS OF YOUR MULTI-STAGE GROWTH DCF**

8   **MODEL?**

9 A As shown in Exhibit MPG-9, the average and median multi-stage growth DCF

10   returns on equity for my proxy group are 8.97% and 9.01%, respectively.

11

12 Q **PLEASE SUMMARIZE THE RESULTS FROM YOUR DCF ANALYSES.**

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

14

15

16

17

18

19

20

21

TABLE 3	
Summary of DCF Results	
Description	**Average**
Constant Growth DCF Model (Analysts' Growth)	9.10%
Constant Growth DCF Model (Sustainable Growth)	9.10%
Multi-Stage Growth DCF Model	8.97%

22

23 **Risk Premium Model**

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

25 A This model is based on the principle that investors require a higher return to

1   assume greater risk. Common equity investments have greater risk than bonds

2   because bonds have more security of payment in bankruptcy proceedings than

3   common equity and the coupon payments on bonds represent contractual

4   obligations. In contrast, companies are not required to pay dividends or

5   guarantee returns on common equity investments. Therefore, common equity

6   securities are considered to be more risky than bond securities.

7   This risk premium model is based on two estimates of an equity risk

8   premium. First, I estimated the difference between the required return on utility

9   common equity investments and U.S. Treasury bonds. The difference between

10   the required return on common equity and the Treasury bond yield is the risk

11   premium. I estimated the risk premium on an annual basis for each year over the

12   period 1986 through June 2013. The common equity required returns were

13   based on regulatory commission-authorized returns for electric utility companies.

14   Authorized returns are typically based on expert witnesses' estimates of the

15   contemporary investor-required return. I selected the period 1986 through June

16   2013 because public utility stocks consistently traded at a premium to book value

17   during that period. This is illustrated in Exhibit MPG-10, which shows that market

18   to book ratio since 1986 was consistently above 1.0. This is an indication that

19   the commission-authorized returns on equity were positively received by the

20   market.

21   The second equity risk premium estimate is based on the difference

22   between regulatory commission-authorized returns on common equity and

23   contemporary "A" rated utility bond yields.   Over this period, regulatory

24   authorized returns were sufficient to support market prices that at least exceeded

25   book value. This is an indication that regulatory authorized returns on common

1   equity supported a utility's ability to issue additional common stock without

2   diluting existing shares. It further demonstrates that utilities were able to access

3   equity markets without a detrimental impact on current shareholders.

4   Based on this analysis, as shown in Exhibit MPG-11, the average

5   indicated equity risk premium over U.S. Treasury bond yields has been 5.35%.

6   Of the 28 observations, 22 indicated risk premiums fall in the range of 4.41% to

7   6.31%. Since the risk premium can vary depending upon market conditions and

8   changing investor risk perceptions, I believe using an estimated range of risk

9   premiums provides the best method to measure the current return on common

10   equity using this methodology.

11   As shown in Exhibit MPG-12, the average indicated equity risk premium

12   over contemporary Moody's utility bond yields was 3.95% over the period 1986

13   through June 2013. The indicated equity risk premium estimates based on this

14   analysis primarily fall in the range of 3.03% to 4.89% over this time period.

15

16   Q   DO YOU BELIEVE THAT THESE EQUITY RISK PREMIUM ESTIMATES ARE

17   BASED ON A TIME PERIOD THAT IS TOO LONG OR TOO SHORT TO DRAW

18   ACCURATE CONCLUSIONS CONCERNING CONTEMPORARY MARKET

19   CONDITIONS?

20   A   No. Contemporary market conditions can change dramatically during the period

21   that rates determined in this proceeding will be in effect. A relatively long period

22   of time where stock valuations reflect premiums to book value is an indication

23   that the authorized returns on equity and the corresponding equity risk premiums

24   were supportive of investors' return expectations and provided utilities access to

25   the equity markets under reasonable terms and conditions. Further, this time

1   period is long enough to smooth abnormal market movement that might distort

2   equity risk premiums. While market conditions and risk premiums do vary over

3   time, this historical time period is a reasonable period to estimate contemporary

4   risk premiums.

5   The time period I use in this risk premium study is a generally accepted

6   period to develop a risk premium study using "expectational" data. Conversely,

7   studies have recommended that use of "actual achieved return data" should be

8   based on very long historical time periods. The studies find that achieved returns

9   over short time periods may not reflect investors' expected returns due to

10   unexpected and abnormal stock price performance. However, these short-term

11   abnormal actual returns would be smoothed over time and the achieved actual

12   returns over long time periods would approximate investors' expected returns.

13   Therefore, it is reasonable to assume that averages of annual achieved returns

14   over long time periods will generally converge on the investors' expected returns.

15   My risk premium study is based on expectational data, not actual returns,

16   and, thus, need not encompass very long time periods.

17

18 Q   **BASED ON HISTORICAL DATA, WHAT RISK PREMIUM HAVE YOU USED**

19   **TO ESTIMATE GULF POWER'S COST OF COMMON EQUITY IN THIS**

20   **PROCEEDING?**

21 A   The equity risk premium should reflect the relative market perception of risk in

22   the utility industry today. I have gauged investor perceptions in utility risk today

23   in Exhibit MPG-13. On that exhibit, I show the yield spread between utility bonds

24   and Treasury bonds over the last 34 years. As shown on this exhibit, the

25   average utility bond yield spreads over Treasury bonds for "A" and "Baa" rated

1   utility bonds for this historical period are 1.55% and 1.96%, respectively. The

2   utility bond yield spreads over Treasury bonds for "A" and "Baa" rated utilities

3   during June 2013 are 1.06% and 1.58%, respectively.

4   A current 13-week average "A" rated utility bond yield of 4.73%, when

5   compared to the current Treasury bond yield of 3.71% as shown in Exhibit

6   MPG-14, page 1 implies a yield spread of around 1.02%. This current utility

7   bond yield spread is lower than the 34-year average spread for "A" utility bonds

8   of 1.55%. Similarly, the current spread for the "Baa" utility yields of 1.55% is

9   lower than the 34-year average spread of 1.96%.

10   These utility bond yield spreads are clear evidence that the market

11   considers the utility industry to be a relatively low-risk investment and

12   demonstrates that utilities continue to have strong access to capital.

13

14   Q   **HOW DID YOU ESTIMATE GULF POWER'S COST OF COMMON EQUITY**

15   **WITH THIS RISK PREMIUM MODEL?**

16   A   I added a projected long-term Treasury bond yield to my estimated equity risk

17   premium over Treasury yields. The 13-week average 30-year Treasury bond

18   yield, ending September 20, 2013 was 3.71%, as shown in Exhibit MPG-14,

19   page 1. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond yield

20   to be 4.20%, and a 10-year Treasury bond yield to be 3.20%.[17] Using the

21   projected 30-year bond yield of 4.00%, and a Treasury bond risk premium of

22   4.41% to 6.31%, as developed above, produces an estimated common equity

23   return in the range of 8.61% (4.20% + 4.41%) to 10.51% (4.20% + 6.31%). My

24   risk premium estimates fall in the range of 8.61% to 10.51%.

---

[17]*Blue Chip Financial Forecasts*, September 1, 2013 at 2.

1   I next added my equity risk premium over utility bond yields to a current

2   13-week average yield on "Baa" rated utility bonds for the period ending

3   September 20, 2013 of 5.23%. Adding the utility equity risk premium of 3.03% to

4   4.89%, as developed above, to rated bond yield of 5.23%, produces a cost of

5   equity in the range of 8.26% (5.23% + 3.03%) to 10.12% (5.23% + 4.89%).

6 Q   **WHAT IS YOUR RECOMMENDED RETURN FOR GULF POWER BASED ON**

7   **YOUR RISK PREMIUM STUDY?**

8 A   My recommendation considers both utility security risk and market interest rate

9   risk.   Current interest rate spreads suggest the market is embracing utility

10   investments as relatively low-risk investment alternatives. This is clearly evident

11   from the low utility bond spreads relative to Treasury bonds currently compared

12   to the historical time period studied. (See Exhibits MPG-13 and MPG-14). Also,

13   the market is pricing "A" utility bonds to produce lower yields compared to

14   general corporate "A" bonds. On average over time, "A" utility bond yields are

15   higher than "A" corporate bond yields, but not currently. (*Id.*) All of this supports

16   my conclusion that the utility industry is perceived as a low-risk stable

17   investment.

18   On the other hand, the Federal Reserve has been procuring long-term

19   Treasury and collateralized bonds in an effort to stimulate the U.S. economy.

20   This stimulus has reduced long-term interest rates. This government stimulus

21   initiative is expected to be suspended in the near future. The suspension of the

22   Federal Reserve's stimulus in long-term interest rate markets could cause long-

23   term market interest rates to increase. As such, I believe there is additional risk

1   in long-term interest rate markets created by this Federal Reserve stimulus

2   policy.

3   I recommend giving more weight to the high-end of my risk premium

4   results to reflect the greater market interest rate risk in the current market. I

5   propose to provide 75% weight to the high-end of my risk premium estimates and

6   25% to the low-end of my risk premium estimates. Providing more weight to the

7   high-end risk premium captures the greater market interest rate risk. This results

8   in a risk premium estimate over Treasury bond yields of 10.04%,[18] and a risk

9   premium estimate over "A" utility bond yields of 9.66%.[19]

10   My risk premium analysis produces a risk premium in the range of 9.66%

11   to 10.04%, with a midpoint of 9.85%.

12

Capital Asset Pricing Model ("CAPM")

14   **Q**   **PLEASE DESCRIBE THE CAPM.**

15   A   The CAPM method of analysis is based upon the theory that the market-required

16   rate of return for a security is equal to the risk-free rate, plus a risk premium

17   associated with the specific security. This relationship between risk and return

18   can be expressed mathematically as follows:

19      $R_i = R_f + B_i \times (R_m - R_f)$ where:

20   R_i = Required return for stock i

21   R_f = Risk-free rate

22   R_m = Expected return for the market portfolio

23   B_i = Beta - Measure of the risk for stock

---

[18] 75% x 10.51% + 25% x 8.61% = 10.04%.
[19] 75% x 10.12% + 25% x 8.26% = 9.66%.

1   The stock-specific risk term in the above equation is beta.   Beta

2   represents the investment risk that cannot be diversified away when the security

3   is held in a diversified portfolio. When stocks are held in a diversified portfolio,

4   firm-specific risks can be eliminated by balancing the portfolio with securities that

5   react in the opposite direction to firm-specific risk factors (e.g., business cycle,

6   competition, product mix, and production limitations).

7   The risks that cannot be eliminated when held in a diversified portfolio are

8   non-diversifiable risks.   Non-diversifiable risks are related to the market in

9   general and are referred to as systematic risks. Risks that can be eliminated by

10   diversification are regarded as non-systematic risks.   In a broad sense,

11   systematic risks are market risks, and non-systematic risks are business risks.

12   The CAPM theory suggests that the market will not compensate investors for

13   assuming risks that can be diversified away.   Therefore, the only risk that

14   investors will be compensated for are systematic or non-diversifiable risks. The

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

16

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

18   A   The CAPM requires an estimate of the market risk-free rate, the company's beta,

19   and the market risk premium.

20

21   Q   **WHAT DID YOU USE AS AN ESTIMATE OF THE MARKET RISK-FREE**

22   **RATE?**

23   A   As previously noted, *Blue Chip Financial Forecasts*' projected 30-year Treasury

24   bond yield is 4.20%.[20]   The current 30-year Treasury bond yield is 3.71%, as

---

[20]*Blue Chip Financial Forecasts*, September 1, 2013 at 2.

1   shown in Exhibit MPG-14, page 1. To produce a conservative estimate, I used

2   *Blue Chip Financial Forecasts'* projected 30-year Treasury bond yield of 4.20%

3   for my CAPM analysis.

4

5   Q   **WHY DID YOU USE LONG-TERM TREASURY BOND YIELDS AS AN**

6   **ESTIMATE OF THE RISK-FREE RATE?**

7   A   Treasury securities are backed by the full faith and credit of the United States

8   government, so long-term Treasury bonds are considered to have negligible

9   credit risk. Also, long-term Treasury bonds have an investment horizon similar to

10   that of common stock. As a result, investor-anticipated long-run inflation

11   expectations are reflected in both common-stock required returns and long-term

12   bond yields. Therefore, the nominal risk-free rate (or expected inflation rate and

13   real risk-free rate) included in a long-term bond yield is a reasonable estimate of

14   the nominal risk-free rate included in common stock returns.

15   Treasury bond yields, however, do include risk premiums related to

16   unanticipated future inflation and interest rates. A Treasury bond yield is not a

17   risk-free rate. Risk premiums related to unanticipated inflation and interest rates

18   are systematic or market risks. Consequently, for companies with betas less

19   than 1.0, using the Treasury bond yield as a proxy for the risk-free rate in the

20   CAPM analysis can produce an overstated estimate of the CAPM return.

21

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

23   A   As shown in Exhibit MPG-15, the proxy group average *Value Line* beta estimate

24   is 0.74.

25

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

2 A I derived two market risk premium estimates, a forward-looking estimate and one

3 based on a long-term historical average.

4 The forward-looking estimate was derived by estimating the expected

5 return on the market (as represented by the S&P 500) and subtracting the risk-

6 free rate from this estimate. I estimated the expected return on the S&P 500 by

7 adding an expected inflation rate to the long-term historical arithmetic average

8 real return on the market. The real return on the market represents the achieved

9 return above the rate of inflation.

10 Morningstar's *Stocks, Bonds, Bills and Inflation 2013 Classic Yearbook*

11 estimates the historical arithmetic average real market return over the period

12 1926 to 2012 as 8.7%.[21] A current consensus analysts' inflation projection, as

13 measured by the Consumer Price Index, is 2.2%.[22] Using these estimates, the

14 expected market return is 11.10%.[23] The market risk premium then is the

15 difference between the 11.10% expected market return, and my 4.20% risk-free

16 rate estimate, or approximately 6.9%.

17 The historical estimate of the market risk premium was also estimated by

18 Morningstar in *Stocks, Bonds, Bills and Inflation 2013 Classic Yearbook*. Over

19 the period 1926 through 2012, Morningstar's study estimated that the arithmetic

20 average of the achieved total return on the S&P 500 was 11.8%,[24] and the total

21 return on long-term Treasury bonds was 6.1%.[25] The indicated market risk

---

[21] *Morningstar, Inc., Ibbotson SBBI 2013 Classic Yearbook* at 88.
[22] *Blue Chip Financial Forecasts*, August 1, 2013 at 2.
[23] $\{ [(1 + 0.087) * (1 + 0.022)] - 1 \} * 100$.
[24] *Morningstar, Inc. Ibbotson SBBI 2013 Classic Yearbook* at 87.
[25] *Id.*

1   premium is 5.7% (11.8% - 6.1% = 5.7%).   The average of my market risk

2   premium estimates is 6.3% (6.9% to 5.7%).

3

4   Q   HOW DOES YOUR ESTIMATED MARKET RISK PREMIUM RANGE

5   COMPARE TO THAT ESTIMATED BY MORNINGSTAR?

6   A   Morningstar's analysis indicates that a market risk premium falls somewhere in

7   the range of 6.0% to 6.7%. My market risk premium falls in the range of 5.7% to

8   7.0%. My average market risk premium of 6.4% is in the middle of Morningstar's

9   range.

10   Morningstar estimates a forward-looking market risk premium based on

11   actual achieved data from the historical period of 1926 through 2012. Using this

12   data, Morningstar estimates a market risk premium derived from the total return

13   on large company stocks (S&P 500), less the income return on Treasury bonds.

14   The total return includes capital appreciation, dividend or coupon reinvestment

15   returns, and annual yields received from coupons and/or dividend payments.

16   The income return, in contrast, only reflects the income return received from

17   dividend payments or coupon yields. Morningstar argues that the income return

18   is the only true risk-free rate associated with Treasury bonds and is the best

19   approximation of a truly risk-free rate.[26] I disagree with this assessment from

20   Morningstar, because it does not reflect a true investment option available to the

21   marketplace and therefore does not produce a legitimate estimate of the

22   expected premium of investing in the stock market versus that of Treasury

23   bonds.   Nevertheless, I will use Morningstar's conclusion to show the

24   reasonableness of my market risk premium estimates.

---

[26]*Morningstar, Inc., Ibbotson SBBI 2013 Valuation Yearbook* at 55.

