BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into affiliated cost-plus fuel supply relationships of Florida Power Corporation (Phase I).	DOCKET NO. 860001-EI-G ORDER NO. 20604 ISSUED: 1-13-89

The following Commissioners participated in the disposition of this matter:

KATIE NICHOLS, Chairman
THOMAS M. BEARD
GERALD L. GUNTER
JOHN T. HERNDON
MICHAEL McK. WILSON

APPEARANCES: MICHAEL P. GRANEY, Esquire, and CYNTHIA S. VAUGHN, Esquire, Simpson, Thatcher & Bartlett, Ninth Floor, One Riverside Plaza, Columbus, Ohio 43215, and JAMES A. McGEE, Esquire, P. O. Box 14042, St. Petersburg, Florida 33733
On behalf of Florida Power Corporation.

JOSEPH A. McGLOTHLIN, Esquire, Lawson, McWhirter, Grandoff & Reeves, 522 E. Park Avenue, Suite 200, Tallahassee, Florida 32301
On behalf of the Florida Industrial Power Users Group.

EARLE H. O'DONNELL, Esquire, and ZORI G. FERKIN, Esquire, Sutherland, Asbill & Brennan, 1275 Pennsylvania Avenue, N.W., Washington, D. C. 20006-2803
On behalf of Occidental Chemical Corporation.

JACK SHREVE, Esquire, and STEPHEN C. REILLY, Esquire, Office of the Public Counsel, c/o Florida House of Representatives, The Capitol, Tallahassee, Florida 32399-1300
On behalf of the Citizens.

MICHAEL B. TWOMEY, Esquire, Florida Public Service Commission, 101 East Gaines Street, Tallahassee, Florida 32399-0863
On behalf of the Commission Staff.

PRENTICE P. PRUITT, Office of General Counsel, Florida Public Service Commission 101 East Gaines Street, Tallahassee, Florida 32399-0861
Counsel to the Commissioners.

ORDER IMPOSING MARKET-BASED PRICING ON COAL PURCHASED FROM AN AFFILIATE

BY THE COMMISSION:

SUMMARY

We have determined as a matter of policy that utilities seeking the recovery of the cost of coal purchased from an affiliate through their fuel and purchased power cost recovery clauses shall have their recovery limited by a "market price" standard, rather than under the "cost-plus" standard now in effect. We have also directed the parties to this docket to negotiate in an attempt to arrive at an agreed upon methodology for establishing market prices for affiliate coal and coal handling services.

BACKGROUND

In February, 1986, we opened Docket No. 860001-EI-G for the purpose of investigating the affiliated cost-plus fuel supply relationships between Florida Power Corporation (FPC) and Tampa Electric Company (TECO) and their respective affiliated fuel supply corporations. Also, in February, 1986, we established Docket No. 860001-EI-F, Investigation into Certain Fuel Transportation Costs Incurred By Florida Power Corporation in Order No. 15895 for the purpose of determining why FPC's costs to transport coal by its affiliated waterborne system exceeded its costs to transport coal by non-affiliate rail. In September, 1987, we issued Order No. 18122, which removed TECO from Docket No. 860001-EI-G, established Docket No. 870001-EI-A for hearing the TECO issues, consolidated the two FPC issues for hearing in Docket No. 860001-EI-G and closed Docket No. 860001-EI-F.

By Order No. 18982, issued on March 11, 1988, this Commission determined to bifurcate the hearings in this docket on (1) the policy issue of whether a market price standard should be imposed on the recovery of costs for goods and services purchased from affiliated companies and (2) the separate issue of whether any of the monies FPC had recovered through its fuel and purchased power cost recovery clause for goods and services purchased from affiliates from 1984 to date had been imprudently or unreasonably incurred and should, therefore, be refunded to its customers. Hearings on the policy issue in this docket were held on May 11-13, 1988. Separate hearings were held in Docket 870001-EI-A on May 26, 1988, on the advisability of continuing TECO's recovery for affiliated transactions on a cost-plus basis. Hearings on the prudence issue in this docket were held December 14-16, 1988,and will be continued this year at a date to be announced.

After considering the post-hearing briefs of the parties and our Staff's recommendations, we, at our September 6, 1988 Agenda Conference, determined that affiliated coal should be priced at market price for recovery through the utilities' fuel cost recovery clauses and that affiliated coal transportation and handling services should also be priced at "market" where it was reasonably possible to construct a market price for the good or service being considered. We directed our Staff to conduct workshops amongst the affected parties for the purpose of determining how best to establish and implement market pricing mechanisms.

The resolution of TECO's case in Docket No. 870001-EI-A, to include our acceptance of a Stipulation establishing methods for pricing TECO's affiliated coal and coal handling and transportation on a "market price" basis are reported in Order No. 20298.

