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ALABAMA POWER CO  
Form S-3  
October 24, 2002

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON OCTOBER 24, 2002.

SUBJECT TO AMENDMENT. REGISTRATION NOS.

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM S-3  
REGISTRATION STATEMENT  
UNDER  
THE SECURITIES ACT OF 1933  
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ALABAMA POWER COMPANY	ALABAMA	
ALABAMA POWER CAPITAL TRUST VI	DELAWARE	A
ALABAMA POWER CAPITAL TRUST VII	DELAWARE	A
ALABAMA POWER CAPITAL TRUST VIII	DELAWARE	A
(Exact name of registrant as specified in its charter)	(State or other jurisdiction of incorporation or organization)	(I.R.S. Emp

600 NORTH 18TH STREET  
BIRMINGHAM, ALABAMA 35203  
(205) 257-1000  
(Address, including zip code, and telephone number, including area code, of each registrant's principal executive offices)

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WILLIAM E. ZALES, JR.  
VICE PRESIDENT AND CORPORATE SECRETARY  
ALABAMA POWER COMPANY  
600 NORTH 18TH STREET  
BIRMINGHAM, ALABAMA 35203  
(205) 257-2714  
(Name, address, including zip code, and telephone number, including area code, of agent for service of each registrant)

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THE COMMISSION IS REQUESTED TO MAIL SIGNED COPIES OF ALL ORDERS, NOTICES AND COMMUNICATIONS TO:

GALE E. KLAPPA  
FINANCIAL VICE PRESIDENT  
THE SOUTHERN COMPANY  
270 PEACHTREE STREET, N.W.

WALTER M. BEALE, JR., ESQ.  
BALCH & BINGHAM LLP  
1901 SIXTH AVENUE NORTH  
SUITE 2600

JOHN D. MCLANAHAN, ESQ.  
TROUTMAN SANDERS LLP  
600 PEACHTREE STREET, N.E.  
SUITE 5200

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ATLANTA, GEORGIA 30303

BIRMINGHAM, ALABAMA 35203

ATLANTA, GEORGIA 30308-2216

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 APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC: From time to time after the effective date of this registration statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. [ ]

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box: [X]

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ] \_\_\_\_\_

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [ ] \_\_\_\_\_

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. [ ]

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 CALCULATION OF REGISTRATION FEE

TITLE OF EACH CLASS OF SECURITIES TO BE REGISTERED	AMOUNT TO BE REGISTERED (1)	PROPOSED MAXIMUM OFFERING PRICE PER UNIT (1) (2) (3)
Alabama Power Company Class A Preferred Stock.....		
Alabama Power Company First Mortgage Bonds.....		
Alabama Power Capital Trust VI Preferred Securities...		
Alabama Power Capital Trust VII Preferred Securities.....		
Alabama Power Capital Trust VIII Preferred Securities.....		
Alabama Power Company Senior Notes.....		
Alabama Power Company Junior Subordinated Notes.....		
Alabama Power Company Guarantees with respect to Preferred Securities of Alabama Power Capital Trust VI, Alabama Power Capital Trust VII and Alabama Power Capital Trust VIII(4) (5).....		
Total.....	\$2,045,000,000	100%

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- (1) There are being registered hereunder such presently indeterminate number of Preferred Securities of Alabama Power Capital Trust VI, Alabama Power Capital Trust VII and Alabama Power Capital Trust VIII, such presently indeterminate number of Class A Preferred Stock and such presently indeterminate principal amount of First Mortgage Bonds, Senior Notes and Junior Subordinated Notes of Alabama Power Company with an aggregate initial offering price not to exceed \$2,045,000,000. Junior Subordinated Notes also may be issued to Alabama Power Capital Trust VI, Alabama Power Capital Trust VII or Alabama Power Capital Trust VIII and later distributed upon dissolution and distribution of the assets thereof, which would include such Junior Subordinated Notes for which no separate consideration will be received. Pursuant to Rule 457(o) under the Securities Act of 1933, which permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed, the table does not specify by each class information as to the amount to be registered, proposed maximum offering price per unit or proposed maximum aggregate offering price.
- (2) Estimated solely for the purpose of determining the registration fee.
- (3) Exclusive of accrued interest and distributions, if any.
- (4) No separate consideration will be received for the Alabama Power Company Guarantees. Pursuant to Rule 457(n) no separate fee is payable in respect of the Alabama Power Company Guarantees.
- (5) Includes the obligations of Alabama Power Company under the respective Trust Agreements, the Subordinated Note Indenture, the related series of Junior Subordinated Notes, the respective Guarantees and the respective Agreements as to Expenses and Liabilities, which include the Company's covenant to pay any indebtedness, expenses or liabilities of the Trusts (other than obligations pursuant to the terms of the Preferred Securities or other similar interests), all as described in this registration statement.

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THE REGISTRANTS HEREBY AMEND THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANTS SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

The within Prospectus contains information required by Rule 429 of the Commission under the Securities Act of 1933 with respect to \$25,000,000 of Class A Preferred Stock, First Mortgage Bonds, Preferred Securities, Senior Notes, Junior Subordinated Notes and Alabama Power Company Guarantees remaining unsold under Registration Statement No. 333-72784, declared effective November 15, 2001 for which a fee of \$2,300 was paid.

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This information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

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SUBJECT TO COMPLETION, DATED OCTOBER 24, 2002

PROSPECTUS

ALABAMA POWER COMPANY  
FIRST MORTGAGE BONDS  
CLASS A PREFERRED STOCK  
CUMULATIVE, PAR VALUE \$1 PER SHARE

SENIOR NOTES  
JUNIOR SUBORDINATED NOTES

ALABAMA POWER CAPITAL TRUST VI  
ALABAMA POWER CAPITAL TRUST VII  
ALABAMA POWER CAPITAL TRUST VIII  
TRUST PREFERRED SECURITIES  
FULLY AND UNCONDITIONALLY GUARANTEED, AS SET FORTH HEREIN, BY  
ALABAMA POWER COMPANY  
A SUBSIDIARY OF THE SOUTHERN COMPANY

We will provide the specific terms of these securities in supplements to this Prospectus. You should read this Prospectus and the applicable Prospectus Supplement carefully before you invest.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

This Prospectus is dated \_\_\_\_\_, 2002

## ABOUT THIS PROSPECTUS

This Prospectus is part of a registration statement filed with the Securities and Exchange Commission (the "Commission") using a "shelf" registration process under the Securities Act of 1933, as amended (the "1933 Act"). Under the shelf process, Alabama Power Company (the "Company") may sell, in one or more transactions,

- first mortgage bonds (the "new Bonds")
- class A preferred stock (the "new Stock")
- senior notes (the "Senior Notes")
- junior subordinated notes (the "Junior Subordinated Notes")

and Alabama Power Capital Trust VI, Alabama Power Capital Trust VII and Alabama Power Capital Trust VIII (individually, a "Trust" and collectively, the "Trusts") may sell,

- trust preferred securities (the "Preferred Securities")

in one or more offerings up to a total dollar amount of \$2,070,000,000. This Prospectus provides a general description of those securities. Each time we sell securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering ("Prospectus Supplement"). The

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Prospectus Supplement may also add, update or change information contained in this Prospectus. You should read this Prospectus and the applicable Prospectus Supplement together with additional information under the heading "Available Information."

### AVAILABLE INFORMATION

The Company is subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and in accordance therewith files reports and other information with the Commission. Such reports and other information can be inspected and copied at the Public Reference Room of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549, and at the Commission's Regional Offices at 500 West Madison Street, Suite 1400, Chicago, Illinois 60661 and 233 Broadway, New York, New York 10279. Information on the operation of the Public Reference Room may be obtained by calling the Commission at 1-800-SEC-0330. Copies of such material can also be obtained at prescribed rates by writing to the Public Reference Section of the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549. The Commission maintains a Web site that contains reports, proxy and information statements and other information regarding registrants including the Company that file electronically at <http://www.sec.gov>. In addition, reports and other material concerning the Company can be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005, on which Exchange certain of the Company's securities are listed.

No separate financial statements of any Trust are included herein. The Company considers that such statements would not be material to holders of the Preferred Securities because each Trust has no independent operations and exists for the sole purpose of investing the proceeds of the sale of its Trust Securities (as defined below) in Junior Subordinated Notes.

### INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The following documents have been filed with the Commission pursuant to the 1934 Act and are incorporated herein by reference and made a part of this Prospectus:

- (a) the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002;
- (b) the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2002 and June 30, 2002; and

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- (c) the Company's Current Reports on Form 8-K dated February 13, 2002, March 28, 2002, June 21, 2002, September 26, 2002 and October 16, 2002.

All documents filed by the Company with the Commission pursuant to Section 13(a), 13(c), 14 or 15(d) of the 1934 Act subsequent to the date of this Prospectus and prior to the termination of this offering shall be deemed to be incorporated herein by reference and made a part of this Prospectus from the date of filing of such documents. Any statement contained in a document incorporated or deemed to be incorporated by reference herein shall be deemed to be modified or superseded for purposes of this Prospectus to the extent that a statement contained herein or in any other subsequently filed document which

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also is or is deemed to be incorporated by reference herein modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Prospectus.

THE COMPANY WILL PROVIDE WITHOUT CHARGE TO EACH PERSON TO WHOM THIS PROSPECTUS IS DELIVERED, ON THE WRITTEN OR ORAL REQUEST OF ANY SUCH PERSON, A COPY OF ANY OR ALL DOCUMENTS INCORPORATED HEREIN BY REFERENCE (OTHER THAN THE EXHIBITS TO SUCH DOCUMENTS UNLESS SUCH EXHIBITS ARE SPECIFICALLY INCORPORATED BY REFERENCE). SUCH REQUESTS SHOULD BE DIRECTED TO WILLIAM E. ZALES, JR., VICE PRESIDENT AND CORPORATE SECRETARY, ALABAMA POWER COMPANY, 600 NORTH 18TH STREET, BIRMINGHAM, ALABAMA 35203, TELEPHONE: (205) 257-2714.

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### SELECTED INFORMATION

The following material, which is presented herein solely to furnish limited introductory information regarding the Company, has been selected from, or is based upon, the detailed information and financial statements appearing in the documents incorporated herein by reference or elsewhere in this Prospectus, is qualified in its entirety by reference thereto and, therefore, should be read together therewith.

#### ALABAMA POWER COMPANY

Business.....	Generation, transmission, distribution and sale of electric energy
Service Area.....	Approximately 44,500 square miles comprising most of the State of Alabama
Service Area Population (2000 Census).....	Approximately 3,537,815
Customers at December 31, 2001...	1,341,638
Generating Capacity at December 31, 2001 (kilowatts).....	12,153,000
Sources of Generation during 2001 (kilowatt-hours).....	Coal (64%), Nuclear (18%), Hydro (6%), Oil and Gas (12%)

### CERTAIN RATIOS

The following table sets forth the Ratios of Earnings to Fixed Charges and Earnings to Fixed Charges Plus Preferred Dividend Requirements (Pre-Income Tax Basis) for the periods indicated.

YEAR ENDED DECEMBER 31,				
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1997	1998	1999	2000	2001

SI  
MON  
END  
JUNE  
20

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Ratio of Earnings to Fixed Charges(1) (2).....	3.46	3.12	3.59	3.46	3.31	3.
Ratio of Earnings to Fixed Charges Plus Preferred Dividend Requirements						
(Pre-Income Tax Basis) (2) (3).....	3.18	2.90	3.26	3.18	3.05	3.

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- (1) This ratio is computed as follows: (i) "Earnings" have been calculated by adding to "Earnings Before Interest and Income Taxes" the debt portion of allowance for funds used during construction; and (ii) "Fixed Charges" consist of "Net Interest Charges" plus the debt portion of allowance for funds used during construction.
  - (2) These ratios have been revised to reflect a reclassification of income and expense of the Company's external nuclear decommissioning trust funds as presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2001.
  - (3) In computing this ratio, "Preferred Dividend Requirements" represent the before-tax earnings necessary to pay such dividends, computed at the effective tax rates for the applicable periods.

