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DATE: March 23, 2004

TO: Kay B. Flynn, Chief of Records and Hearing Services, Division of the Commission Clerk & Administrative Services

FROM: William C. Keating, Senior Attorney, General Counsel WCK

RE: Item 12 – March 30, 2004, Agenda Conference

Item 12 on the Commission's March 30, 2004, Agenda Conference, is a staff recommendation addressing motions for reconsideration of a portion of the Commission's final order in Docket No. 030001-EI. At page 4, the recommendation indicates that the relevant portion of that order is attached to the recommendation as Attachment A. The attachment was inadvertently not included with the filed recommendation.

Attached to this memorandum is the missing Attachment A. Please have this attachment included with the recommendation and provided to those persons who were sent copies of the recommendation. Addition of this attachment does not change the body or substance of staff's recommendation in any way.

Thank you for your assistance. Please let me know if you need anything else to process this correction.

WCK

cc: Mary A. Bane, Executive Director
Jorge Chamizo
Cayce Hinton
JoAnn Chase
Larry Harris
Katrina Tew

Replacement Fuel Costs Associated with Ceasing Operations at Gannon Units 1-4

Pursuant to a Consent Final Judgment (CFJ) entered into with the Florida Department of Environmental Protection, signed December 6, 1999, and a Consent Decree (CD) entered into with the United States Environmental Protection Agency and Department of Justice, signed February 29, 2000, TECO must cease operating coal-fired generation at its Gannon Station[2] by December 31, 2004. Specifically, the CD requires TECO to repower coal-fired generating capacity at Gannon of no less than 200 megawatts (MW) by May 1, 2003. As a result, according to TECO witness William T. Whale, Gannon Units 5 and 6 are being repowered from coal to natural gas and are being renamed as Bayside Units 1 and 2, respectively.[3] Mr. Whale stated that the shutdown schedules for Gannon Units 5 and 6 are driven by the in-service dates of Bayside Units 1 and 2.

Mr. Whale testified that to achieve the required May 1, 2003, in-service date for Bayside Unit 1, Gannon Unit 5 was shut down on January 30, 2003, to convert its steam turbine generator to the Bayside Unit 1 combined cycle configuration. He further testified that due to the planned January 15, 2004, in-service date for Bayside Unit 2, the shutdown date for Gannon Unit 6 would occur around September 30, 2003. Mr. Whale stated that Gannon Units 3 and 4 would be shut down around October 15, 2003,

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[2]Mr. Whale described the Gannon Station Units as follows: Gannon Unit 1 was commissioned in 1957 and, prior to being shut down and placed on long-term reserve standby, had a net capacity rating of 94 MW; Gannon Unit 2 was commissioned in 1958 and, prior to being shut down and placed on long-term reserve standby, had a net capacity rating of 100 MW; Gannon Unit 3 was commissioned in 1960 and has a net capacity rating of 155 MW; Gannon Unit 4 was commissioned in 1963 and has a net capacity rating of 100 MW. Each of the Gannon units has one boiler supplying steam to one steam turbine generator.

[3]Mr. Whale described the Bayside Units as follows: Bayside Unit 1 went into commercial operation on April 24, 2003, with a net capacity of 690 MW in the summer and 779 MW in the winter; Bayside Unit 2 is expected to be in service January 15, 2004, with a net capacity of 908 MW in the summer and 1,022 MW in the winter.

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so that Bayside Unit 2 could utilize the transmission facilities currently used for the operation of Gannon Unit 4. He testified that the existing transmission facilities cannot accommodate the operation of both Bayside Unit 2 and Gannon Unit 4, making it necessary for Gannon Unit 4 to cease operations to allow for the tie-in and testing of Bayside Unit 2 prior to its commercial operation.