THE FPC AFFILIATE SYSTEM

Roberta S. Bass, a Planning and Research Economist in the Fuel Procurement Bureau of this Commission's Division of Electric and Gas, provided an overview of the organizational structure of FPC's affiliate coal supply and coal transportation system. From her testimony and that of the other witnesses to this proceeding, the following picture appears.

In March, 1976, Electric Fuels Corporation (EFC) was established as a wholly-owned subsidiary of FPC. In February, 1977, EFC and FPC executed a Coal Supply and Delivery Agreement for the purchase and delivery of coal to Crystal River Units 1 and 2 (CR-1 and 2). The contract, in effect until 1991, had a minimum tonnage of 1.9 million tons per year, plus or minus 15% and provided for an adjustable base coal price based on changes in EFC's costs of mining, acquisition, handling and transportation of coal. This agreement was amended in October, 1977, to include in the basis for price adjustment, inclusion of a return on EFC's equity at a rate equal to the mid-point authorized FPC by this Commission. In December, 1978, EFC and FPC executed a similar Coal Supply and Delivery Agreement for CR-4 and 5, which provided for an annual minimum tonnage of 1.0 million tons for the two units. Since 1982, when Florida Progress Corporation, a holding company, was formed, EFC has been an affiliate of FPC.

In March, 1977, EFC executed a partnership agreement with Dixie Bulk Transport, Inc., creating a partnership called Dixie Fuels Limited (Dixie). EFC holds a 65% ownership in Dixie, while Dixie Bulk Transport has the remaining 35%. The purpose of the partnership was to create an ocean-going barge system for the transportation of coal from the New Orleans area to Crystal River. In December, 1977, EFC executed an affreightment contract with Dixie to provide ocean-going barge services for the period March, 1978 through March, 2002. Pursuant to the contract and its addenda, three barge/tug units are dedicated to FPC business to transport a minimum of 1.2 million tons per year. Initially, based on a daily rate per tow, the affreightment agreement provided that the base transportation rate would be escalated quarterly based on specified indices. In 1981, the affreightment agreement was amended to establish a daily freight rate based on a three-month, rolling average of actual costs, plus a fixed profit component. Under this "dedicated" barge concept, all operating costs of the barge/tug units were charged to FPC business. In mid-1985, as a result of a Commission fuel adjustment proceeding, profits resulting from "backhaul" business from the Tampa area to the New Orleans area were ordered to be used to offset the cost of barge/tug service for FPC business.

In October, 1985, EFC and Dixie executed Addendum 10, which substantially changed the original affreightment contract by providing four barge/tug units and increasing the minimum tonnage to be shipped to 2.4 million tons per year. The base freight rate was changed from a daily charter rate to a base freight rate per ton. The base freight rate is escalated quarterly, based on specified indices. Addendum 10 establishes an affreightment rate which spreads fixed costs, variable costs and a profit component over the 2.4 million ton contract minimum. Any shipments made in excess of the contract minimum have a price determined by variable costs and the profit component. Any income received from third-party operations is used to offset the fixed cost and profit component charges required from EFC. This is done by reducing the 2.4 million ton contract minimum by the number of tons EFC would have been required to ship to recover fixed cost dollars and profit dollars equal to the third-party income. Third-party operations serve to reduce the minimum tonnage obligation, and to reduce the overall effective rate if the lower minimum tonnage obligation is surpassed. Profits realized by Dixie are shared 65% by EFC and 35% by Dixie Bulk Transport. EFC's share of the profits are allocated 75% to reduce the price of coal to FPC, while 25% are retained by EFC. Only 75% of the profits are used to reduce the price of coal to FPC because FPC maintains that it, through EFC, has an equity investment in only 3 of the 4 barge/tug units being used for FPC business.

In June, 1977, EFC entered into a partnership agreement with Marine Terminals Incorporated and Associated Energy Transporters to establish International Marine Terminals Partnership (IMT). The purpose of this partnership was to develop and operate for profit the Island Creek Dock as a bulk commodities terminal facility. Since the original partnership was formed, partner entities have changed several times. Currently, the partners are Mississippi River Terminals, Inc. (MRT) (a wholly owned subsidiary of EFC), P&C "Bituminous Coal", Inc. and Kentucky-Ohio Transportation Company. Each of these partners own a 33-1/3% interest in IMT. Concurrent with the execution of the original partnership agreement, EFC signed a terminal agreement with IMT for the provision of coal handling and storage services. The original agreement established a minimum of 1,220,000 tons, plus or minus 10%, to be received, stored and/or transferred through the IMT facilities. The base price to be paid by EFC for the unloading of EFC's coal from river barges, the storage and handling of such coal, and the reloading of such coal to ocean-going vessels was established at a cost per net ton of coal tendered at the terminal. The base price was subject to various escalators and adjustors.

