FLORIDA PUBLIC SERVICE COMMISSION

Fletcher Building
101 East Gaines Street
Tallahassee, Florida 32399-0850

M E M O R A N D U M

JUNE 21, 1990

TO: DIRECTOR OF RECORDS AND REPORTING

FROM: DIVISION OF AUDITING AND FINANCIAL ANALYSIS (A. CAUSSEAUX)
DIVISION OF ELECTRIC AND GAS (REVELL, ROMIG, WALSH)
DIVISION OF LEGAL SERVICES (RULE)

RE: DOCKET NO. 890148-EI PETITION OF THE FLORIDA INDUSTRIAL POWER USERS GROUP TO DISCONTINUE FLORIDA POWER & LIGHT COMPANY'S OIL BACKOUT COST RECOVERY FACTOR

AGENDA: JULY 17, 1990

CRITICAL DATES: NONE

ISSUE AND RECOMMENDATION SUMMARY

ISSUE 1: Is Florida Power & Light Company'S (FPL) attached ruling request adequate and complete and such that it should be filed with the Internal Revenue Service (IRS)?
RECOMMENDATION: Yes, the ruling request is adequate and complete and should be filed with the IRS.

ISSUE 2: Should FPL, its parent, agents, representatives and affiliates and all other parties to this proceeding be directed to inform each other of any written or verbal contact regarding the ruling request, or the subject matter of the ruling request, which has occurred or does occur with the IRS or the U. S. Department of the Treasury (Treasury)?
RECOMMENDATION: Yes, all parties to this proceeding should be directed to report any such contacts.

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ISSUE 3: Should FPL, its parent, agents, affiliates and representatives and all other parties be required to furnish to each other a copy of any additional information to be submitted to the IRS or Treasury in regard to the ruling request, or the subject matter of the ruling request both before and after it is submitted to the IRS?
RECOMMENDATION: Yes, material to be submitted to the IRS or actually submitted to the IRS should be furnished to this Commission and all other parties to this proceeding.

ISSUE 4: Should FPL be required to clear dates for any conferences to be held with the IRS with this Commission, the FIPUG and the OPC before dates are established?
RECOMMENDATION: Yes, dates for conferences should be cleared with those to attend before they are established.

ISSUE 5: Upon receipt of the IRS ruling, should FPL make the appropriate refund and adjust its investment tax credit (ITC) amortization if the IRS finds that to do so is not violative of the Internal Revenue Code (Code) and the underlying Regulations?
RECOMMENDATION: Yes, if the IRS finds that the proposal is not violative, FPL should make the appropriate refund and adjust its ITC amortization accordingly.

ISSUE 6: Upon receipt by this Commission of a copy of FPL's ruling from the IRS, may this docket be closed?
RECOMMENDATION: This docket should be closed upon receipt of a copy of FPL's ruling from the IRS and staff's verification that the refund of appropriate revenues, plus interest, has been accomplished and that the ITC amortization has been adjusted, if appropriate.

DISCUSSION OF ISSUES

ISSUE 1: Is Florida Power & Light Company'S (FPL) attached ruling request adequate and complete and such that it should be filed with the Internal Revenue Service (IPS)?
RECOMMENDATION: Yes, the ruling request is adequate and complete and should be filed with the IRS.
STAFF ANALYSIS: FPL, the OPC, the FIPUG and staff all participated in drafting the ruling request and believe that it is adequate and complete. Therefore, staff recommends that the Commission direct FPL to file the ruling request with the IRS.

ISSUE 2: Should FPL, its parent, agents, representatives and affiliates and all other parties to this proceeding be directed to inform each other of any written or verbal contact regarding the ruling request, or the subject matter of the ruling request, which has occurred or does occur with the IRS or Treasury?
RECOMMENDATION: Yes, all parties to this proceeding should be directed to report any such contacts.
STAFF ANALYSIS: Any ruling received will not be accepted by a party as authoritative unless all parties are aware of all information on which the IRS based its decision. Therefore, staff recommends that any contacts regarding this matter by one party should be reported to the other parties.

ISSUE 3: Should FPL, its parent, agents, affiliates and representatives and all other parties be required to furnish to each other a copy of any additional information to be submitted to the IRS or Treasury in regard to the ruling request, or the subject matter of the ruling request both before and after it is submitted to the IRS?
RECOMMENDATION: Yes, material to be submitted to the IRS and actually submitted to the IRS should be furnished to this Commission and all other parties to this proceeding.
STAFF ANALYSIS: In order for the parties to accept any IRS ruling as authoritative, they must be aware of all information on which the IRS based its decision. Therefore, staff recommends that all information be shared by all parties both before it is sent to the IRS and after.

ISSUE 4: Should FPL be required to clear dates for any conferences to be held with the IRS with this Commission, the FIPUG and the OPC before dates are established?
RECOMMENDATION: Yes, dates for conferences should be cleared with those to attend before they are established.
STAFF ANALYSIS: The ruling request states that all parties may attend and participate in any conferences. Therefore, staff recommends that the dates be chosen for those conferences after first consulting those to attend.

ISSUE 5: Upon receipt of the IRS ruling, should FPL make the appropriate refund and adjust its investment tax credit (ITC) amortization if the IRS finds that to do so is not violative of the Internal Revenue Code (Code) and the underlying Regulations?
RECOMMENDATION: Yes, if the IRS finds that the proposal is not violative, FPL should make the appropriate refund and adjust its ITC amortization accordingly.
STAFF ANALYSIS: This docket has been left open, with revenues subject to refund, pending resolution of this question. Therefore, staff recommends that FPL make the appropriate refund and adjust its amortization upon receipt of an IRS ruling that the proposed treatment of the ITC amortization does not violate the provisions of the Code or the underlying Regulations.