ALABAMA POWER COMPANY

The Company is a corporation organized under the laws of the State of Alabama on November 10, 1927, by the consolidation of the predecessor Alabama Power Company, Gulf Electric Company and Houston Power Company. The predecessor Alabama Power Company had a continuous existence since its incorpora-

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tion in 1906. The principal executive offices of the Company are located at 600 North 18th Street, Birmingham, Alabama 35203, and the telephone number is (205) 257-1000.

The Company is a wholly owned subsidiary of The Southern Company ("Southern"), a holding company registered under the Public Utility Holding Company Act of 1935, as amended (the "1935 Act"). The Company is engaged, within the State of Alabama, in the generation and purchase of electricity and the distribution and sale of such electricity at retail in over 1,000 communities (including Anniston, Birmingham, Gadsden, Mobile, Montgomery and Tuscaloosa), and at wholesale to 15 municipally owned electric distribution systems, 11 of which are served indirectly through sales to the Alabama Municipal Electric Authority, and two rural distributing cooperative associations. The Company also supplies steam service in downtown Birmingham. The Company owns coal reserves near its Gorgas Steam Electric Generating Plant and uses the output of coal from the reserves in its generating plants. It also sells, and cooperates with dealers in promoting the sale of, electric appliances.

The Company and one of its affiliates, Georgia Power Company ("GEORGIA"), each own 50% of the common stock of Southern Electric Generating Company ("SEGCO"). SEGCO owns generating units with an aggregate capacity of 1,019,680 kilowatts at the Ernest C. Gaston Steam Plant ("Plant Gaston") on the Coosa River near Wilsonville, Alabama. The Company and GEORGIA are each entitled to one-half of the capacity and energy of these units. The Company acts as SEGCO's agent in the operation of SEGCO's units and furnishes coal to SEGCO as fuel for

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its units. SEGCO also owns three 230,000 volt transmission lines extending from Plant Gaston to the Georgia state line.

### THE TRUSTS

Each Trust is a statutory trust created under Delaware law pursuant to the filing of a certificate of trust with the Delaware Secretary of State on October 21, 2002. Each Trust's business is defined in a trust agreement, executed by the Company, as Depositor, and the Delaware Trustee thereunder. This trust agreement of each Trust will be amended and restated in its entirety substantially in the form filed as an exhibit to the Registration Statement of which this Prospectus forms a part (the "Trust Agreement"). Each Trust Agreement will be qualified as an indenture under the Trust Indenture Act of 1939, as amended (the "1939 Act"). The Company will own all the common securities (the "Common Securities" and, together with the Preferred Securities, the "Trust Securities"). The Trust Securities represent undivided beneficial interests in the assets of the respective Trusts. Each Trust exists for the exclusive purposes of (i) issuing its Trust Securities representing undivided beneficial interests in the assets of such Trust, (ii) investing the gross proceeds of its Trust Securities in a related series of Junior Subordinated Notes, and (iii) engaging in only those other activities necessary, appropriate, convenient or incidental thereto. The payment of periodic cash distributions on the Preferred Securities of each Trust and payments on liquidation and redemption with respect to the Preferred Securities of each Trust, in each case to the extent each Trust has funds legally and immediately available therefor, will be guaranteed by the Company (individually, a "Guarantee" and collectively, the "Guarantees"). See "Description of the Guarantees."

Each Trust's business and affairs will be conducted by its trustees, which shall be appointed by the Company as the holder of the Common Securities: two employees of the Company as Administrative Trustees; JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank) as Property Trustee; and Chase Manhattan Bank USA, National Association as Delaware Trustee (collectively, the "Securities Trustees"). The Property Trustee of each Trust will act as the indenture trustee with respect to such Trust for purposes of compliance with the provisions of the 1939 Act.

The principal place of business of each Trust shall be c/o the Company, 600 North 18th Street, Birmingham, Alabama 35203, telephone (205) 257-2714, Attn: Corporate Secretary.

Reference is made to the Prospectus Supplement relating to the Preferred Securities of each Trust for further information concerning such Trust.

### ACCOUNTING TREATMENT OF TRUSTS

For financial reporting purposes, the Trusts will be treated as subsidiaries of the Company and, accordingly, the accounts of the Trusts will be included in the consolidated financial statements of the Company. The Preferred Securities will be presented as a separate line item in the consolidated balance sheet of the Company, and appropriate disclosures concerning the Preferred Securities, the Guarantees and the Junior Subordinated Notes will be included in the notes to the consolidated financial statements. For financial reporting purposes, the Company will record distributions payable on the Preferred Securities as an expense.



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### USE OF PROCEEDS

Each Trust will invest the proceeds received from the sale of its Preferred Securities in Junior Subordinated Notes. Except as may be otherwise described in an applicable Prospectus Supplement, the net proceeds received by the Company from such investment and any proceeds received from the sale of its new Bonds, new Stock or Senior Notes or other sales of its Junior Subordinated Notes will be used in connection with its ongoing construction program, to pay scheduled maturities and/or refundings of its securities, to repay short-term indebtedness to the extent outstanding and for other general corporate purposes.

### DESCRIPTION OF THE NEW BONDS

Set forth below is a description of the general terms of the Company's new Bonds. The following description does not purport to be complete and is subject to, and is qualified by reference to, the Indenture, dated as of January 1, 1942, between the Company and JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as trustee (the "First Mortgage Bond Trustee"), as to be supplemented by a supplemental indenture (the "Supplemental Indenture") thereto establishing the new Bonds of each series (the Indenture, as so supplemented, is hereinafter referred to as the "First Mortgage Bond Indenture"), the forms of which are filed as exhibits to the Registration Statement of which this Prospectus forms a part. The terms of such new Bonds will include those stated in the First Mortgage Bond Indenture and those made a part of the First Mortgage Bond Indenture by reference to the 1939 Act. Certain capitalized terms used herein are defined in the First Mortgage Bond Indenture.

The new Bonds will mature on the date shown in their title as set forth in the Prospectus Supplement.

The new Bonds in definitive form will be issued only as registered bonds without coupons in denominations of \$1,000 or authorized multiples thereof or in such other denominations as set forth in the Prospectus Supplement. New Bonds will be exchangeable for a like aggregate principal amount of new Bonds of other authorized denominations, and are transferable, at the principal corporate trust office of the First Mortgage Bond Trustee in New York City, or at such other office or agency of the Company as the Company may from time to time designate, without payment of any charge other than for any tax or taxes or other governmental charge.

Any proposed listing of the new Bonds on a securities exchange will be described in the Prospectus Supplement.

Except as otherwise may be indicated in the Prospectus Supplement, there are no provisions of the First Mortgage Bond Indenture which are specifically intended to afford holders of the new Bonds protection in the event of a highly leveraged transaction involving the Company.

**Interest Rate Provisions:** The Prospectus Supplement will set forth the interest rate provisions of the new Bonds, including payment dates, the record dates and the rate or rates, or the method of determining the rate or rates (which may involve periodic interest rate settings through remarketing or auction procedures or pursuant to one or more formulae, as described in the Prospectus Supplement).

**Redemption Provisions:** The redemption provisions applicable to the new Bonds will be described in the Prospectus Supplement.

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**Priority and Security:** The new Bonds will rank equally as to security with the bonds of other series presently outstanding under the First Mortgage Bond Indenture, which is a direct first lien on substantially all of the Company's fixed property and franchises, used or useful in its public utility business, subject only to excepted encumbrances, as defined in the First Mortgage Bond Indenture (Section 1.02).

The First Mortgage Bond Indenture permits, within certain limitations specified in Section 7.05, the acquisition of property subject to prior liens. Under certain conditions specified in Section 7.14, additional indebtedness secured by such prior liens may be issued to the extent of 60% of the cost to the Company or the fair value at date of acquisition, whichever is less, of the net property additions made by the Company to the property subject to such prior lien.

**Improvement Fund Requirement:** Pursuant to the Supplemental Indenture and similar provisions of the supplemental indentures creating other series of bonds currently outstanding under the First Mortgage Bond Indenture (other than bonds aggregating \$146,800,000 in principal amount issued and outstanding as of June 30, 2002 as collateral security for certain obligations), the annual improvement fund requirement applicable to the new Bonds and the bonds of each such other series, which must be satisfied on or before June 1 in each year, is equal to 1% of the principal amount of bonds authenticated of each such series prior to January 1 of that year (less bonds of such series retired directly or indirectly as a result of the release of property). The improvement fund requirements may be satisfied in cash or in principal amount of bonds authenticated under the First Mortgage Bond Indenture or to the extent of 60% of the cost or fair value, whichever is less, of unfunded net property additions. Any cash so deposited is to be used by the First Mortgage Bond Trustee for the redemption at their then special redemption prices or other retirement of bonds of such series as may be designated by the Company (subject to such limitation, if any, as to the new Bonds as set forth in the Prospectus Supplement and except as to limitations which have been or may be established in the supplemental indentures creating other series of bonds) or may be withdrawn by the Company against the deposit of bonds or to the extent of 60% of unfunded net property additions.

**Replacement Requirement:** By Section 4 of the Supplemental Indenture dated as of October 1, 1981, the Company is required to certify to the First Mortgage Bond Trustee unfunded net property additions or to deposit with the First Mortgage Bond Trustee cash or bonds in an amount equal to the amount by which annual expenditures for renewals and replacements are less than 2.25% of the average annual amount of depreciable mortgaged property or such revised percentage as shall be authorized or approved by the Commission, or any successor commission, under the 1935 Act. Any available replacement credit may be carried forward and deposited cash or bonds may be withdrawn, used or applied in accordance with the provisions of said section.

Any limitation on the right of the Company to redeem new Bonds through the operation of the replacement provisions of the First Mortgage Bond Indenture will be described in the Prospectus Supplement.

The First Mortgage Bond Indenture (Section 7.16) provides for an examination of the mortgaged property by an independent engineer at least once every five years. The Company covenants to make good any maintenance deficiency shown by the certificate of such engineer and to record retirements as called for thereby.

**Issuance of Additional Bonds:** Additional bonds may be issued under the

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First Mortgage Bond Indenture (a) under Article IV to the extent of 60% of the cost or fair value at date of acquisition, whichever is less, of unfunded net property additions, as defined in the First Mortgage Bond Indenture (Sections 1.08 through 1.11, as amended), or (b) under Article V against the retirement of other bonds theretofore outstanding under the First Mortgage Bond Indenture, or (c) under Article VI against the deposit of cash equal to the principal amount of bonds to be issued. Such additional bonds, however, may be issued, except in certain cases when issued under Article V, only if, for a period of twelve consecutive calendar months within the fifteen preceding calendar months, the net earnings of the Company, as defined in the First Mortgage Bond Indenture (Section 1.03, as amended), shall have been at least twice the interest requirements for one year on all bonds outstanding, including the additional bonds applied for and all outstanding prior lien bonds and other indebtedness of the character described in the First Mortgage Bond Indenture. Such net earnings are computed, in effect, after making certain deductions including (i) all operating expenses other than

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income and excess profits taxes and (ii) the amount, if any, by which the aggregate charges to expense or income to provide for depreciation are less than 2.25% of the average amount of depreciable mortgaged property. Under this provision, no amount is included in interest requirements on account of \$32,600,000 principal amount of first mortgage bonds (out of a total of \$146,800,000 principal amount) issued and outstanding as of June 30, 2002, as collateral for certain obligations for which such bonds are pledged as security. No interest is payable on any such bonds unless and until default occurs on such obligations.

Cash deposited as the basis for the issuance of bonds may be applied to the retirement of bonds or be withdrawn against the deposit of bonds or be withdrawn to the extent of 60% of the cost or fair value, whichever is less, of unfunded net property additions (Article VI).

**Release and Substitution of Property:** The First Mortgage Bond Indenture (Article X) provides that, subject to various limitations, property may be released from the lien thereof when sold or exchanged, upon the basis of cash deposited with the First Mortgage Bond Trustee, bonds or purchase money obligations delivered to the First Mortgage Bond Trustee, prior lien bonds delivered to the First Mortgage Bond Trustee or reduced or assumed, property additions acquired in exchange for the property released or unfunded net property additions certified to the First Mortgage Bond Trustee.

