

**Florida
Power**
CORPORATION

ORIGINAL

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November 28, 1997

**Ms. Blanca S. Bayó, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850**

Re: Docket No. 961184-BQ

Dear Ms. Bayó:

**Enclosed for filing in the subject docket is an original and 15 copies of the
Posthearing Statement of Florida Power Corporation.**

**Please acknowledge your receipt of the above filing on the enclosed copy of
this letter and return to the undersigned. Also enclosed is a 3.5 inch diskette
containing the above-referenced document in WordPerfect format. Thank you for
your assistance in this matter.**

Very truly yours,

James A. McGee

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12186 DEC-15

Florida Power Corporation

Docket No. 961184-BQ

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of the enclosed Posthearing Statement of Florida Power Corporation has been furnished to the following individuals by U.S. Mail on December 1, 1997:

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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for approval of early termination amendment to negotiated qualifying facility contract with Orlando Cogen Limited, Ltd. by Florida Power Corporation.

Docket No. 961184-EQ

Submitted for filing:
December 1, 1997

**POSTHEARING STATEMENT OF
FLORIDA POWER CORPORATION**

Florida Power Corporation ("FPC" or "Florida Power"), pursuant to Rule 25-22.056, Florida Administrative Code, hereby submits its Posthearing Statement in support of approval of the early termination amendment to its negotiated contract with Orlando Cogen Limited, Ltd. (OCL), and states as follows:

Statement of General Position

The early termination amendment between OCL and Florida Power presents the Commission with an inescapable choice between two dramatically different alternatives. It can approve the amendment, which will buyout of the last, and most expensive, ten years of the OCL contract and provide customers with over \$470 million in net savings, or it can reject the buyout and reaffirm the original OCL contract which, by any standard, has become a bad, and increasingly worse, deal for customers in light of recent reductions in the cost of generation alternatives. The Commission's choice is made even easier by the fact that the amendment will not only relieve future customers of the tremendous cost burden shifted to them when the OCL contract was approved, but will still leave current customers who pay the cost of the buyout better off under the amended OCL contract than if the generating unit avoided by the contract had been built.

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Issues and Positions¹

Issue 1: Are the economic risks associated with projected ratepayer savings resulting from the Amendment to the Negotiated Contract between Florida Power Corporation and Orlando Cogas Limited, Ltd., reasonable?

**** Yes.** Every sensitivity study presented to the Commission using an appropriate discount rate (FPC's incremental cost of capital), even Mr. Sallcup's most pessimistic case, produces positive net present value savings from the buyout. The Commission should reject the unprecedented use of novel, untested discount rates in evaluating the benefits of the buyout.

Discussion

Distilled to its essence, this issue is only about the proper discount rate to be used in calculating the net present value of the OCL buyout. This is because the benefits of the buyout are so large that, using conventional analysis, they yield positive net present value savings under even the most pessimistic forecast assumptions. This being the case, the only way the risk associated with these benefits can be called into question is by resorting to the use of novel, untested, and controversial discount rates to artificially reduce the net present value of the buyout's savings. It is telling that the witnesses proposing these unconventional discount rates know of no instance where they have been used by the Commission in any of the various types of proceedings that involve the evaluation of generation alternatives. Tr. 302, 389, 405.

This is unsurprising, since the Commission has consistently used the utility's incremental cost of capital as the appropriate discount rate whenever it has been

¹ Position summaries are denoted by a double asterisk (**).

called upon to evaluate the benefits of competing generation alternatives, including such proceedings as need determinations, DSM program approvals, ten-year site plan reviews, annual planning hearings, and, in particular, QF avoided cost determinations. With respect to the determination of avoided cost in evaluating QF contracts, the use of the utility's incremental cost of capital as the discount rate is not only appropriate but mandatory under Commission Rule 25-17.0832(6)(a), F.A.C.²

Thus, when the Commission determined Florida Power's avoided cost in the course of approving the original OCL contract, it used Florida Power's incremental cost of capital.³ This is of particular importance here when one considers Commission Rule 25-17.0836(6), F.A.C., which establishes the standard for evaluating modifications to existing QF contracts. It provides that:

The modifications and concessions of the utility and developer shall be evaluated against both the existing contract and the current value of the purchasing utility's avoided cost. (Emphasis added.)