ISSUE 6: Upon receipt by this Commission of a copy of FPL's ruling from the IRS, may this docket be closed?
RECOMMENDATION: If the IRS rules that the proposal is violative, this docket should be closed upon receipt of a copy of FPL's ruling from the IRS. However, if the IRS rules that the proposal is not violative, this docket should be closed upon receipt of a copy of FPL's ruling from the IRS and staff's verification that the refund of appropriate revenues, plus interest, has been accomplished and that the ITC amortization has been adjusted, if appropriate.
STAFF ANALYSIS: This docket was left open, with monies subject to refund, for resolution of this issue. If the IRS rules that the proposal is violative of the Code and underlying Regulations, this docket should be closed as there will be nothing further required of FPL. If the IRS rules that the proposal is not violative of the Code and underlying Regulations, the appropriate refund should be made and the ITC amortization should be adjusted. Therefore, staff recommends that the docket be closed upon receipt of a copy of the IRS ruling and, if appropriate, staff verification that both the refund and ITC amortization adjustment have been accomplished.

DOCKET NO. 890148-EI
JUNE 21, 1990

DRAFT AS OF June 20, 1990

________ __, 1990

HAND DELIVERED

Internal Revenue Service
Associate Chief Counsel (Technical and International)
Attention: CC:IND:D:C
Room 6561
111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Sir:

Based on the facts and authorities hereinafter set forth, Florida Power & Light Company (Company) respectfully requests that the Internal Revenue Service (Service) issue a ruling with respect to the Federal income tax consequences resulting from the issuance of Order No. 22268 (Order) (Exhibit A) by the Florida Public Service Commission (FPSC). The Order requires a change in the flow-back of unamortized investment tax credits (ITC) associated with certain property the costs of which have been fully recovered through straight-line and additional book depreciation as defined by Rule 25-17.016, Florida Administrative Code, Oil-Backout Cost Recovery Factor (OBO Rule) (Exhibit B). Revenues relating to that aspect of the Order which is the subject of this ruling request will be collected subject to refund until the Service issues its ruling.

The Company is uncertain as to whether the treatment of ITC under the Order complies with the requirements of section 46(f) of the Internal Revenue Code of 1986 (Code) and Regulations section 1.46-6. Accordingly, the Company seeks a ruling from the Service on this issue.

For purposes of section 6110 of the Code, no information other than names, addresses and other identifying information, including the FPSC order number, need be deleted.

STATEMENT OF FACTS

A. Taxpayer

The Company (EIN #59-0247775) is an investor-owned public utility incorporated in the State of Florida and is a wholly-owned subsidiary of FPL Group, Inc. (EIN #59-2449419). The Company is engaged in the operation of an integrated electric public utility system involving the generation, transmission, distribution and sale of electric energy in thirty-five counties within the State of Florida.

The Company's address is 9250 W. Flagler Street, Miami, Florida 33174. FPL Group, Inc. files a consolidated Federal income tax return with its affiliated corporations, including the Company. Attached hereto as Exhibit C is a complete list of companies which join with FPL Group, Inc. in the filing of a consolidated return. The return is filed with the Internal Revenue Service Center in Chamblee, Georgia on a calendar year basis using the accrual method of accounting. The Company is under the audit jurisdiction of the District Director of Internal Revenue in Ft. Lauderdale, Florida.

In 1972, the Company made a timely election, pursuant to section 46(f)(2) of the Internal Revenue Code of 1954, as amended, to use the ratable flow-through method of accounting and ratemaking for the ITC. The Company has fully normalized all book-tax timing differences, including depreciation since

1976.

B. Oil-Backout Cost Recovery

On January 29, 1982, the FPSC adopted the OBO Rule. The OBO Rule was intended to allow for timely recovery of the cost of implementing supply side conservation projects primarily for the economic displacement of oil-generated electricity. All costs associated with a conservation project subject to the Rule are to be recovered through the Oil-Backout Cost Recovery Factor (Factor), including straight-line depreciation expense over the used and useful life of the project, capital costs, actual tax expense and operating and maintenance expenses (O&M). The OBO Rule also allows additional amounts to be recovered in rates and recorded on the regulatory books of account as additional book depreciation expense in an amount equal to two-thirds of the actual net savings, if any, associated with an Oil-Backout Project (OBO Project). All costs associated with an OBO Project are segregated and accounted for separately. The revenue requirements of an OBO Project are determined on the basis of the OBO Project's own independent capital structure, capital investment and expenses.

The following is a simplified example of how the Factor works. It is used for illustrative purposes only and the numbers therein do not represent actual data.

> An OBO Project is constructed with depreciable capital costs (book basis) of $1,000,000 and a regulatory book life of 10 years. Before the property is placed in service, O&M costs are estimated to be $30,000 for the first six months of operations. The Company's after-tax rate of return is 12 percent per year. The Factor is set so that the revenue to be collected will cover all estimated costs for the six-month period including an after-tax return of $60,000 ($1,000,000 book basis x (12%/2)).[1] Assuming a statutory tax rate of 34 percent, revenue requirements to be recovered through the Factor would be $170,909, calculated as follows: $30,000 O&M costs + $50,000 straight-line depreciation for six months + $90,909 pre-tax return on investment. ($60,000/(1-.34)).[2] This amount of $170,909 would be

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[1] For simplicity, the beginning balance of net investment is used in the example rather than the monthly balances that would actually be used in computing the Factor. The net investment is the investment in the OBO Project less the cumulative straight-line and cumulative additional book depreciation allowed as of the end of the prior month.

[2] This factor grosses-up an after-tax return to yield the required revenues. The revenues less the $30,000 O&M costs and the $50,000 straight-line book depreciation yield book taxable income of $90,909. the revenues are sufficient to recover all costs plus the $60,000 authorized after-tax return ($90,909 less income tax of $30,909). For simplicity, the state income tax effect is not computed and property, ad valorem and sales taxes are ignored. Other costs, including non-depreciable capital costs that may be associated with

added to the Company's normally established revenue requirements and charged to its customers. Any actual overcollection or undercollection of costs during the six-month period would be reflected as an offset or addition to the Factor to be charged to the customers in subsequent six-month periods. In addition, two-thirds of any net savings that result in a period will be treated as additional book depreciation in the following period.