The original terminal agreement was replaced, in part, by a settlement agreement between IMT and EFC which settled a dispute between the two regarding deficit tonnages and demurrage incurred by EFC in 1982 and 1983. The total dollars in dispute were approximately $3.6 million. The settlement agreement was intended for EFC's recoupment of these dollars. A new minimum tonnage was set at 1.75 million tons per year. For 1984 and 1985, a new base rate was established with a per ton discount for all tons shipped over 1.25 million tons and a reduction in the base price for all tons shipped in excess of 1.95 million. For the years 1986 through 1988, the base price was fixed with discounts given for tons handled over 1.25 million tons.

EFC's partnership interest in IMT receives 33-1/3% of the profit/loss resulting from IMT operations. The profit/loss is passed through to EFC and any profit associated with FPC coal business reduces the price of coal to FPC. IMT allocates income and expenses between FPC coal business and non-FPC business. Non-FPC business includes services provided to other coal suppliers/shippers and other bulk commodities suppliers/ shippers.

<u>Little Black Mountain Land Company/Dulcimer Land Company/Powell Mountain Joint Venture/Coal Field Leasing Joint Venture</u>

In 1979, EFC purchased an 80% undivided interest in 33,000 acres of land in Kentucky and Virginia, including the mineral and surface rights. EFC's 80% interest in this land is held by the Little Black Mountain Land Company (LBMLC), which is owned 100% by EFC. The 33,000 acres is, in turn, leased to Dulcimer Land Company (Dulcimer), which is a partnership between Little Black Mountain Coal Reserves, Inc. (LBMCR), a wholly-owned subsidiary of EFC, and Murphy's Coal Company with partnership interests of 80% and 20%, respectively. Dulcimer subleases the coal reserves to various coal producers, one of which is Powell Mountain Joint Venture (Powell Mountain).

Powell Mountain is a 50%-50% partnership between Homeland Coal Company, Inc., a wholly-owned subsidiary of EFC, and Angus Minerals Company, Inc. Murphy's Coal Company and Angus Minerals Company are wholly-owned subsidiaries of Amvest Corporation, the company EFC purchased its interest in the coal reserves from.

Powell Mountain mines, processes and ships coal to FPC under a coal supply agreement executed with EFC in 1980. The contract is for the term January 1, 1983 through December 31, 2002. It establishes a base price per ton for coal, which consists of a base cost plus a base margin for overhead and profit. The billing price for coal was to be adjusted quarterly to reflect the difference between the specified base cost per ton and the actual cost per ton. The base margin (overhead and profit) was to be adjusted annually based upon changes in specified indices.

In 1984, EFC negotiated a "price cap" with Powell Mountain to constrain the escalating base price of the coal. The dollar difference between the invoiced price using the price cap and the calculated base price is to accumulate in a "recoupable reserve" fund. Repayment of this fund by EFC is to be triggered when the Powell Mountain price cap is equal to or more than $1.00 per ton less than the average delivered price of domestic compliance coal received by EFC from contract coal suppliers with contract terms of four years or more. When repayment is triggered, Powell Mountain will receive $1.00 per ton more than the current billing price.

In May, 1987, a letter of agreement was executed by EFC and Powell Mountain that established a fixed billing price for coal for the period June, 1987 through December 31, 1988. This agreement amended the "trigger" mechanism for the recoupment fund established in 1984, so that payments from EFC shall occur when the then current billing price of Powell Mountain coal sold to EFC is less than the highest price paid by EFC to a third-party supplier of similar quality coal. At that time, EFC will pay Powell Mountain one-half of the difference between the price paid to a third-party supplier and the then current billing price for coal under the Coal Sales Agreement. This mechanism applies to coal purchased up until May 31, 1987.

During the Fixed Billing Price Period established by this letter of agreement, a second recoupment fund is established, which accumulates the difference between the actual margin and the base margin calculated under the Coal Sales Agreement. Repayment of this fund will be triggered in the same manner as the first recoupment fund. Payment of the first fund will occur first and then the second.

Powell Mountain sells compliance coal to EFC and high sulfur coal to Tennessee Eastman Company. The coal is obtained three different ways: (1) mined by Powell Mountain at company-owned mines; (2) mined by contract operators on Powell Mountain property; (3) or purchased from surrounding mine operations. All company-mined coal is sold to EFC. Homeland Coal Company's share of the profits/losses from Powell Mountain flows directly to EFC and does not reduce the price of coal to FPC.

Kentucky May Coal Company

EFC purchased Kentucky May Coal Company, Inc. (Kentucky May) in December, 1985, and also obtained a 60% interest in Hatfield Terminals, Inc., a coal processing and bulk commodities terminalling company on the Ohio River. On January 1, 1986, EFC and Kentucky May executed an agreement for the sale and purchase of coal. The agreement and the resulting sales price were the result of negotiations between various EFC officers. This agreement was amended effective August 1, 1987, to establish a base price for coal, subject to semiannual adjustments based on specified indices. The annual amount of coal to be delivered under this addendum is 300,000 tons plus or minus 10%. Any profits EFC receives from Kentucky May are retained and are not used to reduce the cost of coal to FPC.

