State of Florida

Public Service Commission

CAPITAL CIRCLE OFFICE CENTER • 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

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

DATE: December 7, 2006

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Economic Regulation (Gardner, Springer, Kyle)
Office of the General Counsel (Brown)

RE: Docket No. 050381-EI- Petition for approval of modification of depreciation rates and dismantlement study for Plant Crist, Plant Smith, and Smith Unit 3 Combined Cycle, by Gulf Power Company

AGENDA: 12/19/06 – Regular Agenda – Proposed Agency Action - Interested Persons May Participate

COMMISSIONERS ASSIGNED:

PREHEARING OFFICER:

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\\050381.RCM.DOC

Case Background

Rule 25-6.0436, Florida Administrative Code, requires investor-owned utilities to file comprehensive depreciation studies at least once every four years. The Commission authorized the approval of new depreciation rates for Gulf Power Company (Gulf Power or Company) effective January 1, 2006, by Order No. PSC-06-0348-PAA-EI, in Docket No. 050381-EI, issued May 19, 2006. On October 9, 2006, the Company filed a petition to modify the currently approved depreciation study to request an increase in the average service life and resulting depreciation rate changes for the coal fired generating Plant Crist Units 4, 5, 6, and 7; Plant Smith Units 1 and 2; and Plant Smith Unit 3 combined cycle.

This recommendation addresses the request for approval of revised depreciation rates and fossil dismantlement accruals for 2007. Staff is recommending a decrease in annual depreciation expense for production plant in the amount of $7,526,991. Also, this request by the Company is part of its strategic planning in handling the increasing costs to the Company by the implementation and impact of new and related regulations from the Florida Department of Environmental Protection (FDEP) and the Federal Department of Environmental Protection Agency (EPA) for the Clean Air Interstate Rule ("CAIR"), and the Clean Air Mercury Rule ("CAMR").

The Commission has jurisdiction over these matters through several provisions of Chapter 366, Florida Statutes, including Sections 366.04, 366.05, and 366.06.

Discussion of Issues

Issue 1: Should the Commission permit Gulf Power Company to implement its proposed change in depreciation rates and provision for dismantlement for the coal fired generating Plant Crist Units 4, 5, 6, and 7; Plant Smith Units 1 and 2, and Plant Smith Unit 3 combined cycle"?

Recommendation: Yes. The Commission should approve the Company's revised lives, net salvages, reserves, resulting depreciation rates, and provision for dismantlement as shown on Attachments A, B, and C. (Gardner)

Staff Analysis: Order No. PSC-06-0348-PAA-EI , issued May 19, 2006, authorized Gulf Power to implement a change in depreciation rates and fossil dismantlement accruals effective January 1, 2006. Subsequent to this order, the EPA and the FDEP implemented new regulations that impact Gulf Power's Commission-approved plant service lives. In June 2006, the FDEP adopted more stringent regulations for compliance with CAIR and CAMR than the EPA. As a result, in August 2006, the Company finalized its strategy for compliance with the FDEP for both the Clean Air Interstate Rule (CAIR) and the Clean Air Mercury Rule (CAMR).

To comply with the CAIR and CAMR, Gulf Power is proposing to modify the Commission-approved rates and fossil dismantlement accruals that became effective January 1, 2006. The primary difference between the approved 2006 annual expense and provision for dismantlement and the instant revised proposal related to the projection of longer service lives for Plant Crist Units 4, 5, 6, and 7, Plant Smith Units 1 and 2, and Plant Smith Unit 3 combined cycle. Gulf Power's proposed change in life parameters created the need to recalculate depreciation rates.

