State of Florida

Public Service Commission

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DATE: AUGUST 22, 2002

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (HARLOW, BOHRMANN) TB WBM
OFFICE OF THE GENERAL COUNSEL (C. KEATING) WCK JDJ

RE: DOCKET NO. 020404-EQ - PETITION FOR APPROVAL OF PLAN TO SHARE RISKS OF BAY COUNTY QUALIFYING FACILITY CONTRACT MODIFICATION BY FLORIDA POWER CORPORATION

AGENDA: 09/03/02 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\020404.RCM

CASE BACKGROUND

On June 17, 1988, by Order No. 19509, the Commission approved a contract for the purchase of capacity and energy between Florida Power Corporation (FPC) and Bay County (County). The negotiated contract provides FPC with 11 megawatts of capacity and associated energy from the County's Resource Recovery Facility. The contract expires on December 31, 2022. The contract provided for early capacity payments to Bay County by applying the capacity and O&M payments from the out years (2013 to 2022) to the County in the first seven years of the contract (1988 through 1994) on a present-valued, levelized basis. Years 2013 through 2022 of the contract provide firm energy with no capacity payments.

On October 16, 2001, FPC filed a petition for approval of an amendment to its purchased power contract with the County. The amendment terminates the contract in 2006 rather than 2022, and requires FPC to pay consulting fees of $610,000 incurred by the

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County. FPC estimated that the contract amendment would save ratepayers a net present value (NPV) of $4.4 million, when compared to replacement energy costs. By Order No. PSC-02-0483-PAA-EQ, issued April 8, 2002, in Docket No. 011365-EQ, the Commission granted FPC's petition to amend the Bay County contract, and approved the $610,000 for cost recovery. In its Order, the Commission also recognized that:

> The risks associated with variances from the projected energy and capacity costs used to measure the cost-effectiveness of this amendment are, at present, borne entirely by FPC's ratepayers . . . A sharing of both the risks and rewards associated with this amendment could be beneficial to both the utility and its customers.

The Commission therefore ordered FPC to consider a sharing plan, and to either file a petition seeking approval of a sharing plan, or submit a report detailing why a sharing plan was not proposed. On May 8, 2002, FPC filed a petition for approval of its plan to share the risks of the Bay County contract amendment. FPC's proposed sharing plan is the subject of this recommendation.

Jurisdiction in this matter is vested in the Commission by various provisions of Chapter 366, Florida Statutes, including Sections 366.04, 366.05, 366.06, and 366.051, Florida Statutes.

ISSUE 1: Should Florida Power Corporation's petition for approval of a plan to share the risks of the Bay County qualifying facility contract modification be approved?

RECOMMENDATION: No. FPC's proposed sharing plan does not address the long-term nature of the risk to which ratepayers are exposed. The sharing plan also appears to favor FPC's shareholders, because FPC's ratepayers will still be required to pay all the up-front costs. FPC's sharing plan will reduce expected ratepayer NPV savings from $4.4 million to $1.9 million, leaving less room for error that ratepayers will not be harmed by the contract modification. Further, due to the unusual nature of the original contract, which provided for firm energy with no capacity charges from 2013 through 2022, FPC's shareholders will not be exposed to any significant risk until 2013.

STAFF ANALYSIS:

The Bay County Contract Amendment: By Order No. PSC-02-0483-PAA-EQ, issued April 8, 2002, the Commission approved FPC's petition to amend the Bay County contract. The amendment terminates the contract in 2006 rather than 2022 and requires FPC to pay consulting fees of $610,000 incurred by Bay County.

FPC estimated that terminating the contract in 2006 would save ratepayers a NPV of $4.4 million, when compared to replacement energy costs. According to FPC, these savings occur because the capacity and energy costs of the original Bay County contract are expected to be higher than the estimated market costs to replace the contract during 2007 through 2012. Ratepayer costs will increase in 2002 when the $610,000 payment to Bay County is recovered from ratepayers through the Fuel and Purchased Power Recovery Clause. Ratepayer costs to replace the contract are expected to increase in 2013 through 2022, because the contract provided firm energy during this period with zero capacity costs.