1   Morningstar's range is based on several methodologies. First,

2   Morningstar estimates a market risk premium of 6.7% based on the difference

3   between the total market return on common stocks (S&P 500) less the income

4   return on Treasury bond investments. Second, Morningstar found that if the New

5   York Stock Exchange (the "NYSE") was used as the market index rather than the

6   S&P 500, that the market risk premium would be 6.5%, not 6.7%. Third, if only

7   the two deciles of the largest companies included in the NYSE were considered,

8   the market risk premium would be 6.0%.[27]

9   Finally, Morningstar found that the 6.7% market risk premium based on

10   the S&P 500 was influenced by an abnormal expansion of price-to-earnings

11   ("P/E") ratios relative to earnings and dividend growth during the period 1980

12   through 2001. Morningstar believes this abnormal P/E expansion is not

13   sustainable.[28] Therefore, Morningstar adjusted this market risk premium

14   estimate to normalize the growth in the P/E ratio to be more in line with the

15   growth in dividends and earnings. Based on this alternative methodology,

16   Morningstar published a long-horizon supply-side market risk premium of 6.0%.[29]

17   To again be conservative in the CAPM estimate, I will use the higher

18   6.7% market risk premium in my CAPM study as opposed to the 6.4% that I

19   calculated independently.

20

21

22

23

---

[27]Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large
capitalization benchmarks. *Id.* at 54.
[28]*Morningstar, Inc., Ibbotson SBBI 2013 Valuation Yearbook* at 54.
[29]*Id.*

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

2   A   As shown in Exhibit MPG-16, based on Morningstar's market risk premium of

3   6.7%, a risk-free rate of 4.20%, and a beta of 0.74, my CAPM analysis produces

4   a return of 9.14%, rounded to 9.10%.

5

6   **Return on Equity Summary**

7   **Q   BASED ON THE RESULTS OF YOUR RETURN ON COMMON EQUITY**

8   **ANALYSES DESCRIBED ABOVE, WHAT RETURN ON COMMON EQUITY DO**

9   **YOU RECOMMEND FOR GULF POWER?**

10 A   Based on my analyses, I estimate Gulf Power's current market cost of equity to

11   be 9.45%

TABLE 4	
Return on Common Equity Summary	
Description	**Results**
DCF	9.10%
Risk Premium	9.85%
CAPM	9.10%

19 .   My recommended return on common equity is 9.45%. My recommended

20   return on equity is in the range of approximately 9.10% to 9.85%. The low-end

21   recommended return of 9.10% is based on my DCF and CAPM return estimates.

22   The high-end is supported by my risk premium result, 9.85%.

23

24

25

1   ## Financial Integrity

2   **Q   WILL YOUR RECOMMENDED OVERALL RATE OF RETURN SUPPORT AN**

3   **INVESTMENT GRADE BOND RATING FOR GULF POWER?**

4   A   Yes. I have reached this conclusion by comparing the key credit rating financial

5   ratios for Gulf Power, at my proposed return on equity and capital structure, to

6   S&P's benchmark financial ratios using S&P's new credit metric ranges.

7

8   **Q   PLEASE DESCRIBE THE MOST RECENT S&P FINANCIAL RATIO CREDIT**

9   **METRIC METHODOLOGY.**

10   A   S&P publishes a matrix of financial ratios that correspond to its assessment of

11   the business risk of the utility company and related bond rating. On May 27,

12   2009, S&P expanded its matrix criteria[30] by including additional business and

13   financial risk categories. Based on S&P's most recent credit matrix, the business

14   risk profile categories are "Excellent," "Strong," "Satisfactory," "Fair," "Weak," and

15   "Vulnerable." Most electric utilities have a business risk profile of "Excellent" or

16   "Strong." The financial risk profile categories are "Minimal," "Modest,"

17   "Intermediate," "Significant," "Aggressive," and "Highly Leveraged." Most of the

18   electric utilities have a financial risk profile of "Aggressive." Gulf Power has an

19   "Excellent" business risk profile and a "Significant" financial risk profile.

20

21

22

23

---

[30]S&P updated its 2008 credit metric guidelines in 2009, and incorporated utility metric benchmarks with the general corporate rating metrics. *Standard & Poor's RatingsDirect*: "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

1 Q **PLEASE DESCRIBE S&P'S USE OF THE FINANCIAL BENCHMARK RATIOS**

2 **IN ITS CREDIT RATING REVIEW.**

3 A S&P evaluates a utility's credit rating based on an assessment of its financial and

4 business risks. A combination of financial and business risks equates to the

5 overall assessment of Gulf Power's total credit risk exposure. S&P publishes a

6 matrix of financial ratios that defines the level of financial risk as a function of the

7 level of business risk.

8 S&P publishes ranges for three primary financial ratios that it uses as

9 guidance in its credit review for utility companies. The three primary financial

10 ratio benchmarks it relies on in its credit rating process include: (1) Total Debt to

11 Total Capital; (2) Debt to Earnings Before Interest, Taxes, Depreciation and

12 Amortization ("EBITDA"); and (3) Funds From Operations ("FFO") to Total Debt.[31]

13

14 Q **HOW DID YOU APPLY S&P'S FINANCIAL RATIOS TO TEST THE**

15 **REASONABLENESS OF YOUR RATE OF RETURN RECOMMENDATIONS?**

16 A I calculated each of S&P's financial ratios based on Gulf Power's cost of service

17 for its retail jurisdictional electric operations. While S&P would normally look at

18 total consolidated Gulf Power financial ratios in its credit review process, my

19 investigation in this proceeding is not the same as S&P's. I am attempting to

20 judge the reasonableness of my proposed cost of capital for rate-setting in Gulf

21 Power's retail regulated utility operations. Hence, I am attempting to determine

22 whether my proposed rate of return will in turn support cash flow metrics, balance

23 sheet strength, and earnings that will support an investment grade bond rating

24 and Gulf Power's financial integrity for those operations.

---

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

1   Q   **DID YOU INCLUDE ANY OFF-BALANCE SHEET DEBT EQUIVALENTS?**

2   A   Yes. As shown on page 3 of my Exhibit MPG-17, I included $1.3 million of

3   off-balance sheet debt equivalents including purchased power agreements and

4   operating leases and their associated interest and depreciation expenses. I

5   included these debt equivalents in my credit metric calculations.

6

7   Q   **PLEASE DESCRIBE THE RESULTS OF THIS CREDIT METRIC ANALYSIS**

8   **FOR GULF POWER.**

9   A   The S&P financial metric calculations for Gulf Power at a 9.45% return are

10   developed on Exhibit MPG-17, page 1.

11   Gulf Power's adjusted total debt ratio is approximately 47%. This is at the

12   low end of the "Aggressive" utility guideline range of 50% to 60%. This total debt

13   ratio will support an investment grade bond rating.

14   As shown in Exhibit MPG-17, page 1, column 1, based on an equity

15   return of 9.45%, Gulf Power will be provided an opportunity to produce a debt to

16   EBITDA ratio of 3.0x. This is at the low end of "Significant" guideline range of

17   3.0x to 4.0x.[32] This ratio also supports an investment grade credit rating.

18   Finally, Gulf Power's retail operations FFO to total debt coverage at a

19   9.45% equity return would be 24%, which is also within S&P's "Significant" metric

20   guideline range of 20% to 30%. The FFO/total debt ratio will support an

21   investment grade bond rating.

22   At my recommended return on equity of 9.45% and proposed capital

23   structure, Gulf Power's financial credit metrics are supportive of its current

24   investment grade utility bond rating.

---

[32] *Standard & Poor's RatingsDirect*: "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009 at 4.

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

2   Q   **WHAT IS DR. VANDER WEIDE'S RETURN ON EQUITY**

3   **RECOMMENDATION?**

4   A   Gulf Power's rate of return witness, Dr. Vander Weide, recommends a return on

5   equity of 11.5%. His recommended return is based on an estimated return for

6   his proxy group of 10.8% including a flotation cost adder of about 24 basis points,

7   plus a leverage adjustment of 70 basis points. The leverage adjustment is based

8   on Dr. Vander Weide's belief that Gulf Power has greater financial risk than the

9   proxy group.

10

11   Q   **HOW DID DR. VANDER WEIDE DEVELOP HIS RETURN ON EQUITY**

12   **RANGE?**

13   A   Dr. Vander Weide developed his return on equity recommendation by applying

14   the DCF, Risk Premium and CAPM models to a utility proxy group. Dr. Vander

15   Weide arrived at his recommendations by reviewing Gulf Power's business

16   operations, market conditions, and utility industry trends at the time of his filing.

17

18   Q   **PLEASE SUMMARIZE DR. VANDER WEIDE'S PROPOSED RETURN ON**

19   **EQUITY FOR GULF POWER.**

20   A   As shown below in Table 5, his analyses produce an average return on equity of

21   10.8% without his CAPM return estimates, and 10.7% including all of his results.

22   However, as I demonstrate below, Dr. Vander Weide's DCF and RP studies, with

23   reasonable adjustments, produce a return on equity for Gulf Power of

24   approximately 9.25%.

25

1

2

3

4

5

6

7

8

9

10

11

12

13

TABLE 5		
Gulf Power's ROE Analysis		
Model	Vander Weide Proposed	Adjusted
Constant Growth DCF	10.4%	9.10%
Ex Ante Risk Premium	11.2%	9.40%
Ex Post Risk Premium	10.8%	9.00%
CAPM Historical	10.4%	9.1%
CAPM DCF	10.7%	9.1%
Point Estimate	10.8%	9.0%
Leverage Adjustment	0.7%	Reject
Recommendation	11.5%	9.25%

Sources: Vander Weide Direct at 50.

14

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

16   A   He develops this on his Exhibit ___ (JVW-1), Schedule 9. On that schedule, he

17   develops a post-tax cost of equity using his proposed 10.8% cost of equity, and

18   the market weighted average capital structure for his proxy group. This produced

19   a weighted average cost of capital, post-tax, of 7.17%.

20   He then estimated the return on common equity that would produce the

21   same post-tax weighted average cost of capital (7.17%) when applied to Gulf

22   Power's book value capital structure. As shown on his Schedule 9, a return on

23   book value equity at 11.5% would produce the same post-tax cost of equity on

24   Gulf Power's book value capital structure, as he produced using the market value

25   capital structure of his proxy group.

1   Q   WHY IS DR. VANDER WEIDE'S PROPOSED LEVERAGE EQUITY RETURN

2   ADDER UNREASONABLE?

3   A   The leverage adjustment increases the return on equity to reflect Gulf Power's

4   greater book value financial risk compared to the market value financial risk of

5   the proxy group. However, such an adjustment to the equity return is erroneous

6   for at least two reasons.

7   First, Dr. Vander Weide's contention that an adjustment should be made

8   for differentials in book value and market value financial risk is without merit. The

9   implicit premise of Dr. Vander Weide's leverage adjustment is that financial risk is

10   measured differently using book value capitalization versus market value

11   capitalization. This premise is without merit, because the Company's financial

12   risk is tied to both its book value capitalization which in turn drives its market

13   value capitalization. They are not separate risk factors.

14   Second, Dr. Vander Weide's proposed leverage adjustment is really

15   nothing more than a flawed market-to-book ratio adjustment. The leverage

16   equity return adder results in an excess return on incremental utility plant

17   investments.

18   For these reasons, the leverage adjustment is without merit, and should

19   continue to be rejected by the Commission just as it was in Gulf Power's last rate

20   case.

21

22

23

24

25

1   Q   WHY DO YOU BELIEVE THAT A COMPANY DOES NOT HAVE DIFFERENT

2   FINANCIAL RISK WHETHER IT IS MEASURED ON BOOK VALUE OR

3   MARKET VALUE CAPITAL STRUCTURE?

4   A   The company's financial risk concerns its ability to meet its financial obligations.

5   Its ability to meet its financial obligations is tied to its ability to reliably produce

6   internal generation of earnings and cash to pay its financial obligations.   A

7   company does not have one level of financial risk based on its book value capital

8   structure, and another level of financial risk based on its market value capital

9   structure.

10

11   Q   HOW DOES BOOK VALUE LEVERAGE ESTABLISH A COMPANY'S

12   FINANCIAL RISK?

13   A   Book value leverage represents the utility's contractual obligations to pay debt

14   interest and principal payments. These book value financial obligations must be

15   paid from utility operating cash flows.

16   In generating free cash flow, the utility must make debt interest payments

17   from operating income, and produce net cash flow after interest payments are

18   made to support debt principal payments, construction expenditures, and to pay

19   common dividends. Internal cash flows must support book value leverage. If

20   cash flows are not adequate to meet book value obligations, the company can be

21   forced into default. Financial risk concerns the likelihood a utility cannot pay

22   these financial obligations.

23   The market value capital structure leverage does not measure whether a

24   utility's earnings and free cash flow will cover its contractual financial obligations.

25   These cash flows do drive stock valuations which produce the market

1   capitalization structure. Nevertheless, the resulting stock valuations and market

2   capitalization do not describe how reliably the internally generated cash flows will

3   cover the fixed financial obligations of the company.

4   For these reasons, the financial risk is best described by the book value

5   financial obligations in relationship to the cash flows produced on the company's

6   books and records.

7

8   **Q**   **IS GULF POWER'S FINANCIAL RISK COMPARABLE TO THAT OF THE**

9   **PROXY GROUP?**

10 **A**   Yes. All factors considered by market participants indicate Gulf Power's financial

11   risk is comparable to, if not lower than, that of the proxy group. This is evidenced

12   from the following: The best indicator of total financial risk for any company is in

13   its bond ratings. The Company's bond ratings from S&P and Moody's are "A"

14   and "A3", respectively. When determining its ratings, S&P tends to look at it from

15   the view of a consolidated basis, where as Moody's, while taking the ability to

16   move capital between subsidiaries and the parent into consideration, tends to

17   base its ratings on an individual operating subsidiary basis. Of my 28-company

18   proxy group, there is only one company that has as high of a bond rating from

19   Moody's as Gulf Power, and that is Wisconsin Energy Corporation. The proxy

20   group's average bond rating from Moody's, which is shown on my Exhibit MPG-

21   2, is "Baa2". Gulf Power's "A3" rating is two notches higher than the group

22   average. The only company in the proxy group with an "A" rating from S&P,

23   which is also the highest rating within the group and the same as Gulf Power's

24   S&P rating, is Southern Company, Gulf Power's parent holding company. This

1   evidence suggests that Gulf Power, in fact, has less financial risk than that of the

2   proxy group, contrary to the belief Dr. Vander Weide.

3   Secondly, as shown on my Exhibit MPG-2, Gulf Power has a common

4   equity ratio of approximately 47.5% on an investor supplied basis (inclusive of

5   short-term debt). The average common equity ratio of my 28-company proxy

6   group from SNL is 45.1%. This is approximately 240 basis points less than that

7   of the Company's. In fact, out of the 28 companies in my proxy group, only ten

8   have a thicker common equity ratio than that of Gulf Power. It should be noted

9   that each of those ten companies also have a lower bond rating from **both** S&P

10   and Moody's than that of Gulf Power. It is prudent to compare the Company's

11   47.5% common equity ratio to the proxy group's common equity ratios provided

12   by SNL because it includes short-term debt in its capital structure calculations.

13   These factors indicate that Gulf Power's financial risk is lower than that of

14   the proxy group, not higher as Dr. Vander Weide erroneously concludes.

15

16   Q   **WHY WILL DR. VANDER WEIDE'S LEVERAGE RETURN ADDER PROVIDE**

17   **EXCESSIVE COMPENSATION ON INCREMENTAL UTILITY PLANT**

18   **INVESTMENTS?**

19   A   Because it will provide Gulf Power an excessive risk adjusted return on

20   incremental plant investments, I will use Dr. Vander Weide's DCF results to

21   illustrate this point.

22   If Gulf Power were to repurchase its own stock, it would expect to earn a

23   market-based return of 10.80% based on Dr. Vander Weide's unadjusted DCF

24   results. However, if the Commission accepted Dr. Vander Weide's leverage

1   adjusted return, it could earn a return on incremental utility plant investments of

2   11.50% (the 10.80% plus 0.7% leverage adjustment).

3   If the utility was considering its options for reinvesting its retained

4   earnings, it could be faced with the alternative investments of: (1) repurchase its

5   own stock at a 10.80% return, or (2) invest in new utility plant at a 11.50% return.

6   These are comparable risk investments because utility plant investments drive

7   earnings, and earnings drive dividends and stock price. Under Dr. Vander

8   Weide's proposal, the utility would be encouraged to gold-plate utility plant

9   investment because it would be provided with an above-market risk adjusted

10   return on such investments. Providing a utility an incentive to earn more than a

11   fair risk adjusted return on utility plant investments will result in rates not being

12   just and reasonable.

13

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

15   A   Dr. Vander Weide applied the traditional DCF model to a utility proxy group.

16   Based on his utility group, his DCF study produces a return on equity of 10.4%.

17   (Vander Weide Direct at 32 and Exhibit___ (JHV-1), Schedule 1).