The First Mortgage Bond Indenture (Section 10.05) permits the cash proceeds of released property and other funds to be withdrawn either upon a showing that unfunded net property additions exist or against the deposit of bonds and also permits such proceeds and other funds to be applied to the retirement of bonds.

**Restrictions on Common Stock Dividends:** There are various restrictions on Common Stock dividends in the First Mortgage Bond Indenture (which are to remain in effect so long as certain series of bonds are outstanding). Any restrictions on dividends and distributions on Common Stock in the Supplemental Indenture will be set forth in the Prospectus Supplement.

**Amendments to the First Mortgage Bond Indenture:** By Section 6(g) of the Supplemental Indenture dated as of October 1, 1981, the First Mortgage Bond Indenture may be modified with the consent of the holders of not less than a majority in principal amount of the bonds at the time outstanding which would be

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affected by the action proposed to be taken. However, the bondholders shall have no power (i) to extend the fixed maturity of any bonds, or reduce the rate or extend the time of payment of interest thereon, or reduce the principal amount thereof, without the express consent of the holder of each bond which would be so affected, or (ii) to reduce the aforesaid percentage of bonds, the holders of which are required to consent to any such modification, without the consent of the holders of all bonds outstanding, or (iii) to permit the creation by the Company of any mortgage or pledge or lien in the nature thereof, not otherwise permitted under the First Mortgage Bond Indenture, ranking prior to or equal with the lien of the First Mortgage Bond Indenture on any of the mortgaged and pledged property, or (iv) to deprive the holder of any bond outstanding under the First Mortgage Bond Indenture of the lien thereof on any of the mortgaged and pledged property. The First Mortgage Bond Trustee shall not be obligated to enter into a supplemental indenture which would affect its own rights, duties or immunities under the First Mortgage Bond Indenture or otherwise.

Regarding the First Mortgage Bond Trustee: JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), the First Mortgage Bond Trustee, also serves as Senior Note Indenture Trustee, as Subordinated Note Indenture Trustee, as Property Trustee and as Guarantee Trustee. The Company and certain of its affiliates maintain deposit accounts and banking relationships with JPMorgan Chase Bank. JPMorgan Chase Bank also serves as trustee under other indentures pursuant to which securities of the Company and affiliates of the Company are outstanding.

Enforcement Provisions: The First Mortgage Bond Indenture (Section 11.05) provides that, upon the occurrence of certain events of default, the First Mortgage Bond Trustee or the holders of not less than 20% in principal amount of outstanding bonds may declare the principal of all outstanding bonds immediately due and payable, but that, upon the curing of any such default, the holders of a majority in principal amount of outstanding bonds may waive such default and its consequences.

The holders of a majority in principal amount of outstanding bonds may direct the time, method and place of conducting any proceeding for the enforcement of the First Mortgage Bond Indenture (Sections 11.01

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and 11.12). No holder of any bond has any right to institute any proceedings to enforce the First Mortgage Bond Indenture or any remedy thereunder, unless such holder shall previously have given to the First Mortgage Bond Trustee written notice of a default, and unless such holder or holders shall have tendered to the First Mortgage Bond Trustee indemnity against costs, expenses and liabilities, and unless the holders of not less than 20% in principal amount of outstanding bonds shall have tendered such indemnity and requested the First Mortgage Bond Trustee to take action and the First Mortgage Bond Trustee shall have failed to take action within 60 days (Section 11.14).

Defaults: By Section 11.01 of the First Mortgage Bond Indenture, the following events are defined as "defaults": failure to pay principal; failure for 60 days to pay interest; failure for 90 days to pay any sinking or other purchase fund installment; certain events in bankruptcy, insolvency or reorganization; and failure for 90 days after notice to perform other covenants. By Section 9.03 of the First Mortgage Bond Indenture, a failure by the Company to deposit or direct the application of money for the redemption of bonds called for redemption also constitutes a default.

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Evidence as to Compliance with Conditions and Covenants: The First Mortgage Bond Indenture requires the Company to furnish to the First Mortgage Bond Trustee, among other things, a certificate of officers and an opinion of counsel as evidence of compliance with conditions precedent provided for therein; a certificate of an engineer (who, in certain instances, must be an independent engineer) with respect to the fair value of property certified or released; and a certificate of an accountant (who, in certain instances, must be an independent public accountant) as to compliance with the earnings, improvement fund and replacement requirements. Various certificates and other documents are required to be filed periodically or upon the happening of certain events; however, no general periodic evidence is required by the First Mortgage Bond Indenture to be furnished as to the absence of default or as to compliance with the terms of the First Mortgage Bond Indenture in general.

### DESCRIPTION OF THE NEW STOCK

Set forth below is a description of the general terms of the new Stock.

The statements herein concerning the new Stock are an outline and do not purport to be complete. Such statements make use of defined terms and are qualified in their entirety by express reference to the cited provisions of the charter of the Company, as amended (the "charter"), a copy of which is filed as an exhibit to the Registration Statement of which this Prospectus forms a part. The general provisions which apply to the preferred stock of the Company of all classes, which are now or may hereafter be authorized or created, are set forth in the charter.

General: The new Stock is to be established by resolutions of the Board of Directors of the Company (the "Resolutions"), a copy of which is an exhibit to the Registration Statement (or incorporated by reference therein) to which reference is hereby made. The Resolutions shall include a provision fixing the stated capital of the new Stock.

At June 30, 2002, there were outstanding 8,000,000 shares of Class A Preferred Stock with a stated capital of \$25 per share, 500,000 shares of Class A Preferred Stock with a stated capital of \$100 per share and 200 shares of Class A Preferred Stock with a stated capital of \$100,000 per share. Additionally, at June 30, 2002, the Company had outstanding 475,115 shares of Preferred Stock which have a par value of \$100 per share. The Class A Preferred Stock ranks on a parity as to dividends and assets with the outstanding Preferred Stock and has the same rights and preferences as the outstanding Preferred Stock. On all matters submitted to a vote of the holders of the Preferred Stock and the Class A Preferred Stock (other than a change in the rights and preferences of only one, but not the other, such kind of stock), both kinds of stock vote together as a single class, and each share of Preferred Stock and Class A Preferred Stock shall have the relative voting rights described in "Voting Rights" herein.

The new Stock will not be subject to further calls or to assessment by the Company.

Any proposed listing of the new Stock on a securities exchange will be described in the Prospectus Supplement.

Transfer Agent and Registrar: Unless otherwise indicated in the applicable

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Prospectus Supplement, the new Stock will be transferable at the office of Southern Company Services, Inc., 270 Peachtree Street, N.W., Atlanta, Georgia 30303, which will also serve as the Registrar.

**Dividend Rights:** The holders of the Preferred Stock and Class A Preferred Stock of each class are entitled to receive cumulative dividends, payable when and as declared by the Board of Directors, at the rates determined for the respective classes, before any dividends may be declared or paid on the Common Stock. Dividends on the Preferred Stock and Class A Preferred Stock must have been or be contemporaneously declared and set apart for payment, or paid, on the Preferred Stock and Class A Preferred Stock of all classes for all dividend periods terminating on the same or an earlier date (Charter -- A. Preferred Stock -- 2. General Provisions -- a and b).

The Prospectus Supplement will set forth the dividend rate provisions of the new Stock, including the payment dates and the rate or rates, or the method of determining the rate or rates (which may involve periodic dividend rate settings through remarketing or auction procedures or pursuant to one or more formulae, as described in the Prospectus Supplement). Dividends payable on the new Stock will be cumulative from the date of original issue.

**Redemption Provisions:** The redemption provisions applicable to the new Stock will be described in the Prospectus Supplement.

The charter provides that the Company shall not redeem, purchase or otherwise acquire any shares of Preferred Stock or Class A Preferred Stock if, at the time of such redemption, purchase or other acquisition, dividends payable on the Preferred Stock or Class A Preferred Stock of any class shall be in default in whole or in part unless, prior to or concurrently with such redemption, purchase or other acquisition, all such defaults shall be cured or unless such action has been ordered, approved or permitted under the 1935 Act by the Commission or any successor commission or regulatory authority of the United States of America (Charter -- A. Preferred Stock -- 2. General Provisions -- d).

**Voting Rights:** At the election of directors at each annual meeting of the shareholders, the holders of the Preferred Stock and Class A Preferred Stock shall have full voting rights with the holders of the Common Stock, all voting together as a single class. Each share of Preferred Stock and Class A Preferred Stock with a stated capital of \$100 will have two-fifths vote, each share of Preferred Stock and Class A Preferred Stock with a stated capital of \$25 will have one-tenth vote, each share of Preferred Stock and Class A Preferred Stock with a stated capital of \$100,000 will have 400 votes and each share of Common Stock will have one vote. On all other matters, except as otherwise provided by law or in the charter, the right to vote is vested in the holders of the Common Stock; provided, however, that, if and so long as four quarterly dividends payable on the Preferred Stock or Class A Preferred Stock of any class shall be in default, the holders of the Preferred Stock and Class A Preferred Stock of all classes shall have the exclusive right, voting separately and as a single class, to elect the smallest number of directors which shall constitute a majority of the then authorized number of directors and, on all other matters, the right to vote together with the holders of t=5% align=right nowrap>

17

18

Deferred income

18

20

Other current liabilities

22

30

Total current liabilities

321

375

Pension and postretirement benefits

356

378

Long-term debt



362

362

Other liabilities

79

80

Total liabilities

1,118

1,195

Commitments and contingencies

Stockholders' Equity

Preferred stock, par value \$1.00 per share, 250,000,000 shares authorized and no

shares issued and outstanding

□

□

Common stock, par value \$0.01 per share, 1,000,000,000 shares authorized and

168,635,102 shares outstanding as of December 31, 2006 and 166,362,294 shares

outstanding as of September 30, 2006

2

2

Additional paid-in capital

7,437

7,629

Accumulated deficit

(6,753)

)

(6,769

)

Accumulated other comprehensive loss

(292

)

(305

)

Treasury stock, at cost, 1,500,000 common shares at December 31, 2006 and

17,692,137 common shares at September 30, 2006

(23

)

(255

)

Total stockholders' equity

371

302

Total liabilities and stockholders' equity

\$

1,489

\$

1,497

See Notes to Condensed Consolidated Financial Statements.



## AGERE SYSTEMS INC. AND SUBSIDIARIES

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Dollars in Millions)**  
**(Unaudited)**

	<b>Three Months Ended</b>	
	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 16	\$ (19)
Less: Income from discontinued operations	□	4
Income (loss) from continuing operations	16	(23)
Adjustments to reconcile income (loss) from continuing operations to net cash provided (used) by operating activities:		
Restructuring and other charges □ net of cash payments	(7)	8
Depreciation and amortization	25	27
Stock-based compensation expense	11	10
Provision for deferred income taxes	1	2
Provision for uncollectibles	1	□
Provision for inventory write-downs	5	2
Decrease (increase) in receivables	1	(1)
Decrease in inventories	30	3
Decrease in accounts payable	(27)	(4)
Decrease in payroll and benefit liabilities	(14)	(8)
Increase (decrease) in tax accruals	1	(11)
Changes in other operating assets and liabilities	(26)	(12)
Other adjustments for non-cash items □ net	2	□
<b>NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES</b>	<b>19</b>	<b>(7)</b>
<b>INVESTING ACTIVITIES</b>		
Capital expenditures	(10)	(39)
Return of capital from investments	12	34
Proceeds from the sale or disposal of property, plant and equipment	1	5
Acquisition of intangible assets	□	(7)
<b>NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES</b>	<b>3</b>	<b>(7)</b>
<b>FINANCING ACTIVITIES</b>		
Proceeds from the issuance of stock □ net of expense	28	6
Purchase of treasury stock	□	(41)
<b>NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES</b>	<b>28</b>	<b>(35)</b>
Net increase (decrease) in cash and cash equivalents	50	(49)
Cash and cash equivalents at beginning of period	406	698
Cash and cash equivalents at end of period	\$ 456	\$ 649

See Notes to Condensed Consolidated Financial Statements.