The Commission ordered FPC to consider a sharing plan due to the concern that FPC's ratepayers would bear all "the risks associated with variances from the projected energy and capacity costs used to measure the cost-effectiveness of this amendment." As stated in the Order:

> All these projections are based on long term estimates, that is, over the twenty year remaining life of the

existing contract. There could conceivably be much risk and volatility associated with those projections compared to the existing agreement, given that at present, beginning in year 2013, the capacity payments are zero.

FPC's Proposed Sharing Plan: FPC states in its petition that its proposed sharing plan will "share the risks and benefits of the modified Bay County contract with its customers on a 50/50 basis." FPC proposes that the sharing plan be implemented on an annual basis through the fuel adjustment proceedings, beginning with FPC's projection filing for the calendar year 2007 through the projection filing for 2022.

FPC's proposed sharing plan is based on annual estimates for each upcoming projection period. In each fuel adjustment projection filing, FPC will provide the Commission with estimates of: 1) the costs that would have been incurred in the upcoming year if the original Bay County contract had remained in effect; and, 2) the costs to replace the contract for the upcoming year. FPC will then charge or credit one-half of the difference to FPC's recoverable fuel costs for the upcoming year to reflect the shareholders' portion of the savings or additional costs for that year. FPC's projected costs under the original contract will include applicable capacity payments, plus estimated energy payments. Using the methodology provided by the Bay County contract, these estimated energy payments will be based on the lower of the forecasted coal price at Big Bend Unit 4 multiplied by a heat rate of 9,790 MMBTU per kWh, or FPC's marginal energy cost in cents per kWh. Projected replacement power costs will be based on FPC's forecasted hourly marginal energy cost in cents per kWh. FPC does not intend to re-estimate these costs using actual data for each year for true-up purposes. FPC's proposed sharing plan does not address the $610,000 paid by its ratepayers in 2002.

Staff's Analysis of FPC's Proposed Sharing Plan: Staff has the following concerns about FPC's proposed sharing plan:

1) <u>FPC's Sharing Plan Does Not Address the Long-term Nature of Ratepayer Risk</u>: Staff does not believe that FPC's proposed sharing mechanism meets the intent of the Commission's order to address long-term ratepayer risk. It bears repeating that, in Order No. PSC-02-0483-PAA-EQ, the Commission required FPC to consider a sharing plan due to the concern that FPC's ratepayers would bear all "the risks associated with variances from the projected energy

and capacity costs used to measure the cost-effectiveness of this amendment." FPC's estimate of $4.4 million NPV in ratepayer savings was based on long-term estimates. FPC's proposed sharing plan is not based on long-term estimates, but rather annual estimates for each upcoming projection period. Staff believes that using year by year projections does not address the long-term nature of the risk to which ratepayers are exposed. It is staff's understanding from our review of the order and the transcript from the March 19, 2002, Agenda Conference, that the Commission's intent was for FPC shareholders to explore options for sharing the long-term risk that the expected $4.4 million in benefits would not materialize. In order to address long-term risk, staff believes that a sharing plan must use the predicted benefits at the time of approval as a benchmark to judge a utility's performance over the life of the original contract. This would allow a utility to share in the benefits if expectations are surpassed, as well as the risk if expectations are not met.