Corbin Railway Service Company

In late-1986, EFC purchased Corbin Railway Service Company (Corbin), a company which provides train repair and servicing. EFC had a service and maintenance agreement with Corbin for its unit trains prior to purchasing the company. The agreement was renegotiated in 1987 and 1988 by Corbin and its corporate parent, EFC, again with officers of EFC essentially negotiating with themselves. All profits/losses from this company flow directly to EFC and do not reduce the price of coal to FPC.

Coal Field Leasing Joint Venture (CFLJV)

CFLJV is a joint venture between EFC and Amvest Leasing and Capital Corporation, a wholly-owned subsidiary of Amvest Corporation, with each partner having a 50% ownership interest. The purpose of the joint venture is to acquire and lease mining and other real and personal property. CFLJV leases property, primarily mining equipment, to Powell Mountain. EFC's share of the profits from this joint venture are retained by EFC.

MEMCO

Although EFC currently transports coal on the Mississippi River via a non-affiliate river barge company, it has purchased a river barge company, MEMCO, which may begin to supply river barge services to FPC as early as 1989.

Occidental Chemical Corporations' Position

Occidental Chemical Corporation (Occidental), FPC's largest customer, took the position that the current cost-plus system has no checks to ensure that FPC's affiliated fuel and fuel-related costs are no more than those which would be obtained in the market from non-affiliates. According to Occidental's witness, Dr. Robert L. Sansom, in 1986 alone, FPC's ratepayers were charged more than $33.4 million in coal costs beyond what they would have paid for competitively priced coal and transportation services.

Occidental says that EFC was created and managed by FPC employees who had no prior experience in coal procurement. Despite their lack of experience, they acquired massive interests in and committed FPC's ratepayers to pay for water terminalling facilities, Gulf barges, and coal reserves. Occidental states that EFC employees serve on the management committees of, and as directors of these affiliated companies, which it argues places them in an obvious conflict of interest when they are expected to protect FPC's ratepayers by acquiring the lowest cost coal consistent with quality and reliability criteria. Occidental says that because EFC and Progress shareholder profits decrease when affiliate prices are minimized, it is obvious that EFC's affiliate interests directly conflict with ratepayer interests in these transactions.

In coal procurement, Occidental states that EFC's coal supply contracts with its affiliates Kentucky May and Powell Mountain were not obtained through competitive solicitation and lack the protections provided by the open, competitive process. Specifically, Occidental charges that the Powell Mountain contract is the longest (23 years) Central Appalachian compliance contract entered into by any utility between 1978 and 1981, yet it has no provision for a price reopener to reflect changing market conditions. In contrast to this, Occidental states that all of EFC's non-affiliate coal contracts either contain price reopeners or are short enough in duration to reflect changes in market conditions.

Occidental states that EFC entered into the Powell Mountain contract in 1980 without issuing a contemporaneous solicitation to determine market conditions despite the fact that there was then a drastically softened market for compliance coal. Occidental argues that coal purchased from Powell Mountain is and has always been FPC's highest priced coal.

With respect to Kentucky May, Occidental claimed that shortly after EFC acquired that company it entered into a 3-year contract for 300,000 tons of coal from Kentucky May despite the fact that EFC had sufficient volumes of coal under term contract at the time and had been advised in 1983 by its coal consulting expert that it had too many long-term commitments and should purchase more spot coal. Occidental states that the Kentucky May contract appears unjustified because spot coal was available at a lower price. Occidental submits that even though the Kentucky May price was lowered as the result of a market reopener provision a year and a half into the contract, the price still exceeds spot market prices.

Occidental argues that EFC's contracts with its water transportation affiliates also demonstrate FPC's affiliate bias and have resulted in excess costs to FPC ratepayers. While acknowledging the apparent reasonableness of FPC's initial decision to ship a portion of its coal requirements to Crystal River by water, Occidental argues that the price of EFC's initial minimum commitment to IMT and Dixie, the decision to increase that commitment, and the escalation formula in both contracts result in excessive costs to ratepayers. This, says Occidental, has resulted in EFC paying above-market rates for affiliate water transportation from the beginning. Furthermore, Occidental claims that: (1) FPC has not documented that it competitively solicited Gulf barge services; (2) the EFC/Dixie and IMT contracts escalate "fixed" costs contrary to the practice in the competitive market; (3) EFC expanded its minimum contractual commitments to both IMT and Dixie without any credible evidence to demonstrate that studies were conducted to determine whether less expensive alternative transportation was available; and (4) regardless of the performance of Dixie or IMT in terms of profits or losses, EFC's returns on its equity investment in these companies is guaranteed to be collected from FPC's ratepayers through a "true-up" mechanism.

Occidental took the position that this Commission had broad discretion to adopt methods to assure the reasonableness of amounts to be recovered from ratepayers through the fuel adjustment clause and its witness, Dr. Sansom, testified to methodologies that he said would replicate market costs for both the affiliate coal purchased and the coal transportation and handling services.