In establishing the basis for the request for modification of the Commission approved depreciation study, staff requested that the Company provide a comparative analysis of the life estimates and trends for all applicable plant for the 2005 depreciation study and the partial modification of that study for the Plant Crist Units, Plant Smith Units, and Plant Smith Unit 3 combined cycle. In the last depreciation study, the Company requested and was granted a change in production plant units from a 45 to 55 year service life. At that time, the Company based the change on current maintenance being performed and found that units with 45 to 50 year lives could meet customers' needs beyond the stated life span. Before the Company furthered its strategic planning to comply with forthcoming governmental regulations, the Company conservatively reviewed the useful lives of the Southern electric system and the Florida electric industry and determined that a 55 year useful life was reasonable at the time to meet its current needs.

In the instant petition, the Company is requesting Commission approval to increase the average service lives from the original study. This change would increase the service life for Plant Crist Units and Plant Smith Units from 55 to 65 years (10 years). Also, for Plant Smith Unit 3 combined cycle the Company is requesting an increase in service life from 25 to 34 years (nine years). A segment of the Company's initial strategy, which it considered to be the most cost effective way to comply with the new regulations, was to make a significant investment in environmental controls at the coal fired generating units at the Crist and Smith plants. For the

period of 2006 through 2009, the Company intends to expend a capital outlay for plant in the amount of $576.7 million to replace equipment and to implement environmental controls for Plants Crist and Smith, which will extend the useful life of these units. Gulf Power believes that, with a reasonable level of maintenance, the coal fired generating units at Plants Crist and Smith will continue to serve the customers' needs for an additional ten years beyond their current retirement dates. Also, the Company used the experience gained from the operation of Plant Scholz, where it expects a useful life of 58 years, and the Southern electric system's experience with coal fired plants with expected useful lives of 60-65 years.

The effort to comply with CAIR and CAMR requirements is not isolated to Florida utilities, but is also occurring in other states. Staff reviewed the actions taken by other states with respect to the changing climate for coal fired generating plants. Staff reviewed a report prepared by the staff of the Michigan Public Service Commission entitled, "Michigan Capacity Need Forum: Staff Report to the Michigan Public Service Commission Report," issued January 2006. The group formed the following assumptions on plant retirements: " ...units built since 1950 should expect to realize longer economic life than older units. The group recommends a 65 year retirement age be used for modeling coal fired generating units. While it is likely that some will retire sooner than 65 years old and some will retire later, 65 years is a reasonable modeling assumption."[1]

Staff reviewed the life span methodology of the regulated Florida electric utilities and found that the proposed life parameters for production plants owned by Gulf Power are reasonable and in line with the electric industry. Staff recognizes that the considerations of new factors, such as, governmental actions on the federal, state, and the Commission level, new technologies, and growth, will continue to impact the life patterns of various segments of major structures of plant. Staff will enhance its monitoring of the regulated utilities' annual status reports and future depreciation studies for changes in life parameters as a result of new regulations.

In summary, the depreciation rates and provision for dismantlement should be adjusted to reflect the proposed plants current life expectancy. This proposal would decrease production plant annual expenses for depreciation and fossil dismantlement by an estimated $6,879,574 and $647,417, respectively, as shown on Attachments A and C. The total resulting decrease in annual expenses for production plant will be an estimated $7,526,991. The Company's filing shows an estimated decrease in the amount of $8,020,043 annual expenses. Staff's annual expenses is less than the Company's by $540,775 which is due to the rounding of life parameters and the recalculation of the depreciation rate of Plant Crist.

[1] Michigan Public Service Commission's report was prepared by Operations and Wholesale Markets Division, Section 6.1 Plant Retirements, page E-11.

Issue 2: What should be the implementation date for the new depreciation rates and provision for dismantlement accruals?

Recommendation: January 1, 2007, should be the implementation date for Gulf Power's revised depreciation rates and provision for fossil dismantlement as shown on Attachments A, B, and C. (Gardner)

Staff Analysis: Rule 25-6.0436, Florida Administrative Code, requires that data submitted in a depreciation study, including plant and reserve balances or company estimates, "shall be brought to the effective date of the proposed rates." In this regard, Gulf Power's supporting data and calculations have been provided matching a January 1, 2007, implementation date.