2) FPC's Proposed Sharing Plan Favors Shareholders: At the time the modification was approved, FPC was willing to credit one hundred percent of the estimated $4.4 million savings to ratepayers. In exchange, ratepayers were required to pay $610,000 through the Fuel Clause in 2002. Ratepayers paid all the up-front costs in expectation of all the benefits, and, as the Commission expressed, took on all the long-term risk. Under FPC's proposed sharing plan, FPC's ratepayers will still experience an immediate rate increase of $610,000. However, FPC will split the resulting savings/costs each year with ratepayers from 2007 through 2022. At first glance it appears that FPC's shareholders are taking on half the risk. However, because ratepayers are still paying the up-front costs, FPC's plan favors FPC's shareholders, and may actually increase the risk that there will be a negative NPV impact for FPC's ratepayers. This is best illustrated with a theoretical example. FPC calculated the estimated $4.4 million NPV savings by subtracting the $610,000 up-front cost from the estimated $5.0 million NPV cost savings achieved by replacing the contract. If one assumes that FPC's long-term estimates are correct and applies FPC's proposed sharing plan methodology, FPC's ratepayers will experience $1.9 million NPV in savings, while FPC's shareholders will receive $2.5 million NPV in benefits. Staff calculated the $1.9 million NPV ratepayer savings by subtracting $610,000 from half the estimated $5 million NPV savings from replacing the contract.

As an additional sensitivity, staff calculated the NPV for the contract modification if replacement costs increase by ten percent. Applying FPC's sharing plan in this case reduces ratepayer benefits from a NPV of $3 million to $1.2 million, and provides an expected NPV of $1.8 million to FPC's shareholders. (This calculation is attached as Table 1.) As can be seen by these examples, FPC's sharing plan may significantly reduce expected ratepayer benefits and leave much less room for error that ratepayers will not be harmed by the contract modification. Staff also believes that due to the unusual nature of the original contract, which provided for firm energy with no capacity charges from 2013 through 2022, FPC's shareholders will not be exposed to any significant risk until 2013.

Conclusion: Staff recommends that FPC's petition for approval of a plan to share the risks of the Bay County qualifying facility contract modification should be denied. FPC's proposed sharing plan is based on annual estimates for each upcoming projection period. Using year by year estimates does not address the long-term nature of the risk to which ratepayers are exposed. FPC's proposed sharing plan also appears to favor FPC's shareholders, because FPC's ratepayers will still be required to pay all the up-front costs. FPC's sharing plan will reduce the expected ratepayer NPV savings from $4.4 million to $1.9 million, leaving less room for error that ratepayers will not be harmed by the contract modification. Further, due to the unusual nature of the original contract, which provided for firm energy with no capacity charges in 2013 through 2022, FPC's shareholders will not be exposed to any significant risk until 2013.

ISSUE 2: Should this docket be closed?

RECOMMENDATION: Yes, if no person whose substantial interests are affected by this proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order.

STAFF ANALYSIS: If no person whose substantial interests are affected by this proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order.

TABLE 1

YEAR	ORIGINAL CONTRACT COSTS (1)	MODIFIED CONTRACT COSTS (2)	SAVINGS/COST (FPC's estimates) (1) - (2)	SAVINGS/COST (with 10% increase in FPC's replacement estimates) (1) - (2); 2002-2006 (1) - [(2) x 1.10]; 2007-2022
2002	4156	4766	-610	-610
2003	4332	4332	0	0
2004	4586	4586	0	0
2005	4224	4224	0	0
2006	4429	4429	0	0
2007	4646	2567	2079	1822
2008	4882	2229	2653	2430
2009	5121	2539	2582	2328
2010	5373	2256	3117	2891
2011	5640	2487	3153	2904
2012	5936	2468	3468	3221
2013	1377	2623	-1246	-1508
2014	1391	2569	-1178	-1435
2015	1405	2680	-1275	-1543
2016	1423	2621	-1198	-1460
2017	1433	2742	-1309	-1583
2018	1447	2690	-1243	-1512
2019	1462	2809	-1347	-1628
2020	1481	2792	-1311	-1590
2021	1491	2972	-1481	-1778
2022	1506	2859	-1353	-1639
			NPV (No sharing): $4.4 mil. ratepayers **NPV (With sharing): $1.9 mil. ratepayers $2.5 mil. shareholders**	**NPV (No sharing): $3.0 mil ratepayers** **NPV (With sharing): $1.2 mil. ratepayers $1.8 mil shareholders**