**FLORIDA PUBLIC SERVICE COMMISSION**

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 **M E M O R A N D U M**

 **January 19, 1995**

**TO : DIRECTOR, DIVISION OF RECORDS AND REPORTING [BAYÓ]**

**FROM : DIVISION OF ELECTRIC AND GAS [DUDLEY, BASS]**

 **DIVISION OF LEGAL SERVICES [JOHNSON]**

 **DIVISION OF AUDITING AND FINANCIAL ANALYSIS [MAUREY]**

**RE : DOCKET NO. 950001-EI - PETITION OF TAMPA ELECTRIC COMPANY FOR RECOVERY OF PEABODY COAL CONTRACT BUY-OUT COSTS.**

**AGENDA: 2/7/95 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE**

**CRITICAL DATES:NONE**

**SPECIAL INSTRUCTIONS:I:\PSC\EAG\WP\950001.RCM**

 **CASE BACKGROUND**

 On December 23, 1994, Tampa Electric Company (TECO) filed a petition to recover costs associated with the buy-out of the Peabody Coal Sales, Inc. (Peabody) coal contract. The company proposes to recover the retail portion of a $25.5 million buy-out payment, plus carrying costs, through the Fuel and Purchased Power Cost Recovery Clause beginning with the April through September 1995 fuel adjustment period. As a result of the contract buy-out, the company estimates that TECO's ratepayers will realize $88 million in cumulative nominal savings through the year 2004.

 On July 8, 1983, TECO and Peabody entered into a twenty year coal contract. Over the years the contract underwent several provision changes. Beginning in 1994, TECO became increasingly concerned about Peabody's ability to reliably ship the contract tonnages. Therefore, on July 8, 1994, TECO indicated their concerns to Peabody and requested some assurances. Peabody did not respond, and on August 11, 1994, TECO sent Peabody an additional letter indicating that they viewed the contract as being cancelled. Peabody then took the matter through several levels of litigation until it was successfully resolved by Peabody and TECO agreeing to terminate the disputed contract. TECO and Peabody mutually agreed to terminate the original contract on December 31, 1994, and to replace it with two new contracts beginning January 1, 1995. In addition to obtaining adequate assurances of reliable coal supplies, TECO was also able to obtain significant price reductions that will produce substantial savings over the original contract price.

 Once termination of the original contract had been resolved, TECO began negotiating the terms of the two replacement coal contracts with Peabody. The first replacement contract will replace 250,000 tons/yr of the original 750,000 tons/yr and will continue until 2004, the full term of the original contract. The second replacement contract will make-up the remaining 500,000 tons/yr, but will only last until 1999. After 1999, TECO will have to purchase supplemental coal from the spot market to balance out the original 750,000 tonnage requirement. In addition, TECO will also purchase supplemental spot market coal to equate the replacement coal with the original contract on a BTU basis.

 **DISCUSSION OF ISSUES**

**ISSUE 1:** Should the Commission approve Tampa Electric Company's petition to recover costs associated with the buy-out of the Peabody coal contract?

**RECOMMENDATION:** Yes, the Peabody coal contract buy-out appears to produce substantial savings to Tampa Electric's ratepayers. Therefore, the Commission should allow Tampa Electric Company to recover the $25.5 million buy-out cost plus carrying costs through the Fuel and Purchased Power Cost Recovery clause beginning April 1995. (Dudley)

**STAFF ANALYSIS:** Exhibit #3 to TECO's filing is an analysis of the projected savings associated with the buy-out. As indicated on the exhibit, TECO projects that the original contract, minus replacement coal cost, simple amortization of the $25.5 million payment and carrying costs at 13.47%, will provide positive net savings in every year through 2004. Attachment 1 to the recommendation is Staff's analysis of TECO's method and two additional scenarios under which recovery of the buy-out cost could occur. The first is as filed by TECO and as detailed on Exhibit #3. The second scenario has the $25.5 million payment amortized through 1999, when the second contract ends and TECO begins relying heavily on spot market coal, and carrying costs based on the 90-day commercial paper rate which is also used to calculate fuel adjustment true-up amounts. The final scenario reduces the $25.5 million plus carrying costs, based on the 90-day commercial paper rate, by the amount of the annual fuel savings until it is fully amortized. This scenario offers no benefit to the ratepayer until the fourth year, when the fuel savings begins to outweigh the remaining principal balance. Though the remaining issues in this recommendation will suggest the appropriate amortization period and interest rate, it should be noted that all three scenarios provide for positive cumulative savings.