Net savings are computed by comparing all costs associated with the OBO Project with the costs the Company would have incurred if the OBO Project had not been built: for example, avoided fuel costs and the revenues that would have been required if additional generating capacity had been constructed instead of the OBO Project. Using the same facts in Example 1 and an estimated $300,000 net savings in the first six-month period of the third year, two-thirds of estimated net savings, or $200,000, would be included in calculating the revenue to be used in establishing the Factor. The $200,000 would also be recorded as additional book depreciation of the OBO Project to be collected during the six-month period that the newly computed Factor would be in effect. Return on investment would be lower than in year 1, because two years of book depreciation expense ($100,000 per year) had been recovered. The after-tax return on investment for the first six-month period in the third year would be $48,000 ((12%/2) x 800,000).[3] It is further assumed that there was no overcollection or undercollection in the previous period and that O&M costs will remain at $30,000. The Factor would be established to recover revenue of $352,727 ($30,000 O&M costs + $50,000 six months of straight-line book depreciation + $200,000 additional book depreciation + $72,727 return on net book investment ($48,000 after-tax return on investment/(1-.34))).

As is indicated by the examples, the OBO Project revenues and, consequently, the Factor charged to customers to collect them, are increased as a result of the increased amounts treated as additional book depreciation expense that are allowed once net savings occur.

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the OBO Project are ignored through they are recovered through the Factor

[3] For simplicity, the beginning balance of net investment is used in the example rather than the monthly balances that would actually be used in computing the Factor. The net investment is the investment in the OBO Project less the cumulative straight-line and cumulative additional book depreciation allowed as of the end of the prior month.

C. 500 Kilovolt Transmission Line

In Order No. 11217 (Exhibit D), the Commission granted approval for the Company to recover the cost of a 500 Kilovolt transmission line project (the KTL Project) through the Factor, effective October 1, 1982.

The KTL Project was built in three phases to import coal fired generation from Georgia. The primary purpose of the KTL Project was to reduce dependency on oil while assuring adequate service at a reasonable cost to the ratepayers. It also deferred the need for the Company to build additional power plants. Facilities comprising Phase 1 of the KTL Project were placed in service for tax purposes and the associated costs were first reflected in rates and on the Company's books in 1982.[4] From October 1, 1982, forward, all related costs of the KTL Project--book depreciation expense computed using the straight-line method, a rate of return on the unrecovered capital costs of the KTL Project and associated income taxes--were recovered through the mechanism provided by the OBO Rule[5]. The accounting treatment of the assets and expenses associated with the KTL Project has been separately maintained. Recovery of the costs associated with the KTL Project was through the fuel adjustment clause, an additional line item on the customers bill, and not through base rates. The cost recovery mechanism for the KTL Project does not establish base rates and is, therefore, not a conventional ratemaking method.

Phases 2 and 3 of the KTL Project were placed in service for tax and book purposes in subsequent years, and the entire KTL Project was complete as of June, 1985. A net savings was achieved by the KTL Project beginning in August, 1987.[6] As a result, the Factor was increased under operation of the OBO Rule to reflect two-thirds of net savings.[7] The increase in the factor was recorded on the books as approximately $270 million of additional book depreciation expense resulting in the Company fully recovering the KTL

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[4] Some of the Phase I property was placed in service for tax purposes in April and August of 1982. To the extent any associated costs were reflected in non-Oil-Backout rates, such costs were subsequently removed from such rates for recovery under the Rule.

[5] From December 23, 1982 through July 20, 1984 a minor portion of the investment in the KTL Project ($706,000) was recovered in base rates

[6] There was an allowance for a minor amount of additional book depreciation reflecting net savings for the period October - December, 1982

[7] Net savings were computed based on the difference between the actual revenue requirements of the Company and the estimated revenue requirements of the Company that would have existed if the KTL Project had not been undertaken and the Company had constructed additional power plants instead

Project's depreciable capital costs by August 1989.[8]: a seven year period instead of the longer, previously established, book life. All parties agree that the additional book depreciation has been treated in the same manner as the straight-line book depreciation for the following purposes: deferred taxes, cost of service and the calculation of the revenue requirements. The sum of the straight-line and additional book depreciation was the depreciation expense used by the FPSC for purposes of establishing the Company's cost of service for calculating the revenue requirements related to the KTL Project and translated into rates charged to customers. The seven years was the period of time actually used by the Company in computing its regulated depreciation expense for the KTL Project property. Both the straight-line and additional OBO Project book depreciation were used to calculate tax deferrals.

Since the time the KTL Project was placed in service, including the period additional book depreciation was being recovered, the Company has amortized the ITC generated by the KTL Project at a composite book life for all utility property, including KTL Project property, qualifying for the ITC without consideration of the additional capital recovered through KTL Project book depreciation. The composite ITC amortization rate is calculated by dividing book depreciation expense--without the additional KTL Project book depreciation expense--for the year by the year-end plant balance including KTL Project property. Under the Company's ITC amortization method, the flow-back of the unamortized ITC associated with KTL Project property will be over approximately the next 17 to 20 years, depending on the date the associated property was placed in service. During that period of time, a return will be earned on only the non-depreciable KTL Project property.

D. Proposed Regulatory Treatment of Unamortized ITC

Contingent on the ruling requested here, the FPSC has ordered the Company to flow-back, to the ratepayers, the approximately $17 million of unamortized ITC associated with the KTL Project over the six-month period beginning April, 1990.

The Order will not affect the return to be earned by unamortized ITC balances not related to the KTL Project nor will it affect the period of time over which those other ITC are amortized.

RULING REQUESTED

The Company respectfully requests the Service to issue a ruling stating:

Whether or not, under the facts as presented, a final determination by the FPSC that orders the Company to flow-back in rates the unamortized ITC associated with the KTL Project, the depreciable capital costs of which have been fully recovered through rates, would violate the normalization requirements of Code section 46(f)(2).

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[8] Based on the FPSC order, which reduced return on equity as of April 1, 1988, the net savings would be reduced and depreciable capital costs would not be fully recovered until October, 1989. The company's petition for reconsideration of this issue is currently pending.