Issue 3: Should the Commission change the depreciation rates?

Recommendation: Yes. The Commission should approve the change in the lives, net salvages, reserves, and resulting depreciation rates as shown on Attachment B. These rates result in a decrease in annual depreciation expense by $7,526,991 based on January 1, 2007, investments. Gulf Power concurs with staff's recommendation. (Gardner)

Staff Analysis: Staff analysis represents a review of the Company's proposed life, salvage, and reserve factors, as well as the establishment of a fixed levelized annual accrual for dismantlement of fossil plants in accordance with Order No. 24741, issued July 1, 1991, in Docket No. 890186-EI, In re: Investigation of the ratemaking and accounting treatment for the dismantlement of fossil fueled generating stations. The analysis of the Company's data and resulting expenses reflects the impact of current planning and adherence to regulatory requirements to ensure that assets are fully recoverered at the time of retirement as reflected on Attachments B and C. Attachment B shows a comparison of rate components (lives, salvages, and reserves). Attachment C shows the estimated resulting annual expenses based upon January 1, 2007, investments. A summary of changes to the annual expense is as follows:

FUNCTIONAL CHANGE TO ANNUAL DEPRECIATION		
PRODUCTION	($6,879,574)	(See Attachment C)
FOSSIL DISMANTLEMENT	($ 647,117)	(See Attachment A)
Total Depreciation and Dismantling Cost	($7,526,691)	

In the modified/revised depreciation study, the significant changes in expenses relate to the change in average service life, the increase in net salvage, and the resulting decrease in depreciation rates for production plant. Gulf Power uses three life categories of 1-20 years, 21-35 years, and 36 years through the life of the plant. The Company used the same investment stratification from its last depreciation study. The remaining life of the categories increased by ten years for the 36 years through the life of the plant category and less than ten years for the other categories. The average remaining life rate decreased due to the increase in the average remaining life.

The major impact to production plant is a 21 percent decrease in production plant expense as of January 1, 2007. The capital investment for the period of 2006 to 2009, related to enhancement of the air emission controls, will significantly impact Gulf's cost recovery through the Environmental Cost Recovery Clause. At this time, there is no change to base rates. Also, the $7.5 million expense decrease represents approximately 75 basis points on return on equity.

The initial activities of the Company will be geared to adherence to the requirements imposed by FDEP for CAIR and CAMR. The Company states that the strategic planning to meet the Commission's directives on storm hardening has not been finalized yet. Also, the

increase in service life of the Smith Unit 3 combined cycle was due to the Company's review of company-wide and Southern electric system experience in handling combined cycle plants. Staff will continue to monitor the Company's life parameters for production, transmission, and distribution.

Issue 4: Should the Commission permit the change in the currently approved annual provision for fossil dismantlement?

Recommendation: Yes. The Commission should approve a total annual provision for fossil fuel dismantlement of $5,239,243, as shown on Attachment A. This represents a decrease in the annual provision for fossil fuel dismantlement accruals of $647,417 for Plant Crist, Plant Smith, and Plant Smith Unit 3 combined cycle. These accruals reflect current estimates of dismantlement cost on a site-specific basis using the latest inflation forecasts and a 10% contingency factor. The Company concurs with staff's recommendation. (Gardner, Springer)

Staff Analysis: By the Fossil Fuel Dismantlement Order No. 24741, issued July 1, 1991, in Docket No. 891086-EI, In re: Investigation of the ratemaking and accounting treatment for the dismantlement of fossil-fueled generating stations, the Commission established the methodology for the treatment of costs associated with the dismantlement of fossil-fueled generating facilities. The methodology depends on three factors: estimated base costs of dismantling the fossil fueled plants, projected inflation, and a contingency factor. The purpose of this modified/revised review of fossil dismantlement for Plants Crist and Smith is to reflect changes in life estimates, inflation factors, and environmental requirements caused by the replacement and upgrading of Plant Crist Units 4, 5, 6, and 7, and Plant Smith Units 1 and 2, necessitated by the implementation of CAIR and CAMR regulations.