Clearly, if the evaluation against the existing contract required by this rule is to be meaningful, the OCL contract amendment must be evaluated consistent with the discount rate methodology applied to the existing contract to avoid an "apples and oranges" comparison. Likewise, consistency requires that the evaluation of the OCL amendment use the same discount rate methodology required by Rule 25-17.0832(6)(a) for determining Florida Power's current avoided cost. Simply put, the evaluation of the OCL contract amendment required by Rule 17-25.0836(6) cannot

² Subsection (6)(a) prescribes the method of calculating the year-by-year value of deferral of a utility's avoided cost, which is made applicable to negotiated contracts by subsection (3) of the rule. The calculation methodology in subsection (6)(a) defines the annual discount rate as "the utility's incremental after tax cost of capital." Subsections (6)(b) and (c) prescribe the same discount rate definition for early capacity payments and levelized capacity payments.

³ Order No. 26734, issued July 1, 1991 in Docket No. 91001-EO.

be properly performed using a discount rate other than Florida Power's incremental cost of capital.

Despite this background of the Commission's consistent use of the utility's cost of capital in evaluating generating alternatives -- a use mandated by rule in the case of QF generating alternatives -- witnesses Larkin and Stallcup urge the Commission to ignore its traditional practice and rules and, instead, adopt for the first time a radical approach to discount rates in evaluating the OCL contract amendment. The reason they give for this departure from normalcy is that the proposed buyout should be viewed, not as a utility generating alternative, but as ratepayer investment opportunity because the cost of the buyout is to be funded directly by them through the fuel and capacity cost recovery clauses. Tr. 233, 235, 347.

This desperate attempt to distinguish the generating alternative presented by the OCL amendment from other QF generating alternatives on the basis that its cost will be recovered through the fuel and capacity cost recovery clauses is patently wrong. By Commission rule, all payments made under approved QF contracts are recovered through these clauses.⁴ This distinction without a difference provides no basis whatsoever for the use of radically different discount rates than those used in evaluating all other QF contracts whose payments are recovered in the same manner. Moreover, it completely ignores the Commission's rules that mandate the use of the utility's cost of capital as the discount rate when evaluating QF payments. There are proper means to challenge or modify the Commission's rules -- this proceeding is not one of them.

⁴ Rule 25-17.0032(8)(a), F.A.C.

Even if the Commission's rules did allow the use of discount rates other than Florida Power's cost of capital in evaluating the OCL contract amendment, the novel discount rates offered by witnesses Larkin and Stallcup would be poor replacement candidates. As noted above, both witnesses attempt to justify their discount rates on the notion that the OCL amendment should be considered as a ratepayer investment opportunity because ratepayers will pay the cost of the amendment. While this is a fundamentally flawed view of generating alternatives, including the OCL amendment, the search for a proper customer discount rate would still end at the utility's cost of capital. Each utility in Florida has a statutory duty to serve customers within its retail service area and those customers have a concomitant obligation to purchase exclusively from that utility at rates that reflect the cost of providing service. Those rates obviously include the cost of generation, whether produced by the utility's own plants or purchased from other suppliers, such as QFs. Since customers are obligated to pay the cost of the generating alternatives included in the utility's rates, it follows that in evaluating these generating alternatives, the utility's cost of capital is the customers cost of capital.

For this reason, Mr. Larkin misses the point when he rejects the use of Florida Power's cost of capital as a customer discount rate simply because it is Florida Power's cost of capital. The point is that it is also the best proxy for a customer discount rate in evaluating generating alternatives that will be included in customers electric rates. Tr. 488. Instead, Mr. Larkin proposes the incongruent use of a short term credit card rate for evaluating long term generating alternatives. In doing so, he conveniently ignores a variety of other scenarios that would yield much lower customer discount rates and reveal the complexity of the issue he raises, such as customers with no credit card debt, customers with regular deposits to passbook

savings accounts earning 3 - 4% (before taxes), customer who invest in CDS at 6% or in bonds at 8%, and customers who fall within various combinations of the above. Tr. 489-90. This lends further support to the use of the utility's cost of capital as a reasonable proxy for a customer discount rate that is otherwise hopelessly complex.