Dr. Sansom said that the market test for the cost of Powell Mountain coal should be the price derived from a competitive solicitation for term purchases of compliance coal. Since EFC's Golden Oak and A. T. Massey contract prices are based on the results of solicitations and on identical types of coal, they should serve as the benchmark for Powell Mountain. For Kentucky May, Dr. Sansom said the market standard should be the lowest price (adjusted for Btu) derived from a competitive solicitation for spot market coal purchases. He added that different market prices should be established for 1% coal and compliance coal provided by Kentucky May. For affiliate waterborne transportation costs for Dixie and IMT Dr. Sansom testified that the market test should be different depending on whether the test is applied against the costs of FPC's initial contract commitment to these partnerships or its second commitment. He said the preferred market test for the costs due to the original two Dixie barges is one that would have allowed arm's-length waterborne service providers to earn a fair return at the time. With respect to the terminal services, Dr. Sansom said the preferred market test for the original 1.2 million ton commitment at IMT is an arm's-length barge transloading rate plus a 15% after-tax return. For the third and fourth Dixie barges and the second commitment at IMT, the market test should be a "cap" on the cost of water transportation measured by the cost of the least-cost alternative mode of transporting that tonnage to Crystal River.

Staff's Position

Hugh Stewart, a General Engineer in the Energy and Fuels Analysis Branch, Office of Electric Power Regulation, Federal Energy Regulatory Commission, testified on behalf of our Staff. Mr. Stewart reviewed the circumstances under which FPC implemented a policy of using affiliate coal companies to supply its coal requirements. Based on this review, Mr. Stewart concluded that FPC's affiliated contractual relationships have resulted in high coal costs being passed on to the utility's ratepayers and, further, that the affiliate contracts had inhibited the replacement of the affiliate coal with less expensive coal available on the market.

Mr. Stewart testified that it was his opinion that the affiliated coal relationships had taken a significant portion of FPC's coal requirements out of a highly competitive market and had placed it, instead, into a situation where prices were not subject to the normal competitive forces of the market. He concluded that the conflict of interest problems associated with FPC's affiliate coal relations, or that of any utility, could only be addressed by insuring that affiliate coal prices reflect what would otherwise have been paid in the competitive market.

John Pyrdol, an Industry Economist in the Energy and Fuels Analysis Branch, Office of Electric Power Regulation, Federal Energy Regulatory Commission, also testified for our Staff. He said that the benefit of a market price standard for pricing the services provided by affiliated companies is that it would put FPC and its affiliates in basically the same posture as FPC is with all of its arm's-length fuel suppliers. Mr. Pyrdol said that adoption of such a standard would eliminate the conflict of interest problems inherent in FPC's affiliated fuel relationships, which make FPC more willing to accept a higher price from an affiliate, either to keep the affiliate whole or to help the affiliate earn greater profits.

Mr. Pyrdol testified that the affiliated fuel supplier knows it has a captive buyer for its product who will pay all the supplier's costs, no matter how high, plus a guaranteed rate of return. In contrast to this situation, he said that FPC, when it goes to the competitive marketplace to purchase coal and other services from arm's-length suppliers has no incentive other than to get the lowest price possible. Mr. Pyrdol said that adoption of a market price standard for affiliated transactions would limit what FPC pays for these goods and services to what it could reasonably expect to pay for them on the open market.

Mr. Pyrdol testified that cost-plus contracts of the type FPC has with EFC, and EFC, in turn, has with its affiliate, Powell Mountain, are rarely used in arm's-length coal transactions and are almost solely found in affiliated transactions. He said that with a cost-plus contract the affiliate is allowed to recover all of its costs, plus earn a guaranteed profit. In contrast to this, Mr. Pyrdol said that a coal supplier operating in the competitive, open market would receive only the competitive coal price irrespective of what its actual costs of producing the coal were.

Mr. Pyrdol stated that he thought a market price for the Powell Mountain coal could most fairly be calculated by using prices actually paid for similar quality coal purchased by other utilities from the same coal fields in which the Powell Mountain coal is produced. He said that the market price analysis should be limited to other contracts signed at about the same time as the Powell Mountain contract and should also be limited to similar coal, in this case bituminous, compliance coals with similar burn characteristics to those of Powell Mountain coal. As a result of his analysis, Mr. Pyrdol calculated a 1987 market price for Powell Mountain coal of about $35 per ton FOB mine, which he said was less than what EFC had actually been paying for that coal during the period. Mr. Pyrdol said the 1987 base price should then be adjusted on an annual basis by the percentage change in the prices of lower sulfur coal from Bureau of Mines, District No. 8, which is where Powell Mountain is located. He also recommended that the price resulting from his recommended market pricing methodology be reviewed every two or three years to ensure that it continued to fairly reflect market conditions.

