

FLORIDA PUBLIC SERVICE COMMISSION
Capital Circle Office Center • 2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

M E M O R A N D U M

September 30, 1996

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF ELECTRIC & GAS (BUDLEY, JENKINS, TRAPP, *PLT*
FLOYD, KUMMER, *OK* BASS, *OK* BOHRMANN, *OK* HAFF) *MSH BC, LW*
DIVISION OF LEGAL SERVICES (ELIAS, CULPEPPER, ERSTLING, *OK* *JDJ*
WAGNER) *RVE*
DIVISION OF AUDITING & FINANCIAL ANALYSIS (SALAK, *OK*
MAILHOT, CAUSSEAUX, LEE, MAUREY, SLEMKEWICZ) *SAPC* *hpt*

RE: DOCKET NO. 960409-EI - TAMPA ELECTRIC COMPANY - PRUDENCE
REVIEW TO DETERMINE REGULATORY TREATMENT OF TAMPA
ELECTRIC'S POLK UNIT

AGENDA: 10/08/96 - REGULAR AGENDA - POST HEARING DECISION -
PARTIES' PARTICIPATION IS LIMITED TO ANSWERING QUESTIONS

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\EAG\WP\960409EI.RCM

CASE BACKGROUND

By Order No. PSC-92-0002-FOF-EI, issued March 2, 1992, in Docket No. 910883-EI, the Commission approved Tampa Electric Company's Petition for Determination of Need for a proposed 220 megawatt electric generating unit and associated facilities, to be located in Polk County, Florida.

The facility proposed was an Integrated Gasified Combined Cycle (IGCC) unit, fueled by gasified coal. Approval was conditioned on Tampa Electric Company (TECO) securing a grant from the United States Department of Energy (DOE) in the amount of \$120 million to defray the cost of constructing and operating the plant. Tampa Electric Company did obtain the grant.

Order No. PSC-92-0002-FOF-EI (Need Order) states at page 9 "The unit is projected to have an installed cost of 389 million dollars (1996), including the DOE funding." Currently, TECO projects the cost of the unit, now scheduled to be placed in service in October, 1996, to be approximately \$506 million net of

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the DOE grant. TECO states that the difference is attributable to land and site development costs of approximately \$65 million and AFUDC which were not included in the \$389 million amount.

By Order No. PSC-96-0670-S-EI issued May 20, 1996, in Docket No. 950379-EI the Commission approved a stipulation entered into by TECO, the Office of Public Counsel (OPC) and the Florida Industrial Power Users Group (FIPUG). The stipulation resolved the issues regarding over-earnings by TECO and specified the disposition of those over-earnings for the period 1995 through 1998. The stipulation:

- 1) freezes existing base rate levels through December 31, 1998;
- 2) refunds \$25 million plus interest over a one year period commencing on October 1, 1996;
- 3) defers 60% of the net revenues that contribute to a return on equity (ROE) in excess of 11.75% for 1996;
- 4) defers 60% of the net revenues that contribute to a ROE in excess of 11.75% up to a net ROE of 12.75% for 1997;
- 5) defers 60% of the net revenues that contribute to a ROE in excess of 11.75% up to a net ROE of 12.75% for 1998;
- 6) refunds any net revenues contributing to a net ROE in excess of 12.75% for 1998 plus any remaining deferred revenues from 1996 and 1997;
- 7) allows Tampa Electric Company the discretion to reverse and add to its 1997 or 1998 revenues all or any portion of the balance of the previously deferred revenues;
- 8) prohibits TECO from using the various cost recovery clauses to recover capital items that would normally be recovered through base rates; and
- 9) requires separate consideration of the regulatory treatment of the Polk Power Station and Port Manatee site investments.

As a result of this stipulation, Docket No. 960409-EI was opened to review the prudence of and appropriate regulatory treatment for Polk IGCC Unit One (Polk Unit). Pursuant to notice a public hearing was held on July 17 and 18, 1996.

On September 25, 1996, TECO filed a new stipulation on behalf of itself, OPC, and the FIPUG. This stipulation represents an

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agreement between the parties to: a comprehensive settlement of all issues in this docket; a comprehensive rate settlement covering Tampa Electric's base rates and rate of return for the period January 1, 1999 through December 31, 1999, and a modification to the Stipulation approved in Order PSC-96-0670-S-EI dated May 20, 1996 ("the First Stipulation"). In response to staff's concerns, on September 27, 1996 the parties submitted an amendment to the September 25, 1996 stipulation modifying the wholesale/retail separation treatment of future sales involving the Polk IGCC unit.

ISSUE 1: Should the September 25, 1996 stipulation as amended on September 27, 1996 between TECO, OPC, and FIPUG be approved?