The Dismantlement Order established the methodology for calculating the annual accrual. The fixed accrual amount is based on a four-year average of the accruals related to the years between depreciation study reviews. In addition, utilities are required to provide updated dismantlement studies at least once every four years in connection with their depreciation study. The Company provided an updated modified calculation of the four-year average of the accruals due to the change in life parameters for each requested plant site.

Gulf Power's currently approved annual accrual for fossil fuel dismantlement is $5,886,660. Its proposed annual accrual of $5,286,966 is based on inflation factors from Economy.com as of September 2006. At the request of staff, Gulf Power updated its accruals to reflect the most recent inflation factors. The updated annual accrual, reflecting inflation factors as of November 2006, represents a decrease from the proposed accrual of $47,723. Staff believes it is reasonable for the accrual to reflect the most recent inflation estimates. The Company agrees with staff's recommendation that the revised annual accrual should be $5,239,243, which represents a decrease of $647,417 from the currently approved level.

In summary, staff recommends that the four year average annual accrual for fossil fuel dismantlement should be $5,239,243.

Issue 5: Should the current amortization of investment tax credits and flow back of excess deferred income taxes be revised to reflect the approved depreciation rates?

Recommendation: Yes. The current amortization of investment tax credits (ITC) and the flowback of excess deferred income taxes (EDIT) should be revised to match the actual recovery periods for the related property. The utility should file detailed calculations of the revised ITC amortization and flowback of EDIT at the same time it files its surveillance report covering the period ending December 31, 2006. (Kyle)

Staff Analysis: In earlier issues, staff has recommended approval of the Company's proposed remaining lives, to be effective January 1, 2007. Revising a utility's book depreciation lives generally results in a change in its rate of ITC amortization and flowback of EDIT in order to comply with the normalization requirements of the Internal Revenue Code (IRC) and its underlying Regulations found in Sections 46, 167, and 168, and 1.46, 1.67, and 1.68, respectively.

Staff, the Internal Revenue Service, and independent outside auditors examine a company's books and records and the orders and rules of the jurisdictional regulatory authorities to determine if the books and records are maintained in the appropriate manner and to determine the intent of the regulatory bodies in regard to normalization. Therefore, staff recommends the current amortization of ITC and the flowback of EDIT be revised to reflect the approved remaining lives.

Section 46(f)(6), IRC, states that "the amortization of ITC should be determined by the period of time actually used in computing depreciation expense for ratemaking purposes and on the regulated books of the utility." Since staff is recommending approval of the Company's proposed remaining lives, it is also important to change the amortization of ITC to avoid violation of the provisions of Sections 46, IRC and 1.46, REGs.

Section 203(3) of the Tax Reform Act of 1986 (the Act) prohibits rapid flowback of depreciation related (protected) EDIT. Further, Rule 25-14.013, Florida Administrative Code, Accounting for Deferred Income Taxes Under SFAS 109, generally prohibits EDIT from being written off any faster than allowed under the Act. The Act, SFAS 109, and Rule 25-14.013, regulate the flowback of EDIT. Therefore, staff recommends that the flowback of EDIT be adjusted to comply with the Act, SFAS 109, and Rule 25-14.013.

Issue 6: Should this docket be closed?

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

Staff Analysis: If no person whose substantial interests are affected by the 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.