Mr. Whale testified that TECO never anticipated or planned for the shutdown of Gannon Units 1 through 4 to occur exactly on December 31, 2004. He testified that TECO made a determination that it would attempt to keep the units running as long as reliably possible without incurring significant expenditures given the age of the units, the short remaining life, and the associated outage time necessary for any planned maintenance work. Mr. Whale stated that in light of TECO's obligations to cease coal-fired generation at the station and the age of the units, the company determined that the most prudent approach to maintenance was to use a "patch and go" approach which required limited investment with minimal planned outage time.

Mr. Whale testified that by the summer of 2002, TECO began to perform detailed evaluations, considering numerous options, for possible shutdown dates for Gannon Units 1 through 4. Mr. Whale stated that the company ran multiple scenarios to evaluate ratepayer impacts (including fuel and purchased power costs), operation and maintenance (O&M) impacts, and wholesale sales opportunities for off-system sales. Mr. Whale testified that by late 2002, it became apparent that the units needed to be shut down in 2003. Mr. Whale asserted that this realization was driven primarily by four factors: the declining availability and reliability of the units; the significant expenditures that would need to be incurred in an effort to keep the units running reliably; the potential for safety incidents; and the short window of time until the units would be required to shut down under the CFJ and CD, regardless of how much the company might invest in an effort to keep them operating. Mr. Whale stated that, based on these considerations, a plan was formalized to shut down Gannon Units 1 and 2 on March 15, 2003, and Gannon Units 3 and 4 in September 2003. Mr. Whale indicated that these plans were communicated to the Florida Department of Environmental Protection, the Environmental Protection Agency, and the Department of Justice on February 7, 2003.

Mr. Whale testified that given the current condition of Gannon Units 1 through 4, TECO estimated that it would need to incur additional O&M expense of approximately $57 million to keep the units operating somewhat reliably beyond the actual and currently planned shutdown dates and through 2004. Mr. Whale asserted that to the extent the performance of the units continues to decline despite investment in repairs and maintenance, there could be additional costs incurred to replace power during forced unplanned outages.

TECO witness Benjamin F. Smith testified that in TECO's February, 2003, and most recent analysis, TECO did not project the need to purchase replacement firm capacity as a result of the shutdown of the Gannon Units to meet its summer 2003 reserve margin requirements, due to the April 2003 in-service date of Bayside Unit 1. Mr. Smith stated that the company did anticipate purchasing supplemental energy as needed in 2003. Mr. Smith asserted that TECO projects it will purchase 50 MW of firm capacity for its summer 2004 reserve margin requirement and anticipates purchasing supplemental energy as needed in 2004. Mr. Smith testified that although TECO projects its system capacity and energy needs, it is neither feasible nor appropriate to isolate and then attribute costs to a single variable, such as the shutdown of the Gannon units, on an actual basis due to system dynamics. Mr. Smith identified these system dynamics as including unit forced outages, operating restrictions, weather, customer demand, and statewide transmission and stability issues.

TECO witness Joann T. Wehle testified that the replacement fuel costs associated with the shutdown of Gannon Units 1 through 4 are reasonable. Ms. Wehle stated that TECO's units are operated to provide safe, reliable electric service to ratepayers, and the company procures the fuel to operate all units based on their economic dispatch. Ms. Wehle further stated that TECO follows its Commission-reviewed fuel procurement policies and procedures. Referring to Mr. Whale's testimony, Ms. Wehle stated that TECO's decision to shut down Gannon Units 1 through 4 in 2003 was arrived at only after careful and deliberate evaluation of many dynamic, competing and complex factors. Therefore, Ms. Wehle concluded, costs for replacement fuel due to the shutdown of Gannon Units 1 through 4 in 2003 are reasonable and prudently incurred and should be approved for recovery through the fuel clause.

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Witness Michael J. Majoros, testifying on behalf of OPC, asserted that as a result of the early closure of Gannon Units 1 through 4, TECO's stockholders would receive benefits in the form of lower operating expenses, while TECO's ratepayers would be charged higher rates for replacement fuel costs associated with the early closure. Mr. Majoros contended that this Commission should offset TECO's requested fuel cost recovery amounts by the incremental O&M savings associated with the closure of the Gannon units, so that TECO's stockholders are neither better nor worse off as a result of the early closure while ratepayers receive some offset to the higher fuel costs. Mr. Majoros asserted that the O&M savings are $9.1 million for 2003 and $16.0 million for 2004.