STATEMENT OF LAW

The Revenue Act of 1971 added section 46(e), later redesignated as section 46(f) by the Tax Reduction Act of 1975, to the Internal Revenue Code of 1954 to prevent, with respect to public utility property, the immediate flow-through of ITC to customers in the form of lower rates. Section 46(f)(2) of the Code, which the Company has elected, provides the special rule for ratable flow-through as follows:

> "SPECIAL RULE FOR RATABLE FLOW-THROUGH. - If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit determined under subsection (a) shall be allowed by section 38 with respect to any property described in section 50 (as in effect before its repeal by the Revenue Act of 1978) which is public utility property (as defined in paragraph (5)) of the taxpayer --
>
> (A) COST OF SERVICE REDUCTION. -- If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection), or
>
> (B) RATE BASE REDUCTION. -- If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection)."

Code section 46(f)(6) provides as follows:

> "RATABLE PORTION. For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used."

Code section 46(f)(5) provides, in part, that:

> "PUBLIC UTILITY PROPERTY. For purposes of this subsection, the term 'public utility property' means - (A) property which is public utility property within the meaning of subsection (c)(3)(B) ..."

Code section 46(c)(3)(B) provides, in part, as follows:

> "For purposes of subparagraph (A), the term 'public utility property' means property used predominantly in

the trade or business of the furnishing or sale of -

(i) electrical energy, water, or sewage disposal services, ***

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof."

Regulations section 1.46-6(g) provides, in part, as follows:

"Ratable methods. (1) In general. Under this paragraph (g), rules are prescribed for purposes of determination whether or not, under section 46(f)(1), a reduction in the taxpayer's rate base with respect to the credit is restored less rapidly than ratably and whether or not under section 46(f)(2) the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of such credit.

(2) Regulated depreciation expense. What is 'ratable' is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. 'Regulated depreciation expense' is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life system or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of restoring, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to 'original cost' (as defined for purposes of computing regulated depreciation expense). If, with respect to an item of section 46(f) property, the amount to be restored annually to rate base is computed by applying a composite annual percentage rate to the amount by which the rate base was reduced, then the restoration is ratable. Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with

> such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals."

DISCUSSION

A. Position of Florida Power & Light Company

The KTL Project property has been, and continues to be, used in providing electric service under rates established on a rate-of-return basis. Therefore, the KTL Project property is public utility property as defined in Code sections 46(c)(3)(B) and (f)(5) and the Regulations thereunder. As such, the treatment of ITC associated with the KTL Project is subject to the normalization requirements of Code section 46(f) and, as a result of the timely election of the Company in 1972, is specifically subject to the requirements of Code section 46(f)(2). Pursuant to Code section 46(f)(2), the Company's cost of service for ratemaking purposes and in its regulated books of account can be reduced to reflect no more than a ratable portion of the ITC.[9]

The Company believes that a rapid flow-back of the ITC is fair and reasonable because it returns the benefit of the ITC to those ratepayers who have paid the costs associated with the KTL Project through revenue requirements. However, the Company has been, and remains, concerned that the Service could find it to be violative of the normalization requirements of the Code to impute two-thirds of the net savings derived from the KTL Project as depreciation for purposes of computing the ratable period over which unamortized ITC can be flowed back.

Regulations section 1.46-6(g)(2) defines regulated depreciation expense in terms of a period of time expressed in units of years (or shorter periods), units of production, or machine hours. The imputation of net savings to regulated depreciation expense rather than to some other component of rates, therefore, does not appear to be addressed by Regulations section 1.46-6(g)(2). Thus, it is not clear that such imputation properly creates a change in the ratable period for purposes of a flow-back of unamortized ITC.

Regulations section 1.46-6(g)(2) also requires that when the composite annual percentage rate for purposes of computing regulated depreciation expense is revised, then the computation of ratable restoration or ratable portion must be made "beginning with the same period" as the change in depreciation expense. The Company, however, did not revise the amortization schedule as of the beginning of that period due to the concerns expressed above.

KTL Project property, when placed in service for regulatory purposes, was included in the total amount of public utility property used in computing the composite book depreciation rate for purposes of computing the ratable period for a flow-back of ITC. When additional depreciation expense was allowed with respect to KTL Project property, however, there was not a recomputation of composite book life as applied to KTL Project or to the Company's other public utility property for purposes of amortizing ITC to cost of service. Even now that depreciable investment is fully recovered and zero depreciation expense is allowed with respect to KTL Project property, no

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[9] There is no impediment to a reduction of less than a ratable portion of the ITC.

recomputation has been made. Because no change in the composite annual percentage rate has been put into effect, it is not clear that the regulations would permit ITC to be flowed back into cost of service more rapidly than would occur under continued use of the composite annual rate. Thus, the Company is concerned that the Service may conclude that a continued amortization of ITC based on the composite annual percentage rate of depreciation is required.

The Company is also concerned about the inherent inconsistency that the Service may conclude exists when property is included in the class of property with respect to which the annual composite percentage rate of depreciation is based and, at the same time, is segregated out of the composite body and assigned a more rapid ratable period for purposes of Code section 46(f). Although the regulations do not address the consideration one way or another, the Company is uncertain regarding the permissibility of such a procedure.

For the reasons discussed above, the Company is concerned with respect to whether the Order will result in its being found to be in violation of section 46(f) of the Code and respectfully asks for the Service's ruling.

B <u>Position of the Florida Public Service Commission, the Office of the Public Counsel of the State of Florida (OPC), and the Florida Industrial Power Users Group (FIPUG)</u>

Indisputably, the KTL Project property does continue to provide electric service. In the provision of that service, certain expenses are incurred and are recovered from the ratepayers. For example, a return is earned on non-depreciable KTL Project property, the balance of unamortized ITC arising from KTL Project property and the debit balance of deferred taxes created because book depreciation was greater than tax depreciation. O&M expenses, taxes other than income taxes and income taxes are also recovered. Those costs are reduced by the amortization of the remaining balance of the ITC arising from the KTL Project property. However, since the KTL Project property is now fully depreciated for accounting and ratemaking purposes, a return on capital related to depreciable KTL Project property that generated the ITC and book depreciation are not among those expenses that are currently recovered. Indisputably, the majority of the Company's rates are established on a rate-of-return basis. It could be argued, however, that the Factor is not rate-of-return regulation in that the purpose of an OBO Project is to reduce dependence on oil while assuring adequate service at a reasonable cost.