GULF POWER COMPANY
FOSSIL DISMANTLEMENT ACCRUAL

ATTACHMENT A

PLANT	CURRENT ACCRUAL (01/01/2006)	COMPANY PROPOSED ACCRUAL (10/09)2006	COMPANY PROPOSED CHANGE IN ACCRUAL	STAFF RECOMMENDED ACCRUAL (01/01/2007)	STAFF RECOMMENDED CHANGE IN ACCRUAL
	$	$	$	$	$
Plant Crist	3,053,458	2,694,383	359,075	2,659,829	393,629
Plant Smith	1,139,444	962,309	177,135	950,810	188,634
Plant Scholz	521,738	521,738	0	521,738	0
Plant Daniel	754,764	754,764	0	754,764	0
Total Steam(non-UPS)	5,469,404	4,933,194	476,210	4,887,141	582,263
Plant Smith CT	4,612	4,612	0	4,612	0
Plant Pace (Pea Ridge)	6,102	6,102	0	6,102	0
Smith Combined Cycle	299,223	235,739	63,484	234,069	65,154
Total Other Production	309,937	246,453	63,484	244,783	65,154
Total non-UPS Dismantlement	5,779,341	5,179,647	599,694	5,131,924	647,417
Plant Scherer (UPS)	107,309	107,319	0	107,319	0
Total Dismantlement	5,886,660	5,286,966	599,694	5,239,243	647,417

GULF POWER COMPANY
MODIFICATION OF 2005 DEPRECIATION STUDY
COMPARISON OF RATES AND COMPONENTS

ATTACHMENT B

	CURRENT				COMPANY PROPOSED					STAFF RECOMMENDED			
	AVERAGE REMAINING LIFE	NET SALVAGE	1/1/2006 RESERVE	REMAINING LIFE RATE	AVERAGE REMAINING LIFE	NET SALVAGE	01/01/07 RESERVE	REMAINING LIFE RATE	AVERAGE SERVICE LIFE	AVERAGE REMAINING LIFE	NET SALVAGE	01/01/07 RESERVE	REMAINING LIFE RATE
ACCOUNT	(YRS)	(%)		(%)	(YRS)	(%)	(%)	(%)	(YRS)	(YRS.)	(%)	(%)	(%)
Steam Production													
Plant Crist	17.9	-7.0	38.35	3.8	22.3	-10.0	40.01	3.1	34.0	22.0	-10.0	40.01	3.2
Plant Smith	15.2	-4.0	44.85	3.9	22.9	-5.0	48.26	2.5	35.0	23.0	-5.0	48.26	2.5
Other Production													
Smith Unit 3 Combined Cycle	21.0	0.0	4.68	4.0	34.0	0.0	4.34	3.1	34.0	31.0	0.0	4.77	3.1

GULF POWER COMPANY
MODIFICATION OF 2005 DEPRECIATION STUDY
COMPARISON OF EXPENSES

ATTACHMENT C

				Approved Rates		Company Proposed			STAFF RECOMMENDED		
		1/1/2007	1/1/2007	1/1/2006			1/1/2007	CHANGE		1/1/2007	CHANGE
		ESTIMATED	ESTIMATED					IN		ESTIMATED	IN
	ACCOUNT	INVESTMENT	RESERVE	RATE	EXPENSES	RATE	EXPENSES	EXPENSES	RATE	EXPENSES	EXPENSES
Steam Production		($)	($)	(%)	($)	(%)	($)		(%)	($)	($)
	Plant Crist	540,774,334	216,346,902	3.8	20,549,425	3.1	16,764,004	-3,785,421	3.2	17,304,779	-3,244,646
	Plant Smith	139,008,110	67,086,424	3.9	5,421,316	2.5	3,475,203	-1,946,113	2.5	3,475,203	-1,946,113
	Total Plant Crist & Smith	679,782,444	283,433,326		25,970,741		20,239,207	-5,731,534		20,779,982	-5,190,759
Other Production											
	Smith Unit 3 Combined Cycle	187,646,111	8,954,192	4.0	7,505,844	3.1	5,817,029	-1,688,815	3.1	5,817,029	-1,688,815
	Total Plant Crist, Smith & Smith Combined Cycle	867,428,555	292,387,518		33,476,585		26,056,236	-7,420,349		26,597,011	-6,879,574