18

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

20   A   Yes. I have several major issues concerning his DCF analyses. First, Dr.

21   Vander Weide's constant growth DCF study is overstated because the analysts'

22   three- to five-year growth rates he uses are not reasonable estimates of long-

23   term sustainable growth. The constant growth DCF model used by Dr. Vander

24   Weide requires an estimated long-term sustainable growth. In contrast, the

25   analysts' growth rates he relies on reflect only the outlooks over the next three to

1   five years. To the extent the analysts' growth rate estimates are not reasonable

2   estimates of long-term sustainable growth, then the DCF return estimate he

3   produces from this study is not reliable. Because the analysts' growth rates

4   exceed a reasonable estimate of long-term sustainable growth, Dr. Vander

5   Weide's DCF return estimate is inflated and should be rejected.

6   Second, I believe his DCF return estimate is unreasonable because he

7   relies on a quarterly compounding version of the DCF model. For the reasons

8   set forth below, the quarterly compounding of the DCF model overestimates a

9   utility's cost of capital because it provides utilities with an opportunity to earn the

10   dividend reinvestment return twice: first, through authorized returns on equity

11   and earnings to the utility, and a second time after dividends are actually paid to

12   investors and reinvested in alternative investments to the utility stock the

13   dividend was earned upon.

14   Third, Dr. Vander Weide includes a flotation cost adjustment, which

15   increases the DCF return by approximately 24 basis points. Finally, Dr. Vander

16   Weide's data included in his study reflected three months of data ending

17   February 2013 (Vander Weide Exhibit___ (JHV-1), Schedule 1, page 2. This

18   data is stale and does not reflect current market costs. Excluding the three

19   adjustments I made to Dr. Vander Weide's proxy group and eliminating the

20   companies currently involved in merger and acquisition activity, my updated DCF

21   return estimates for his proxy group are approximately 9.1%.[33] This result

22   excludes reliance on excessive growth rates, and on the overstatement of Gulf

23   Power's cost of capital by including the quarterly compounding component and

---

[33]Exhibit MPG-5.

1   excluding the flotation cost adjustment which has not been shown to truly reflect

2   Gulf Power's actual cost of issued stock to the public.

3

4   Q   **PLEASE DESCRIBE WHY YOU BELIEVE DR. VANDER WEIDE'S THREE- TO**

5   **FIVE-YEAR ANALYSTS' GROWTH RATE PROJECTIONS ARE NOT**

6   **REASONABLE ESTIMATES OF LONG-TERM SUSTAINABLE GROWTH.**

7   A   As shown on his Exhibit___ (JHV-1), Schedule 1, the growth rates from his proxy

8   group in every instance but a few exceed the projected nominal growth of the

9   U.S. GDP. As stated above, consensus economists' projections of long-term

10   growth for the U.S. GDP are around 4.9%. In contrast, Dr. Vander Weide's 30

11   utility company proxy group has an average growth rate of 5.6%.

12   I explained above that both practitioners and academics support the

13   notion that long-term sustainable growth cannot be greater than the economy in

14   which the company sells its goods and services. Growth can exceed the service

15   area economic growth over short periods of time, but over the long-term the

16   expectation that the growth will exceed the economy in which it sells its services

17   is not rational nor reasonable. Because Dr. Vander Weide's growth rates exceed

18   a maximum sustainable long-term growth, his DCF results are inflated and

19   unreliable. The analysts' growth rates Dr. Vander Weide relies on reflect only the

20   growth outlooks over the next three to five years. The constant growth DCF

21   model requires a growth rate that can be sustained indefinitely. To the extent the

22   analysts' 3-5 year projected growth rate estimates are not reasonable estimates

23   of long-term sustainable growth, then the DCF return estimates Dr. Vander

24   Weide produces are inflated and not reliable.

25

1 Q WHY IS A QUARTERLY COMPOUNDING ADJUSTMENT TO A DCF RETURN

2   ESTIMATE NOT REASONABLE?

3 A Including the quarterly compounding adjustment to Gulf Power's authorized

4   return on equity is inappropriate. If a quarterly compounding adjustment is added

5   to a DCF return estimate, shareholders will be permitted to earn the dividend

6   reinvestment return twice: (1) through the higher authorized return on equity,

7   and (2) through actual receipt of dividends and the reinvestment of those

8   dividends throughout the year. This double counting of the dividend

9   reinvestment return is not reasonable and will unjustly inflate Gulf Power's rates.

10

11 Q PLEASE EXPLAIN WHY THE QUARTERLY COMPOUNDING RETURN

12   SHOULD NOT BE INCLUDED IN GULF POWER'S AUTHORIZED RETURN

13   ON EQUITY.

14 A Simply put, the quarterly compounding component of the return is not a cost to

15   the utility. Only the utility's cost of common equity capital should be included in

16   the authorized return on equity.

17   This issue surrounds whether or not the DCF return estimate should

18   include the expectations by investors that they will receive cash flows within the

19   year, that can be reinvested in other investments of comparable risk, and thus

20   the cash flows will produce compounded returns throughout the year. The

21   relevant issue for setting rates is whether or not that reinvestment return <u>is a cost</u>

22   <u>to the utility</u>. It is not!

23   The reinvestment return is not a cost to the utility and therefore should not

24   be included in the authorized return on equity. While it is reasonable for

25   investors to expect to have the opportunity to earn the compounded return

1   produced by cash flows received within the year, the compound return is not paid

2   to investors by the utility.

3

4   Q   **CAN YOU PROVIDE AN EXAMPLE OF WHY THE COMPOUNDING RETURN**

5   **ESTIMATE IS NOT A COST TO THE UTILITY?**

6   A   Yes. I will provide two examples to help illustrate this point. First, consider the

7   cost to the utility of an outstanding utility bond. Most utility bonds pay a coupon

8   every six months. The utility annual cost paid to the bond investor is the sum of

9   the two semi-annual coupon payments. A bond investor expects to receive the

10   semi-annual coupon payments from the utility, but also has an opportunity to

11   reinvest the first coupon payment for the remaining six months of the year to

12   enhance his end-of-year return. This compound return component is, however,

13   not a cost to the utility because the utility does not pay the extra return.

14   For example, assume Gulf Power has an outstanding bond with a face

15   value of $1,000, at an interest rate of 6% which is paid in two semi-annual $30

16   coupon payments. Gulf Power's cost of this bond is 6%. This 6% cost to Gulf

17   Power is based on a $30 coupon payment paid in month 6 and month 12 for an

18   annual payment of $60 relative to the $1,000 face value of the bond. However,

19   the bond investor would have an annual expected return on this bond of 6.1%.

20   This annual expected return would be realized by receiving the first $30 semi-

21   annual coupon payment from Gulf Power and reinvesting it for the remaining six

22   months of the year. This would produce $0.89 of semi-annual compounding

23   return ($30 x [$(1.06)^{\frac{1}{2}}$ - 1]). Hence, the bond investor would receive $60 from

24   Gulf Power, and $0.89 from investing the first coupon for a total annual return of

25   6.09%, or 6.1%.

1   Importantly, if Gulf Power were to recover a 6.1% cost of this bond in its

2   cost of service, and paid that return out to the bond investor, then the bond

3   investor would receive $60.89 from Gulf Power, rather than the $60.00 actual

4   cost, but the bond investor could still reinvest the semi-annual coupon, now

5    $30.89 for the remaining six months of the year. This would provide the investor

6   with the reinvestment return twice, once from utility ratepayers, and a second

7   time after the semi-annual coupon payment was paid and reinvested.

8   Reflecting this compounding assumption in the authorized return on

9   equity therefore will double count the reinvestment return opportunity.

10

11   Q   DOES THIS EXAMPLE ALSO APPLY TO UTILITY STOCK INVESTMENTS?

12   A   Yes. Assume now that an investor purchased Gulf Power stock for $100, and

13   expects to receive four quarterly dividends of $1.50, or $6.00 per year. The

14   expected cost to the utility of this dividend payment over the year would be

15   $6.00, or 6.0%. However, the expected effective yield of the dividend to

16   investors would be 6.13% because the quarterly dividends could be reinvested

17   for the remaining term of the year. Hence, the expected end-of-year value of

18   those four $1.50 quarterly dividend payments to the investor would be $6.13.[34]

19   Again, the utility pays $6.00 of annual dividends. The $0.13 is not paid to

20   investors from the utility, but is rather earned in the other investments that earn

21   the same return, which the dividends were invested in throughout the year.

22   Importantly, the reinvestment return of the dividends is not paid by the

23   utility, and therefore is not part of the utility's cost of capital. Again, if this

24   dividend reinvestment return is included in the utility's authorized return on

---

[34] $1.5 \times (1.06)^{.75} + 1.5 \times (1.06)^{.5} + 1.5 \times (1.06)^{.25} + 1.5 = \$6.13$.

1   equity, then investors will receive the dividend reinvestment return twice, once

2   through the authorized return on equity, and a second time when dividends are

3   actually received by investors and reinvested.

4

5   Q   DO YOU HAVE ANY COMMENTS CONCERNING DR. VANDER WEIDE'S

6   FLOTATION COSTS ADJUSTMENT?

7   A   Yes. Dr. Vander Weide increased his DCF results to account for flotation costs.

8   This was done by adjusting the yield by 1 minus a flotation cost allowance of 5%.

9   (Direct at 29 and Schedule 1 at 21). This adjustment created a flotation cost

10   adder of 24 basis points.

11

12   Q   DO YOU AGREE WITH DR. VANDER WEIDE'S FLOTATION COST

13   ESTIMATE?

14   A   No. Dr. Vander Weide's flotation cost estimate is flawed and it should not be

15   taken into consideration when determining a fair return for Gulf Power.

16   Flotation costs are a legitimate cost of doing business. However, flotation

17   costs should only be included in the development of cost of service under two

18   conditions. First, the Company has to demonstrate what its actual flotation costs

19   are, and prove they are reasonable. It is not appropriate to approximate flotation

20   costs for utility companies and build those approximated costs into a utility's cost

21   of service. Costs should be known and measurable and should be verifiable and

22   most importantly should be shown to be reasonable before they are included in

23   cost of service. This is not possible if a utility's flotation costs are approximated,

24   as Dr. Vander Weide has done.

25

1   Second, and more important, Gulf Power is not a publicly traded

2   company.   Rather, it is a wholly-owned subsidiary of Berkshire Hathaway.

3   Hence, Gulf Power does not incur costs related to selling common stock to the

4   market.   Gulf Power's common equity capital comes from two sources:

5   (1) retained earnings, which incur no flotation costs, and (2) equity infusion from

6   its parent company.

7   Therefore, Dr. Vander Weide's adder to account for flotation costs should

8   be disregarded and not considered in determining Gulf Power's return on equity.

9

10 Q   **PLEASE DESCRIBE DR. VANDER WEIDE'S EX ANTE RISK PREMIUM**

11   **METHODOLOGY.**

12 A   Dr. Vander Weide estimated a DCF return on a proxy group of electric

13   companies relative to the utility bond yield with a rating of "A." Based on this

14   study, Dr. Vander Weide asserts that his risk premium estimate was 4.62% for

15   this historical period based on prospective DCF return estimates relative to bond

16   yields.

17   To this estimated market risk premium of 4.62%, he added a projected

18   "A" rated Moody's bond utility yield of 6.55%. He then concluded that this

19   produced a return on common equity of 11.2%. (Vander Weide Direct at 35).

20

21 Q   **PLEASE DESCRIBE THE ISSUES YOU HAVE WITH DR. VANDER WEIDE'S**

22   **EX ANTE RISK PREMIUM ANALYSIS.**

23 A   I believe Dr. Vander Weide's estimated market risk premium from his ex ante risk

24   premium study represents a very high-end estimate of an appropriate risk

25   premium for this proceeding. However, because bond yields are relatively low

1   currently, it can be used to produce a reasonable return on equity estimate for

2   Gulf Power. Also, Dr. Vander Weide's projected "A" rated utility yield is highly

3   problematic.

4

5 Q **WHY DO YOU BELIEVE THAT THE ACCURACY OF FORECASTED**

6   **INTEREST RATES IS HIGHLY PROBLEMATIC?**

7 A Over the last several years, observable current interest rates have been a more

8   accurate predictor of future interest rates than economists' consensus

9   projections. Exhibit MPG-18 illustrates this point. On this exhibit, under Columns

10   1 and 2, I show the actual market yield at the time a projection is made for

11   Treasury bond yields two years in the future. In Column 1, I show the actual

12   Treasury yield and, in Column 2, I show the projected yield two years out.

13   As shown in Columns 1 and 2, over the last several years, Treasury

14   yields were projected to increase relative to the actual Treasury yields at the time

15   of the projection. In Column 4, I show what the Treasury yield actually turned out

16   to be two years after the forecast. Under Column 5, I show the actual yield

17   change at the time of the projections relative to the projected yield change.

18   As shown in this exhibit, over the last several years, economists

19   consistently have been projecting that interest rates will increase. However, as

20   demonstrated under Column 5, those yield projections have turned out to be

21   overstated in virtually every case. Indeed, actual Treasury yields have

22   decreased or remained flat over the last five years, rather than increase as the

23   economists' projections indicated. As such, current observable interest rates are

24   just as likely to predict future interest rates as are economists' projections.

25

1 Q CAN DR. VANDER WEIDE'S EX ANTE RISK PREMIUM STUDY BE REVISED

2 TO PRODUCE A MORE REASONABLE RESULT?

3 A Yes. Applying his equity risk premium estimate of 4.62% to the current

4 observable "A" rated utility bond yield of 4.73% produces a return on equity of

5 9.36%, rounded to 9.40% for Gulf Power.

6

7 Q PLEASE DESCRIBE DR. VANDER WEIDE'S EX POST RISK PREMIUM

8 METHODOLOGY.

9 A In Dr. Vander Weide's ex post risk premium methodology, he compared the

10 historical realized return on the S&P 500 relative to estimated changes in bond

11 price for an "A" rated utility bond. He performed a second ex post risk premium

12 analysis comparing the historical achieved return on the S&P Utility Index,

13 relative again to changes in "A" rated utility bond yields.

14 Based on this analysis, Dr. Vander Weide estimates an equity risk

15 premium in the range of 4.4% (based on S&P 500) to 3.7% (based on utility

16 yields).

17 He then applies this estimated equity risk premium to his projected "A"

18 rated utility bond yield of 6.55% to produce an estimated equity risk premium in

19 the range of 10.3% to 10.9% with a midpoint of 10.6% before his 24 basis points

20 flotation cost adder. (Vander Weide Direct at 40).

21

22 Q DO YOU BELIEVE THAT DR. VANDER WEIDE'S EX POST RISK PREMIUM

23 RECOMMENDATION IS REASONABLE?

24 A No, for several reasons. First, as discussed earlier, his projected "A" rated utility

25 bond yield of 6.55% substantially exceeds current observable utility bond yields

1   of 4.36%. While these bond yields are low, Dr. Vander Weide's projected yield is

2   abnormally high.   Reflecting just the high-end of his estimated equity risk

3   premium using his ex post risk premium study of 4.4%, with current bond yields

4   of 4.73%, would indicate a fair return on equity for Gulf Power in this case of

5   9.03%, rounded to 9.0%. Accordingly, Dr. Vander Weide's recommended return

6   on equity with this methodology substantially overstates current observable

7   market costs.

8

9   Q   PLEASE DESCRIBE DR. VANDER WEIDE'S CAPM STUDIES.

10   A   Dr. Vander Weide performed a historical DCF study based on a market risk

11   premium of 6.7%, a risk-free rate of 5.25%, and beta estimate of 0.73.   This

12   study produced a return on equity estimate of 10.14%. (Vander Weide Direct at

13   44). Then he added a 24 basis point flotation adder, which increased his CAPM

14   return from 10.14% to 10.38%, rounded to 10.4%.

15   Dr. Vander Weide also performed a DCF-based CAPM study, where he

16   estimated the market risk premium using a DCF return on the S&P 500. Based

17   on that study, Dr. Vander Weide estimated a market risk premium of 7.2%, and

18   use of his risk-free rate of 5.25%, and beta estimate of 0.73, produced a CAPM

19   return estimate of 10.5% increased to 10.7% including a 24 basis point flotation

20   cost adder. (Vander Weide Direct at 48).

21

22

23

24

25

1 Q DO YOU HAVE ANY CONCERNS ABOUT DR. VANDER WEIDE'S

2   HISTORICAL AND DCF-BASED CAPM RETURN ESTIMATES?

3 A Yes. I have two issues. First, his risk-free rate of 5.25% is inflated and

4   unreliable and should be disregarded. Second, his inclusion of flotation cost has

5   not been shown to be cost justified for Gulf Power and should be disregarded.

6

7 Q HOW DID DR. VANDER WEIDE DERIVE HIS RISK-FREE RATE OF 5.25%?

8 A He derived a forecasted yield of a Treasury bond rate based on data he gathered

9   from *Value Line*, EIA and other sources. Specifically, he relies on a *Value Line*

10   forecast of 10-year Treasury note of 4.2% and adds a spread of 80 basis points

11   to produce his estimated forecasted yield on a long-term Treasury bond of

12   around 5%.