Without giving consideration to whether or not the Factor is rate-of-return regulation, the period of time actually used in computing the Company's depreciation expense for the KTL Project property was approximately seven years: October 1, 1982, until October, 1989. Thus, the property's life for ratemaking purposes was approximately seven years. Both the straight-line and additional book depreciation constituted the depreciation expense actually used by the FPSC in establishing the cost of service and revenue requirements for ratemaking purposes of the KTL Project. For ratemaking purposes, both the straight-line and additional book depreciation were used when deferred taxes attributable to book-tax depreciation differences were calculated.

A violation of Section 46(f)(2) occurs when ITC are flowed back to cost of service more rapidly than ratably. Regulations section 1.46-6(g)(2) provides that ratable "is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which the credit is allowed". The property in question was fully depreciated on the Company's books by the end of 1989. The actual period of time used in computing the Company's regulated depreciation expense was seven years

The rapid recovery of costs reversed previously reflected timing

differences and created additional timing differences that have been reflected in the Company's books. Deferred taxes related to the KTL Project property have been calculated by taking into consideration total book depreciation from KTL Project property.

The computation of the "ratable" period is not immutably fixed at the time property is placed in service. From time-to-time circumstances require that there be a change in regulated depreciation expense. Depreciation rates may be changed because of changes in technology or to achieve various social purposes.

Section 1.46-6(g)(2) of the Regulations, requires a revision of the ratable restoration period when the composite annual percentage rate is revised. It is only when the composite annual percentage rate is decreased and the ratable restoration period is unchanged that there is a potential for a more rapid than ratable flow-back of ITC to cost of service. However, this provision could be interpreted to require an alteration of the ratable restoration period in a situation when the composite annual percentage rate is either directly or indirectly **increased**. Regulations section 1.46-6(g)(2) specifically contemplates recomputations of the ratable period, stating that:

> "If such composite annual percentage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period."

Under the Order, the additional depreciation expense reflected in rates is, in fact, a revision of the composite annual percentage rate: regulated depreciation expense is permitted in excess of the amount that would be permitted if only the composite annual straight-line percentage rate had been used. This change occurred as of August, 1987, and resulted in substantially greater depreciation expense being recovered through the Factor and being recorded on the Company's books. Thus, the portion of unamortized ITC being amortized in rates should have been increased at that time. Because amortization was not increased, a less than ratable portion of ITC was reflected in the Factor. No violation of normalization principles occurs as a result of a less than ratable flow-back between August, 1987, and August, 1989. See, e.g., Letter Ruling (LR) 8601074 (October 9, 1985) holding that "Section 46(f)(2)(A) of the Code does not require that the flow-through to cost of service be ratable. It requires only that it be no faster than 'ratable.'"[10] If less than a ratable portion is flowed-back in one year, neither the Code nor the Regulations prohibit the difference being made up in a later year or years.

The FPSC's past practices and current proposal, both allow a less than ratable amortization in prior years with a final amount of flow-back in 1990. The total amount of flow-back does not exceed the allowable flow-back over the same period.

Congress intended, in enacting the ITC normalization requirements, to permit regulatory commissions to "divide" the benefits of the ITC between the regulated company and the ratepayers, with specified limitations. Senate

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[10] A Private Letter Ruling is not considered precedent, but does indicate the Service's thinking at a particular point in time. Rowan Companies v. United States, 452, U.S. 247 (1981).

Finance Committee Report No. 92-437, 1972-1 C.B. 559, 579; House Ways & Means Committee Report No. 92-533, 1972-1 C.B. 498, 510. The past practice and current proposal of the FPSC provide for a division or sharing of the ITC between the Company and its ratepayers and do not require that the ITC be amortized over too short a period of time.

A flow-back of ITC related to KTL Project property over the composite book-life determined with reference to all of the Company's public utility property would not be consistent with sound regulatory principles that also underlie the ratable flow-back requirement of the Code. A flow-back of the ITC over the same period during which ratepayers are charged for the capital costs of the property generating the ITC matches the benefits and the burdens. Further, other costs associated with the receipt of service from the property are recovered from the ratepayers of the utility during the same period of time.

The FPSC, OPC and FIPUG believe that there are three private letter rulings--LR 8326081 (March 29, 1983), LR 8414013 (December 23, 1983), and LR 8438029 (June 18, 1984).[11]--which, when considered together, lead to the conclusion that the treatment proposed by the FPSC does not violate the provisions of section 46(f)(2) of the Code or the underlying regulations. A comparison of the facts and circumstances of the three letter rulings leads to the following conclusions:

1. If amortization of utilized ITC begins when the related property is placed in service and depreciation commences for accounting and ratemaking purposes and continues until, or beyond, the completion of depreciation for accounting and ratemaking purposes; the amortization is not more rapid than ratable and is not violative;

2. If amortization of utilized ITC begins before the related property is placed in service and depreciation commences for accounting and ratemaking purposes, the amortization is violative regardless of whether the amortization continues until or beyond the completion of depreciation for accounting and ratemaking purposes;

3. If amortization of utilized ITC begins when the related property is placed in service and depreciation commences for accounting and ratemaking purposes and stops before the completion of depreciation for accounting and ratemaking purposes, the amortization is more rapid than ratable and is, therefore, violative; and

4. If amortization of realized but unused ITC begins before the ITC can be utilized, it is violative.

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[11] LR 8438029 states, "In addition, section 46(f)(6) of the Code defines 'ratable portion' as the period of time used for purposes of reflecting operating results in the taxpayer's regulated books of account.". LR 8438029 also states, "Therefore, section 46(f)(2) and the regulations thereunder can be said to provide for the restoration of the QPE credits over the useful life of the property for regulatory purposes."