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

**1. Basis of Presentation and Summary of Significant Accounting Policies**

Agere Systems Inc. (the "Company" or "Agere") is a leading provider of integrated circuit solutions for a variety of communications and computing applications. Some of the Company's solutions include related software and reference designs. Agere's customers include manufacturers of hard disk drives, mobile phones, advanced communications and networking equipment and personal computers. The Company also generates revenue from the licensing of intellectual property.

***Merger Agreement with LSI Logic***

On December 3, 2006, LSI Logic Corporation ("LSI") and Agere entered into a definitive merger agreement under which Agere will be merged into a wholly owned subsidiary of LSI. If the proposed merger is completed, holders of Agere common stock will be entitled to receive 2.16 shares of LSI common stock for each share of Agere common stock that they own. The transaction is subject to the approval of stockholders of both companies as well as customary conditions and regulatory approvals. Agere will hold its stockholders meeting on March 29, 2007 and expects the transaction to close shortly thereafter.

***Interim Financial Information***

These condensed financial statements have been prepared in accordance with the rules of the Securities and Exchange Commission for interim financial statements and do not include all annual disclosures required by accounting principles generally accepted in the United States. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended September 30, 2006. The condensed financial information as of December 31, 2006 and for the three months ended December 31, 2006 and 2005 is unaudited, but includes all adjustments that management considers necessary for a fair presentation of the Company's consolidated results of operations, financial position and cash flows. Results for the three months ended December 31, 2006 are not necessarily indicative of results to be expected for the full fiscal year 2007 or any other future periods.

**2. Recent Pronouncements**

In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (an interpretation of FASB Statement No. 109) ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires an entity to recognize the impact of a tax position in its financial statements if that position is more likely than not to be sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective for Agere as of the beginning of fiscal 2008, with earlier application encouraged. Any cumulative effect of the change in accounting principle will be recorded as an adjustment to the opening accumulated deficit balance. The Company is evaluating the timing of its adoption of FIN 48 and the potential effects of implementing this Interpretation on its financial condition and results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the U.S., and expands disclosures about fair value measurements. SFAS 157 is effective for Agere as of the beginning of fiscal 2009, with earlier application encouraged. Any cumulative effect will be recorded as an adjustment to the opening accumulated deficit balance, or other appropriate component of equity. The Company is evaluating the timing of its adoption of SFAS 157 and the potential effects of implementing this Statement on its financial condition and results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS 158"), which amends SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" and SFAS 132(R) "Employers' Disclosure about Pensions and Other Postretirement Benefits" an amendment of

*FASB Statements No. 87, 88 and 106.* SFAS 158 requires an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes through comprehensive income in that funded status in the year in which the changes occur. This Statement requires entities to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The recognition of the funded status under SFAS 158 is effective for Agere as of the end of fiscal 2007. The requirement to measure plan assets and benefit obligations as of the date of the entity's fiscal year-end statement of

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

financial position will have no effect on Agere as that is the current practice. If SFAS 158 had been effective as of December 31, 2006 the pension and postretirement liability reflected in the balance sheet would have decreased by \$129 and accumulated other comprehensive loss would have decreased by \$129, excluding any tax impacts.

**3. Stock Compensation Plans**

Agere has stock-based compensation plans under which employees and non-employee directors receive stock options and other stock-based awards. The plans provide for the granting of stock options, performance awards, restricted stock awards, cash awards, stock appreciation rights and other stock unit awards. Shares issued under these plans may consist of authorized and unissued shares, treasury shares or shares purchased in the open market. The number of shares authorized and available for awards under Agere plans as of December 31, 2006, was 12,447,211. As of December 31, 2006, awards relating to 28,503,329 shares were outstanding, including awards relating to 1,863,929 shares that were granted by Lucent Technologies Inc. (Lucent), or companies acquired by Lucent prior to Agere's spin-off by Lucent, and converted later into Agere awards. During the first quarter of fiscal 2007 and 2006, employees and non-employee directors of the Company were granted stock options and other equity-based awards. Agere stock options are granted with an exercise price equal to 100% of the market value of a share of common stock on the date of the grant, generally have seven-year contractual terms, and vest no later than four years from the date of grant. Agere has also granted restricted stock units at no cost to employees, that vest based on completion of a required service period or a combination of required service and satisfaction of market or performance based goals such as earnings per share or a total stockholder return greater than that of a market capitalization weighted peer group index of nine companies over a four-year period.

Agere's Employee Stock Purchase Plan (ESPP) has purchase periods that run for six months beginning each May 1 and November 1. Under the terms of the ESPP, participating employees may have up to 10% of eligible compensation (subject to limitations on the number of shares and fair market value of shares that may be acquired each purchase period) deducted from their pay to purchase the Company's common stock. The per share purchase price in any purchase period is equal to 85% of the lower of either the market price on the first trading day of the purchase period, or the last trading day of the purchase period. The number of shares authorized and available for awards under the ESPP, as of December 31, 2006, was 4,530,733. During the three months ended December 31, 2006, 324,930 shares were purchased under the plan and \$4 cash was received from employees.

The Company follows the provisions of SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS 123R), which establishes the financial accounting and reporting standards for stock-based compensation plans. SFAS 123R requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors, including stock options and restricted stock units, and purchases under the ESPP. Under the provisions of SFAS 123R, stock-based compensation cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense on a straight-line basis over the requisite service period of the entire award (generally the vesting period of the award).

Stock-based compensation expense for fiscal 2007 and 2006 includes expense for all equity awards granted prior to, but not yet vested as of October 1, 2005. This compensation expense was based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123) as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*. Compensation expense for stock-based compensation awards granted subsequent to October 1, 2005 was based on the grant-date fair value determined in accordance with the provisions of SFAS 123R. Since the adoption of SFAS 123R in October 2005, there have been no changes to the Company's stock compensation plans or modifications to outstanding stock-based awards which would change the value of any awards outstanding. During the three months ended December 31, 2006, the Company recognized compensation expense of \$6 for stock options, \$4 for restricted stock units and \$1 for the ESPP. All of this expense was recognized in the statement of operations. For the three months ended December 31, 2006 and 2005, no significant stock-based compensation costs were capitalized.



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

The following table presents the total stock-based compensation expense resulting from stock option awards, restricted stock unit awards and the ESPP included in the statements of operations:

	<b>Three Months Ended</b>	
	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Costs	\$ 1	\$ 2
Selling, general and administrative	5	4
Research and development	5	2
Restructuring and other charges □ net (1)	□	2
Stock-based compensation expense before income taxes	11	10
Benefit for income taxes (2)	□	□
Net compensation expense	\$ 11	\$ 10

(1) Represents the total amount of stock-based compensation expense for employees on leave of absence for the period of time during which their awards continue to vest but the employees' requisite service period has been completed.

(2) The stock-based compensation expense has not been tax-effected due to the recording of a full valuation allowance against U.S. net deferred tax assets.

The fair value of each stock option grant is estimated as of the grant date using the Black-Scholes option-pricing model with the following assumptions:

	<b>Stock Options</b>		<b>ESPP</b>	
	<b>December 31,</b>	<b>December 31,</b>	<b>December 31,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Dividend yield	0.00%	0.00%	0.00%	0.00%
Expected volatility	47.1%	58.0%	51.2%-58.0%	59.0%-67.0%
Weighted-average volatility	47.1%	58.0%	53.5%	62.0%
Risk-free interest rate	4.29%-4.46%	4.18%-4.43%	4.73%-4.97%	2.76%-3.43%
Expected term (in years)	4.0	4.0	0.5	0.5

*Dividend Yield.* The Company has never paid cash dividends and does not currently intend to pay cash dividends, and thus has assumed a 0% dividend yield.

*Expected Volatility.* The Company uses third-party analysis to assist in developing expected volatility. The expected volatility is based on a combination of both Company and peer company historical volatility and Company or peer company market-based implied volatility.

*Risk-Free Interest Rate.* The interest rate used in valuing awards is based on the yield at the time of grant of a U.S. Treasury security with an equivalent remaining term.

*Expected Term.* The expected term is based on several factors including historical observations of employee exercise patterns, peer company employee exercise behavior, and expectations of employee exercise behavior in the future giving consideration to the contractual terms of the stock-based awards. The expected term of ESPP options is determined by the length of the purchase period.

*Pre-Vesting Forfeitures.* Estimates of pre-vesting forfeitures of stock-based awards are determined from Company experience and industry trends. The Company will adjust its estimates of forfeitures over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from such estimates.



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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**(Unaudited)**

**Stock Options**

The following table summarizes the Company's stock option activity during the three months ended December 31, 2006:

<b>Stock Options</b>	<b>Shares (000's)</b>	<b>Weighted- Average Exercise Price</b>	<b>Weighted-Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at September 30, 2006	23,721	\$ 48.15		
Granted	2,708	\$ 18.09		
Exercised	(1,645)	\$ 14.03		
Forfeited or Expired	(609)	\$ 61.19		
Outstanding at December 31, 2006	24,175	\$ 46.79	3.88	\$ 58
Vested or expected to vest at December 31, 2006	23,331	\$ 46.79	3.88	\$ 56
Exercisable at December 31, 2006	16,248	\$ 62.17	2.84	\$ 24

The weighted-average per share grant-date fair value of options granted during the three months ended December 31, 2006 and 2005 was \$7.56 and \$6.19, respectively. The total fair value of stock options vested during the three months ended December 31, 2006 and 2005 was \$24 and \$29, respectively. As of December 31, 2006, there was a total of \$56 of unrecognized compensation cost related to nonvested stock options. The cost is expected to be recognized over a weighted-average period of 1.9 years.

The aggregate intrinsic value of options exercised during the three months ended December 31, 2006 and 2005 was \$7 and \$0, respectively. Cash received from option exercises was \$23 and \$2 for the three months ended December 31, 2006 and 2005, respectively.

**Restricted Stock Units**

The value of time-condition restricted stock units is determined by their intrinsic value (as if the underlying shares were vested and issued) on the grant date. The time-condition restricted stock unit awards vest over a two-year or four-year period. The following table summarizes the Company's time-condition nonvested share activity during the three months ended December 31, 2006:

<b>Nonvested Shares (Time-condition)</b>	<b>Shares (000's)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Nonvested at September 30, 2006	2,740	\$ 13.36
Granted	1,129	\$ 17.68
Vested	(264)	\$ 12.80
Forfeited	(54)	\$ 13.77

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Nonvested at December 31, 2006

3,551

\$ 14.77

As of December 31, 2006, there was a total of \$40 of unrecognized compensation cost related to time-based nonvested restricted stock unit awards. The cost is expected to be recognized over a weighted-average period of 2.1 years.