13   He uses an EIA forecasted 10-year Treasury bond yield of 4.7%, and

14   adds the 80 basis point spread to produce a forecasted long-term Treasury bond

15   yield of 5.5%. His point estimate of 5.25% is the midpoint of his forecast using

16   these *Value Line* and EIA projected 10-year Treasury bond yields.

17

18 Q IS DR. VANDER WEIDE'S PROJECTION OF A RISK-FREE RATE

19   REASONABLE?

20 A No. He has not shown that his projected Treasury bond yields reflect current

21   capital market participants' outlooks, and therefore are not a general assessment

22   of independent market analysts' assessment of Gulf Power's market cost of

23   capital. A more balanced methodology would be to use *The Blue Chip Financial*

24   *Forecasts'* consensus economists' projected Treasury bond rates. This is a

25   source I used as an independent assessment of what market participants believe

1   Treasury bond rates will be two years out. Based on that assessment, a

2   Treasury bond rate of 4.2% is appropriate.

3

4 Q   **HOW WOULD DR. VANDER WEIDE'S CAPM STUDIES CHANGE IF *THE***

5   ***BLUE CHIP FINANCIAL FORECASTS'* PROJECTED TREASURY BOND**

6   **RATE OF 4.1% WAS USED?**

7 A   Using a risk-free rate projection of 4.2%, a beta estimate of 0.73, and market risk

8   premium of 6.7% indicates a CAPM return estimate of 9.10%.

9

10 Q   **DID DR. VANDER WEIDE ALSO PERFORM A DCF CAPM ANALYSIS USING**

11   **A REVISED BETA ESTIMATE OF 0.89?**

12 A   No. However, Dr. Vander Weide states that the CAPM analysis overstates the

13   return estimates when the beta coefficient exceeds 1.0 and understates the

14   results when it is below 1.0. Hence, he finds it appropriate to adjust *Value Line*'s

15   beta based on the ratio relationship of the S&P 500 risk premium of 5.78% and

16   the risk premium on Treasury yields of 5.14%.

17

18 Q   **IS DR. VANDER WEIDE'S 0.89 ADJUSTED BETA APPROPRIATE FOR**

19   **MEASURING GULF POWER'S COST OF EQUITY IN THIS PROCEEDING?**

20 A   No. While I do agree that the CAPM theory typically adjusts betas for producing

21   a reliable CAPM return estimate, Dr. Vander Weide is adjusting an adjusted beta

22   which already reflects the expectation of betas converging toward the mean over

23   time. Therefore, Dr. Vander Weide's adjustment to the *Value Line* adjusted

24   betas double-counts this beta adjustment necessary to produce a reliable CAPM

25   return estimate.

1   This deficiency of the CAPM analysis has been well documented in

2   financial literature and many investors' services such as *Value Line* and

3   Bloomberg have estimated adjusted betas. Dr. Vander Weide then concludes

4   that the actual utility beta of 0.73 was understated and proposes to use his

5   adjusted beta of 0.89. This conclusion is not supportable.

6

7 **Q** **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

8 A Yes, it does.

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

1   <u>Qualifications of Michael P. Gorman</u>

2 Q   **PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A   Michael P. Gorman.   My business address is 16690 Swingley Ridge Road,

4   Suite 140, Chesterfield, MO 63017.

5

6 Q   **PLEASE STATE YOUR OCCUPATION.**

7 A   I am a consultant in the field of public utility regulation and a Managing Principal

8   with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

9

10 Q   **PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK**

11   **EXPERIENCE.**

12 A   In 1983 I received a Bachelors of Science Degree in Electrical Engineering from

13   Southern Illinois University, and in 1986, I received a Masters Degree in

14   Business Administration with a concentration in Finance from the University of

15   Illinois at Springfield. I have also completed several graduate level economics

16   courses.

17   In August of 1983, I accepted an analyst position with the Illinois

18   Commerce Commission ("ICC"). In this position, I performed a variety of anal-

19   yses for both formal and informal investigations before the ICC, including:

20   marginal cost of energy, central dispatch, avoided cost of energy, annual system

21   production costs, and working capital. In October of 1986, I was promoted to the

22   position of Senior Analyst. In this position, I assumed the additional respon-

23   sibilities of technical leader on projects, and my areas of responsibility were

24   expanded to include utility financial modeling and financial analyses.

25

1   In 1987, I was promoted to Director of the Financial Analysis Department.

2   In this position, I was responsible for all financial analyses conducted by the staff.

3   Among other things, I conducted analyses and sponsored testimony before the

4   ICC on rate of return, financial integrity, financial modeling and related issues. I

5   also supervised the development of all Staff analyses and testimony on these

6   same issues. In addition, I supervised the Staff's review and recommendations

7   to the Commission concerning utility plans to issue debt and equity securities.

8   In August of 1989, I accepted a position with Merrill-Lynch as a financial

9   consultant. After receiving all required securities licenses, I worked with indi-

10   vidual investors and small businesses in evaluating and selecting investments

11   suitable to their requirements.

12   In September of 1990, I accepted a position with Drazen-Brubaker &

13   Associates, Inc. ("DBA"). In April 1995, the firm of Brubaker & Associates, Inc.

14   ("BAI") was formed. It includes most of the former DBA principals and Staff.

15   Since 1990, I have performed various analyses and sponsored testimony on cost

16   of capital, cost/benefits of utility mergers and acquisitions, utility reorganizations,

17   level of operating expenses and rate base, cost of service studies, and analyses

18   relating industrial jobs and economic development. I also participated in a study

19   used to revise the financial policy for the municipal utility in Kansas City, Kansas.

20   At BAI, I also have extensive experience working with large energy users

21   to distribute and critically evaluate responses to requests for proposals ("RFPs")

22   for electric, steam, and gas energy supply from competitive energy suppliers.

23   These analyses include the evaluation of gas supply and delivery charges,

24   cogeneration and/or combined cycle unit feasibility studies, and the evaluation of

25   third-party asset/supply management agreements. I have participated in rate

1   cases on rate design and class cost of service for electric, natural gas, water and

2   wastewater utilities. I have also analyzed commodity pricing indices and forward

3   pricing methods for third party supply agreements, and have also conducted

4   regional electric market price forecasts.

5   In addition to our main office in St. Louis, the firm also has branch offices

6   in Phoenix, Arizona and Corpus Christi, Texas.

7

8   Q   HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?

9   A   Yes. I have sponsored testimony on cost of capital, revenue requirements, cost

10   of service and other issues before the Federal Energy Regulatory Commission

11   and numerous state regulatory commissions including: Arkansas, Arizona,

12   California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa,

13   Kansas, Louisiana, Michigan, Missouri, Montana, New Jersey, New Mexico, New

14   York, North Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Texas,

15   Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, and

16   before the provincial regulatory boards in Alberta and Nova Scotia, Canada. I

17   have also sponsored testimony before the Board of Public Utilities in Kansas

18   City, Kansas; presented rate setting position reports to the regulatory board of

19   the municipal utility in Austin, Texas, and Salt River Project, Arizona, on behalf of

20   industrial customers; and negotiated rate disputes for industrial customers of the

21   Municipal Electric Authority of Georgia in the LaGrange, Georgia district.

22

23

24

25

1   Q   **PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR**

2   **ORGANIZATIONS TO WHICH YOU BELONG.**

3   A   I earned the designation of Chartered Financial Analyst ("CFA") from the CFA

4   Institute. The CFA charter was awarded after successfully completing three

5   examinations which covered the subject areas of financial accounting,

6   economics, fixed income and equity valuation and professional and ethical

7   conduct. I am a member of the CFA Institute's Financial Analyst Society.

8

\\Doc\Shares\ProlawDocs\SDW\9823\Testimony-BAI\246837.docx

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

Gulf Power Company

Rate of Return
Adjusted Capital Structure
2014 Test Year

Line	Description	Amount (000) (1)	Specific Adjustments (2)	Pro Rata Adjustments (3)	System Adjusted (4)	Allocation (5)	Juris Adjusted Amount (6)	Weight (7)	Cost (8)	Weighted Cost (9)
1	Long-Term Debt	$ 1,281,856	$ (103,347)	$ (600,313)	$ 578,196	0.9809660	$ 567,191	30.11%	4.96%	1.49%
2	Short-Term Debt	$ 51,663	$ (4,154)	$ (24,200)	$ 23,309	0.9809660	$ 22,865	1.21%	0.82%	0.01%
3	Preferrence Stock	$ 147,998.0	$ (11,941)	$ (69,305)	$ 66,752	0.9809660	$ 65,481	3.48%	6.00%	0.21%
4	Common Equity	$ 1,332,898	$ (102,440)	$ (626,775)	$ 603,683	0.9809660	$ 592,193	31.43%	9.45%	2.97%
5	Customer Deposits	$ 35,350	$ -	$ -	$ 35,350	1.0000000	$ 35,350	1.88%	2.30%	0.04%
6	Deferred Income Tax	$ 707,553	$ (53,944)	$ -	$ 653,609	0.9809660	$ 641,168	34.03%	0.00%	0.00%
7	FASB 109 Deferred Taxes	$ (47,899)	$ 3,652	$ -	$ (44,247)	0.9809660	$ (43,405)	-2.30%	0.00%	0.00%
8	Investment Tax Credit	$ 3,492	$ (375)	$ -	$ 3,117	0.9809660	$ 3,058	0.16%	7.07%	0.01%
9	Total	$ 3,512,911	$ (272,549)	$ (1,320,593)	$ 1,919,769		$ 1,883,901	100.00%		4.74%

Investor Capital Structure

Line	Description	Investor Capital Amount (000)* (1)	Weight (2)	Pro-Rata Allocation (3)
10	Long-Term Debt	$ 1,178,509	45.46%	$ (600,313)
11	Short-Term Debt	$ 47,509	1.83%	$ (24,200)
12	Preferrence Stock	$ 136,057	5.25%	$ (69,305)
13	Common Equity	$ 1,230,458	47.46%	$ (626,775)
14	Total	$ 2,592,533	100.00%	$ (1,320,593)

Source:
MFR Schedule D-1a.
* Sum of Columns 1 and 2, Lines 1 through 4.

Gulf Power Company

Proxy Group

Line	Company	Credit Ratings[1]		Common Equity Ratios		S&P Business
		S&P (1)	Moody's (2)	SNL[1] (3)	Value Line[2] (4)	Risk Score[3] (5)
1	ALLETE, Inc.	BBB+	Baa1	54.1%	56.3%	Strong
2	Alliant Energy Corporation	A-	Baa1	46.1%	48.4%	Excellent
3	American Electric Power Company, Inc.	BBB	Baa2	44.3%	49.4%	Excellent
4	Black Hills Corporation	BBB	Baa3	48.3%	56.8%	Excellent
5	CenterPoint Energy, Inc.	A-	Baa2	30.5%	34.0%	Excellent
6	CMS Energy Corporation	BBB	Baa3	29.7%	31.6%	Excellent
7	Dominion Resources, Inc.	A-	Baa2	32.6%	38.2%	Excellent
8	DTE Energy Company	BBB+	Baa1	47.6%	51.2%	Strong
9	Duke Energy Corporation	BBB+	Baa2	50.1%	52.9%	Excellent
10	Great Plains Energy Inc.	BBB	Baa3	46.9%	54.4%	Excellent
11	Hawaiian Electric Industries, Inc.	BBB-	Baa2	50.0%	53.1%	Strong
12	Integrys Energy Group, Inc.	A-	Baa1	52.1%	60.4%	Excellent
13	NextEra Energy, Inc.	A-	Baa1	37.0%	40.9%	Strong
14	Northeast Utilities	A-	Baa2	49.7%	55.4%	Excellent
15	NorthWestern Corporation	BBB	Baa1	43.5%	46.2%	Excellent
16	OGE Energy Corp.	A-	Baa1	43.6%	49.3%	Excellent
17	Otter Tail Corporation	BBB	Baa3	54.4%	54.4%	Strong
18	Pepco Holdings, Inc.	BBB+	Baa3	44.4%	52.7%	Excellent
19	Pinnacle West Capital Corporation	BBB+	Baa2	52.9%	55.4%	Excellent
20	PNM Resources, Inc.	BBB	Ba1	45.5%	48.7%	Excellent
21	Portland General Electric Company	BBB	Baa1	51.1%	52.9%	Excellent
22	SCANA Corporation	BBB+	Baa3	42.0%	45.6%	Excellent
23	Sempra Energy	BBB+	Baa1	43.5%	46.7%	Strong
24	Southern Company	A	Baa1	43.8%	47.3%	Excellent
25	Vectren Corporation	A-	N/A	44.0%	49.6%	Excellent
26	Westar Energy, Inc.	BBB	Baa2	45.4%	48.8%	Excellent
27	Wisconsin Energy Corporation	A-	A3	43.9%	48.0%	Excellent
28	Xcel Energy Inc.	A-	Baa1	44.6%	46.7%	Excellent
29	**Average**	BBB+	Baa2	45.1%	49.1%	**Excellent**
30	Gulf Power Company	A[4]	A3[4]	47.5%[5]		Excellent

Sources:

[1] SNL Financial, Downloaded on September 24.

[2] *The Value Line Investment Survey,* August 2, August 23, and September 20, 2013.

[3] *S&P RatingsDirect:* "U.S. Regulated Utilities, Strongest To Weakest," July 30, 2013.

[4] Teel Direct at 18.

[5] Teel Direct at 23.

Gulf Power Company

Consensus Analysts' Growth Rates

Line	Company	Zacks		SNL		Reuters		Average of Growth Rates
		Estimated Growth %[1] (1)	Number of Estimates (2)	Estimated Growth %[2] (3)	Number of Estimates (4)	Estimated Growth %[3] (5)	Number of Estimates (6)	(7)
1	ALLETE, Inc.	6.00%	N/A	6.00%	1	6.00%	1	6.00%
2	Alliant Energy Corporation	5.27%	N/A	4.40%	2	5.40%	2	5.02%
3	American Electric Power Company, Inc.	3.87%	N/A	4.00%	5	4.06%	7	3.98%
4	Black Hills Corporation	4.00%	N/A	5.00%	2	4.00%	1	4.33%
5	CenterPoint Energy, Inc.	5.30%	N/A	4.70%	3	4.50%	5	4.83%
6	CMS Energy Corporation	5.85%	N/A	5.80%	3	5.87%	4	5.84%
7	Dominion Resources, Inc.	5.82%	N/A	6.70%	2	6.66%	4	6.39%
8	DTE Energy Company	4.64%	N/A	4.50%	2	4.60%	3	4.58%
9	Duke Energy Corporation	3.69%	N/A	3.60%	3	3.85%	7	3.71%
10	Great Plains Energy Inc.	6.49%	N/A	6.20%	3	6.43%	3	6.37%
11	Hawaiian Electric Industries, Inc.	2.40%	N/A	2.40%	1	3.70%	2	2.83%
12	Integrys Energy Group, Inc.	5.00%	N/A	5.50%	2	5.00%	1	5.17%
13	NextEra Energy, Inc.	6.19%	N/A	6.30%	3	6.10%	5	6.20%
14	Northeast Utilities	7.85%	N/A	8.10%	3	7.19%	6	7.71%
15	NorthWestern Corporation	4.50%	N/A	6.00%	3	N/A	N/A	5.25%
16	OGE Energy Corp.	5.53%	N/A	5.40%	3	4.55%	2	5.16%
17	Otter Tail Corporation	N/A	N/A	N/A	N/A	N/A	N/A	N/A
18	Pepco Holdings, Inc.	5.02%	N/A	4.80%	5	3.82%	5	4.55%
19	Pinnacle West Capital Corporation	4.59%	N/A	4.60%	5	4.72%	4	4.64%
20	PNM Resources, Inc.	7.77%	N/A	7.80%	3	6.43%	3	7.33%
21	Portland General Electric Company	5.90%	N/A	5.90%	2	6.22%	4	6.01%
22	SCANA Corporation	4.70%	N/A	4.30%	2	4.83%	3	4.61%
23	Sempra Energy	4.95%	N/A	2.90%	1	2.90%	1	3.58%
24	Southern Company	4.44%	N/A	4.10%	4	4.54%	6	4.36%
25	Vectren Corporation	5.00%	N/A	N/A	N/A	N/A	N/A	5.00%
26	Westar Energy, Inc.	3.37%	N/A	2.50%	3	2.50%	3	2.79%
27	Wisconsin Energy Corporation	5.38%	N/A	5.30%	3	5.21%	3	5.30%
28	Xcel Energy Inc.	4.34%	N/A	4.20%	4	5.45%	5	4.66%
29	**Average**	**5.11%**	**N/A**	**5.04%**	**3**	**4.98%**	**4**	**5.04%**

Sources:

[1] Zacks Elite, http://www.zackselite.com/, downloaded on September 24, 2013.

[2] SNL Interactive, http://www.snl.com/, downloaded on September 24, 2013.