Mr. Pyrdol emphasized that the market price standard should be used continuously in the future regardless of whether the Powell Mountain/EFC contract price was higher or lower than that market price. He said that use of the market price standard for Powell Mountain coal would effectively treat it as if it were being purchased pursuant to the base price, plus escalator contract with market price reopener clause used by FPC and many other utilities in many of their arm's-length contracts. Mr. Pyrdol concluded that in addition to providing FPC and its affiliates with a competitive environment similar to the free market, the market price standard should also lessen the need for this Commission to continuously scrutinize every nuance of FPC's extensive chain of affiliates to ensure that all affiliated costs were just and reasonable.

Mr. Harry T. Shea, Chief of the Bureau of Fuel Procurement, of the Commission's Division of Electric and Gas, testified on behalf of the Commission Staff. He said that in 1983 the Commission, in Order No. 12645, established general fuel procurement guidelines that state that all fuel purchases from affiliates should be priced at levels not to exceed prices which could be obtained in a competitive market. To obtain this goal he recommended that the Commission use one of three methodologies to evaluate the reasonableness of affiliated fuel transactions. He said the preferred methodology was that of a market test. If the preferred methodology was unavailable, Mr. Shea said the second method would use an allocation procedure which would assign variable costs and pro rate fixed costs and a reasonable profit between utility and non-utility operations. The third method and the least preferred would be to conduct a cost of service study.

Mr. Shea recommended that a market test should be used to evaluate the cost of coal purchased from Powell Mountain and Kentucky May. He said that unless we could establish a reasonable market test for the services provided by Corbin Railway, IMT, and Dixie, we should use the allocation methodology to evaluate the reasonableness of the services provided by those affiliates.

FIPUG's Position

FIPUG sponsored no witnesses but took the position that market price standards should be used for the cost recovery of all affiliate transactions where a competitive market price can be identified. Where a market price cannot be established and the affiliate engages in both utility and non-utility operations, a cost allocation methodology should be used. Only as a last resort, submitted FIPUG, should the Commission attempt to review the affiliate's operations to determine a reasonable transaction price.

In the case of FPC's affiliated transactions, FIPUG took the position that a market price standard could and should be established for the coal purchased from Powell Mountain and Kentucky May, while the cost allocation methodology should be used for affiliated transactions involving IMT and Dixie and other affiliates unless appropriate market prices could be established. Lastly, FIPUG took the position that the Commission should review EFC's operations to establish what level of equity investment is necessary to support cost-effective operations.

Public Counsel's Position

Public Counsel did not sponsor any witnesses in this proceeding but took the position that market prices could and should be established for FPC's affiliate coal purchases and should be established for its affiliate transportation and transloading companies, if possible.

With respect to the Powell Mountain coal purchases, Public Counsel urged that the market price standard should equal: (1) the average price of the non-affiliated long and mid-term contract compliance coal delivered to CR-4 and 5; or (2) the price resulting from the FOB mine, market price methodology recommended by Witness Pyrdol. For Kentucky May, Public Counsel said the market price should be equal to the lowest spot market compliance coal on a delivered basis to CR-4 and 5.

Public Counsel said that, if possible, market prices should be determined for the affiliate transportation and transloading operations. However, if this was not possible, he took the position that their rates should be determined by an equitable cost allocation of expenses between FPC and non-FPC business. Further, Public Counsel took the position that depreciation and interest expenses should be allocated to FPC business only for the related investment needed to support utility business.

FPC's Position

FPC's position is that the Commission's Fuel Procurement Policy was appropriate when it was adopted and continues to produce good results and should, therefore, not be changed in the way it is applied to FPC.

Dr. Jack B. Critchfield, President of Florida Progress Corporation and formerly Group Vice-President for Energy and Technology and President of Electric Fuels Corporation (EFC) described the "cost-plus" relationship between EFC and FPC and the reasons he believed the relationship had well served the interests of both FPC, its ratepayers, and EFC. He testified that in the aftermath of the OPEC oil embargo, FPC had adopted a long-term strategy to gain control over its fuel destiny. He said that coal was a cornerstone of that strategy and that EFC was formed in March, 1976, and charged with the objective of providing FPC with a reliable supply of coal at the lowest cost consistent with FPC's reliability and quality requirements.

To accomplish its objective, Dr. Critchfield said that EFC sought maximum flexibility by obtaining coal from many different sources and locations, and by delivering the coal to FPC using a mix of rail and waterborne transportation. He said to establish the coal supply and transportation system and attain a degree of control, EFC secured an ownership interest in the key elements of the system, to include the IMT bulk transfer terminal, large ocean-going tug and barge units, a fleet of rail cars, high quality, low sulphur coal reserves and a deep mining complex.

Dr. Critchfield testified that approximately 96% of the total cost of coal to FPC in 1987 consisted solely of charges initially incurred by EFC from its coal and transportation suppliers, approximately 22% of the total being from affiliated suppliers. He said that none of the 96% included "cost-plus" charges. He added that FPC's coal costs had declined 21% during the past five years, which resulted in the utility's cost of energy from coal-fired units being lower than any other investor-owned utility in Florida during the past three years.