Total stockholder return is a market target measured against a peer group index and constitutes a market condition as defined by SFAS 123R. The fair value of market-condition restricted stock units is determined by a Monte Carlo simulation technique. The market-condition restricted stock unit awards vest four years after the grant date if the total stockholder return goal has been met. If the goal is not met, the restricted stock units will expire and compensation cost previously recognized for these restricted stock units

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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will not be reversed. The following table summarizes the Company's market-condition, nonvested share activity during the three months ended December 31, 2006:

<b>Nonvested Shares (Market-condition)</b>	<b>Shares (000's)</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Nonvested at September 30, 2006	450	\$ 8.02
Granted	127	\$ 11.49
Vested	□	
Forfeited	□	
Nonvested at December 31, 2006	577	\$ 8.79

As of December 31, 2006, there was a total of \$3 of unrecognized compensatiodonture dated as of January 1, 1942, between Alabama Power Company and the Chase Manhattan Bank, as Trustee, and indentures supplemental thereto through that dated as of December 1, 1994. (Designated in Registration Nos. 2-59843 as Exhibit 2(a)-2, 2-60484 as Exhibits 2(a)-3 and 2(a)-4, 2-60716 as Exhibit 2(c), 2-67574 as Exhibit 2(c), 2-68687 as Exhibit 2(c), 2-69599 as Exhibit 4(a)-2, 2-71364 as Exhibit 4(a)-2, 2-73727 as Exhibit 4(a)-2, 33-5079 as Exhibit 4(a)-2, 33-17083 as Exhibit 4(a)-2, 33-22090 as Exhibit 4(a)-2, in Form 10-K for the year ended December 31, 1990, File No. 1-3164, as Exhibit 4(c), in Registration Nos. 33-43917 as Exhibit 4(a)-2, 33-45492 as Exhibit 4(a)-2, 33-48885 as Exhibit 4(a)-2, 33-48917 as Exhibit 4(a)-2, in Form 8-K dated January 20, 1993, File No. 1-3164, as Exhibit 4(a)-3, in Form 8-K dated February 17, 1993, File No. 1-3164, as Exhibit 4(a)-3, in Form 8-K dated March 10, 1993, File No. 1-3164, as Exhibit 4(a)-3, in Certificate of Notification, File No. 70-8069, as Exhibits A and B, in Form 8-K dated June 24, 1993, File No. 1-3164, as Exhibit 4, in Certificate of Notification, File No. 70-8069, as Exhibit A, in Form 8-K dated November 16, 1993, File No. 1-3164, as Exhibit 4(b), in Certificate of Notification, File No. 70-8069, as Exhibits A and B, in Certificate of Notification, File No. 70-8069, as Exhibit A, in Certificate of Notification, File No. 70-8069, as Exhibit A and in Form 8-K dated November 30, 1994, File No. 1-3164, as Exhibit 4.) 4.2 -- Form of Supplemental Indenture to First Mortgage Bond Indenture to be used in connection with the issuance of new Bonds.\* 4.3 -- Charter of Alabama Power Company and amendments thereto through November 21, 2001. (Designated in Registration Nos. 2-59634 as Exhibit 2(b), 2-60209 as Exhibit 2(c), 2-60484 as Exhibit 2(b), 2-70838 as Exhibit 4(a)-2, 2-85987 as Exhibit 4(a)-2, 33-25539 as Exhibit 4(a)-2, 33-43917 as Exhibit 4(a)-2, in Form 8-K dated February 5, 1992, File No. 1-3164, as Exhibit 4(b)-3, in Form 8-K dated July 8, 1992, File No. 1-3164, as Exhibit 4(b)-3, in Form 8-K dated October 27, 1993, File No. 1-3164, as Exhibits 4(a) and 4(b), in Form 8-K dated November 16, 1993, File No. 1-3164, as Exhibit 4(a), in Certificate of Notification, File No. 70-8191, as Exhibit A, in Form 10-K for the year ended December 31, 1997, File No. 1-3164, as Exhibit 3(b)2, in Form 8-K dated August 10, 1998, File No. 1-3164, as Exhibit 4.4, in Form 10-K for the year ended December 31, 2000, File No. 1-3164, as Exhibit 3(b)2 and in Form 10-K for the year ended December 31, 2001, File No. 1-3164, as Exhibit 3(b)(2).) 4.4 -- Form of proposed Certificate of Resolutions of Board of Directors of Alabama Power Company establishing the new Stock.\* 4.5 -- By-laws of Alabama Power Company as amended effective April 26, 2002, and presently in effect. II-3 EXHIBIT NUMBER ----- 4.6 -- Senior Note Indenture dated as of December 1, 1997 between Alabama Power Company and JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Trustee, and indentures supplemental thereto through that dated October 16, 2002. (Designated in Form 8-K dated December 4, 1997, File No. 1-3164, as Exhibits 4.1 and 4.2, in Form 8-K dated February 20, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated April 17, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated August 11, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated September 8, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated September 16, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated October 7, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated October 28, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated November 12, 1998, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated May 19, 1999, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated August 13, 1999, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated September 21, 1999, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated May 11, 2000, File No. 1-3164, as Exhibit 4.2, in Form 8-K dated August 22, 2001, File No. 1-3164, as Exhibits 4.2(a) and 4.2(b), in Form 8-K dated June 21, 2002, File No. 1-3164, as Exhibit 4.2(a) and in Form 8-K dated October 16, 2002, File No. 1-3164,

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as Exhibit 4.2(a).) 4.7 -- Form of Supplemental Indenture to Senior Note Indenture to be used in connection with the issuance of Senior Notes.\* 4.8 -- Subordinated Note Indenture dated as of January 1, 1997 between Alabama Power Company and JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Trustee and indentures supplemental thereto through that dated as of February 25, 1999. (Designated in the Company's Current Report on Form 8-K dated January 9, 1997 as Exhibits 4.1 and 4.2, in Form 8-K dated February 18, 1999, File No. 3164, as Exhibit 4.2 and Form 8-K dated September 26, 2002, File No. 1-3164, as Exhibits 4.9-A and 4.9-B) 4.9 -- Form of Supplemental Indenture to Subordinated Note Indenture to be used in connection with the issuance of Junior Subordinated Notes.\* 4.10-A -- Certificate of Trust of Alabama Power Capital Trust VI. 4.10-B -- Certificate of Trust of Alabama Power Capital Trust VII. 4.10-C -- Certificate of Trust of Alabama Power Capital Trust VIII. 4.11-A -- Trust Agreement of Alabama Power Capital Trust VI. 4.11-B -- Trust Agreement of Alabama Power Capital Trust VII. 4.11-C -- Trust Agreement of Alabama Power Capital Trust VIII. 4.12-A -- Form of Amended and Restated Trust Agreement of Alabama Power Capital Trust VI. 4.12-B -- Form of Amended and Restated Trust Agreement of Alabama Power Capital Trust VII. 4.12-C -- Form of Amended and Restated Trust Agreement of Alabama Power Capital Trust VIII. 4.13-A -- Form of Preferred Security of Alabama Power Capital Trust VI (included in Exhibit 4.12-A above). 4.13-B -- Form of Preferred Security of Alabama Power Capital Trust VII (included in Exhibit 4.12-B above). 4.13-C -- Form of Preferred Security of Alabama Power Capital Trust VIII (included in Exhibit 4.12-C above). 4.14 -- Form of Senior Note (included in Exhibit 4.7 above). 4.15 -- Form of Junior Subordinated Note (included in Exhibit 4.9 above). 4.16-A -- Form of Guarantee relating to Alabama Power Capital Trust VI. 4.16-B -- Form of Guarantee relating to Alabama Power Capital Trust VII. 4.16-C -- Form of Guarantee relating to Alabama Power Capital Trust VIII. 4.17-A -- Form of Agreement as to Expenses and Liabilities relating to Alabama Power Capital Trust VI (included in Exhibit 4.12-A above). 4.17-B -- Form of Agreement as to Expenses and Liabilities relating to Alabama Power Capital Trust VII (included in Exhibit 4.12-B above). II-4 EXHIBIT NUMBER ----- 4.17-C -- Form of Agreement as to Expenses and Liabilities relating to Alabama Power Capital Trust VIII (included in Exhibit 4.12-C above). 5.1 -- Opinion of Balch & Bingham LLP. 5.2-A -- Opinion of Richards, Layton & Finger, P.A. relating to Alabama Power Capital Trust VI. 5.2-B -- Opinion of Richards, Layton & Finger, P.A. relating to Alabama Power Capital Trust VII. 5.2-C -- Opinion of Richards, Layton & Finger, P.A. relating to Alabama Power Capital Trust VIII. 12.1 -- Computation of ratio of earnings to fixed charges. 12.2 -- Computation of ratio of earnings to fixed charges plus preferred dividend requirements (pre-income tax basis). 23.1 -- Consent of Balch & Bingham LLP (included in Exhibit 5.1 above). 23.2 -- Consent of Richards, Layton & Finger, P.A. (included in Exhibits 5.2-A, 5.2-B and 5.2-C above). 24.1 -- Powers of Attorney and Resolution. 25.1 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as First Mortgage Bond Indenture Trustee. 25.2 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Senior Note Indenture Trustee. 25.3 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank (formerly known as The Chase Manhattan Bank), as Subordinated Note Indenture Trustee. 25.4 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank, as Property Trustee, relating to Alabama Power Capital Trust VI. 25.5 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank, as Guarantee Trustee, relating to Alabama Power Capital Trust VI. 25.6 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank, as Property Trustee, relating to Alabama Power Capital Trust VII. 25.7 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended, of JPMorgan Chase Bank, as Guarantee Trustee, relating to Alabama Power Capital Trust VII. 25.8 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended of JPMorgan Chase Bank, as Property Trustee, relating to Alabama Power Capital Trust VIII. 25.9 -- Statement of Eligibility under Trust Indenture Act of 1939, as amended of JPMorgan Chase Bank, as Guarantee Trustee, relating to Alabama Power Capital Trust VIII. Exhibits listed above which have heretofore been filed with the Commission and which were designated as noted above are hereby incorporated herein by reference and made a part hereof with the same effect as if filed herewith.

----- \* To be subsequently filed or incorporated by reference. II-5 ITEM 17. UNDERTAKINGS. (a) Undertaking related to Rule 415 offering: The undersigned registrants hereby undertake: (1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement: (i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933; (ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement; Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than 20% change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement. (iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement; Provided, however, that paragraphs (a)(1)(i) and (a)(1)(ii) do not apply if the registration statement is on Form S-3, S-8 or F-3 and the information required to be included in a

post-effective amendment by those paragraphs is contained in periodic reports filed by the registrants pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in the registration statement. (2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof. (3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering. (b) Undertaking related to filings incorporating subsequent Securities Exchange Act of 1934 documents by reference: The undersigned registrants hereby undertake that, for purposes of determining any liability under the Securities Act of 1933, each filing of the Company's annual report pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof. (c) Undertaking related to acceleration of effectiveness: Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrants pursuant to the foregoing provisions or otherwise, the registrants have been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the II-6 payment by the registrants of expenses incurred or paid by a director, officer or controlling person of the registrants in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrants will, unless in the opinion of their counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue. (d) The undersigned registrants hereby undertake that: (1) For purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by the registrants pursuant to Rule 424(b)(1) or (4) or 497(h) under the Act shall be deemed to be part of this registration statement as of the time it was declared effective. (2) For the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof. II-7 SIGNATURES PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, ALABAMA POWER COMPANY CERTIFIES THAT IT HAS REASONABLE GROUNDS TO BELIEVE THAT IT MEETS ALL OF THE REQUIREMENTS FOR FILING ON FORM S-3 AND HAS DULY CAUSED THIS REGISTRATION STATEMENT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF BIRMINGHAM, STATE OF ALABAMA, ON THE 24TH DAY OF OCTOBER, 2002. ALABAMA POWER COMPANY By: CHARLES D. MCCRARY, President and Chief Executive Officer By: WAYNE BOSTON, Attorney-in-fact PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, THIS REGISTRATION STATEMENT HAS BEEN SIGNED BY THE FOLLOWING DIRECTORS AND OFFICERS OF ALABAMA POWER COMPANY IN THE CAPACITIES AND ON THE DATE INDICATED. SIGNATURE TITLE DATE ----- ---- CHARLES D. MCCRARY President, Chief Executive Officer and Director (Principal Executive Officer) WILLIAM B. HUTCHINS, III Executive Vice President, Chief Financial Officer and Treasurer (Principal Financial Officer) ART P. BEATTIE Vice President and Comptroller (Principal Accounting Officer) WHIT ARMSTRONG CARL E. JONES, JR. JAMES K. LOWDER WALLACE D. MALONE, JR. MAYER MITCHELL ROBERT D. POWERS ANDREAS RENSCHLER C. DOWD RITTER JAMES H. SANFORD JOHN COX WEBB, IV JAMES W. WRIGHT By WAYNE BOSTON October 24, 2002 (WAYNE BOSTON, ATTORNEY-IN-FACT) Directors II-8 PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, ALABAMA POWER CAPITAL TRUST VI CERTIFIES THAT IT HAS REASONABLE GROUNDS TO BELIEVE THAT IT MEETS ALL OF THE REQUIREMENTS FOR FILING ON FORM S-3 AND HAS DULY CAUSED THIS REGISTRATION STATEMENT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF BIRMINGHAM, STATE OF ALABAMA, ON THE 24TH DAY OF OCTOBER, 2002. ALABAMA POWER CAPITAL TRUST VI By: ALABAMA POWER COMPANY, Depositor By: WAYNE BOSTON, Assistant Secretary PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, ALABAMA POWER CAPITAL TRUST VII CERTIFIES THAT IT HAS REASONABLE GROUNDS TO BELIEVE THAT IT MEETS ALL OF THE REQUIREMENTS FOR FILING ON FORM S-3 AND HAS DULY CAUSED THIS REGISTRATION STATEMENT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF BIRMINGHAM, STATE OF ALABAMA, ON THE 24TH DAY OF OCTOBER, 2002. ALABAMA POWER CAPITAL TRUST VII By: ALABAMA POWER COMPANY, Depositor By: WAYNE BOSTON, Assistant Secretary PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1933, ALABAMA POWER CAPITAL TRUST VIII CERTIFIES THAT IT HAS REASONABLE GROUNDS TO BELIEVE THAT IT MEETS ALL OF THE REQUIREMENTS FOR FILING ON FORM S-3 AND HAS DULY CAUSED THIS REGISTRATION STATEMENT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF BIRMINGHAM, STATE OF ALABAMA, ON THE 24TH DAY OF OCTOBER, 2002. ALABAMA POWER CAPITAL