RECOMMENDATION: Yes. Although there are advantages and disadvantages with the stipulation, we believe that, overall, the stipulation achieves a reasonable balance between stockholder and ratepayer interests and should be approved.

STAFF ANALYSIS: The September 25, 1996 stipulation (Attachment 1) is summarized as follows:

- 1) extends the existing freeze on TECO's base rates from January 1, 1999 through December 31, 1999;
- 2) precludes TECO from filing a rate increase request prior to July 1, 1999 and precludes TECO from requesting an interim increase in any such docket which is filed prior to January 1, 2000;
- 3) provides for an additional \$25 million refund over fifteen months beginning about October 1, 1997 and credited to customer's bill based on actual KWH usage adjusted for line losses;
- 4) allows TECO to defer into 1999 any portion of its 1998 revenues not subject to refund;
- 5) provides for the refund in the year 2000 of 60% of any revenues which contribute to a ROE in excess 12% up to a net ROE of 12.75% for calendar year 1999;
- 6) provides for the refund in the year 2000 of 100% of any revenues which contribute to a ROE in excess of 12.75% for calendar year 1999;

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- 7) resolves all of the issues in Docket 960409-EI by conferring a finding of prudence on the commencement and continued construction of the Polk IGCC unit by TECO;
- 8) allows TECO to include the actual final capital cost of the Polk IGCC unit in rate base for all regulatory purposes, up to an amount equal to one percent above the capital cost estimate of \$506,165,000 plus related estimated working capital of \$13,029,000;
- 9) allows TECO to include the full operating expense of the Polk IGCC unit in the calculation of net operating income for all regulatory purposes (estimated to be \$20,582,000 net of DOE funding for the first 12 months);
- 10) places the entire investment in the Port Manatee site and any future gain on sale of this site to an independent third party below the line;
- 11) continues to use the separation procedure adopted in the company's last rate case to separate any current and future wholesale sales from the retail jurisdiction;
- 12) provides that any further Commission action relative to this stipulation will be considered in Docket No. 950379-EI.

Staff believes there are advantages and disadvantages with the stipulation. Taken as a whole, however, we believe that the stipulation achieves a reasonable balance between stockholder and ratepayer interests and should be approved. The advantages and disadvantages are discussed below.

Advantages: Approving the proposed stipulation results in an additional one year extension of the rate freeze established by "the First Stipulation" and a guaranteed additional \$25 million refund starting in October, 1997. The added year to the existing rate freeze and the guaranteed additional refund of over-earnings are important because they mitigate for a longer period of time the effect of adding the high capital and O&M cost of the Polk IGCC unit to rate base and net operating income.

Additional rate stability is particularly important during the initial years of operation at the Polk IGCC unit. The Polk IGCC project involves the testing of experimental technology during the first two years of the unit's operation. Pursuant to TECO's agreement with the DOE, the unit must be operated on a variety of coal based feedstocks during the first two years. According to the

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record in this case, TECO determined as early as 1993 that, based on its own forecasts of coal and natural gas prices, the Polk IGCC would not be cost-effective over the life of the project using coal as a feedstock to the gasifier. The evidence in the record of this case makes it clear that the long term cost-effectiveness of the Polk IGCC unit is largely dependent on the ability to switch to and rely on low cost petroleum coke as a gasifier feedstock. Therefore, by burning coal during the first two years of the unit's operation, TECO will be experiencing higher fuel costs than it otherwise would burning petroleum coke. The additional rate freeze and refunds will help offset this additional cost as TECO makes the transition to petroleum coke.

TECO is experiencing increasing pressure from large-use customers, such as IMC-AGRICO, which are threatening to find other power supply alternatives. Another advantage of the proposed stipulation is that should TECO respond to these pressures by seeking authority to negotiate discount rates with large-use "at-risk" customers, rates to the remaining ratepayers would not increase during the period the existing and proposed stipulations are in effect.

The proposed stipulation also recognizes that the Port Manatee site is not currently nor planned to be used and useful and places the current book cost of the site below the line for regulatory purposes.

The parties have filed an amendment to the stipulation which would allow the Commission to determine the appropriate separation treatment of any off-system sale that is priced based on the Polk IGCC unit incremental fuel cost. This amendment addresses staff's concerns regarding the potential subsidization of wholesale sales by the retail ratepayers.

Disadvantages: Approving the proposed stipulation confers a determination of prudence and, hence, authorizes full cost recovery for the continued construction of the Polk IGCC unit. Staff questions the prudence of the continued construction of the Polk IGCC unit in lieu of a natural gas fired combined cycle alternative in 1993.