[3] Reuters, http://www.reuters.com/, downloaded on September 24, 2013.

Gulf Power Company

Constant Growth DCF Model
(Consensus Analysts' Growth Rates)

Line	Company	13-Week AVG Stock Price[1] (1)	Analysts' Growth[2] (2)	Annualized Dividend[3] (3)	Adjusted Yield (4)	Constant Growth DCF (5)
1	ALLETE, Inc.	$49.75	6.00%	$1.90	4.05%	10.05%
2	Alliant Energy Corporation	$50.99	5.02%	$1.88	3.87%	8.90%
3	American Electric Power Company, Inc.	$44.48	3.98%	$1.96	4.58%	8.56%
4	Black Hills Corporation	$50.38	4.33%	$1.52	3.15%	7.48%
5	CenterPoint Energy, Inc.	$23.76	4.83%	$0.83	3.66%	8.50%
6	CMS Energy Corporation	$27.19	5.84%	$1.02	3.97%	9.81%
7	Dominion Resources, Inc.	$58.69	6.39%	$2.25	4.08%	10.47%
8	DTE Energy Company	$67.92	4.58%	$2.62	4.03%	8.61%
9	Duke Energy Corporation	$68.12	3.71%	$3.12	4.75%	8.46%
10	Great Plains Energy Inc.	$22.99	6.37%	$0.87	4.03%	10.40%
11	Hawaiian Electric Industries, Inc.	$25.66	2.83%	$1.24	4.97%	7.80%
12	Integrys Energy Group, Inc.	$58.74	5.17%	$2.72	4.87%	10.04%
13	NextEra Energy, Inc.	$82.44	6.20%	$2.64	3.40%	9.60%
14	Northeast Utilities	$42.25	7.71%	$1.47	3.75%	11.46%
15	NorthWestern Corporation	$41.31	5.25%	$1.52	3.87%	9.12%
16	OGE Energy Corp.	$35.88	5.16%	$0.84	2.45%	7.61%
17	Otter Tail Corporation	$28.67	N/A	$1.19	N/A	N/A
18	Pepco Holdings, Inc.	$19.56	4.55%	$1.08	5.77%	10.32%
19	Pinnacle West Capital Corporation	$55.98	4.64%	$2.18	4.07%	8.71%
20	PNM Resources, Inc.	$22.69	7.33%	$0.66	3.12%	10.46%
21	Portland General Electric Company	$30.07	6.01%	$1.10	3.88%	9.88%
22	SCANA Corporation	$49.41	4.61%	$2.03	4.30%	8.91%
23	Sempra Energy	$84.27	3.58%	$2.52	3.10%	6.68%
24	Southern Company	$43.21	4.36%	$2.03	4.90%	9.26%
25	Vectren Corporation	$34.39	5.00%	$1.42	4.34%	9.34%
26	Westar Energy, Inc.	$31.97	2.79%	$1.36	4.37%	7.16%
27	Wisconsin Energy Corporation	$41.57	5.30%	$1.53	3.88%	9.17%
28	Xcel Energy Inc.	$28.57	4.66%	$1.12	4.10%	8.77%
29	**Average**	**$43.60**	**5.04%**	**$1.66**	**4.05%**	**9.09%**
30	**Median**					**9.12%**

Sources:

[1] SNL Financial, Downloaded on September 25, 2013

[2] Exhibit MPG-3.

[3] *The Value Line Investment Survey,* August 2, August 23, and September 20, 2013.

Gulf Power Company

Payout Ratios

Line	Company	Dividends Per Share		Earnings Per Share		Payout Ratio	
		2012 (1)	Projected (2)	2012 (3)	Projected (4)	2012 (5)	Projected (6)
1	ALLETE, Inc.	$1.84	$2.20	$2.58	$3.75	71.32%	58.67%
2	Alliant Energy Corporation	$1.80	$2.20	$3.05	$4.00	59.02%	55.00%
3	American Electric Power Company, Inc.	$1.88	$2.30	$2.98	$3.75	63.09%	61.33%
4	Black Hills Corporation	$1.48	$1.70	$1.97	$3.00	75.13%	56.67%
5	CenterPoint Energy, Inc.	$0.81	$1.00	$1.35	$1.75	60.00%	57.14%
6	CMS Energy Corporation	$0.96	$1.30	$1.53	$2.00	62.75%	65.00%
7	Dominion Resources, Inc.	$2.11	$2.70	$2.75	$3.75	76.73%	72.00%
8	DTE Energy Company	$2.42	$3.15	$3.88	$4.75	62.37%	66.32%
9	Duke Energy Corporation	$3.03	$3.35	$3.71	$5.00	81.67%	67.00%
10	Great Plains Energy Inc.	$0.86	$1.20	$1.35	$2.00	63.70%	60.00%
11	Hawaiian Electric Industries, Inc.	$1.24	$1.30	$1.68	$1.75	73.81%	74.29%
12	Integrys Energy Group, Inc.	$2.72	$2.90	$3.67	$4.25	74.11%	68.24%
13	NextEra Energy, Inc.	$2.40	$3.60	$4.56	$6.50	52.63%	55.38%
14	Northeast Utilities	$1.32	$1.80	$1.89	$3.25	69.84%	55.38%
15	NorthWestern Corporation	$1.48	$1.80	$2.26	$3.00	65.49%	60.00%
16	OGE Energy Corp.	$0.80	$1.25	$1.79	$2.25	44.69%	55.56%
17	Otter Tail Corporation	$1.19	$1.30	$1.05	$2.00	113.33%	65.00%
18	Pepco Holdings, Inc.	$1.08	$1.16	$1.24	$1.70	87.10%	68.24%
19	Pinnacle West Capital Corporation	$2.67	$2.60	$3.50	$4.25	76.29%	61.18%
20	PNM Resources, Inc.	$0.58	$1.08	$1.31	$2.15	44.27%	50.23%
21	Portland General Electric Company	$1.08	$1.25	$1.87	$2.25	57.75%	55.56%
22	SCANA Corporation	$1.98	$2.25	$3.15	$4.00	62.86%	56.25%
23	Sempra Energy	$2.40	$3.00	$4.35	$5.50	55.17%	54.55%
24	Southern Company	$1.94	$2.30	$2.67	$3.25	72.66%	70.77%
25	Vectren Corporation	$1.41	$1.60	$1.94	$2.70	72.68%	59.26%
26	Westar Energy, Inc.	$1.32	$1.52	$2.15	$2.70	61.40%	56.30%
27	Wisconsin Energy Corporation	$1.20	$2.00	$2.35	$3.00	51.06%	66.67%
28	Xcel Energy Inc.	$1.07	$1.35	$1.85	$2.25	57.84%	60.00%
29	**Average**	**$1.61**	**$1.97**	**$2.44**	**$3.23**	**66.74%**	**61.14%**

Source:
The Value Line Investment Survey, August 2, August 23, and September 20, 2013.

Gulf Power Company

Sustainable Growth Rate

| Line | Company | 3 to 5 Year Projections | | | | | | | | | | Sustainable |
		Dividends Per Share (1)	Earnings Per Share (2)	Book Value Per Share (3)	Book Value Growth (4)	ROE (5)	Adjustment Factor (6)	Adjusted ROE (7)	Payout Ratio (8)	Retention Rate (9)	Internal Growth Rate (10)	Growth Rate (11)
1	ALLETE, Inc.	$2.20	$3.75	$36.50	3.67%	10.27%	1.02	10.46%	58.67%	41.33%	4.32%	6.17%
2	Alliant Energy Corporation	$2.20	$4.00	$34.50	4.08%	11.59%	1.02	11.83%	55.00%	45.00%	5.32%	6.04%
3	American Electric Power Company, Inc.	$2.30	$3.75	$38.00	3.91%	9.87%	1.02	10.06%	61.33%	38.67%	3.89%	4.22%
4	Black Hills Corporation	$1.70	$3.00	$33.25	3.59%	9.02%	1.02	9.18%	56.67%	43.33%	3.98%	4.52%
5	CenterPoint Energy, Inc.	$1.00	$1.75	$12.25	4.02%	14.29%	1.02	14.57%	57.14%	42.86%	6.24%	6.60%
6	CMS Energy Corporation	$1.30	$2.00	$16.25	6.09%	12.31%	1.03	12.67%	65.00%	35.00%	4.44%	5.36%
7	Dominion Resources, Inc.	$2.70	$3.75	$25.50	6.80%	14.71%	1.03	15.19%	72.00%	28.00%	4.25%	7.51%
8	DTE Energy Company	$3.15	$4.75	$53.00	4.38%	8.96%	1.02	9.15%	66.32%	33.68%	3.08%	4.24%
9	Duke Energy Corporation	$3.35	$5.00	$63.75	1.89%	7.84%	1.01	7.92%	67.00%	33.00%	2.61%	2.64%
10	Great Plains Energy Inc.	$1.20	$2.00	$25.00	2.82%	8.00%	1.01	8.11%	60.00%	40.00%	3.24%	3.26%
11	Hawaiian Electric Industries, Inc.	$1.30	$1.75	$20.75	4.97%	8.43%	1.02	8.64%	74.29%	25.71%	2.22%	5.05%
12	Integrys Energy Group, Inc.	$2.90	$4.25	$50.50	5.39%	8.42%	1.03	8.64%	68.24%	31.76%	2.74%	3.46%
13	NextEra Energy, Inc.	$3.60	$6.50	$52.75	6.84%	12.32%	1.03	12.73%	55.38%	44.62%	5.68%	7.35%
14	Northeast Utilities	$1.80	$3.25	$34.75	3.39%	9.35%	1.02	9.51%	55.38%	44.62%	4.24%	4.38%
15	NorthWestern Corporation	$1.80	$3.00	$31.25	4.49%	9.60%	1.02	9.81%	60.00%	40.00%	3.92%	4.53%
16	OGE Energy Corp.	$1.25	$2.25	$19.25	6.58%	11.69%	1.03	12.06%	55.56%	44.44%	5.36%	6.21%
17	Otter Tail Corporation	$1.30	$2.00	$18.00	4.52%	11.11%	1.02	11.36%	65.00%	35.00%	3.97%	5.98%
18	Pepco Holdings, Inc.	$1.16	$1.70	$21.50	2.15%	7.91%	1.01	7.99%	68.24%	31.76%	2.54%	2.56%
19	Pinnacle West Capital Corporation	$2.60	$4.25	$43.25	3.62%	9.83%	1.02	10.00%	61.18%	38.82%	3.88%	4.40%
20	PNM Resources, Inc.	$1.08	$2.15	$23.60	3.31%	9.11%	1.02	9.26%	50.23%	49.77%	4.61%	4.62%
21	Portland General Electric Company	$1.25	$2.25	$26.75	3.18%	8.41%	1.02	8.54%	55.56%	44.44%	3.80%	4.88%
22	SCANA Corporation	$2.25	$4.00	$40.75	5.30%	9.82%	1.03	10.07%	56.25%	43.75%	4.41%	6.64%
23	Sempra Energy	$3.00	$5.50	$52.00	4.16%	10.58%	1.02	10.79%	54.55%	45.45%	4.91%	5.52%
24	Southern Company	$2.30	$3.25	$25.75	4.07%	12.62%	1.02	12.87%	70.77%	29.23%	3.76%	5.23%
25	Vectren Corporation	$1.60	$2.70	$23.00	4.37%	11.74%	1.02	11.99%	59.26%	40.74%	4.88%	5.86%
26	Westar Energy, Inc.	$1.52	$2.70	$29.65	5.31%	9.11%	1.03	9.34%	56.30%	43.70%	4.08%	4.60%
27	Wisconsin Energy Corporation	$2.00	$3.00	$21.25	3.32%	14.12%	1.02	14.35%	66.67%	33.33%	4.78%	4.78%
28	Xcel Energy Inc.	$1.35	$2.25	$23.00	4.80%	9.78%	1.02	10.01%	60.00%	40.00%	4.00%	4.62%
29	**Average**	**$1.97**	**$3.23**	**$31.99**	**4.32%**	**10.39%**	**1.02**	**10.61%**	**61.14%**	**38.86%**	**4.11%**	**5.04%**

Sources and Notes:
Cols. (1), (2) and (3): *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.
Col. (4): [Col. (3) / Page 2 Col. (2)] ^ (1/5) - 1.
Col. (5): Col. (2) / Col. (3).
Col. (6): [2 * (1 + Col. (4))] / (2 + Col. (4)).
Col. (7): Col. (6) * Col. (5).
Col. (8): Col. (1) / Col. (2).
Col. (9): 1 - Col. (8).
Col. (10): Col. (9) * Col. (7).
Col. (11): Col. (10) + Page 2 Col. (9).

Gulf Power Company

Sustainable Growth Rate

Line	Company	13-Week Average Stock Price[1] (1)	2012 Book Value Per Share[2] (2)	Market to Book Ratio (3)	Common Shares Outstanding (in Millions)[2] 2012 (4)	Common Shares Outstanding (in Millions)[2] 3-5 Years (5)	Growth (6)	S Factor[3] (7)	V Factor[4] (8)	S * V (9)
1	ALLETE, Inc.	$49.75	$30.48	1.63	39.40	45.50	2.92%	4.77%	38.74%	1.85%
2	Alliant Energy Corporation	$50.99	$28.25	1.81	110.99	116.00	0.89%	1.60%	44.60%	0.71%
3	American Electric Power Company, Inc.	$44.48	$31.37	1.42	485.67	505.00	0.78%	1.11%	29.48%	0.33%
4	Black Hills Corporation	$50.38	$27.88	1.81	44.21	45.70	0.67%	1.20%	44.66%	0.54%
5	CenterPoint Energy, Inc.	$23.76	$10.06	2.36	427.44	433.00	0.26%	0.61%	57.65%	0.35%
6	CMS Energy Corporation	$27.19	$12.09	2.25	264.10	274.00	0.74%	1.66%	55.54%	0.92%
7	Dominion Resources, Inc.	$58.69	$18.35	3.20	576.00	620.00	1.48%	4.74%	68.73%	3.26%
8	DTE Energy Company	$67.92	$42.78	1.59	172.35	190.00	1.97%	3.13%	37.02%	1.16%
9	Duke Energy Corporation	$68.12	$58.04	1.17	704.00	710.00	0.17%	0.20%	14.79%	0.03%
10	Great Plains Energy Inc.	$22.99	$21.75	1.06	153.53	156.00	0.32%	0.34%	5.39%	0.02%
11	Hawaiian Electric Industries, Inc.	$25.66	$16.28	1.58	97.93	124.50	4.92%	7.75%	36.55%	2.83%
12	Integrys Energy Group, Inc.	$58.74	$38.84	1.51	77.90	83.50	1.40%	2.11%	33.88%	0.72%
13	NextEra Energy, Inc.	$82.44	$37.90	2.18	424.00	455.00	1.42%	3.09%	54.02%	1.67%
14	Northeast Utilities	$42.25	$29.41	1.44	314.05	319.00	0.31%	0.45%	30.39%	0.14%
15	NorthWestern Corporation	$41.31	$25.09	1.65	37.22	39.00	0.94%	1.55%	39.26%	0.61%
16	OGE Energy Corp.	$35.88	$14.00	2.56	197.60	203.00	0.54%	1.39%	60.98%	0.84%
17	Otter Tail Corporation	$28.67	$14.43	1.99	36.17	40.00	2.03%	4.04%	49.66%	2.01%
18	Pepco Holdings, Inc.	$19.56	$19.33	1.01	230.02	255.00	2.08%	2.11%	1.17%	0.02%
19	Pinnacle West Capital Corporation	$55.98	$36.20	1.55	109.74	115.00	0.94%	1.45%	35.33%	0.51%
20	PNM Resources, Inc.	$22.69	$20.05	1.13	79.65	80.00	0.09%	0.10%	11.62%	0.01%
21	Portland General Electric Company	$30.07	$22.87	1.31	75.56	89.50	3.44%	4.53%	23.95%	1.08%
22	SCANA Corporation	$49.41	$31.47	1.57	132.00	160.00	3.92%	6.16%	36.31%	2.24%
23	Sempra Energy	$84.27	$42.42	1.99	242.37	250.00	0.62%	1.24%	49.66%	0.61%
24	Southern Company	$43.21	$21.09	2.05	867.77	930.00	1.39%	2.86%	51.19%	1.46%
25	Vectren Corporation	$34.39	$18.57	1.85	82.20	87.00	1.14%	2.11%	46.00%	0.97%
26	Westar Energy, Inc.	$31.97	$22.89	1.40	126.50	135.00	1.31%	1.83%	28.40%	0.52%
27	Wisconsin Energy Corporation	$41.57	$18.05	2.30	229.04	227.50	-0.13%	-0.31%	56.58%	-0.18%
28	Xcel Energy Inc.	$28.57	$18.19	1.57	487.96	515.00	1.08%	1.70%	36.34%	0.62%
29	**Average**	**$43.60**	**$26.00**	**1.75**	**243.76**	**257.26**	**1.40%**	**2.36%**	**38.50%**	**0.96%**

Sources and Notes:

[1] SNL Financial, Downloaded on September 25, 2013

[2] *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.