Mr. Stallcup's proposed risk adjusted discount rates, while more sophisticated than Mr. Larkin's credit card rate, are at least three steps removed from conventional discount rates consistently employed by this Commission. First, as Mr. Stallcup admits, risk adjusted discount rates have never been used by the Commission in any proceeding (Tr. 389) and they conflict with the approach used by the Commission in approving the original OCL contract (Tr. 405). Second, Mr. Stallcup has departed from conventional risk adjusted discount rate theory by adjusting his discount rates downward in recognition of higher risks. His only authority for the counter-intuitive technique is an academic text discussing "risky cash outflows" that is disputed by other academic peers. Tr. 376, 500, 506-07. Third, Mr. Stallcup has departed from the "risky cash outflows" methodology described in the referenced text by making his downward risk adjustment to a risk free rate, *i.e.*, a rate that reflects no risk to begin with, even though his cited authority applies the downward adjustment to an average risk. Tr. 377-78, 505, 508-09. Even if the Commission were free to use a discount rate other than Florida Power's cost of capital, it would have good reason to be skeptical of the radical, unsupported and untested approach proposed by Mr. Stallcup.

Having discussed the reasons why the Commission may not and should not use the discount rates proposed by witnesses Larkin and Stallcup, it is nonetheless a noteworthy testament to the enormity of the savings provided by the OCL contract amendment that these savings continue to support approval of the amendment even

when subjected to the distorted analyses of these witnesses. For example, in contrast to Mr. Schuster's analysis showing that Florida Power reasonably expects the OCL amendment to provide net savings of \$472.2 million, with a NPV of \$34.6 million (Composite Exhibit 1 (LGS-7)), Mr. Stallcup performed a sensitivity analysis using substantially higher natural gas prices and construction costs -- assumptions he admits "can't get any worse." Tr. 427. Despite the use of these "worst case" assumptions, in combination, his analysis still shows net savings from the amendment of \$297.3 million, with a positive NPV \$5.8 million.

Even the analysis performed by Mr. Stallcup using his highly distorted risk adjusted discount rates supports approval of the OCL contract amendment. Based on this analysis, he concluded that there is a 75% chance the amendment will provide ratepayer savings and only a 25% chance it will not. Tr. 365. In other words, Mr. Stallcup's analysis shows that customers are three times more likely to fare better with the OCL amendment in place than without it. Even Mr. Larkin, after complaining that a return to customers of 8.67% (Florida Power after tax cost of capital) was too low, admitted that the OCL amendment would actually provide customers with a return of 12.9%. Tr. 324.

In short, the evidence shows that the economic risks associated with the projected ratepayer savings resulting from the OCL contract amendment are not only reasonable, but virtually nonexistent.

Issue 2: Are the intergenerational inequities among Florida Power Corporation's ratepayers, if any, associated with the Amendment to the Negotiated Contract between Florida Power Corporation and Orlando Cogen Limited, Ltd., reasonable?

**** There is no intergenerational inequity associated with the OCL contract amendment. To the contrary, the amendment helps to mitigate the intergenerational inequity created when the original OCL contract was approved, which shifted enormous costs away from current customers, at the expense of future customers. Even when the costs of the buyout have been completely recovered, current customers still will have paid less under the OCL contract than they would have paid if the unit avoided by the contract had been built. Moreover, the Commission has never attempted to objectively define intergenerational fairness and has, in fact, frequently approved generating alternatives that shift substantial costs to current customers, as well as others, like the original OCL contract, that shift disproportionate costs to future customers. The shifting of costs associated with the OCL buyout is well within this range that the Commission has previously approved.**

Discussion

Florida Power's position on this issue is two-fold: First, for sound policy reasons, intergenerational considerations should have no role in the Commission's evaluation of the OCL contract amendment. Second, if intergenerational equity is to be a consideration, the case for approving the OCL contract amendment is made even stronger because the amendment will mitigate, although not completely offset, a significant intergenerational inequity inherent in the original contract.

With respect to the first point, the policy implications suggested by this issue are profound. It implies that a generation alternative with long term net present value savings compared to competing alternatives could nonetheless be rejected if those savings happened to flow too unevenly over the life of that alternative. To Florida

Power's knowledge, the Commission has never rejected a generation alternative that provides positive net present value savings over its expected life because of intergenerational considerations, and there is certainly nothing in the Commission's rules authorizing such a result.