Staff has some concerns about the proposed method of distributing the proposed temporary base rate reduction. The stipulation provides for the \$25 million base rate reduction to be distributed on an energy basis, rather than on a demand basis. Applying a reduction factor to KWH usage results in large-use industrial (especially non-firm customers) receiving a greater

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share of the reduction than merited based on the cost allocations underlying the rates which generated the over-earnings.

If the \$25 million is allocated on energy, the residential customers could realize up to \$4.25 million less in total refund dollars than if the refund were allocated on demand (\$10.75 million versus \$15 million). According to the cost of service study filed by TECO in its last rate case, the residential class represented 60% of the total MWH. Under a coincident CP demand allocation, the interruptible class would receive no refund, since they are allocated no coincident CP demand costs. Even the definition of demand used to allocate substations and transmission lines which includes demand for interruptible customers results in the residential class receiving 55% and the interruptible class 8% of the refund compared to 43% and 12%, respectively, under an energy allocation. Allocation of the refund on a demand basis is more consistent with the way costs were allocated in setting base rates. If it is appropriate to allocate the over-earnings on an energy basis, it could be argued that it is appropriate to allocate the cost of Polk on energy as well.

Large-use customers are likely to have the most opportunities to use alternative electric suppliers, and, as a result, "strand" utility plant. There is an inherent unfairness in giving a smaller share of a refund resulting from over recovery of base rate costs to the customers who will likely be asked to shoulder the bulk of any stranded generation costs in a competitive environment.

Staff supports the exclusion of the investment in the Port Manatee site, but not its subsequent ratemaking treatment. When an item has been included in rate base and then later is excluded, the general Commission policy provides for any subsequent gain or loss on the disposition of the item to be shared proportionally between the ratepayers and the stockholders. The basis for sharing is determined based on the length of time that the item was included in rate base versus the length of time that it was excluded from rate base. The proposed stipulation provides that TECO's stockholders would get 100% of any subsequent gain or loss on the sale of the Port Manatee site. On the plus side, however, TECO has stipulated that if all or part of the site is subsequently reacquired by TECO for utility purposes, site costs will be placed back on the books at original book value. As a result, the ratepayers would be no worse off than had the site not been excluded from rate base.

The beginning point for sharing for calendar year 1999 is 12.00%, rather than the 11.75% for the previous years in "the First

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Stipulation." As a result, TECO can retain more 1999 earnings before it must start to share. The net ROE cap of 12.75% remains unchanged as does the 60%/40% split.

The proposed stipulation states that if TECO is able to acquire any Section 29 tax credits for the Polk IGCC unit, those credits shall be applied to TECO's base revenue requirements if and when such credits are recognized. Because the Section 29 tax credits are directly tied to the Btu content of the synthesis gas produced by the coal burned, staff believes if any credits become available they should flow through the fuel clause.

Other comments: It should also be noted that "the First Stipulation" remains in effect except as specifically modified by the second stipulation. The modifications include the additional \$25 million refund effective October 1, 1997 and the methodology for calculating the potential refunds of 1998 and 1999 earnings.

The proposed stipulation provides that "All reasonable and prudent expenses and investment..." are to be included in the calculation of the actual ROE for 1999. Similar language was also included in "the First Stipulation." The Commission makes the final determination of "reasonable and prudent" in reviewing the basis of the ROE calculations. The Commission's approval of this stipulation is not a blanket authorization for TECO to deem every expense and investment as reasonable and prudent, or to bypass any filing requirements that are required by the Commission's rules or the Uniform System of Accounts to include those items in the retail jurisdiction.

It will likely be some years before the Internal Revenue Service rules on the appropriate tax depreciation life for the Polk IGCC Unit. Staff believes that the Commission should continue to withhold a determination of the appropriate treatment of any penalties and interest that may result from the tax depreciation life TECO uses (Order No. PSC-96-0670-S-EI, issued May 20, 1996). We do not believe that this issue is affected by the proposed stipulation.

ISSUE 2: Should this docket be closed?

RECOMMENDATION: Yes. Any further activities pursuant to the stipulation should be conducted in Docket No. 950379-EI.

STAFF ANALYSIS: If no party files a Motion for Reconsideration or Notice of Appeal of the Commission's Final Order, no further action will be required in this docket. Therefore, this docket should be

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closed. By Order No. PSC-96-0670-S-EI, issued May 20, 1996, in Docket No. 950379-EI, the Commission approved the stipulation covering the period through 1998. That Order states that Docket 950379-EI is to remain open for the purposes of resolving any issues pertaining to the calculation of earned ROE for the periods covered by the stipulation; implementing the refunds provided for in the stipulation; and determining TECO's earnings for the purposes of revenue deferral and sharing as set forth in that stipulation. Any further Commission action pursuant to this new stipulation should also be considered in Docket No. 950379-EI.