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TRUST VIII By: ALABAMA POWER COMPANY, Depositor By: WAYNE BOSTON, Assistant Secretary II-9

2005

Net income (loss) \$ 16 \$ (19 ) Other comprehensive income (loss):

Minimum pension liability adjustment

13 □

Total comprehensive income (loss)

\$ 29 \$ (19 )

The minimum pension liability adjustment has not been adjusted for income taxes due to recording a full valuation allowance against US net deferred tax assets.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

**8. Income (Loss) Per Share**

The following table shows information about the numerators and denominators used in the calculation of basic and diluted net income (loss) per share.

	<b>Three Months Ended</b>	
	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Numerator:		
Income (loss) from continuing operations □ basic and diluted	\$ 16	\$ (23)
	<b>(shares in thousands)</b>	
Denominator:		
Weighted average shares outstanding □ basic	167,441	180,780
Stock options, restricted stock units and certain other equity compensation instruments	2,330	□
Weighted average shares outstanding □ diluted	169,771	180,780
Excluded from weighted average shares outstanding □ diluted: (1)		
Convertible notes	10,935	11,237
Stock options, restricted stock units and certain other equity compensation instruments	□	158
Total excluded	10,935	11,395

(1) Items excluded from the diluted weighted average shares outstanding calculation as their effect would be anti-dilutive.

**9. Benefit Obligations**

The Company has pension plans covering substantially all U.S. employees, excluding management employees hired after June 30, 2003. Retirement benefits are offered under a defined benefit plan and are based on either an adjusted career average pay or dollar per month formula or on a cash balance plan which is based on a pay and interest credit. The cash balance plan covers certain employees of companies acquired since 1996 and management employees hired after January 1, 1999 and before July 1, 2003, and provides for amounts credited to a participant's account each year based on their age and compensation, and interest on existing balances. The Company also has postretirement benefit plans that include healthcare benefits and life insurance coverage. Participants in the cash balance plan and management employees hired after June 30, 2003 are not entitled to Company paid benefits under the postretirement benefit plans. The Company also has pension plans covering certain international employees.

**Net Periodic Benefit Cost**

	<b>Three Months Ended</b>		<b>Three Months Ended</b>	
	<b>December 31, 2006</b>		<b>December 31, 2005</b>	
	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>
Service cost	\$ 2	\$ □	\$ 3	\$ □

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Interest cost	18	1	18	3
Expected return on plan assets	(21)	(1)	(21)	(1)
Amortization of prior service cost	□	(3)	□	(2)
Recognized net actuarial loss	3	□	3	1
Net periodic benefit cost	2	(3)	3	1
Curtailement gain	□	(1)	□	□
Total benefit cost	\$ 2	\$ (4)	\$ 3	\$ 1



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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**(Unaudited)**

The curtailment gain reflects accelerated recognition of prior service cost, as the expected years of future service of participants was reduced, primarily as a result of the Company's workforce reductions.

The Company does not currently plan to make contributions to its pension plans during fiscal 2007.

### 10. Intangible Assets

The Company has goodwill and acquired intangible assets resulting from acquisitions. Intangible assets with finite lives are amortized over their useful lives and goodwill is tested for impairment at least annually. The following table reflects the Company's goodwill by reportable segment:

	<b>December 31, 2006</b>	<b>September 30, 2006</b>
Unamortized intangible assets:		
Goodwill:		
Consumer segment	\$ 152	\$ 152
Networking segment	44	44
Goodwill	\$ 196	\$ 196

The following table reflects the other acquired intangible assets by major class and the related accumulated amortization.

	<b>December 31, 2006</b>			<b>September 30, 2006</b>		
	<b>Gross</b>	<b>Accumulated Amortization</b>	<b>Net</b>	<b>Gross</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Amortized intangible assets:						
Existing technology (1)	\$ 11	\$ 4	\$ 7	\$ 11	\$ 3	\$ 8
Non-competition agreements (2)	9	8	1	9	7	2
Acquired intangible assets	\$ 20	\$ 12	\$ 8	\$ 20	\$ 10	\$ 10

(1) Existing technology relates to the Networking segment.

(2) Non-competition agreements relate to the Consumer Segment.

Intangible asset amortization expense for the three months ended December 31, 2006 was \$2, of which \$1 was included in costs. Intangible asset amortization expense for the three months ended December 31, 2005 was \$1. Intangible asset amortization expense for the remainder of fiscal 2007 is estimated to be \$2. The amortization for future fiscal years is estimated to be \$2 for each of fiscal 2008, 2009 and 2010.

### 11. Segment Information

The Company is organized into three operating segments: Storage, Mobility and Networking. The Storage and Mobility operating segments represent one reportable segment, Consumer. The Networking segment is the other reportable segment. Storage provides integrated circuit solutions for hard disk drives used in computing and

consumer electronics products. Mobility provides integrated circuit solutions for end-user applications such as mobile phones and satellite radio receivers. Networking provides semiconductor solutions for communications networks, storage area networks, as well as personal computer based consumer communications applications.

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131"), establishes standards for the way that public companies report information about operating segments in annual financial statements and requires that those companies report selected financial information about operating segments in interim financial reports. SFAS 131 also establishes standards for related disclosures about products and services, major customers and geographic areas. Although the Company had three operating segments at December 31, 2006, under the aggregation criteria set forth in SFAS 131, the Company had two reportable segments, Consumer and Networking.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

Each operating segment is managed separately. Disclosure of segment information is on the same basis used internally for evaluating segment performance and allocating resources. Performance measurement and resource allocation for the segments are based on many factors. The primary financial measure used is segment gross margin, which excludes restructuring related charges and stock-based compensation charges included in costs. The Company's primary segment financial measure also excludes operating expenses, interest income or expense, other income or expense, and income taxes. The Company does not identify or allocate assets by operating segment.

The Company generates revenues from the sale of one product, integrated circuits. Integrated circuits are made using semiconductor wafers imprinted with a network of electronic components. They are designed to perform various functions such as processing electronic signals, controlling electronic system functions and processing and storing data. The Company also generates revenue from the licensing of intellectual property. Each operating segment includes revenue from the sale of integrated circuits and the licensing of intellectual property related to that segment. There were no inter-segment sales.

**Reportable Segments**

	<b>Three Months Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Revenue		
Consumer:		
Storage	\$ 128	\$ 173
Mobility	123	90
Consumer	251	263
Networking	121	140
Total	\$ 372	\$ 403
Gross margin (excluding restructuring related charges and stock-based compensation expense included in costs)		
Consumer	\$ 96	\$ 111
Networking	79	84
Total	\$ 175	\$ 195

**Reconciling Items**

A reconciliation of reportable segment gross margin to gross margin reported in the condensed consolidated statements of operations is shown below:

	<b>Three Months Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Reportable segment gross margin	\$ 175	\$ 195
Deduct: Stock-based compensation expense included in costs	1	2
Gross margin	\$ 174	\$ 193

**12. Financial Guarantees**

The Company generally indemnifies its customers from third party intellectual property infringement litigation claims related to its products. No liability recognition is required as of December 31, 2006 for indemnification clauses and no estimate of potential future payments is provided because the reliability of any measurement cannot be verified independently.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in Millions Except Per Share Amounts)**  
**(Unaudited)**

The Company's product warranty accrual includes specific accruals for known product issues and an accrual for an estimate of incurred but unidentified product issues based on historical activity. The warranty accrual is recorded within other current liabilities. The table below presents a reconciliation of the changes in the Company's aggregate product warranty liability reserve for the three months ended December 31, 2006 and 2005:

	<b>Three Months Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Balance as of beginning of period	\$ 1	\$ 2
Accruals for new and pre-existing warranties (including changes in estimates)	□	□
Settlements made (in cash or in kind) during the period	□	□
Balance as of end of period	\$ 1	\$ 2

### 13. Discontinued Operations

During fiscal 2003, the Company exited its optoelectronic components business. The condensed consolidated financial statements reflect this business as discontinued operations. During the three months ended December 31, 2005 a reserve of \$4 related to the optoelectronics business was deemed no longer necessary and therefore was reversed. Income from operations of discontinued business before income taxes was \$4 for the three months ended December 31, 2005. There was no income from discontinued operations during the three months ended December 31, 2006.

### 14. Commitments and Contingencies

In the normal course of business, the Company is involved in proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to environmental, tax and other matters. The semiconductor industry is characterized by substantial litigation concerning patents and other intellectual property rights. From time to time, the Company may be party to inquiries or claims in connection with these rights. In addition, from time to time the Company is involved in legal proceedings arising in the ordinary course of business, including unfair labor charges filed by its unions with the National Labor Relations Board, claims before the U.S. Equal Employment Opportunity Commission and other employee grievances. These matters are subject to many uncertainties, and outcomes are not predictable with assurance. Consequently, the ultimate aggregate amount of monetary liability or financial impact with respect to these matters at December 31, 2006 cannot be ascertained. While these matters could affect the operating results of any one quarter when resolved in future periods and while there can be no assurance with respect thereto, management believes that after final disposition, any monetary liability or financial impact to the Company beyond that provided for at December 31, 2006, would not be material to the annual consolidated financial statements.

The Company has a take or pay agreement with SMP under which it has agreed to purchase 51% of the managed wafer capacity from SMP's integrated circuit manufacturing facility and Chartered Semiconductor agreed to purchase the remaining 49% of the managed wafer capacity. SMP determines its managed wafer capacity each year based on forecasts provided by Agere and Chartered Semiconductor. If the Company fails to purchase its required commitments, it will be required to pay SMP for the fixed costs associated with the unpurchased wafers. Chartered Semiconductor is similarly obligated with respect to the wafers allotted to it. The agreement may be terminated by either party upon two years written notice. The agreement may also be terminated for material breach, bankruptcy or insolvency.

On December 6, 2006, Sony Ericsson Mobile Communications USA Inc. filed a lawsuit in Wake County Superior Court in North Carolina, alleging unfair and deceptive trade practices, fraud and negligent misrepresentation in connection with Agere's engagement with Sony Ericsson to develop a wireless data card for

personal computers. While Agere has not completed its review of the matter, based on the information currently available, Agere intends to contest this matter vigorously. No liability has been recorded since any possible loss or range of possible loss cannot be estimated at this time.

Agere has incurred and expects that it will incur substantial costs in connection with the proposed merger with LSI. These costs are primarily the fees of attorneys, accountants and financial advisors. Pursuant to an engagement letter, Agere has agreed to pay Goldman Sachs, Agere's financial advisor, a transaction fee of approximately \$28, substantially all of which is payable upon consummation of the merger. In addition, Agere must pay a fee of \$120 to LSI if the merger agreement is terminated under circumstances specified in the merger agreement.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion of our financial condition and results of operations should be read in conjunction with our unaudited financial statements for the three months ended December 31, 2006 and 2005 and the notes thereto. This discussion contains forward-looking statements. Please see Item 1A, "Risk Factors," in Part II for a discussion of the uncertainties, risks and assumptions associated with these statements.*

**Overview**

We are a leading provider of integrated circuit solutions for a variety of communications and computing applications. Some of our solutions include related software and reference designs. Our customers include manufacturers of hard disk drives, mobile phones, advanced communications and networking equipment and personal computers. We also generate revenue from the licensing of intellectual property.