 Because the original contract will be primarily replaced with two new contracts, the only variable component of the projected savings is the supplemental spot market coal. As mentioned above, TECO will partially rely on this supplemental spot market coal from 1995 through 1999 and will substantially rely on spot market coal beyond 1999. At first, Staff was concerned that TECO may have under stated the rate at which the price of spot market coal will escalate. However, after reviewing TECO's analysis, Staff believes that TECO's estimates are reasonable and that a substantial increase above TECO's projections would have to occur before its ratepayers would not realize a positive cumulative savings. Therefore, Staff recommends that the Commission allow TECO to recover the $25.5 Million buy-out cost plus carrying costs through the Fuel and Purchased Power Cost Recovery clause beginning April 1995.

**ISSUE 2:** What is the appropriate period for amortizing the $25.5 million Peabody coal contract buy-out cost?

**RECOMMENDATION:** Staff recommends TECO be allowed to recover the $25.5 million Peabody coal contract buy-out cost, plus carrying costs, on a straight line basis over a five year period. (Maurey)

**STAFF ANALYSIS:** Staff believes the Commission has three options regarding how TECO should be allowed to recover the $25.5 million Peabody coal contract buy-out cost plus carrying costs. The options include straight line amortization over a 10-year period with interest at a 13.47% rate of return on the unamortized balance, straight line amortization over a 5-year period with interest at the 90-day commercial paper rate, and a breakeven (variable) amortization over 40 months with interest at the 90-day commercial paper rate.

 In its petition, TECO requests that the $25.5 million buy-out cost, plus carrying costs, be amortized on a straight line basis over the period from April, 1995, through December, 2004. TECO is requesting that the company be allowed to earn a return of 13.47% on the unamortized balance of the buy-out cost over the 10 year recovery period. The amortization period is based on the years remaining on the canceled contract. The proposed 13.47% before tax rate of return is based on the embedded capital ratios of investor sources of capital approved in the company's last rate case in Order Nos. PSC-93-0165-FOF-EI and PSC-93-0664-FOF-EI (Docket No. 920324-EI), the return on equity of 11.35% approved in Order No. PSC-94-0337-FOF-EI (Docket No. 930987-EI), and the current embedded cost of long-term debt and preferred stock as reported in the company's October, 1994, Rate of Return Surveillance Report.

 There is precedent for the regulatory treatment requested by TECO. In Order No. 20133 (Docket No. 880001-EI), the Commission approved Gulf Power Company's (Gulf) petition to recover the $60 million Peabody coal contract buy-out cost, plus carrying costs, through the fuel adjustment clause. The Commission approved a straight line amortization over a 10-year period at a before tax rate of return of 14.69%. The amortization period was tied to the years remaining on the canceled contract. The rate of return Gulf was allowed to earn on the unamortized balance was based on a capital ratio of 58.3% long-term debt at a cost rate of 9.2% and 41.7% common equity at a cost rate of 13.75%.

 In support of its request, TECO reports that because "the canceled contract has been replaced with two contracts at significantly lower coal prices, fuel savings in excess of the buy-out cost are guaranteed." The company also notes that "the fuel savings associated with the new contract coal in the first five years alone exceeds the buy-out cost." With this being the case, and given the evolving nature of competition in the electric industry, Staff considered two additional options involving shorter amortization periods.

 In a special report titled "Deferred Charges Revisited" released by Fitch Research on January 9, 1995, the rating service discussed the issue of deferred charges and regulatory assets in light of the new competitive environment. The report stated:

 With competition in the electric market, investors are wary of utilities' deferred assets. The capitalization of utilities' expenses as assets depends on two underlying assumptions: utilities will continue to operate in a monopoly marketplace; and regulatory commissions can and will determine utility revenues based on costs. However, these assumptions are now in question. Regardless of how the future electric power market evolves, it is unlikely that investors will be able to rely on previous regulatory arrangements as an assurance that deferred assets will be recovered.

The implication from the Fitch report is that as the electric industry moves towards increased competition, the utilities with higher deferred asset concentration and higher electric production costs will face greater risk that future revenue may not be sufficient to recover prior investments in regulatory assets and deferred charges.