Mr. Majoros testified that TECO, as part of its 2002 Ten Year Site Plan, stated it would operate Gannon Units 1 through 4 until the December 31, 2004, deadline set forth in the CD and CFJ and would repower Gannon Units 5 and 6 by May, 2003, and May, 2004, respectively. Mr. Majoros further testified that the 2002 TECO budget process contemplated closure of Gannon's coal units in September, 2004, in compliance with the CFJ and CD agreements. Mr. Majoros noted that on February 6, 2003, TECO announced its decision to shut down the Gannon plant early, anticipating that Gannon Units 1 and 2 would cease operations in mid-March 2003, and Gannon Units 3 and 4 would cease operations by October, 2003. Mr. Majoros asserted that although TECO claimed it made this decision in late January and early February, 2003, he believes that TECO made a corporate decision as early as October 2002 to shut down the units in 2003. As support, the witness referenced a document dated October 3, 2002, showing TECO's "base case" as assuming Gannon Units 1 and 2 would shut down on March 15, 2003, Units 3 and 4 would run until September 1, 2003 (or until the budgeted O&M dollars were gone), and Units 5 and 6 would shut down in February and September, 2003, respectively.

In his testimony, Mr. Majoros contended that TECO's decision to shut down Gannon Units 1 through 4 on this schedule was an economic decision designed to allow the company to meet its internal earnings goals more so than a decision based on safety and reliability concerns. Mr. Majoros also questioned the basis for TECO witness Whale's estimate of $57 million to keep the Gannon Units running reliably through 2004. Mr. Majoros asserted that this estimate was based on achieving an 80% to 85%

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availability factor for the units as opposed to a 60% availability factor that more realistically reflects the typical availability of the units and which would require less cost to achieve.

In support of Mr. Majoros' testimony, OPC witness William M. Zaetz testified that safety and reliability were not factors in TECO's decision to shut down Gannon Units 1 through 4 and that any perceived safety or reliability concerns were a result of TECO's failure to conduct adequate preventative maintenance. Mr. Zaetz asserted that he had never seen a plant shut down for safety reasons and that if the decision to close the Gannon units was based on safety concerns, the unit should have been shut down immediately rather than be allowed to continue to run. Mr. Zaetz testified that the Gannon units were running as would be expected given the maintenance conducted on those units. Mr. Zaetz concluded that TECO made a conscious decision to run the Gannon units as long as it could without spending any dollars to increase reliability or to make them safer, and that Gannon's performance was predictable, while any side effects that resulted were dealt with by spending the least amount of money possible.

Witness Sheree L. Brown, on behalf of FIPUG and FRF, testified that the Commission should require TECO to offset its replacement power costs associated with the closure of the Gannon units by her calculation of the O&M savings associated with the units' closure. Ms. Brown asserted that this would be a fair and equitable result due to the following: the decision to shut down the units early was a voluntary decision by TECO within its control; the requirement to shut down the units by the end of 2004 was a direct result of claimed violations by the United States Environmental Protection Agency; the ratepayers will suffer continued harm through additional replacement power costs from 2005 through 2007; and the ratepayers have also paid TECO for the environmental modifications which were challenged by the EPA.