On December 3, 2006, we entered into a definitive merger agreement with LSI Logic Corporation, or LSI, under which we will be merged into a wholly owned subsidiary of LSI. If the proposed merger is completed, holders of our common stock will be entitled to receive 2.16 shares of LSI common stock for each share of Agere common stock that they own. The transaction is subject to the approval of stockholders from both companies as well as customary conditions and regulatory approvals. We plan to hold our stockholder meeting on March 29, 2007, and expect the transaction to close shortly thereafter. Agere and LSI have made pre-merger notification filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, and the waiting period under the Act has expired.

Our business is organized into operating segments that focus on three key markets: Storage, Mobility and Networking. We have two reportable segments, Consumer and Networking. Each segment includes product revenue and revenue from the licensing of intellectual property. The Consumer segment includes the Storage and Mobility operating segments. Storage provides integrated circuit solutions for hard disk drives used in computing and consumer electronics products. Mobility provides integrated circuit solutions for end-user applications such as mobile phones and satellite radio receivers. Networking provides semiconductor solutions for communications networks, storage area networks, as well as personal computer based consumer communications applications.

At the beginning of fiscal 2006, we implemented a turnaround plan to address challenges in our business. The plan is divided into three phases. During the initial stabilization phase we focused on assessing the business, simplifying and improving our business processes and aligning our investments with market opportunities. As part of this phase, we reorganized the senior management team, embedded sales personnel into each business, created customer-centered account teams and challenged employees at all levels to increase operating efficiency and improve overall effectiveness. This effort resulted in significant restructuring related charges during fiscal 2006. We have completed the first phase of the turnaround plan.

In the second phase we increased our earnings, primarily through the management of our costs and expenses. Also the cultural and organizational changes that occurred in the first stage became more fully embedded in the organization during this phase and resulted in a more streamlined, responsive approach from each of our three businesses. We believe that the changes we made gave the three businesses end-to-end responsibility for design win execution, increasing efficiency and ultimately delivering long term revenue growth. Additionally, in this phase of the plan the businesses began to more sharply focus on their technology and leadership positions and looked to work with other companies in areas that can improve our time-to-market performance or provide system-level solutions with the goal of growing market share while providing a reasonable level of return. We have completed the second phase of the turnaround plan.

In the final phase of our turnaround plan, we will seek to achieve competitive levels of revenue growth and consistently higher levels of earnings. We believe that we have a solid base of products, design wins and opportunities from which to drive growth.

Our business depends in large part on demand for mobile phones, communication network equipment, personal computers and associated equipment, and consumer electronics devices. Our revenues can be affected by changes in demand for any of these types of products. The markets for these products are competitive and rapidly changing. Accordingly, significant technological changes, new customer requirements, changes in customer buying behavior or the emergence of competitive products with new capabilities or technologies could

adversely affect our revenues and operating results. In addition, our planned merger with LSI has had an effect on our anticipated revenues from the licensing of intellectual property because some counterparties are reluctant to enter into agreements at this time.



**Restructuring and Decommissioning Activities**

We have implemented restructuring and consolidation actions to improve gross profit, reduce expenses and streamline operations, including the closure of our wafer manufacturing facility in Orlando, Florida, where operations ceased in September 2005. On December 31, 2006, seven employees were assigned to the Orlando facility and primarily engaged in facility decommissioning activities. We expect these people to leave the business by the end of the second quarter of fiscal 2007. The buyer requested some changes to the agreement to sell our Orlando facility, therefore, we reworked the agreement and currently plan to close in the second quarter of fiscal 2007. In addition to our restructuring activities, we are engaged in activities to further resize our business.

The following table shows the amounts recorded within restructuring and other charges-net in our statement of operations during the three months ended December 31, 2006 and 2005.

	<b>Three Months Ended December 31, 2006      2005 (dollars in millions)</b>	
Business resizing expenses□ net	\$ 1	\$ 21
Orlando decommissioning expenses	1	7
Restructuring and related expenses	□	3
Merger expenses	2	□
Restructuring and other charges-net	\$ 4	\$ 31

For additional details on our restructuring and business resizing activities, see Note 4 to our financial statements in Item 1.

To complete our restructuring programs we estimate that we will incur \$2 million of additional cash charges, primarily related to the shutdown of the Orlando facility. The Company expects to pay the majority of these amounts during fiscal 2007.

We estimate that approximately \$23 million of cash is required to complete all of our current restructuring and restructuring related programs. This amount includes \$17 million in our business restructuring reserves, \$4 million in our payroll and benefit liabilities reflected in our balance sheet at December 31, 2006, and the \$2 million of future cash charges noted above. These amounts exclude merger related expenses. The Company expects to fund these cash requirements with cash on hand.

**Results of Operations*****Three months ended December 31, 2006 compared to the three months ended December 31, 2005***

The following table shows certain components of the statements of operations expressed as a percentage of revenue:

	<b>Three Months Ended December 31, 2006      2005</b>	
Gross profit	46.8%	47.9%
Operating expenses	41.4	52.4
Operating income (loss)	5.4	(4.5)
Net income (loss)	4.3%	(4.7)%



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The following table shows the change in revenue, both in dollars and in percentage terms, by segment:

	Three Months Ended December 31,		Change	
	2006	2005	\$	%
	(dollars in millions)			
Revenue by Segment:				
Consumer segment:				
Storage	\$ 128	\$ 173	\$ (45)	(26)%
Mobility	123	90	33	37
Consumer segment	251	263	(12)	(5)
Networking segment	121	140	(19)	(14)
Total Revenue	\$ 372	\$ 403	\$ (31)	(8)%

The revenue discussion below is qualitative in nature as it pertains to price, volume and mix analyses. Traditional price, volume and mix analysis is not practicable due to the diversity of our product lines and the rapid evolution of technology, including the frequent integration of additional functionality on a single integrated circuit.

In the Consumer segment, product revenue was \$236 million for the first quarter of fiscal 2007, a \$7 million decrease from the first quarter of fiscal 2006, and revenue from licensing of intellectual property was \$15 million for the first quarter of fiscal 2007, a \$5 million decrease from the first quarter of fiscal 2006. The components of Consumer segment revenue are discussed below.

**Storage revenue**

	Three Months Ended December 31,		Change	
	2006	2005	\$	%
	(dollars in millions)			
Storage Revenue	\$ 128	\$ 173	\$ (45)	(26)%

In Storage, product revenue was \$126 million for the first quarter of fiscal 2007, a decrease of \$36 million from the first quarter of fiscal 2006, and revenue from licensing of intellectual property was \$2 million for the first quarter of fiscal 2007, a \$9 million decrease from the first quarter of fiscal 2006. The product revenue decrease was primarily driven by product mix and lower volume in our system-on-a-chip solutions as a result of two of our customers merging. Price declines across most applications also contributed to the decrease. The decreases were partially offset by volume increases in sales of pre-amplifiers.

**Mobility revenue**

	Three Months Ended December 31,		Change	
	2006	2005	\$	%
	(dollars in millions)			
Storage Revenue	\$ 123	\$ 90	\$ 33	37%

In Mobility, product revenue was \$110 million in the first quarter of fiscal 2007, an increase of \$29 million from the first quarter of fiscal 2006, and revenue from licensing of intellectual property was \$13 million for the first quarter of fiscal 2007, a \$4 million increase from the first quarter of fiscal 2006. The product revenue increase was mainly due to an increase in shipments of products based on the 2.5G standard, partially offset by

price declines across many applications and product mix.

***Networking revenue***

	<b>Three Months Ended December 31,</b>		<b>Change</b>	
	<b>2006</b>	<b>2005</b>	<b>\$</b>	<b>%</b>
	<b>(dollars in millions)</b>			
Storage Revenue	\$ 121	\$ 140	\$ (19)	(14)%

In the Networking segment, product revenue was \$115 million for the first quarter of fiscal 2007, a decrease of \$13 million from the first quarter of fiscal 2006, and revenue from licensing of intellectual property was \$6 million for the first quarter of fiscal 2007, a \$6 million decrease from the first quarter of fiscal 2006. The decrease in product revenue is due to volume decreases in mature

products, primarily related to a customer changing its personal computer system architecture. Volume decreases in personal computer applications, and price declines across many applications also contributed to the quarterly decline. The decreases were partially offset by favorable mix metrics as new network infrastructure offerings replaced mature products.

### ***Gross margin***

	<b>Three Months Ended December 31,</b>		<b>Change</b>	
	<b>2006</b>	<b>2005</b>		
Total Gross margin	46.8%	47.9%		(1.1)%
Gross margin by segment:				
Consumer segment	38.2%	42.2%		(4.0)%
Networking segment	65.3 %	60.0%		5.3%

The decrease in gross margin percentage resulted from overall price declines in the sale of integrated circuits in each operating segment, unfavorable product mix and lower revenue from licensing of intellectual property. The decrease in gross margin was partially offset by improvement in our cost structure due to our business resizing initiatives.

Although performance measurement and resource allocation for the reportable segments are based on many factors, the primary financial measure is segment gross margin, which excludes restructuring related charges and stock-based compensation charges included in costs. See Note 11 to our financial statements in Item 1 for additional segment information. The decrease in the Consumer segment gross margin reflects price declines in the sale of integrated circuits, unfavorable product mix and lower revenue from the licensing of intellectual property. These decreases were partially offset by improvements in our cost structure due to our business resizing initiatives. The improvement in gross margin for the Networking segment is primarily due to favorable product mix, savings related to improvements in our cost structure due to our business resizing initiatives. These increases were partially offset by price declines in the sale of integrated circuits.

### ***Selling, general and administrative***

	<b>Three Months Ended December 31,</b>		<b>Change</b>	
	<b>2006</b>	<b>2005</b>	<b>\$</b>	<b>%</b>
	<b>(dollars in millions)</b>			
Selling, general and administrative	\$ 45	\$ 61	\$ (16)	(26)%

The decrease in selling, general and administrative expenses is primarily due to headcount and cost reductions resulting from our business resizing activities.

### ***Research and development***

	<b>Three Months Ended December 31,</b>		<b>Change</b>	
	<b>2006</b>	<b>2005</b>	<b>\$</b>	<b>%</b>
	<b>(dollars in millions)</b>			
Research and development	\$ 104	\$ 119	\$ (15)	(13)%

The decrease in research and development expense is primarily related to headcount and cost reductions resulting from our business resizing activities resulting in lower design expenses for networking applications, non-program specific research and development expenses and information technology expenses. Also contributing to the decline is lower mask expenses as the timing for certain projects changed and lower computer assisted design expenses as we renegotiated contracts.

**Other income □ net**

	<b>Three Months Ended December 31,</b>		<b>Change</b>	
	<b>2006</b>	<b>2005</b>	<b>\$</b>	<b>%</b>
	<b>(dollars in millions)</b>			
Other income □ net	\$ 5	\$ 6	\$ (1)	(17)%

The decrease in other income □ net is mainly due to lower interest income, related to a lower cash balance during the current quarter, compared to the prior year quarter.

**Provision for income taxes**

	Three Months Ended December 31,		Change	
	2006	2005	\$	%
	(dollars in millions)			
Provision for income taxes	\$ 3	\$ 4	\$ (1)	(25)%
Effective tax rate	15.8%	(21.1)%	N/A	36.9

For the three months ended December 31, 2006, the effective tax rate differs from the U.S. statutory rate primarily due to the net impact of recording a provision for taxes related to profitable non-U.S. jurisdictions, recording a provision for certain U.S. state taxes, recording deferred taxes on indefinite-lived goodwill intangible assets, and recording a valuation allowance against U.S. net deferred tax assets. For the three months ended December 31, 2005, the effective tax rate differs from the U.S. statutory rate primarily due to net impact of recording a provision for taxes related to profitable non-U.S. jurisdictions, recording deferred taxes on indefinite-lived goodwill intangible assets, and recording a full valuation allowance against U.S. net deferred tax assets.