 It is TECO's position that a long-term rate of return is consistent with recovery over a 10-year period. It is also the company's position that a short-term rate of return, such as the 90-day commercial paper rate, would be consistent with recovery over a shorter period of time. As precedent, in Order No. 18670 (Docket No. 880001-EI), the Commission approved TECO's petition to recover the $49 million Pyramid coal contract buy-out cost, plus carrying costs, through the fuel adjustment clause. In its Pyramid petition, TECO requested recovery of fixed amounts over a 45-month period rather than a straight line amortization. The company also requested to earn interest on the unamortized balance "at the actual commercial paper rate in effect from time to time consistent with the true-up methodology set forth in the fuel adjustment filings." However, in Order No. 18670 the Commission found "having considered the methodologies proposed by TECO and the Staff, we conclude that the simplest method would be a four-year, straight line amortization of the $49 million buy-out costs. This will provide for recovery of a fixed amount during each fuel adjustment period with interest accruing at the rate approved for fuel adjustment proceedings."

 TECO contends the regulatory treatment granted Gulf is warranted in this case rather than the treatment granted in TECO's Pyramid buy-out because the requested amortization period is longer (10 years vs. 4 years.) Staff does not necessarily disagree with the use of a long-term rate of return if the Commission decides the company should be allowed to amortize the buy-out cost over a 10-year period. Similarly, the company does not disagree with the use of a short-term rate of return if a shorter amortization period is approved. Since Staff and the company are in basic agreement on which rate of return to use given the amortization period, the question becomes which amortization period is most appropriate under the current circumstances in the instant case.

 Staff conducted a sensitivity analysis of the fuel savings over a 10-year time horizon under several scenarios. Exhibit 3 from TECO's petition was used as the basis for this analysis. Using the company's forecast of annual fuel savings and varying only the amortization period and rate of return assumptions associated with recovery of the buy-out cost, Staff was able to determine the annual net fuel savings and cumulative present value savings under the three scenarios presented. Attachment 1 of this recommendation details Staff's analysis. Also provided as Attachment 2 is a graph of the annual fuel savings in nominal dollars under each scenario.

 The net fuel savings over each of the first 5 years is greatest under the 10-year amortization scenario. This translates to the lowest rates for ratepayers in the near term. However, the cumulative present value savings over the full 10-year horizon under this scenario of $29.4 million is the lowest of the three options presented.

 Under the breakeven (variable) amortization option, the net fuel savings are zero over the first 3 years as the annual amortization amounts with interest are matched to fuel savings in each year. However, after 40 months the net fuel savings increases appreciably producing the greatest cumulative present value savings over the 10 year horizon of $40.8 million.

 Although the net fuel savings are less over the first 5 years under the 5-year amortization scenario compared to the fuel savings indicated under the 10-year amortization scenario, the $25.5 million buy-out cost is fully recovered and net fuel savings are experienced in each of the first 5 years. As was the case under the breakeven amortization option, once recovery of the buy-out cost is complete the fuel savings increases appreciably. The cumulative present value savings under this scenario is $36.6 million.

 The 10-year amortization option provides the greatest net fuel savings over the first 5 years. From the standpoint of pending competition, this option would result in the lowest rates over the near term. The breakeven amortization option does not allow for any fuel savings over the first 40 months but does provide the greatest cumulative present value savings over the 10-year horizon. While this option would remove the regulatory asset from the company's books in the shortest amount of time, the variable amortization would increase the administrative burden during true-up in the fuel recovery proceedings.

 Based on its analysis, Staff believes the 5-year amortization option is a reasonable approach. The 5-year amortization option allows for greater net fuel savings to be realized and passed on to ratepayers in the near term than under the breakeven scenario and allows for greater net fuel savings to be realized and passed on to ratepayers in the long term than under the 10-year amortization option. Although a 5-year amortization means the regulatory asset will be on the company's books approximately 20 months longer than under the breakeven amortization option, it will be written off 5 years sooner than under the 10-year option. Finally, based on the company's fuel savings forecast, the 5-year option will produce $7.2 million more in cumulative present value savings than would result if the 10-year option were approved.

**ISSUE 3:** What is the appropriate rate of return TECO should be allowed to earn on the unamortized balance of the Peabody coal contract buy-out cost?

**RECOMMENDATION:** If a 5-year amortization period as recommended by Staff in Issue 2 is approved, the rate should be the actual commercial paper rate in effect from time to time consistent with the true-up methodology set forth in the fuel adjustment filings. If a 10-year amortization period as recommended by TECO is approved, the rate should be 13.47%. This rate should remain in effect until the Commission issues another order revising the capital ratios and/or the cost rates. (Maurey)

**STAFF ANALYSIS:** Please see Staff Analysis in Issue 2.

**ISSUE 4 :** Should this Docket be closed?

**RECOMMENDATION:** No. This matter is part of the Fuel and Purchased Power Cost Recovery Clause docket and should remain open. However,