Under the FPSC proposal, amortization did not begin before the ITC were utilized, the plant was placed in service, or the start of depreciation for accounting and ratemaking purposes nor did it stop before the completion of depreciation for accounting and ratemaking purposes. Amortization will, in fact, continue somewhat beyond the completion of depreciation for accounting and ratemaking purposes and will, therefore, be over a period of time longer than that actually used for ratemaking depreciation purposes. Amortization will have occurred over a period of time longer than the useful life for regulatory purposes. Therefore, the amortization can not be more rapid than ratable nor can it be violative.

The very practical effect of the finding in LR 8326081, that an abbreviated flow-back period does not violate the provisions of either Code section 46(f)(2) or Regulations section 1.46-6, is to match--as much as is possible--the amortization period with the period during which the related costs are recovered through the ratemaking process. This is the identical goal of the proposal by the FPSC.

The entire unamortized ITC, with respect to the KTL Project property, could, and should, have been reflected in rates over the abbreviated book depreciable life of the KTL Project when the capital costs were actually recovered through both the straight-line and additional book depreciation or the remaining unamortized balance could, and should, have been amortized in 1989. Such amortization would meet the "no more rapidly than ratably" standard. It follows, a priori, that any flow-back after 1989 is not more rapid than ratable--indeed, it is less rapid than ratable. Therefore, the standards of section 46(f)(2) and the regulations would not be violated.

PROCEDURAL MATTERS

The issue in this ruling request is not clearly and adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin.

To the best of the knowledge of the Company and the Company's representatives, the identical issue is not under examination by a District Director in any return of the Company (or of any taxpayer related to the Company within the meaning of Code section 267, or a member within the meaning of Code section 1504) and has not been so examined within the statutory period of limitation on assessment or refund of tax, and no closing agreement has been entered into on this issue by a District Director. To the best of the knowledge of the Company and the Company's representatives, the identical issue is not being considered by any Appeals Office of the Service in connection with a tax return of the Company for a prior period and has not been considered by an Appeals Office within the statutory period of limitation on assessment or refund of tax, and no closing agreement on this issue has been entered into by any Appeals Office. To the best of the knowledge of the Company and the Company's representatives, the identical or similar issue is not pending in litigation and has not been ruled on by the Service to the Company or any predecessor of the Company, and no request for ruling on this issue has been filed and later withdrawn.

The Company respectfully requests a conference prior to the issuance of a ruling. It is also requested that representatives of the FPSC and all parties to the FPSC proceeding be allowed to attend and participate in this conference. In accordance with Revenue Procedure 88-6, the FPSC has reviewed this request and believes that it is adequate and complete.If further information is needed, please contact Mr. Gary Kuberek of the Company at (305) 552-4333, or the Company's authorized representatives, Raymond F. Dacek, David

E. Jacobson, or Randall V. Griffin at (202) 828-0100. Enclosed is a declaration in the form required by Revenue Procedure 90-1 signed by an officer of the Company and a power of attorney. Also enclosed is the requisite fee of $2,500 as required by Revenue Procedure 90-1.

Under penalties of perjury, I declare that I have examined the foregoing Request for Ruling, including accompanying documents and, to the best of my knowledge and belief, the facts presented in support of the requested ruling are true, correct, and complete.

Assistant Controller
Florida Power & Light Company

All exhibits will be separately attached, in full, to the actual ruling request but have been omitted here to save paper.

EXHIBIT A Order No. 22268 Adopting Oil-Backout Process

EXHIBIT B Rule 25-17.016, F.A.C., Oil-Backout Cost Recovery Factor

EXHIBIT C Companies Joining in Filing of Consolidated Return

EXHIBIT D Order No. 11217 Approving FPL's KTL Project

FLORIDA PUBLIC SERVICE COMMISSION

Fletcher Building
101 East Gaines Street
Tallahassee, Florida 32399-0850

M E M O R A N D U M
July 5, 1990

TO: STEVE TRIBBLE, DIRECTOR
DIVISION OF RECORDS AND REPORTING

FROM: DIVISION OF LEGAL SERVICES (RULE)
DIVISION OF ELECTRIC AND GAS (WALSH)

RE: DOCKET NO. 890148-EI - PETITION OF FLORIDA INDUSTRIAL POWER USER'S GROUP TO DISCONTINUE FLORIDA POWER AND LIGHT COMPANY'S OIL BACKOUT COST RECOVERY FACTOR.

AGENDA: JULY 17, 1990 - CONTROVERSIAL - PARTIES MAY NOT PARTICIPATE.

PANEL: BEARD, EASLEY, GUNTER, WILSON

CRITICAL DATES: NONE

ISSUE AND RECOMMENDATION SUMMARY

1. ISSUE: Should the Commission reconsider its decision in Order No. 22268 which requires Florida Power & Light Company to refund the difference in revenues equivalent to using a 13.6% return on equity rather than a 15.6% return on equity for its oil backout project for the recovery periods April 1, 1988 through September 30, 1989?

RECOMMENDATION: No. In calculating oil backout costs for recovery, FPL incorrectly used its last authorized cost of capital, rather than the actual cost. The Commission has the authority to review costs recovered through adjustment proceedings and therefore acted properly in ordering a refund.

2. ISSUE: Should the Commission reconsider its decision in Order No. 22268 to make no adjustment to the amounts collected as accelerated depreciation and to continue to allow FPL to collect, through the oil backout clause, capacity charges paid to the Southern Company?

RECOMMENDATION: No. In challenging this portion of the order, the Florida Industrial Power Users' Group raised no mistake of fact or

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law such that reconsideration should be granted.

BACKGROUND

In connection with the February, 1989 hearing in Docket No. 890001-EI, FIPUG raised issues relating to discontinuance of FPL's Oil Backout Cost Recovery Factor. FIPUG also filed a separate petition in this docket, which challenged FPL's past and present collection of oil backout cost recovery revenues pursuant to Rule 25-17.016, Florida Administrative Code. The issues in Docket No. 890001-EI were deferred until the August, 1989 hearing, and both dockets were heard at that time.