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

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

Gulf Power Company

Constant Growth DCF Model
(Sustainable Growth Rate)

Line	Company	13-Week AVG Stock Price[1] (1)	Sustainable Growth[2] (2)	Annualized Dividend[3] (3)	Adjusted Yield (4)	Constant Growth DCF (5)
1	ALLETE, Inc.	$49.75	6.17%	$1.90	4.05%	10.22%
2	Alliant Energy Corporation	$50.99	6.04%	$1.88	3.91%	9.95%
3	American Electric Power Company, Inc.	$44.48	4.22%	$1.96	4.59%	8.81%
4	Black Hills Corporation	$50.38	4.52%	$1.52	3.15%	7.67%
5	CenterPoint Energy, Inc.	$23.76	6.60%	$0.83	3.72%	10.32%
6	CMS Energy Corporation	$27.19	5.36%	$1.02	3.95%	9.31%
7	Dominion Resources, Inc.	$58.69	7.51%	$2.25	4.12%	11.64%
8	DTE Energy Company	$67.92	4.24%	$2.62	4.02%	8.26%
9	Duke Energy Corporation	$68.12	2.64%	$3.12	4.70%	7.34%
10	Great Plains Energy Inc.	$22.99	3.26%	$0.87	3.91%	7.17%
11	Hawaiian Electric Industries, Inc.	$25.66	5.05%	$1.24	5.08%	10.13%
12	Integrys Energy Group, Inc.	$58.74	3.46%	$2.72	4.79%	8.25%
13	NextEra Energy, Inc.	$82.44	7.35%	$2.64	3.44%	10.79%
14	Northeast Utilities	$42.25	4.38%	$1.47	3.63%	8.01%
15	NorthWestern Corporation	$41.31	4.53%	$1.52	3.85%	8.38%
16	OGE Energy Corp.	$35.88	6.21%	$0.84	2.47%	8.68%
17	Otter Tail Corporation	$28.67	5.98%	$1.19	4.41%	10.39%
18	Pepco Holdings, Inc.	$19.56	2.56%	$1.08	5.66%	8.23%
19	Pinnacle West Capital Corporation	$55.98	4.40%	$2.18	4.07%	8.46%
20	PNM Resources, Inc.	$22.69	4.62%	$0.66	3.04%	7.66%
21	Portland General Electric Company	$30.07	4.88%	$1.10	3.84%	8.72%
22	SCANA Corporation	$49.41	6.64%	$2.03	4.38%	11.02%
23	Sempra Energy	$84.27	5.52%	$2.52	3.16%	8.67%
24	Southern Company	$43.21	5.23%	$2.03	4.94%	10.17%
25	Vectren Corporation	$34.39	5.86%	$1.42	4.37%	10.23%
26	Westar Energy, Inc.	$31.97	4.60%	$1.36	4.45%	9.05%
27	Wisconsin Energy Corporation	$41.57	4.78%	$1.53	3.86%	8.64%
28	Xcel Energy Inc.	$28.57	4.62%	$1.12	4.10%	8.73%
29	**Average**	**$43.60**	**5.04%**	**$1.66**	**4.06%**	**9.10%**
30	**Median**					**8.72%**

Sources:

[1] SNL Financial, Downloaded on September 25, 2013

[2] Exhibit MPG-6, page 1.

[3] *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.

Gulf Power Company

Electricity Sales Are Linked to U.S. Economic Growth
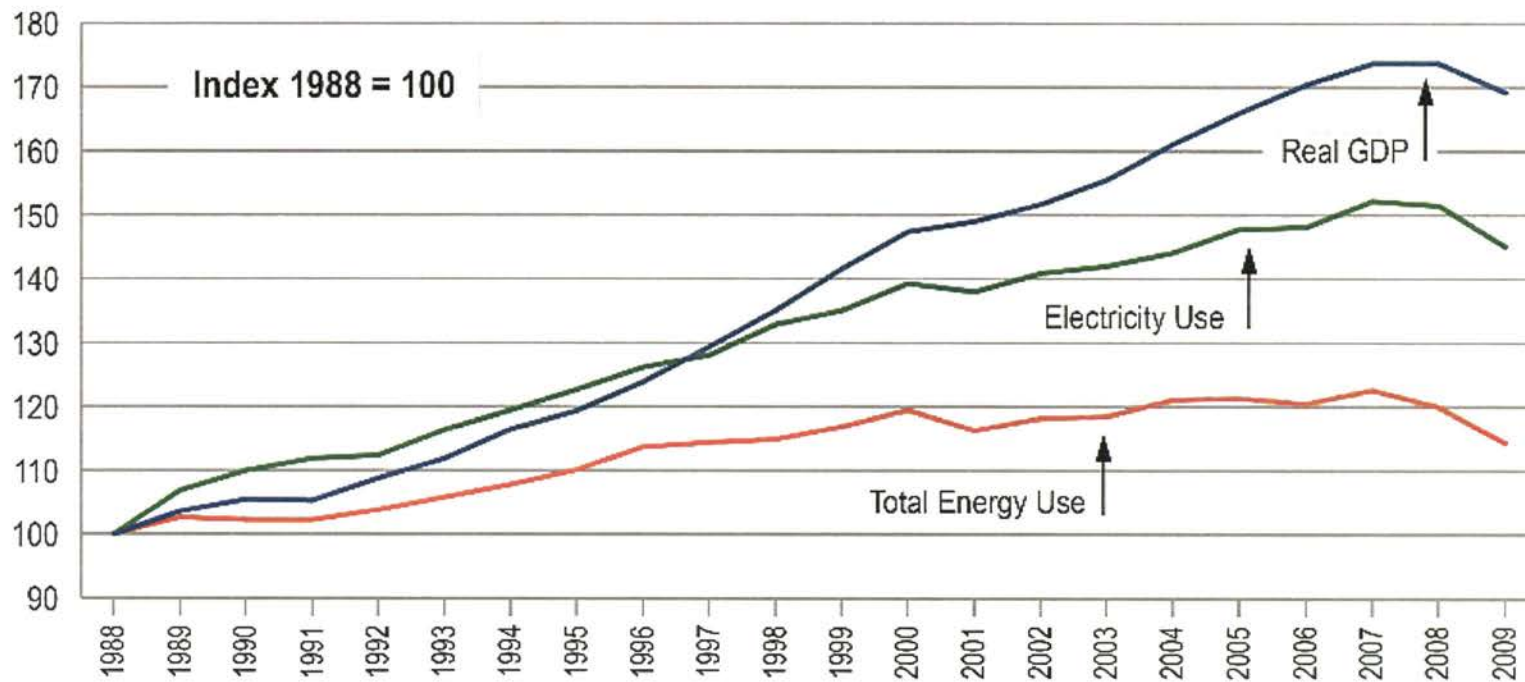
Note:
1988 represents the base year. Graph depicts increases or decreases from the base year.

Sources:
U.S. Department of Energy, Energy Information Administration.
Edison Electric Institute, http://www.eei.org.

Gulf Power Company

Multi-Stage Growth DCF Model

Line	Company	13-Week AVG Stock Price[1] (1)	Annualized Dividend[2] (2)	First Stage Growth[3] (3)	Second Stage Growth					Third Stage Growth[4] (9)	Multi-Stage Growth DCF (10)
					Year 6 (4)	Year 7 (5)	Year 8 (6)	Year 9 (7)	Year 10 (8)		
1	ALLETE, Inc.	$49.75	$1.90	6.00%	5.82%	5.63%	5.45%	5.27%	5.08%	4.90%	9.19%
2	Alliant Energy Corporation	$50.99	$1.88	5.02%	5.00%	4.98%	4.96%	4.94%	4.92%	4.90%	8.80%
3	American Electric Power Company, Inc.	$44.48	$1.96	3.98%	4.13%	4.28%	4.44%	4.59%	4.75%	4.90%	9.26%
4	Black Hills Corporation	$50.38	$1.52	4.33%	4.43%	4.52%	4.62%	4.71%	4.81%	4.90%	7.94%
5	CenterPoint Energy, Inc.	$23.76	$0.83	4.83%	4.84%	4.86%	4.87%	4.88%	4.89%	4.90%	8.55%
6	CMS Energy Corporation	$27.19	$1.02	5.84%	5.68%	5.53%	5.37%	5.21%	5.06%	4.90%	9.07%
7	Dominion Resources, Inc.	$58.69	$2.25	6.39%	6.14%	5.90%	5.65%	5.40%	5.15%	4.90%	9.31%
8	DTE Energy Company	$67.92	$2.62	4.58%	4.63%	4.69%	4.74%	4.79%	4.85%	4.90%	8.86%
9	Duke Energy Corporation	$68.12	$3.12	3.71%	3.91%	4.11%	4.31%	4.50%	4.70%	4.90%	9.36%
10	Great Plains Energy Inc.	$22.99	$0.87	6.37%	6.13%	5.88%	5.64%	5.39%	5.15%	4.90%	9.25%
11	Hawaiian Electric Industries, Inc.	$25.66	$1.24	2.83%	3.18%	3.52%	3.87%	4.21%	4.56%	4.90%	9.35%
12	Integrys Energy Group, Inc.	$58.74	$2.72	5.17%	5.12%	5.08%	5.03%	4.99%	4.94%	4.90%	9.84%
13	NextEra Energy, Inc.	$82.44	$2.64	6.20%	5.98%	5.76%	5.55%	5.33%	5.12%	4.90%	8.54%
14	Northeast Utilities	$42.25	$1.47	7.71%	7.24%	6.78%	6.31%	5.84%	5.37%	4.90%	9.25%
15	NorthWestern Corporation	$41.31	$1.52	5.25%	5.19%	5.13%	5.08%	5.02%	4.96%	4.90%	8.84%
16	OGE Energy Corp.	$35.88	$0.84	5.16%	5.12%	5.07%	5.03%	4.99%	4.94%	4.90%	7.36%
17	Otter Tail Corporation	$28.67	$1.19	N/A	N/A	N/A	N/A	N/A	N/A	4.90%	N/A
18	Pepco Holdings, Inc.	$19.56	$1.08	4.55%	4.61%	4.66%	4.72%	4.78%	4.84%	4.90%	10.57%
19	Pinnacle West Capital Corporation	$55.98	$2.18	4.64%	4.68%	4.72%	4.77%	4.81%	4.86%	4.90%	8.92%
20	PNM Resources, Inc.	$22.69	$0.66	7.33%	6.93%	6.52%	6.12%	5.71%	5.31%	4.90%	8.46%
21	Portland General Electric Company	$30.07	$1.10	6.01%	5.82%	5.64%	5.45%	5.27%	5.08%	4.90%	9.01%
22	SCANA Corporation	$49.41	$2.03	4.61%	4.66%	4.71%	4.76%	4.80%	4.85%	4.90%	9.13%
23	Sempra Energy	$84.27	$2.52	3.58%	3.80%	4.02%	4.24%	4.46%	4.68%	4.90%	7.76%
24	Southern Company	$43.21	$2.03	4.36%	4.45%	4.54%	4.63%	4.72%	4.81%	4.90%	9.67%
25	Vectren Corporation	$34.39	$1.42	5.00%	4.98%	4.97%	4.95%	4.93%	4.92%	4.90%	9.26%
26	Westar Energy, Inc.	$31.97	$1.36	2.79%	3.14%	3.49%	3.85%	4.20%	4.55%	4.90%	8.80%
27	Wisconsin Energy Corporation	$41.57	$1.53	5.30%	5.23%	5.16%	5.10%	5.03%	4.97%	4.90%	8.86%
28	Xcel Energy Inc.	$28.57	$1.12	4.66%	4.70%	4.74%	4.78%	4.82%	4.86%	4.90%	8.95%
29	**Average**	**$43.60**	**$1.66**	**5.04%**	**5.02%**	**5.00%**	**4.97%**	**4.95%**	**4.92%**	**4.90%**	**8.97%**
30	**Median**										**9.01%**

Sources:

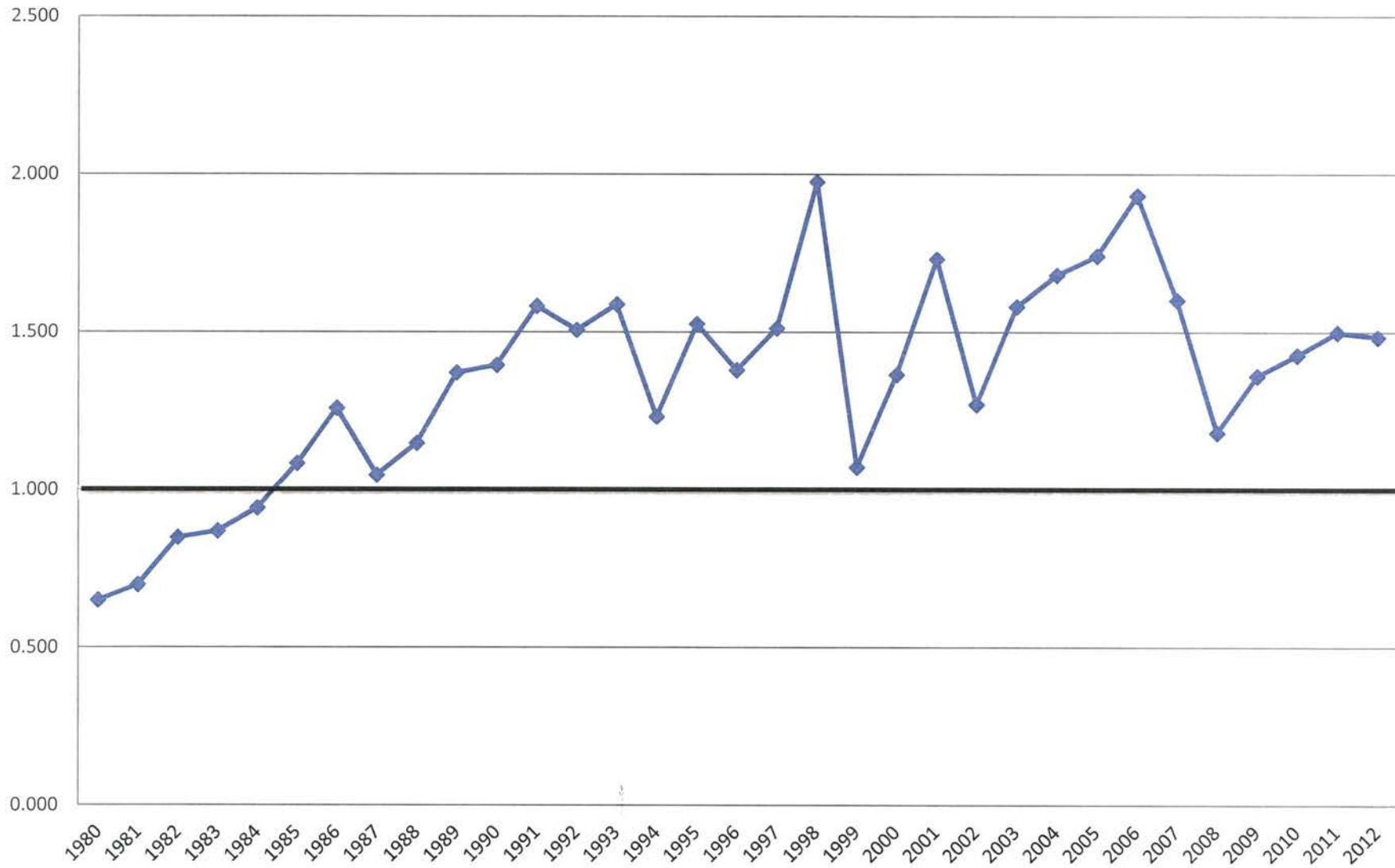[1] SNL Financial, Downloaded on September 25, 2013

[2] *The Value Line Investment Survey*, August 2, August 23, and September 20, 2013.

[3] Exhibit MPG-4.

[4] *Blue Chip Financial Forecasts,* June 1, 2013 at 14.