Instead, the Commission has regularly approved generating alternatives for cost recovery that span the intergenerational range, from those that "front-end load" significant costs on current customers under conventional revenue requirements ratemaking, to alternatives that "back-end load" a disproportionate share of costs on future customers through value of deferral ratemaking, so long as the generating alternative selected was found to provide positive net present value savings compared to the other alternatives. If the Commission were to now adopt the use of intergenerational considerations as an element of its selection criteria, the range of generation alternatives available to the Commission would be severely limited, to the exclusion of most, if not all, of the cost-effective alternatives previously selected.

The application of some heretofore unused and undefined intergenerational standard as a reason for rejecting the OCL contract buyout would effectively eliminate the availability of an important tool to Florida Power and other utilities in their attempts to deal with the serious problem of high-cost QF contracts. An understanding of the nature of this problem is necessary to appreciate the broader implications of applying an intergenerational standard to QF buyouts such as the OCL amendment.

The capacity payment escalation rates in Florida Power's QF contracts will result in an ever widening gap over time between the cost of these contracts and Florida Power's generation alternatives. As a result, the problem that Florida Power seeks to solve is most severe, and the opportunity for cost reductions are greatest, at

the "back end" of these QF contracts. Tr. 61-62. The opportunity to create customer savings exists largely because some QFs are willing to accept "up front" buyout payments that are considerably less than the nominal capacity and energy payments they would otherwise receive in the future. However, it is simply not possible to create substantial savings by altering near term payments to QFs because the replacement cost differential and the time value of money do not create a sufficient opportunity to discount the face value of the payments. Tr.62. Consequently, insisting that the savings from a buyout be realized at or near the time when the costs are incurred creates a standard that is impossible to meet, thus denying utilities the ability to address the one area of QF contracts where the opportunity for meaningful savings exists and ensuring that future customers will be saddled with the horrendous costs of these contracts.

It would be particularly inappropriate for intergenerational inequity to suddenly become a consideration in evaluating the amendment to the OCL contract, since it was not a factor considered by the Commission in evaluating the original OCL contract.⁵ As discussed above, the Commission's rule governing the approval of contract amendments requires the amendment to be evaluated against the existing contract.⁶ In order for this comparison to be properly made, the evaluation of the amendment and the original contract must be on comparable terms. The standard for evaluating the payments in the original contract is whether their "cumulative present

⁵ Nor was intergenerational inequity a factor in the Commission's adoption of Rule 25-17.0832, which prescribed the value of deferral methodology for determining firm capacity payments to QFs. If intergenerational considerations had been applied in either proceeding in the manner suggested here, it is doubtful that the Commission could have adopted the value of deferral rule or approved the OCL contract, since both resulted in a dramatic shift of costs from the current generation of customers to a future generation.

⁶ Rule 25-17.0836(6), F.A.C.

worth ... over the term of the contract are projected to be no greater than ... the cumulative present worth of the value of a year-by-year deferral of the construction and operation of generation or parts thereof by the purchasing utility over the term of the contract ...⁷ Therefore, in comparing the contract amendment against the original contract, the evaluation must be performed over the entire term of the contract, not some discrete portion of the term.

With respect to the second point, if intergenerational considerations are to have any role in this case, it should only be as a recognition, ancillary to long term cost-effectiveness, that approval of the amendment will substantially improve the intergenerational equity of the overall contract. The reason QF contract buyouts mitigate, rather than create, intergenerational inequity was succinctly stated in the August 12, 1997 primary Staff recommendation in Docket No. 961477-EQ that Mr. Schuster quoted in his direct testimony.

The intergenerational equity issue is unclear in this docket because cogeneration purchased power contracts have inverted payment streams to ensure performance in the later years. Compared to setting base rates using traditional regulatory accounting, cost recovery of the inverted cogeneration purchased power payment stream defers to future customers costs that would have been recovered in base rates from existing customers. Thus, existing customers are already paying less than their fair share of cost. For residential customers, adding an approximately 50 cents per 1000 Kilowatt-hours surcharge until 2009 to recover the buyout cost helps correct the present intergenerational inequity." (Emphasis added.) Tr. 63.

With respect to the OCL contract buyout in particular, Mr. Schuster's Composite Exhibit 1 (LGS-5)⁸ demonstrates the magnitude of the intergenerational

⁷ Rule 25-17.0832(3)(b), F.A.C. (Emphasis added.)