Dr. Critchfield, acknowledging that Powell Mountain coal presently cost more than similar coals available, stressed that there was a strong likelihood that the cost of compliance coal would increase dramatically in the future making the cost-plus price appear to be a bargain to the ratepayers. He expressed the concern that allowing the flow-through of a "market" price for affiliate coal during periods of high prices might subject both the utilities and the Commission to severe criticism.

Dr. Critchfield rejected the notion that EFC's officers and employees were subject to any conflicts of interest in balancing shareholder profits against the desire to provide the lowest possible cost coal to FPC's ratepayers, stressing that the ratepayers' interests came first.

FPC's additional witnesses described the history of EFC's formation, including the various investments that were made and the contracts that were entered into. They testified that acquisitions were made when a required good or service was either unavailable or not available on a reliable basis or at a reasonable price. They testified that consultants were commissioned prior to investing in the necessary businesses and that reputable operators were sought as partners in each of the coal and coal handling fields that were entered into. They rejected the assertion that they were subject to conflicts of interest in attempting to obtain the lowest cost coal and coal transportation services for the benefit of FPC's customers, saying that that goal was their first priority. They asserted that FPC's decision to form EFC and EFC's subsequent decisions made in forming a coal procurement system that enjoyed the advantages of a "portfolio" of coal supplies, as well as the benefits of a dual transportation system, were reasonable and prudent when they were made and remained so. More importantly, they stressed, this system provided for a reliable supply of reasonable cost coal.

CONCLUSION

As is reported in Order No. 20298, Tampa Electric Company (TECO), while submitting that the current system of cost-plus pricing had provided an effective means of ensuring that only reasonable and prudently-incurred fuel costs were passed on to its customers, acknowledged that this methodology was administratively costly and caused unnecessary regulatory tension because it left the lingering suspicion, even in the face of outstanding results, that it resulted in higher costs to customers than would have been available through arm's-length contracts. With this recognition, TECO did not object to the adoption of a market pricing system so long as the system fairly represented the price received for comparable coal on the competitive market. As noted at the beginning of this Order, TECO and the other parties to its docket were able to agree on market pricing methodologies for all of its fuel-related affiliated purchases.

FPC, as did TECO, submits that the current methodology of cost-plus pricing for recovery through its fuel cost recovery clause has resulted in only the pass through of reasonably and prudently-incurred fuel costs. Unlike TECO, FPC, however, argues that switching from this methodology to a market price methodology is not only unnecessary and unworkable, but also unfair in the sense that it constitutes changing the rules in the middle of the game.

Several of the parties to this proceeding have alleged that FPC has recovered imprudent or unreasonable fuel costs through its fuel cost recovery clause from 1984 to the present. That issue will be addressed in Phase II of this proceeding and was not before us here. However, irrespective of whether any imprudence or unreasonable expenses are found and disallowances made in Phase II, we believe and find that a change from cost-plus pricing is warranted. While we believe that the current system has been generally successful in allowing only reasonable and prudent costs to be passed through the utilities' fuel adjustment clauses, we believe that it has been administratively costly, caused unnecessary regulatory tension, and left the lingering suspicion that it has resulted in higher costs to a utility's customers.

Implicit in cost-plus pricing is the requirement that one is capable of conducting a cost-of-service analysis of a business to determine that its expenses are both necessary and reasonable. This is a methodology that is demanded for monopoly utility services, and which usually proves to be complex, expensive and time consuming. It is a methodology which requires a high degree of familiarity with the capital requirements and expenses necessitated by the operation of the business being reviewed. Cost-of-service analysis of affiliate operations places additional demands upon the regulatory agency in terms of time, expense and acquiring additional expertise. All come at some additional cost that must eventually be borne by the ratepayer, either in his role as a customer or as a taxpayer. Furthermore, there seems to be no end to the types of affiliated businesses that we are expected to become sufficiently familiar with so that we might judge the reasonableness of their costs on a cost-of-service basis. For example, in this docket and the companion TECO docket we are confronted with the following types of affiliated businesses whose costs are included in the purchase price of the coal: (1) land companies owning coal reserves; (2) financial services companies; (3) equipment leasing companies; (4) coal mining companies; (5) river barge and tug companies; (6) transloading and bulk storage facilities; (7) ocean barge and tug services; (8) marine management and services companies; (9) rail car repair companies; (10) diversified holding companies; and (11) others.

Cost-of-service regulation for public utilities is necessitated by their monopoly status and the attendant lack of significant competition, if any, for their end product. Cost-of-service regulation exists as the proxy for competition to insure that utilities provide efficient, sufficient and adequate service and at a cost that includes only reasonable and necessary expenses. Cost-of-service regulation of some type is essential when there is no competitive market for the product or service being purchased; it is superfluous when such a competitive market exists.