Gulf Power Company

Common Stock Market/Book Ratio

Gulf Power Company

Equity Risk Premium - Treasury Bond

Line	Year	Authorized Electric Returns[1] (1)	Treasury Bond Yield[2] (2)	Indicated Risk Premium (3)
1	1986	13.93%	7.80%	6.13%
2	1987	12.99%	8.58%	4.41%
3	1988	12.79%	8.96%	3.83%
4	1989	12.97%	8.45%	4.52%
5	1990	12.70%	8.61%	4.09%
6	1991	12.55%	8.14%	4.41%
7	1992	12.09%	7.67%	4.42%
8	1993	11.41%	6.60%	4.81%
9	1994	11.34%	7.37%	3.97%
10	1995	11.55%	6.88%	4.67%
11	1996	11.39%	6.70%	4.69%
12	1997	11.40%	6.61%	4.79%
13	1998	11.66%	5.58%	6.08%
14	1999	10.77%	5.87%	4.90%
15	2000	11.43%	5.94%	5.49%
16	2001	11.09%	5.49%	5.60%
17	2002	11.16%	5.43%	5.73%
18	2003	10.97%	4.96%	6.01%
19	2004	10.75%	5.05%	5.70%
20	2005	10.54%	4.65%	5.89%
21	2006	10.36%	4.99%	5.37%
22	2007	10.36%	4.83%	5.53%
23	2008	10.46%	4.28%	6.18%
24	2009	10.48%	4.07%	6.41%
25	2010	10.34%	4.25%	6.09%
26	2011	10.22%	3.91%	6.31%
27	2012	10.00%	2.92%	7.08%
28	2013 [3]	9.80%	3.14%	6.66%
29	Average	11.34%	5.99%	5.35%

Sources:

[1] Regulatory Research Associates, Inc., *Regulatory Focus,* Jan. 85 - Dec. 06, and July 9, 2013, excluding the VA cases, which are subject to a 200 basis point adjustment for certain generation assets.

[2] St. Louis Federal Reserve: Economic Research, http://research.stlouisfed.org/. The yields from 2002 to 2005 represent the 20-Year Treasury yields obtained from the Federal Reserve Bank.

[3] The data includes the period Jan - Jun 2013.

Gulf Power Company

Equity Risk Premium - Utility Bond

Line	Year	Authorized Electric Returns[1] (1)	Average "A" Rated Utility Bond Yield[2] (2)	Indicated Risk Premium (3)
1	1986	13.93%	9.58%	4.35%
2	1987	12.99%	10.10%	2.89%
3	1988	12.79%	10.49%	2.30%
4	1989	12.97%	9.77%	3.20%
5	1990	12.70%	9.86%	2.84%
6	1991	12.55%	9.36%	3.19%
7	1992	12.09%	8.69%	3.40%
8	1993	11.41%	7.59%	3.82%
9	1994	11.34%	8.31%	3.03%
10	1995	11.55%	7.89%	3.66%
11	1996	11.39%	7.75%	3.64%
12	1997	11.40%	7.60%	3.80%
13	1998	11.66%	7.04%	4.62%
14	1999	10.77%	7.62%	3.15%
15	2000	11.43%	8.24%	3.19%
16	2001	11.09%	7.76%	3.33%
17	2002	11.16%	7.37%	3.79%
18	2003	10.97%	6.58%	4.39%
19	2004	10.75%	6.16%	4.59%
20	2005	10.54%	5.65%	4.89%
21	2006	10.36%	6.07%	4.29%
22	2007	10.36%	6.07%	4.29%
23	2008	10.46%	6.53%	3.93%
24	2009	10.48%	6.04%	4.44%
25	2010	10.34%	5.46%	4.88%
26	2011	10.22%	5.04%	5.18%
27	2012	10.00%	4.13%	5.87%
28	2013 [3]	9.80%	4.20%	5.60%
29	Average	11.34%	7.39%	3.95%

Sources:

[1] Regulatory Research Associates, Inc., *Regulatory Focus,* Jan. 85 - Dec. 06, and July 9, 2013, excluding the VA cases, which are subject to a 200 basis point adjustment for certain generation assets.

[2] Mergent Public Utility Manual, Mergent Weekly News Reports, 2003. The utility yields for the period 2001-2009 were obtained from the Mergent Bond Record. The utility yields from 2010-2013 were obtained from http://credittrends.moodys.com/.
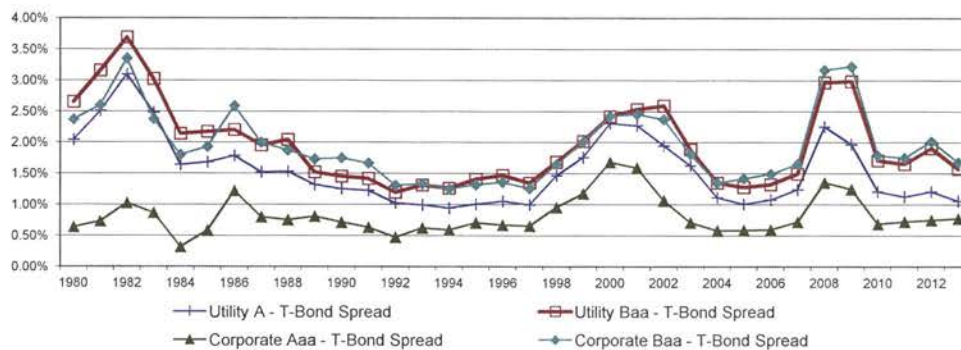
[3] The data includes the period Jan - Jun 2013.

Gulf Power Company

Bond Yield Spreads

Line	Year	T-Bond Yield[1] (1)	Public Utility Bond				Corporate Bond				Utility to Corporate	
			A[2] (2)	Baa[2] (3)	A-T-Bond Spread (4)	Baa-T-Bond Spread (5)	Aaa[1] (6)	Baa[1] (7)	Aaa-T-Bond Spread (8)	Baa-T-Bond Spread (9)	Baa Spread (10)	A-Aaa Spread (11)
1	1980	11.30%	13.34%	13.95%	2.04%	2.65%	11.94%	13.67%	0.64%	2.37%	0.28%	1.40%
2	1981	13.44%	15.95%	16.60%	2.51%	3.16%	14.17%	16.04%	0.73%	2.60%	0.56%	1.78%
3	1982	12.76%	15.86%	16.45%	3.10%	3.69%	13.79%	16.11%	1.03%	3.35%	0.34%	2.07%
4	1983	11.18%	13.66%	14.20%	2.48%	3.02%	12.04%	13.55%	0.86%	2.38%	0.65%	1.62%
5	1984	12.39%	14.03%	14.53%	1.64%	2.14%	12.71%	14.19%	0.32%	1.80%	0.34%	1.32%
6	1985	10.79%	12.47%	12.96%	1.68%	2.17%	11.37%	12.72%	0.58%	1.93%	0.24%	1.10%
7	1986	7.80%	9.58%	10.00%	1.78%	2.20%	9.02%	10.39%	1.22%	2.59%	-0.39%	0.56%
8	1987	8.58%	10.10%	10.53%	1.52%	1.95%	9.38%	10.58%	0.80%	2.00%	-0.05%	0.72%
9	1988	8.96%	10.49%	11.00%	1.53%	2.04%	9.71%	10.83%	0.75%	1.87%	0.17%	0.78%
10	1989	8.45%	9.77%	9.97%	1.32%	1.52%	9.26%	10.18%	0.81%	1.73%	-0.21%	0.51%
11	1990	8.61%	9.86%	10.06%	1.25%	1.45%	9.32%	10.36%	0.71%	1.75%	-0.29%	0.54%
12	1991	8.14%	9.36%	9.55%	1.22%	1.41%	8.77%	9.80%	0.63%	1.67%	-0.25%	0.59%
13	1992	7.67%	8.69%	8.86%	1.02%	1.19%	8.14%	8.98%	0.47%	1.31%	-0.12%	0.55%
14	1993	6.60%	7.59%	7.91%	0.99%	1.31%	7.22%	7.93%	0.62%	1.33%	-0.02%	0.37%
15	1994	7.37%	8.31%	8.63%	0.94%	1.26%	7.96%	8.62%	0.59%	1.25%	0.01%	0.35%
16	1995	6.88%	7.89%	8.29%	1.01%	1.41%	7.59%	8.20%	0.71%	1.32%	0.09%	0.30%
17	1996	6.70%	7.75%	8.17%	1.05%	1.47%	7.37%	8.05%	0.67%	1.35%	0.12%	0.38%
18	1997	6.61%	7.60%	7.95%	0.99%	1.34%	7.26%	7.86%	0.66%	1.26%	0.09%	0.34%
19	1998	5.58%	7.04%	7.26%	1.46%	1.68%	6.53%	7.22%	0.95%	1.64%	0.04%	0.51%
20	1999	5.87%	7.62%	7.88%	1.75%	2.01%	7.04%	7.87%	1.18%	2.01%	0.01%	0.58%
21	2000	5.94%	8.24%	8.36%	2.30%	2.42%	7.62%	8.36%	1.68%	2.42%	-0.01%	0.62%
22	2001	5.49%	7.76%	8.03%	2.27%	2.54%	7.08%	7.95%	1.59%	2.45%	0.08%	0.68%
23	2002	5.43%	7.37%	8.02%	1.94%	2.59%	6.49%	7.80%	1.06%	2.37%	0.22%	0.88%
24	2003	4.96%	6.58%	6.84%	1.62%	1.89%	5.67%	6.77%	0.71%	1.81%	0.08%	0.91%
25	2004	5.05%	6.16%	6.40%	1.11%	1.35%	5.63%	6.39%	0.58%	1.35%	0.00%	0.53%
26	2005	4.65%	5.65%	5.93%	1.00%	1.28%	5.24%	6.06%	0.59%	1.42%	-0.14%	0.41%
27	2006	4.99%	6.07%	6.32%	1.08%	1.32%	5.59%	6.48%	0.60%	1.49%	-0.16%	0.48%
28	2007	4.83%	6.07%	6.33%	1.24%	1.50%	5.56%	6.48%	0.72%	1.65%	-0.15%	0.52%
29	2008	4.28%	6.53%	7.25%	2.25%	2.97%	5.63%	7.45%	1.35%	3.17%	-0.20%	0.90%
30	2009	4.07%	6.04%	7.06%	1.97%	2.99%	5.31%	7.30%	1.24%	3.23%	-0.24%	0.72%
31	2010	4.25%	5.46%	5.96%	1.21%	1.71%	4.94%	6.04%	0.69%	1.79%	-0.08%	0.52%
32	2011	3.91%	5.04%	5.56%	1.13%	1.65%	4.64%	5.66%	0.73%	1.75%	-0.10%	0.40%
33	2012	2.92%	4.13%	4.83%	1.21%	1.91%	3.67%	4.94%	0.75%	2.01%	-0.11%	0.46%
34	2013 [3]	3.14%	4.20%	4.72%	1.06%	1.58%	3.92%	4.82%	0.78%	1.68%	-0.10%	0.28%
35	Average	7.05%	8.60%	9.01%	1.55%	1.96%	7.87%	8.99%	0.82%	1.94%	0.02%	0.73%

Yield Spreads
Treasury Vs. Corporate & Treasury Vs. Utility

Legend:
- Utility A - T-Bond Spread
- Utility Baa - T-Bond Spread
- Corporate Aaa - T-Bond Spread
- Corporate Baa - T-Bond Spread

Sources:

[1] St. Louis Federal Reserve: Economic Research, http://research.stlouisfed.org/.

[2] Mergent Public Utility Manual, Mergent Weekly News Reports, 2003. The utility yields for the period 2001-2009 were obtained from the Mergent Bond Record. The utility yields from 2010-2012 were obtained from http://credittrends.moodys.com/.

[3] The data includes the period Jan - Jun 2013.

Gulf Power Company

Treasury and Utility Bond Yields

Line	Date	Treasury Bond Yield[1] (1)	"A" Rated Utility Bond Yield[2] (2)	"Baa" Rated Utility Bond Yield[2] (3)
1	09/20/13	3.77%	4.79%	5.27%
2	09/13/13	3.84%	4.85%	5.37%
3	09/06/13	3.87%	4.86%	5.37%
4	08/30/13	3.70%	4.67%	5.17%
5	08/23/13	3.80%	4.79%	5.32%
6	08/16/13	3.86%	4.83%	5.39%
7	08/09/13	3.63%	4.61%	5.17%
8	08/02/13	3.69%	4.63%	5.18%
9	07/26/13	3.61%	4.62%	5.13%
10	07/19/13	3.56%	4.62%	5.12%
11	07/12/13	3.64%	4.76%	5.28%
12	07/05/13	3.68%	4.82%	5.38%
13	06/28/13	3.52%	4.67%	5.23%
14	**Average**	**3.71%**	**4.73%**	**5.26%**
15	**Spread To Treasury**		**1.02%**	**1.55%**

Sources:

[1] St. Louis Federal Reserve: Economic Research, http://research.stlouisfed.org.

[2] http://credittrends.moodys.com/.
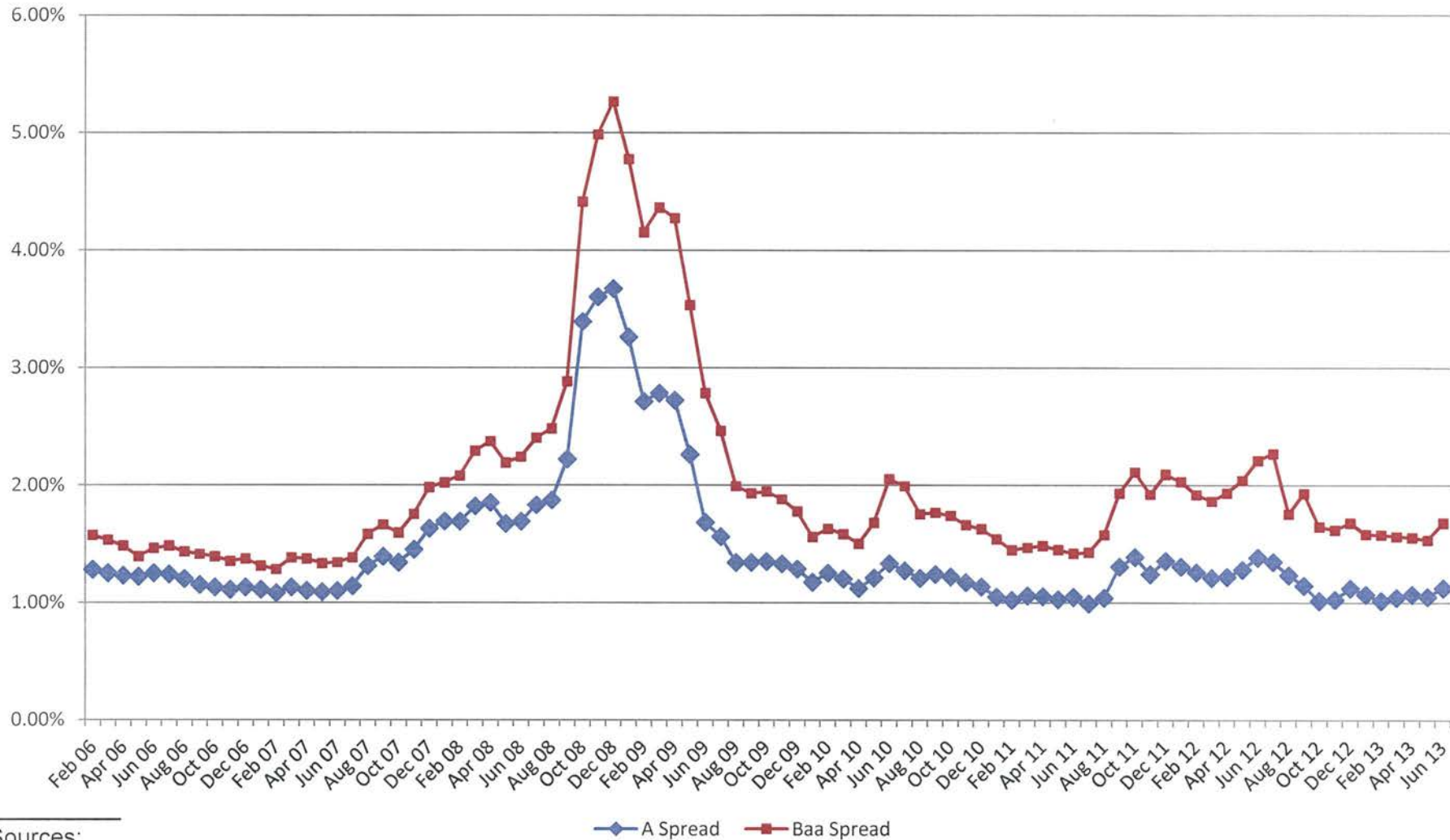
Gulf Power Company