On rebuttal, TECO witness J. Denise Jordan, disputed Ms. Brown's calculation of an adjustment to offset replacement power costs with O&M savings associated with the closure of the Gannon units. Ms. Jordan indicates that Ms. Brown's calculation was not based in fact, and, given the proper facts, should have yielded a much smaller amount. In any event, Ms. Jordan disagreed that any adjustment was necessary and responded to each of the points raised by Ms. Brown as a basis for making an adjustment. First, Ms. Jordan responded that Tampa Electric makes "voluntary" company decisions after careful and complete analysis, as was the scheduling decision for shutting down Gannon Units 1 through 4. She asserted that is no reason to mix or offset base rate revenue or expenses with fuel adjustment revenue or expenses. Second, Ms. Jordan responded that Tampa Electric did not admit violations of environmental requirements but settled litigation initiated by the EPA and DEP because settlement appeared to be the most prudent and cost-effective alternative in light of the litigation and the risks inherent in such litigation. Third, Ms. Jordan responded that Ms. Brown's assertion that ratepayers will suffer continued harm through additional replacement power costs from 2005 through 2007 is misplaced because any such additional costs stem directly from the fact that the coal units at Gannon Station are required to cease operation after December 31, 2004. Fourth, Ms. Jordan responded that Ms. Brown's assertion that the ratepayers' have paid TECO for the environmental modifications that were challenged by the EPA is cumulative and ignores the fact that those modifications were in the economic interest of Tampa Electric's customers.

Ms. Jordan also responded to OPC witness Majoros' calculation of O&M savings associated with closure of the Gannon units, stating that it is fundamentally flawed because it is based on information gathered through discovery but taken out of context. In addition, Ms. Jordan responded to Mr. Majoros' assertion that O&M amounts not spent at Gannon Station represent a savings to TECO that will result in increased earnings to benefit shareholders, and that an offset to recoverable fuel costs is appropriate. First, referring to witness Whale's rebuttal testimony, discussed below, Ms. Jordan stated that TECO did not simply cut O&M spending at its Gannon units, but focused its investment strategies to obtain a better value from its O&M expenditures. Second, Ms. Jordan stated that Mr. Majoros provided no support for his allegation that the company's O&M spending decisions resulted in savings for shareholders but only made a statement that, as a general proposition, increased earnings benefit shareholders. Third, Ms. Jordan stated that Mr. Majoros ignored the structure of cost-based ratemaking in Florida. Ms. Jordan stated that investor-owned utilities collect base rates and operate within an allowable earnings range, and that TECO should not be penalized based only

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on an assertion that shareholders might benefit from increased earnings without a demonstration of such earnings.

On rebuttal, TECO witness Whale responded to the testimony of Mr. Zaetz and Mr. Majoros. Mr. Whale first challenged Mr. Zaetz's qualifications to make a determination as to the safe operational capability of the Gannon units, asserting that Mr. Zaetz has never been a plant manager, maintenance manager, or operations manager; that there is no indication that he has experience in the decision-making process of determining when a unit would need to be shut down, whether for safety or any other reason; and that his testimony does not indicate that he is a Certified Safety Professional or has obtained any industry-recognized safety credentials. Mr. Whale also asserted that Mr. Zaetz has no basic knowledge of the operations of the Gannon units.

Mr. Whale disagreed with Mr. Zaetz' testimony that neither safety nor reliability was a factor in TECO's decision to shut down Gannon Units 1 through 4 in 2003, stating that TECO arrived at the decision to shut down the Gannon units in 2003 after consideration of many complex factors including safety, reliability, and other issues. Mr. Whale also responded to Mr. Zaetz' assertions that any plant can be repaired, regardless of its safety level, and that TECO's failure to repair the aging Gannon facilities demonstrated that the company's concern about continuing to operate the units was solely budgetary. Mr. Whale asserted that the fact that a unit or plant may be repaired does not indicate that making the repairs is a good business decision. Mr. Whale stated that TECO implemented its "patch and go" maintenance strategy to maximize the benefits of its maintenance spending given that Gannon Station would have to be shut down in the near term, regardless of the amounts of time and dollars spent repairing and maintaining it. Mr. Whale asserted that the company's maintenance spending was re-focused on the activities that would keep the Gannon units running safely for limited investment, and improve the operations of the company's other plants, which were not subject to shutdown on or before December 31, 2004. Further, Mr. Whale asserted that in addition to the repair costs to improve the safety and reliability of the Gannon units, TECO would have had to spend significant time and dollars planning outages to repair and replace components, procuring replacement equipment, installing

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the new equipment, and replacing capacity of the affected units while they were off-line for the planned outages.