Another reason for switching to a market pricing system, as recognized by TECO, is that the current system, no matter how outstanding the results, left lingering suspicions that it resulted in higher costs. That this might be true may be seen by contrasting affiliated and non-affiliated contracts. The latter, with few exceptions, are characterized by arm's-length transactions entered into in the competitive marketplace. Typically, the contracts result from competitive bidding systems in which the contract is awarded to the qualified bidder submitting the lowest bid. In any event, the utility's negotiator has clearly defined loyalties and knows whose interests he or she is to protect. In contrast to this, the typical affiliate contract is let without the benefit of competitive bidding. Instead, confident that the contract will be given to the affiliate, representatives of the two companies negotiate the rate at which the product or service will be purchased. They must do so recognizing that a favorable contract concession to the utility (and its ratepayers) comes at the expense of the affiliate and, ultimately, the parent holding company. Conversely, terms favorable to the affiliate come at the expense of the utility and, because of the pass-through nature of the fuel adjustment clauses, its customers. In every instance examined, affiliated contracts were negotiated by persons who ultimately shared at least the common interests of the parent holding company. In at least one case in this docket, two Electric Fuels Corporation (EFC) Vice-Presidents negotiated an affiliate contract with each other, on ostensibly representing the utility or ratepayers' interests and the other the affiliates' interests. Both men were evaluated by EFC's President and all three owned the parent corporation's stock. Whether or not they were acted upon, there existed potential conflicts of interest and the appearance of conflicting interests.

Considering the many advantages offered by a market pricing system, we, as a policy matter, shall require its adoption for all affiliated fuel transactions for which comparable market prices may be found or constructed.

In concluding, we note the following: (1) from the record in this case, we are convinced that market prices can be established for the affiliated coal; (2) market prices for the transportation-related services should be established if possible, but if not, methodologies for reasonably allocating costs should be suggested; (3) cost-of-service methodologies should be avoided, if possible; and (4) where "backhauls" on ocean transits for utility coal shipments help "spread" fixed costs otherwise borne by the utility, the rate for such backhauls for utility ratemaking purposes shall at least cover the variable costs associated with that leg of the voyage and contribute to the fixed costs of the operation.

While the parties to this proceeding have offered volumes of testimony on how market prices may be established both for affiliated coal and coal handling services, as well as why those methodologies will not work or would be unfair, we decline, for now, to impose a methodology. Rather, we believe that the most equitable and manageable solutions or methodologies for constructing market prices are likely to result from the give-and-take of settlement negotiations amongst the parties to this docket. Accordingly, we shall direct the parties to meet for the purpose of discussing methods by which market pricing can be adopted for the affiliated coal and coal transportation transactions between FPC and its affiliates. If agreement is reached by the parties, such an agreement should be reduced to writing and submitted to us for our consideration and possible approval. If, after a reasonable period, agreement has not been reached, we shall impose a market pricing methodology or methodologies, as appropriate, based upon the record evidence in this case, or as supplemented, if we consider it necessary.

Since we have directed the parties to this docket to meet to attempt to agree upon market price methodologies for FPC's affiliated fuel transactions, we consider this Order to be non-final. That is to say, appeals, if any, should not be taken until after settlement negotiations are attempted and fail. Should this occur, we will consider the record as it exists or as supplemental, if we deem it necessary, and impose market price methodologies for FPC's affiliated fuel transactions. In the event, appeals, if any, may then be taken on our policy decision to utilize a market price standard, as well as on the specific methodologies ordered. Presumably, if agreement is reached and we approve it, there will be no appeals.

In view of the above, it is

ORDERED by the Florida Public Service Commission that as a matter of general policy, market-based pricing for affiliate fuel and fuel transportation services shall be used for the purposes of fuel cost recovery where a market for the product or service is reasonably available. It is further

ORDERED that a market-based price, to be effective April 1, 1989, shall be developed for affiliate coal purchased by Florida Power Corporation. As discussed in the body of this Order, the parties are directed to meet for the purpose of discussing methods by which market-pricing can be adopted for affiliate coal purchases, as well as for affiliated coal-handling transactions where to do so is reasonably possible. If it is determined that market prices may not reasonably be constructed for coal-handling transactions, methodologies for allocating or otherwise establishing a transfer price should be proposed. It is further

ORDERED that this Commission shall impose market-price methodologies for affiliated transactions if the parties are unable to agree upon such methodologies. It is further

ORDERED that where third-party backhauls benefit the utility by further spreading fixed costs, the price of such a backhaul for fuel cost recovery purposes shall be equal to the variable costs of the move plus any contribution to fixed costs. It is further

ORDERED that this Order is considered non-final for appellate purposes, as discussed in the body of this Order.

By ORDER of the Florida Public Service Commission, this 13th day of JANUARY, 1989.

Steve Tribble

STEVE TRIBBLE, Director
Division of Records and Reporting

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