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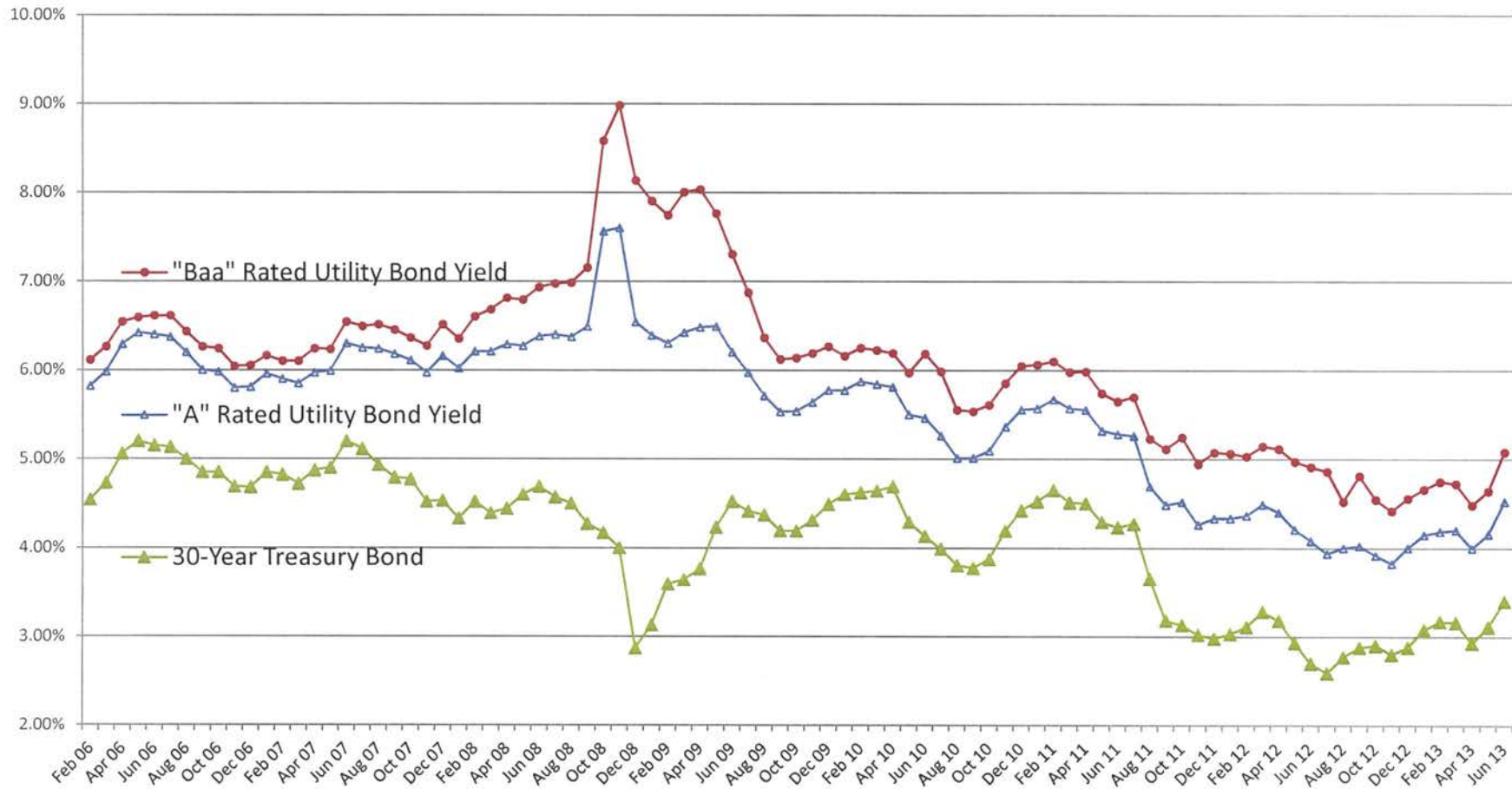
Sources:
Merchant Bond Record.
www.moodys.com, Bond Yields and Key Indicators.
St. Louis Federal Reserve: Economic Research, http://research.stlouisfed.org/

Gulf Power Company

Yield Spread Between Utility Bonds and 30-Year Treasury Bonds

Gulf Power Company

Value Line Beta

Line	Company	Beta
1	ALLETE, Inc.	0.70
2	Alliant Energy Corporation	0.75
3	American Electric Power Company, Inc.	0.70
4	Black Hills Corporation	0.80
5	CenterPoint Energy, Inc.	0.80
6	CMS Energy Corporation	0.75
7	Dominion Resources, Inc.	0.70
8	DTE Energy Company	0.75
9	Duke Energy Corporation	0.60
10	Great Plains Energy Inc.	0.80
11	Hawaiian Electric Industries, Inc.	0.70
12	Integrys Energy Group, Inc.	0.90
13	NextEra Energy, Inc.	0.70
14	Northeast Utilities	0.75
15	NorthWestern Corporation	0.70
16	OGE Energy Corp.	0.75
17	Otter Tail Corporation	0.90
18	Pepco Holdings, Inc.	0.75
19	Pinnacle West Capital Corporation	0.70
20	PNM Resources, Inc.	0.95
21	Portland General Electric Company	0.75
22	SCANA Corporation	0.65
23	Sempra Energy	0.80
24	Southern Company	0.55
25	Vectren Corporation	0.75
26	Westar Energy, Inc.	0.75
27	Wisconsin Energy Corporation	0.65
28	Xcel Energy Inc.	0.60
29	**Average**	**0.74**

Gulf Power Company

CAPM Return

Line	Description	Market Risk Premium
1	Risk-Free Rate[1]	4.20%
2	Risk Premium[2]	6.70%
3	Beta[3]	0.74
4	**CAPM**	**9.14%**

Sources:

[1] *Blue Chip Financial Forecasts*; September 1, 2013, at 2.

[2] Morningstar, Inc. *Ibbotson SBBI 2013 Classic Yearbook* at 88, and Morningstar, Inc. *Ibbotson SBBI 2013 Valuation Yearbook* at 54 and 66.

[3] Exhibit MPG-15

Gulf Power Company

Standard & Poor's Credit Metrics

Line	Description	Retail Cost of Service Amount (1)	S&P Benchmark[1/2] Significant (2)	Significant (3)	Reference (4)
1	Rate Base	$ 1,883,901			Schedule A-1.
2	Weighted Common Return	4.49%			Page 2, Line 4, Col. 4.
3	Pre-Tax Rate of Return	9.91%			Page 2, Line 5, Col. 5.
4	Income to Common	$ 84,495			Line 1 x Line 2.
5	EBIT	$ 186,754			Line 1 x Line 3.
6	Depreciation & Amortization	$ 104,505			Schedule C-1.
7	Imputed Amortization	$ 9,385			Page 4, Line 11, Col. 1.
8	Deferred Income Taxes & ITC	$ 12,686			Schedule C-1.
9	Funds from Operations (FFO)	$ 211,071			Sum of Line 4 and Lines 6 through 8.
10	Imputed Interest Expense	$ 1,313			Page 4, Line 10, Col. 1.
11	EBITDA	$ 301,957			Sum of Lines 5 through 7 and Line 10.
12	Total Debt Ratio	47%	45% - 50%	50% - 60%	Page 3, Line 4, Col. 2.
13	Debt to EBITDA	3.0x	3.0x - 4.0x	4.0x - 5.0x	(Line 1 x Line 12) / Line 11.
14	FFO to Total Debt	24%	20% - 30%	12% - 20%	Line 9 / (Line 1 x Line 12).

Sources:

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

[2] S&P RatingsDirect: "U.S. Regulated Electric Utilities, Strongest to Weakest," July 30, 2013.

Note:

Based on the July 2013 S&P metrics, Gulf Power has an "Excellent" business profile and a "Significant" financial profile.

Gulf Power Company

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

Line	Description	Amount (000) (1)	Weight (2)	Cost (3)	Weighted Cost (4)	Pre-Tax Weighted Cost (5)
1	Long-Term Debt	$ 567,191	45.46%	4.96%	2.25%	2.25%
2	Short-Term Debt	$ 22,865	1.83%	0.82%	0.02%	0.02%
3	Preferrence Stock	$ 65,481	5.25%	6.00%	0.31%	0.31%
4	Common Equity	$ 592,193	47.46%	9.45%	4.49%	7.33%
5	Total	$ 1,247,730	100.00%		7.07%	9.91%
6	Tax Conversion Factor*					1.6340

Sources:
Exhibit MPG-1.
* Schedule A-1.

Gulf Power Company

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

Line	Description	Amount (000) (1)	Weight (2)
1	Long-Term Debt	$ 567,191	45.41%
2	Short-Term Debt	$ 22,865	1.83%
3	Off Balance Sheet Debt*	$ 1,276	0.10%
4	**Total Debt**	$ 591,332	47.34%
5	Preferrence Stock	$ 65,481	5.24%
6	Common Equity	$ 592,193	47.41%
7	**Total**	$ 1,249,006	100.00%

Sources:
Exhibit MPG-1.

Gulf Power Company

Standard & Poor's Credit Metrics
(Off-Balance Sheet Debt)

Line	Description		Amount (000) (1)	Reference (2)
	Jurisdictional Allocator			
1	Jurisdictional Rate Base	$	1,883,901	Schedule B-1.
2	Total Company Rate Base		1,919,769	Schedule B-1.
3	Allocation Factor		0.981317	Line 1 / Line 2.
	Total Company[1]			
4	Operating Leases	$	812	
5	Imputed Interest Expense	$	38	
6	Imputed Amortization Expense	$	372	
7	Purchase Power Agreements	$	465	
8	Imputed Interest Expense	$	1,300	
9	Imputed Amortization Expense	$	9,191	
	Jurisdiction Allocation			
10	Imputed Interest Expense	$	1,313	Line 4 * Lines 6 and 9.
11	Imputed Amortization Expense	$	9,385	Line 4 * Lines 7 and 10.

Source:

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

Gulf Power Company

Accuracy of Interest Rate Forecasts
(Long-Term Treasury Bond Yields - Projected Vs. Actual)

| Line | Date | Publication Data | | | Actual Yield in Projected Quarter | Projected Yield Higher (Lower) Than Actual Yield* |
		Prior Quarter Actual Yield (1)	Projected Yield (2)	Projected Quarter (3)	(4)	(5)
1	Dec-00	5.8%	5.8%	1Q, 02	5.6%	0.2%
2	Mar-01	5.7%	5.6%	2Q, 02	5.8%	-0.2%
3	Jun-01	5.4%	5.8%	3Q, 02	5.2%	0.6%
4	Sep-01	5.7%	5.9%	4Q, 02	5.1%	0.8%
5	Dec-01	5.5%	5.7%	1Q, 03	5.0%	0.7%
6	Mar-02	5.3%	5.9%	2Q, 03	4.7%	1.2%
7	Jun-02	5.6%	6.2%	3Q, 03	5.2%	1.0%
8	Sep-02	5.8%	5.9%	4Q, 03	5.2%	0.7%
9	Dec-02	5.2%	5.7%	1Q, 04	4.9%	0.8%
10	Mar-03	5.1%	5.7%	2Q, 04	5.4%	0.3%
11	Jun-03	5.0%	5.4%	3Q, 04	5.1%	0.3%
12	Sep-03	4.7%	5.8%	4Q, 04	4.9%	0.9%
13	Dec-03	5.2%	5.9%	1Q, 05	4.8%	1.1%
14	Mar-04	5.2%	5.9%	2Q, 05	4.6%	1.4%
15	Jun-04	4.9%	6.2%	3Q, 05	4.5%	1.7%
16	Sep-04	5.4%	6.0%	4Q, 05	4.8%	1.2%
17	Dec-04	5.1%	5.8%	1Q, 06	4.6%	1.2%
18	Mar-05	4.9%	5.6%	2Q, 06	5.1%	0.5%
19	Jun-05	4.8%	5.5%	3Q, 06	5.0%	0.5%
20	Sep-05	4.6%	5.2%	4Q, 06	4.7%	0.5%
21	Dec-05	4.5%	5.3%	1Q, 07	4.8%	0.5%
22	Mar-06	4.8%	5.1%	2Q, 07	5.0%	0.1%
23	Jun-06	4.6%	5.3%	3Q, 07	4.9%	0.4%
24	Sep-06	5.1%	5.2%	4Q, 07	4.6%	0.6%
25	Dec-06	5.0%	5.0%	1Q, 08	4.4%	0.6%
26	Mar-07	4.7%	5.1%	2Q, 08	4.6%	0.5%
27	Jun-07	4.8%	5.1%	3Q, 08	4.5%	0.7%
28	Sep-07	5.0%	5.2%	4Q, 08	3.7%	1.5%
29	Dec-07	4.9%	4.8%	1Q, 09	3.5%	1.4%
30	Mar-08	4.6%	4.8%	2Q, 09	4.0%	0.8%
31	Jun-08	4.4%	4.9%	3Q, 09	4.3%	0.6%
32	Sep-08	4.6%	5.1%	4Q, 09	4.3%	0.8%
33	Dec-08	4.5%	4.6%	1Q, 10	4.6%	0.0%
34	Mar-09	3.7%	4.1%	2Q, 10	4.4%	-0.3%
35	Jun-09	3.5%	4.6%	3Q, 10	3.9%	0.8%
36	Sep-09	4.0%	5.0%	4Q, 10	4.2%	0.8%
37	Dec-09	4.3%	5.0%	1Q, 11	4.6%	0.4%
38	Mar-10	4.3%	5.2%	2Q, 11	4.3%	0.9%
39	Jun-10	4.6%	5.2%	3Q, 11	3.7%	1.5%
40	Sep-10	4.4%	4.7%	4Q, 11	3.0%	1.7%
41	Dec-10	3.9%	4.6%	1Q, 12	3.1%	1.5%
42	Mar-11	4.2%	5.1%	2Q, 12	2.9%	2.2%
43	Jun-11	4.6%	5.2%	3Q, 12	2.8%	2.5%
44	Sep-11	4.3%	4.2%	4Q, 12	2.9%	1.3%
45	Dec-11	3.7%	3.8%	1Q, 13	3.1%	0.7%
46	Mar-12	3.0%	3.8%	2Q, 13	3.2%	0.7%
47	Apr-12	3.1%	3.9%	3Q, 13		
48	May-12	3.1%	3.9%	3Q, 13		
49	Jun-12	3.1%	3.7%	3Q, 13		
50	Jul-12	2.9%	3.6%	4Q, 13		
51	Aug-12	2.9%	3.4%	4Q, 13		
52	Sep-12	2.9%	3.4%	4Q, 13		
53	Oct-12	2.8%	3.4%	1Q, 14		
54	Nov-12	2.8%	3.4%	1Q, 14		
55	Dec-12	2.8%	3.4%	1Q, 14		
56	Jan-13	2.9%	3.4%	2Q, 14		
57	Feb-13	2.9%	3.5%	2Q, 14		
58	Mar-13	2.9%	3.6%	2Q, 14		
59	Apr-13	3.1%	3.7%	3Q, 14		
60	May-13	3.1%	3.7%	3Q, 14		
61	Jun-13	3.1%	3.7%	3Q, 14		
62	Jul-13	3.1%	4.0%	4Q, 14		
63	Aug-13	3.2%	4.1%	4Q, 14		
64	Sep-13	3.2%	4.2%	4Q, 14		

Source:
Blue Chip Financial Forecasts, Various Dates.
* Col. 2 - Col. 4.

<u>CERTIFICATE OF SERVICE</u>

I HEREBY CERTIFY that a true copy of FEDERAL EXECUTIVE AGENCIES' TESTIMONY has been furnished to the following by electronic mail this 16th day of October, 2013:

J. R. Kelly
Joseph McGlothlin
Office of the Public Counsel
c/o Florida Legislature
111 West Madison Street, Room 812
Tallahassee, FL 32399-1400
mcglothlin.joseph@leg.state.fl.us

Jon C. Moyle
Karen A. Putnal
Moyle Law Firm
118 North Gadsden Street
Tallahassee, FL 32301
jmoyle@moylelaw.com
kputnal@moylelaw.com

Maj Christopher Thompson, USAF
AFLOA/JACE-ULFSC
139 Barnes Drive, Suite 1
Tyndall Air Force Base, FL 32403
christopher.thompson.5@us.af.mil

Richard D. Melson
705 Piedmont Drive
Tallahassee, FL 32312
rick@rmelsonlaw.com

Robert L. McGee, Jr.
One Energy Place
Pensacola, Florida 32520-0780
rlmcgee@southernco.com

Jeffrey A. Stone, jas@beggslane.com
Russell A. Badders, rab@beggslane.com
Steven Griffin, srg@beggslane.com
Beggs & Lane
P.O. Box 12950
Pensacola, FL 32591-2950

Suzzane Brownless
Martha Barrera/ Martha Brown
Office Of The General Counsel
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850
sbrownle@psc.state.fl.us
mbarrera@psc.state.fl.us
mbrown@psc.state.fl.us

Wal-Mart Stores East. L.P. and Sam's East, Inc.
c/o Robert Scheffel Wright
John T. La Via, III
Gardner Bist Law Firm
1300 Thomaswood Drive
Tallahassee, FL 32303
schef@gbwlegal.com
jlavia@gbwlegal.com

s/cct
_____
Major Christopher Thompson
Staff Attorney
USAF Utility Law Field Support Center
AFLOA/JCAE – ULFSC
139 Barnes Drive, Suite 1
Tyndall AFB, FL 32403-5319
Phone: 850-283-6350
Email: Christopher.Thompson.5@us.af.mil