⁸ The particular page of LGS-5 containing this demonstration was also marked and admitted as Exhibit 11 during the cross examination of witness Larking. Tr. 312, 338.

inequity favoring current customers that the original OCL contract created, and that, to a less extent, will remain even after the buyout. This exhibit contains a comparison of ratepayer costs under the OCL buyout against the costs of the coal-fired generation avoided by the original OCL contract. It shows that through the year 2001, when the cost of the buyout is fully recovered, customers will have received NPV savings of \$77.7 million from the original OCL contract compared to the costs they would have incurred from the coal-fired capacity. When these savings are offset by costs of the buyout, these customers are still left with a net NPV savings of \$37.3 million under the amended OCL contract.

Contrary to the contention Mr. Lartin that the OCL amendment unfairly imposes costs on current customers for benefits to be received by future customers, Mr. Schuster's exhibit convincingly demonstrates that amendment creates a classic "win-win" situation: Current customers, after paying the cost of the buyout, will remain better off under the amended OCL contract than if the avoided unit had been built, while at the same time future customers will be relieved of much of the tremendous cost burden shifted to them by the original OCL contract. Clearly, the OCL amendment, like QF buyouts in general, promotes the interest of intergenerational fairness and should be encouraged, not shackled by an unattainable standard.

Figure 3: Will the proposed buyout of the OCL contract provide net benefits sooner than 22 years into the future?

- The proposed buyout will provide substantial net benefits in every year of the ten-year buyout period and will completely offset the cost of the buyout in the second year of the period. Overall, the savings realized during the buyout

period will exceed the buyout's cost by a factor of over 10 to 1 (\$522 million to \$49.4 million).

Issue 4: Should the Amendment to the Negotiated Contract between Florida Power Corporation and Orlando Cogas Limited, Ltd., be approved for cost recovery?

**** Yes. The amendment terminating the last ten years of the OCL contract will provide enormous customer savings compared to its near-term cost, while maintaining the beneficial nature of the contract to current customers.**

Discussion

The evidence presented in this case conclusively demonstrates that the OCL amendment satisfies the standard established by Commission rule⁹ for approval of QF contract amendments. The OCL amendment has been evaluated against both the existing contract and Florida Power's current avoided cost and has been shown to be the most cost-effective generating alternative under even the most pessimistic forecast assumptions.¹⁰ This standard is binding upon the parties and the Commission and, as such, requires approval of the OCL contract amendment. Intergenerational consideration have no proper place in comparing the long term cost-effectiveness of the OCL amendment against the existing contract, just as they played no part in evaluating the long term cost-effectiveness of generating alternatives when the contract was initially approved. To the extent the Commission

⁹ Rule 25-17.0836(6), F.A.C.

¹⁰ Composite Exhibit 1(LGB-7), showing NPV savings of \$34.6 million under Florida Power's base case forecast assumptions; Exhibit 16, showing NPV savings of \$5.8 million under Mr. Salkup's "worst case" forecast assumptions.

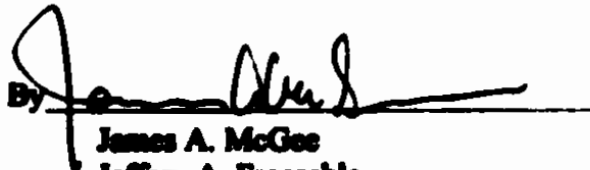
determines to factor intergenerational considerations into its decision, notwithstanding the policy considerations against doing so, it should find that, because of the nature of QF contracts, buyouts in general and the OCL amendment in particular promote the interests of intergenerational fairness while providing relief to customers during the most burdensome period of the contract.

Issue 5: If approved, how should Florida Power Corporation recover the expenses associated with the Amendment to the Negotiated Contract between Florida Power Corporation and Orlando Cogen Limited, Ltd.?

**** The cost of the buyout should be recovered through the CCR and the fuel clause in accordance with the Commission's established policy which allocates the buyout cost in proportion to the ratio of the buyout's capacity and energy savings. Such an allocation results in approximately 77% of the buyout cost being recovered through the CCR and the remaining 23% being recovered through the fuel clause. [Note: This issue was not addressed at the hearing and does not appear to be in dispute.]**

Respectfully submitted,

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FLORIDA POWER CORPORATION**

By 

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