After hearing, the Commission issued Order No. 22268, which denied FIPUG's petition, but which also ordered FPL to refund excess revenues rsulting from the use of the 15.6% return on equity. The utility was ordered to calculate the refund amount based on a 13.6% ROE. FPL filed a Motion for Reconsideration of the refund portion of the order, and FIPUG filed a Motion for Reconsideration of the decision to make no adjustment to amounts collected as accelerated depreciaiton and the decision to continue collection of capacity charges paid to the Southern Company. The parties were granted oral argument upon their motions.

DISCUSSION OF ISSUES

1. ISSUE: Should the Commission reconsider its decision in Order No. 22268 which requires Florida Power & Light Company to refund the difference in revenues equivalent to using a 13.6% return on equity rather than a 15.6% return on equity for its oil backout project for the recovery periods April 1, 1988 through September 30, 1989?

RECOMMENDATION: No. In calculating oil backout costs for recovery, FPL incorrectly used its last authorized cost of capital, rather than the actual cost. The Commission has the authority to review costs recovered through adjustment proceedings and therefore acted properly in ordering a refund.

SUMMARY OF POSITIONS

FIPUG: No. Case law makes it clear that the Commission has the authority and the responsibility to modify prior amounts which have been previously collected by a utility through an adjustment clause, like the oil backout cost recovery clause. Gulf Power v. Florida Public Service Commission, 487 So. 2d 1036 (Fla. 1986), gives this Commission the authority to adjust factors from previous fuel adjustment periods in exchange for the utility's ability to recover these costs on a current and going forward basis. Gulf Power holds:

> Fuel adjustment charges are authorized to

> compensate for utilities' fluctuating fuel expenses. The fuel adjustment proceeding is a continuous proceeding and operates to a utility's benefit by eliminating regulatory lag. This authorization to collect fuel costs close to the time they are incurred should not be used to divest the Commission of the jurisdiction and power to review the prudence of these costs.

Id. at 1037. See also, Richter v. Florida Power Corporation, 366 So. 2d 798 (Fla. 2d DCA 1979).

These cases are not subject to the narrow interpretation urged by FPL. Rather they stand for the principle that the Commission's ability to adjust past amounts for good cause is the quid pro quo for the utilities' ability to enjoy extraordinary non-base rate recovery mechanisms.

To foreclose the Commission's ability to make adjustments for past periods would to be circumscribe the Commission's authority to ensure that only authorized expenses are recovered from ratepayers. FPL proposes an immense curtailment of the Commission's jurisdiction and its position should not be sanctioned.

FPL: FPL raises two challenges to the refund of FPL's oil backout return on equity: (1) it was not properly before the Commission in this case, and (2) it constitutes unlawful retroactive ratemaking. The prospect of a refund of the equity return was never raised until the Staff raised it in their Recommendation after the record was closed: no equity refund was sought in FIPUG's Petition; no equity refund was raised in any issue or party's position in the Prehearing Order; and no suggestion of an equity return refund was made at the hearing. The Commission misapplied FPL's tax savings return on equity stipulations, which specifically excluded the oil backout clause, in reaching its refund decision. No notice was given that this money was at risk; no evidence was taken as to FPL's 1988 and 1989 cost of equity. In response to the argument that there was an oil backout equity allegation in the Petition and an oil backout equity issue in the Prehearing Order, FPL argues that (1) in neither instance was there a suggestion that an equity refund was being sought or considered, (2) FIPUG's Petition sought no equity refund, (3) Staff's position was that the equity return was "inappropriate at this time", and (4) the issue as to equity return was prospective only, and that went into FPL's trial strategy.

The retroactive refund of FPL's oil backout equity return is also unlawful retroactive ratemaking. The equity refund fits none of the narrow exceptions to the prohibition against retroactive ratemaking; there are no extraordinary circumstances, Richter v. Florida Power Corp., 366 So. 2d 798 (Fla. 2d D.C.A. 1979); there is no issue of prudence, Gulf Power Co. v. FPSC, 487 So. 2d 1036 (Fla. 1986); and FPL has not consented to a refund of the oil backout equity return. In response to the argument that the Commission was surprised to learn in this case that FPL was using the equity

return authorized in FPL's last rate case, FPL states: (1) that the practice was adopted by the Commission upon the stipulation of the same parties in FPL's first oil backout recovery proceeding; (2) that policy was consistently followed for seven years in fourteen separate orders; (3) during that time the Commission regularly audited FPL's oil backout clause; and (4) the tax savings return on equity stipulations, agenda conferences and orders clearly excepted the oil backout clause from the operation of those stipulations. In response to the agument that the Commission's jurisdiction over oil backout revenues never ends, FPL maintains (1) even the Richter case recognizes that the Commission "cannot retroactively alter previously entered final rate orders just because hindsight makes a different course of action look preferable", and (2) taken to its logical extreme, this argument would allow the Commission to order not only refunds but also retroactive oil backout revenue increases since the inception of the clause - clearly an untenable result. FPL argues that the oil backout equity return is not subject to true-up, that the only lawful retroactive adjustment to the oil backout clause is the one intended in its design - for the periods subject to true-up. In this case at least two of the three recovery periods for which the equity refund was ordered were already subject to an order setting the final true-up.

OPC: The proscription against retroactive ratemaking is inapplicable in a cost recovery proceeding in which a utility is permitted to true-up differences between projections and actual experience. FPL's previous claims to true-up all costs, including its return on equity, recognized that the proscription against retroactive ratemaking did not apply to its oil backout project. FPL never proved its cost of equity was 15.6%.

STAFF ANALYSIS: Rule 25-17.016, Florida Administrative Code (the Oil Backout Cost Recovery Rule) allows FPL recovery of certain oil backout project costs, including the actual cost of capital of such project. Although the burden of proof of the correctness of its requested recovery is on the utility, FPL did not prove its actual cost of capital in prior oil backout cost recovery proceedings. Rather, the utility admittedly used its last authorized cost of capital in calculating its oil backout cost recovery factor, which is not proper under the rule. As summarized above, FPL now argues that it was not properly placed on notice that its cost of capital was at issue, nor that oil backout cost recovery funds were "at risk". However, neither argument is sufficient to deprive the Commission of the ability to correct FPL's use of an incorrect cost of capital by ordering a refund.