**Income from discontinued operations**

	Three Months Ended December 31,		Change	
	2006	2005	\$	%
	(dollars in millions)			
Income from discontinued operations	\$ -	\$ 4	\$ (4)	N/A

Income from discontinued operations was \$4 million in the first three months ended December 31, 2005, as a result of the reversal of a reserve related to our former Optoelectronics components business deemed no longer necessary. There was no income from discontinued operations for the three months ended December 31, 2006.

**Liquidity and Capital Resources**

As of December 31, 2006, our cash and cash equivalents were \$456 million, an increase of \$50 million as of September 30, 2006. As of December 31, 2006, total debt was \$362 million, which consists entirely of our long-term convertible subordinated notes due in 2009.

Net cash provided by operating activities was \$19 million for the three months ended December 31, 2006 and net cash used by operating activities was \$7 million for the three months ended December 31, 2005. The improvement is attributable to lower cash outflows for costs and operating expenses as a result of our resizing activities, partially offset by lower revenues in the current period.

Net cash provided by investing activities was \$3 million for the three months ended December 31, 2006 compared to a use of \$7 million in cash for the three months ended December 31, 2005. The improvement is primarily due to \$29 million lower capital expenditures in the current quarter and the acquisition of intangible assets of \$7 million in the prior year quarter. The increase was partially offset by a lower return of capital from our joint venture of \$22 million and \$4 million of lower proceeds from the sale of property, plant and equipment.

Net cash provided by financing activities was \$28 million for the three months ended December 31, 2006, compared to a use of cash of \$35 million in the prior year quarter. The improvement is mainly due to

repurchasing \$41 million of our common stock in the prior year quarter and \$22 million higher proceeds from the issuance of stock in the current quarter.

We have incurred and expect that we will incur substantial costs in connection with the proposed merger with LSI. These costs are primarily the fees of attorneys, accountants and financial advisors. Pursuant to an engagement letter, we have agreed to pay Goldman Sachs, our financial advisor, a transaction fee of approximately \$28 million, substantially all of which is payable upon consummation of the merger. In addition, we must pay a fee of \$120 million to LSI if the merger agreement is terminated under circumstances specified in the merger agreement.



Our primary source of liquidity is our cash and cash equivalents. We believe our cash and cash equivalents, together with our cash provided from operations will be sufficient to meet our projected cash requirements for at least the next 12 months.

### Recent Pronouncements

In July 2006, the Financial Accounting Standards Board, or FASB, issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB No. 109, or FIN 48, which clarifies the accounting for uncertainty in tax positions. This Interpretation requires an entity to recognize the impact of a tax position in its financial statements if that position is more likely than not to be sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective for us as of the beginning of fiscal year 2008, with earlier application encouraged. Any cumulative effect of the change in accounting principle will be recorded as an adjustment to the opening accumulated deficit balance. We are evaluating the timing of our adoption of FIN 48 and the potential effects of implementing this Interpretation on our financial condition and results of operations.

In September 2006, the FASB issued statement No. 157, *Fair Value Measurements*, or SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the U.S., and expands disclosures about fair value measurements. SFAS 157 is effective for us as of the beginning of fiscal 2009, with earlier application encouraged. Any cumulative effect will be recorded as an adjustment to the opening accumulated deficit balance, or other appropriate component of equity. We are evaluating the timing of our adoption of SFAS 157 and the potential effects of implementing this statement on our financial condition and results of operations.

In September 2006, the FASB issued statement No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*, or SFAS 158, which amends SFAS No. 87, *Employers Accounting for Pensions*, SFAS No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, *Employers Accounting for Postretirement Benefits Other than Pensions* and SFAS 132(R), *Employers Disclosure about Pensions and Other Postretirement Benefits* an amendment of FASB Statements No. 87, 88 and 106. SFAS 158 requires an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize through comprehensive income changes in that funded status in the year in which the changes occur. This Statement requires entities to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The recognition of the funded status under SFAS 158 is effective for us as of the end of fiscal 2007. The requirement to measure plan assets and benefit obligations as of the date of the entity's fiscal year-end statement of financial position will have no effect on us, as that is the current practice. If SFAS 158 had been effective as of December 31, 2006 our pension and postretirement liability reflected in the balance sheet would have decreased by \$129 million and accumulated other comprehensive loss would have decreased by \$129 million, excluding any tax impacts.

### Risk Management

We are exposed to market risk from changes in foreign currency exchange rates and interest rates that could impact our results of operations and financial position. We manage our exposure to these market risks through our regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. We use derivative financial instruments as risk management tools and not for speculative purposes. We use foreign currency forward contracts, and may from time to time use foreign currency options, to manage the volatility of non-functional currency cash flows resulting from changes in exchange rates. The change in fair market value of derivative instruments was recorded in other income-net and was not material for all periods presented.

While we hedge certain foreign currency transactions, any decline in value of non-U.S. dollar currencies may, if not reversed, adversely affect our ability to contract for product sales in U.S. dollars because our products may become more expensive to purchase in U.S. dollars for local customers doing business in the countries of the affected currencies. The majority of our sales are denominated in U.S. dollars.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We have exposure to foreign exchange and interest rate risk. There have been no material changes in market risk exposures from those disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006. See Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" Risk Management for additional details.

**Item 4. Controls and Procedures**

With the participation of our Chief Executive Officer and Chief Financial Officer, management has carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2006.

No changes occurred during the three months ended December 31, 2006 in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

## **PART II - Other Information**

### **Item 1. Legal Proceedings**

On December 6, 2006, Sony Ericsson Mobile Communications USA Inc. filed a lawsuit against us in Wake County Superior Court in North Carolina, alleging unfair and deceptive trade practices, fraud and negligent misrepresentation in connection with Agere's engagement with Sony Ericsson to develop a wireless data card for personal computers. While we have not completed our review of the matter, based on the information currently available, we intend to contest this matter vigorously.

### **Item 1A. Risk Factors**

This report contain forward-looking statements that are based on current expectations, estimates, forecasts and projections about the industry in which we operate, management's beliefs and assumptions made by management. Words such as "expects," "anticipates," "intends," "plans," "estimates," "believes," "seeks," variations of these words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Except as required under the federal securities laws and the rules and regulations of the Securities and Exchange Commission, we do not have any intention or obligation to update publicly any forward-looking statements whether as a result of new information, future events or otherwise.

The following factors, many of which are discussed in greater detail in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006, could affect our future performance and the price of our stock.

- Because our sales are concentrated on a limited number of key customers, our revenue may materially decline if one or more of our key customers do not continue to purchase our existing and new products in significant quantities.
- If we fail to keep pace with technological advances in our industry or if we pursue technologies that do not become commercially accepted, customers may not buy our products and our results of operations may be adversely affected.
- The integrated circuit industry is intensely competitive, and our failure to compete effectively could result in reduced revenue.
- Our revenue and operating results may fluctuate because we derive most of our revenue from semiconductor devices and the integrated circuits industry is highly cyclical, and because of other characteristics of our business, and these fluctuations may cause our stock price to fall.
- If we do not achieve adequate manufacturing utilization, yields or volumes or sufficient product reliability, our gross margins will be reduced.
- Because we are subject to order and shipment uncertainties, any significant cancellations or deferrals could cause our revenue to decline or fluctuate.
- A joint venture and third parties manufacture all of our wafers for us. If these suppliers are unable to fill our orders on a timely and reliable basis, our revenue may be adversely affected.
- Because many of our current and planned products are highly complex, they may contain defects or errors that are detected only after deployment in commercial applications, and if this occurs, it could harm our reputation and result in reduced revenues or increased expenses.
- We are expanding, and may seek in the future to expand, into new areas, and if we are not successful, our results of operations may be adversely affected.
- A widespread outbreak of an illness or other health issue could negatively affect our manufacturing, assembly and test, design or other operations, making it more difficult and expensive to meet our obligations to our customers, and could result in reduced demand from our customers.

- We may be subject to intellectual property litigation and infringement claims, which could cause us to incur significant expenses or prevent us from selling our products. If we are unable to protect our intellectual property rights, our business and prospects may be harmed.
- We have relatively high gross margin on the revenue we derive from the licensing of our intellectual property, and a decline in this revenue would have a greater impact on our net income than a decline in revenue from the sale of our integrated circuits products.
- If our customers do not qualify our products or manufacturing lines or the manufacturing lines of our third-party suppliers for volume shipments, our results of operations may be adversely affected.
- We conduct a significant amount of our sales activity and manufacturing efforts outside the United States, which subjects us to additional business risks and may adversely affect our results of operations.
- If we fail to attract, hire and retain qualified personnel, we may not be able to develop, market or sell our products or successfully manage our business.
- The development and evolution of markets for our integrated circuits are dependent on factors over which we have no control. For example, if our customers adopt new or competing industry standards with which our products are not compatible or fail to adopt standards with which our products are compatible, our existing products would become less desirable to our customers and our sales would suffer.
- Class action litigation due to stock price volatility or other factors could cause us to incur substantial costs and divert our management's attention and resources.

### **Risk Factors Relating to the Merger**

- If the proposed merger with LSI is not completed, we will have incurred substantial costs that may adversely affect our financial results and operations and the market price of our common stock.

If the merger is not completed, the price of our common stock may decline to the extent that the current market prices of our common stock reflect a market assumption that the merger will be completed. In addition, we have incurred and will incur substantial costs in connection with the proposed merger. These costs are primarily associated with the fees of attorneys, accountants and financial advisors. In addition, we have diverted significant management resources in an effort to complete the merger and are subject to restrictions contained in the merger agreement on the conduct of our business. If the merger is not completed, we will have incurred significant costs, including the diversion of management resources, for which we will have received little or no benefit. Also, if the merger is not completed under certain circumstances specified in the merger agreement, we may be required to pay a termination fee of \$120 million.

In addition, if the merger is not completed, we may experience negative reactions from the financial markets and our suppliers, customers and employees. Each of these factors may adversely affect the trading price of our common stock and our financial results and operations.

- Customer uncertainties related to the merger could adversely affect our businesses, revenue and gross margins.

In response to the announcement of the merger or due to ongoing uncertainty about the merger, customers may delay or defer purchasing decisions or elect to switch to other suppliers. In particular, prospective customers could be reluctant to purchase our products and services due to uncertainty about the direction of the company's offerings and willingness to support its products. To the extent that the merger creates uncertainty among those persons and organizations contemplating purchases such that one large customer, or a significant group of smaller customers, delays, defers or changes purchases in connection with the planned merger, our revenues could be adversely affected. We may make assurances to customers to address their uncertainty about the direction of the company's product and related support offerings which may result in additional obligations for the company. In addition, the announcement of the merger may cause prospective licensees of our intellectual property to delay or defer licensing decisions resulting in a decline in our licensing revenues which could have a significant impact on the profitability of the company. Our quarterly revenues and net earnings could be substantially below expectations of market analysts and a decline in our stock price could result.

**Item 5. Other information**

We will hold our 2007 annual meeting of stockholders on March 29, 2007. Stockholders of record on February 2, 2007 will be entitled to notice of and to vote at the meeting. We anticipate distributing proxy materials to our stockholders for this meeting in mid-February. The deadlines for submitting shareholder proposals for this meeting under Rule 14a-8 under the Securities Exchange Act of 1934 and under our bylaws has passed.

**Item 6. Exhibits**

Exhibits

See Exhibit Index.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AGERE SYSTEMS INC.

/s/ Peter Kelly

Executive Vice President and Chief Financial  
Officer  
(Principal Accounting Officer)

Date: February 9, 2007

**EXHIBIT INDEX**

<u>Exhibits No.</u>	<u>Description</u>
10.1	Agreement and plan of Merger, dated as of December 3, 2006, by and among Agere Systems Inc., LSI Logic Corporation and Atlas Acquisition Corp. (Incorporated by reference to Exhibit 2.1 to our Current Report on Form 8-K, filed December 4, 2006)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350