In response to Mr. Majoros' testimony, Mr. Whale asserted that TECO never had a plan to operate the units until December 31, 2004, but instead recognized that the units' shutdown would require flexibility to respond to dynamic conditions as the deadline approached. Mr. Whale further testified that TECO's estimates of the O&M investments needed to keep Gannon Units 1 through 4 until December 31, 2004, show a range of costs from $37 million to $57 million to achieve an approximate 60% and 85% availability, respectively. Mr. Whale stated that under either scenario, keeping the units running through 2004 would be a very expensive proposition after which TECO would have nothing to show for the expenditures because the units would no longer be permitted to burn coal.

Based on the evidence in the record, we are persuaded that TECO's decision to shut down Gannon Units 1 through 4 when it did was a prudent decision. The evidence indicates that TECO estimated expenditures of $37 million to maintain those units at 60% availability until December 31, 2004, the last date that the units could be operated pursuant to the CFJ and CD. The evidence further indicates that Gannon Units 1 through 4 were not needed for reliability purposes in 2004 due to the addition of Bayside Units 1 and 2. We find that, given TECO's obligations to cease coal-fired generation at the station and the age of the units, the company was prudent in implementing the "patch and go" maintenance approach it chose which required limited investment with minimal planned outage time. Based on our finding that TECO's decision to shut down Gannon Units 1 through 4 was a prudent decision and on Ms. Wehle's testimony supporting the reasonableness of the replacement fuel costs, we find that the replacement fuel costs associated with the early shut down of Gannon Units 1 through 4 were prudently incurred.

We also recognize that TECO's decision to shut down the Gannon units when it did yielded savings to the company in O&M expenses. The record indicates that in 2002, TECO conducted an analysis to determine the cost impacts associated with potential closure dates for Gannon Units 1 through 4. That analysis, set forth in Exhibit MJM-5 to OPC witness Majoros' testimony, showed, among other things, TECO's estimates of O&M savings and replacement fuel costs for 2003 associated with five different

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closure scenarios. On cross-examination, TECO witness Jordan identified one of the scenarios as best reflecting actual events. Under that scenario, TECO estimated O&M savings of $10,521,000.

But for TECO's decision to cease operations at Gannon Units 1 through 4 when it did, the company would not have incurred the replacement fuel costs that we have determined to be reasonable. Further, but for that same decision, the company would not have achieved O&M savings estimated at $10,521,000 for 2003. Because these O&M savings derive from the same finite decision that resulted in replacement fuel costs, we believe that, under the unique circumstances presented, the replacement fuel costs to be borne by customers should be offset to some extent by the amount of savings. We are confronted with testimony from witnesses Majoros, Zaetz, and Brown that make a fair case for offsetting replacement fuel costs by the entire $10,521,000. We are also confronted with our finding that TECO's decision to shut down the units when it did was prudent and based on sound economic, reliability, and safety concerns, which tends to support TECO's argument that no offsetting should occur. Taking into account all of the competing evidence in the record on this point and the unique circumstances presented, we believe that a fair and reasonable sharing of the O&M savings associated with the units' closure will be achieved by providing 80% of the estimated O&M savings, or $8,416,800, to ratepayers as an offset to TECO's recoverable fuel costs, and providing TECO the benefit of the remaining 20% of the O&M savings.

<u>Gains or Losses on Resale of Surplus Coal Associated with Ceasing Operations at Gannon Units 1-4</u>

Based on our finding that TECO's decision to shut down Gannon Units 1 through 4 when it did was prudent, we find that TECO should record any gain or loss on the resale of surplus coal associated with closure of those units as a credit or charge to the fuel clause.