FPL argues that according to Gulf Power Company v. Florida Public Service Commission, 487 So. 2d 1036 (Fla. 1986), the Commission may only reach funds previously approved in adjustment proceedings if there is an issue of prudence. In that case, the Florida Supreme Court affirmed a Commission order which instructed

Gulf to refund excessive fuel costs of $2,200,000 to its ratepayers. The court found that the order did not constitute retroactive ratemaking, and stated that "authorization to collect fuel costs close to the time they are incurred should not be used to divest the commission of the jurisdiction and power to review the prudence of these costs." Id. at 1037. That is, although the fuel costs in question had been previously approved through the Commission's fuel cost recovery mechanism, the Commission retained the power to examine those costs for prudence. The same rationale applies to the present case. The oil backout cost recovery mechanism operates in the exactly the same fashion as the fuel adjustment mechanism. Both pass certain costs directly to ratepayers. There is no reason for distinguishing the examination of the prudence of fuel costs from the examination of the correctness of cost of capital.

FPL argues that it had no notice of a possible equity refund, and thus the issue was not properly before the Commission. Staff finds this argument unpersuasive. FIPUG's petition stated (at page 12) that "FPL has used the oil backout cost recovery mechanism to evade the Commission's ability to monitor and regulate the utility's earned rate of return", further pointing out that "FPL has used the 15.6% ROE in calculating the revenue requirement associated with the transmission line investment which is being collected via the OBCRF [Oil Backout Cost Recovery Factor]." On the same page of its petition, FIPUG stated that "[s]ince the Commission authorized the 15.6% return on equity, capital costs have fallen dramatically. However, FPL has continued to earn a return of 15.6% on its investment in the oil backout project." In its answer to FIPUG's petition, FPL admitted use of the 15.6% ROE in its oil backout recovery. FIPUG's failure to request an equity refund does not prevent the Commission from ordering such a refund on its own motion.

Rule 25-17.016(e), Florida Administrative Code, clearly states that the oil backout cost recovery factor is to be estimated every six months, "based on the most current projections of oil and non-oil fuel prices, other operation and maintenance expenses, taxes, and kilowatt-hour sales and on the actual cost of capital for the qualified oil-backout project." (Emphasis added.) The rule then requires a true-up adjustment, with interest, "to reconcile differences between estimated and actual data." Faced with FPL's use of a return on equity other than the actual cost of capital for the project, the Commission acted properly in ordering a refund. Staff therefore recommends that FPL's motion for reconsideration be denied.

2. ISSUE: Should the Commission reconsider its decision in Order No. 22268 to make no adjustment to the amounts collected as accelerated depreciation and to continue to allow FPL to collect, through the oil backout clause, capacity charges paid to the Southern Company?

RECOMMENDATION: No. In challenging this portion of the order, the Florida Industrial Power Users' Group raised no mistake of fact or law such that reconsideration should be granted.

SUMMARY OF POSITIONS

FIPUG: Yes. The capacity charges which FPL has paid to the Southern Company should be recovered through base rates, particularly if no adjustment is made to the amount of depreciation taken and the line has been fully depreciated. These capacity charges do not fall within the definition of "costs of a qualified oil backout project" recoverable under the rule. Rule 25-17.016(4)(a) explicitly delineates recoverable costs associated with a project - capacity charges paid to another utility are not among them and can't be wedged in now. The energy-based recovery through the clause was simple expediency; one which is unfair to high load factor customers. The Commission need not wait until a rate case to remedy the situation.

FPL: FIPUG's cross motion fails to satisfy the Commission's standard for reconsideration - it does not present a mistake, oversight or misapprehension of fact or law that would justify changing the original decision. FIPUG's arguments are nothing more than a rehash of arguments raised at trial and properly rejected on the weight of the evidence.

FIPUG's argument that the cost estimates and in-service dates for the Martin units were wrong was fully addressed in the hearing, and the preponderance of the evidence supported FPL, as the Commission properly found. (See FPL's Posthearing Brief at 22-23). FIPUG's argument that the Commission improperly shifted the burden to FIPUG is also wrong. As the Petitioner collaterally attacking prior Commission decisions, FIPUG had the ultimate burden of persuasion; however, it is clear from the Order that the Commission weighed conflicting evidence and simply found FPL's more convincing.

FIPUG's argument regarding the impropriety of recovering UPS capacity payments through the factor was also fully aired at the hearing. The evidence supports continued recovery; continued recovery is not inconsistent with the Oil Backout Rule; and it would be manifestly unfair to FPL to disallow such recovery now since FPL's base rates clearly were not designed to recover UPS costs.

OPC: FPL never met its burden of proof in this or any earlier proceeding to establish its entitlement to recover two-thirds of purported net savings as accelerated depreciation. The Commission did not, and pursuant to its statutory responsibilities, could not grant "tacit" approval to the prudence of costs or FPL's claimed 15.6% return on equity. FPL never proved the expected costs of the Martin Units would not have varied from the 1982 assumptions the Commission refused to accept in Order No. 11210, issued September 27, 1982, in Docket No. 820001-EU.

The Commission's treatment of Southern Company capacity charges, however, is consistent with previous decisions based on Rule 25-17.016, Florida Administrative Code. FIPUG's request to include such costs in base rates concedes that they are properly associated with the oil backout project. Order No. 22268 was therefore consistent with the rule and previous decisions and no mistake of fact or law in the original decision adequate to support reconsideration has been demonstrated.

STAFF ANALYSIS: FIPUG's cross motion for reconsideration fails to raise an issue proper for reconsideration. Rather, FIPUG merely argues that the Commission's decision in Order No. 22268 was incorrect. The contentions in FIPUG's motion have been heard and decided by the Commission, and raise no mistake of fact or law sufficent for reconsideration. Staff therefore recommends that FIPUG's cross motion for reconsideration be denied.