State of Florida

Public Service Commission

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DATE: JULY 20, 2000

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

FROM: DIVISION OF SAFETY AND ELECTRIC RELIABILITY (HARLOW, BOHRMANN)
DIVISION OF LEGAL SERVICES (C. KEATING) WCK RVE WBM RJ JDJ

RE: DOCKET NO. 991779-EI - REVIEW OF THE APPROPRIATE APPLICATION OF INCENTIVES TO WHOLESALE POWER SALES BY INVESTOR-OWNED ELECTRIC UTILITIES

AGENDA: 08/1/00 - REGULAR AGENDA - ISSUES 1-3 - POST HEARING DECISION - PARTICIPATION IS LIMITED TO COMMISSIONERS AND STAFF; ISSUE 4 - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\SER\WP\991779.RCM

CASE BACKGROUND

By Order No. 12923, issued January 24, 1984, in Docket No. 830001-EU-B, the Commission established a shareholder incentive mechanism to encourage investor-owned electric utilities to make economy energy sales. At its November 22-23, 1999, hearing in Docket No. 990001-EI, the Commission heard arguments about whether this incentive mechanism is still necessary or appropriate. By Order No. PSC-99-2512-FOF-EI, issued December 22, 1999, the Commission ordered that a proceeding be instituted so that the full Commission could hear this matter. Accordingly, an evidentiary hearing was held on May 10, 2000. Florida Power & Light Company (FPL), Florida Power Corporation (FPC), Gulf Power Company (Gulf), Tampa Electric Company (TECO), the Office of Public Counsel (OPC), and the Florida Industrial Power Users Group (FIPUG) participated in the hearing and filed post-hearing briefs.

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Five proposals were presented at the hearing for the appropriate structure of an incentive on non-separated sales on a going-forward basis. These proposals are summarized below. More detailed information is provided on Attachment 1.

FPC: FPC has proposed a 20 percent stockholder incentive on the gains from all non-separated sales, including firm sales. FPC proposes to include such sales made under existing FERC schedules and under new FERC schedules as they are approved.(TR 125-127,143-145;EXH 3)

FPL: FPL has proposed a sliding scale approach to the shareholder incentive. The incentive would be applied to the gains on all non-firm non-separated sales, including such sales made under newly approved FERC schedules. Under the proposal, FPL's shareholders would receive 20 percent of the first $20 million of gains, 40 percent of the next $20 million of gains, and 50 percent of the gains over $40 million. FPL stated that the specific thresholds for the sliding scale apply only to FPL and should be adjusted as appropriate for other IOUs.(TR 71-72,100-101;EXH 3)

Gulf: Gulf has proposed no change in its current incentive treatment. Gulf currently applies the 20 percent shareholder incentive to all non-separated, non-firm sales, including market-priced sales.(TR 182-183,194;EXH 3)

TECO: TECO's proposal includes all non-separated, non-firm sales. However, the incentive varies based on whether the sale is an in-state or an out-of-state sale. TECO has proposed a 40 percent stockholder incentive for in-state sales, and a 20 percent incentive for out-of-state sales.(TR 206,228-229;EXH 3)

OPC: OPC believes an incentive is not necessary or appropriate. However, as an alternative approach, OPC would place an incentive only on sales made over the Energy Broker Network (Broker). OPC suggests a five year moving average to determine a benchmark based on past energy sales. An IOU would only receive an incentive if this benchmark is exceeded by 25 percent. The proposal also includes a penalty if an IOU falls short of this benchmark, with sales of only 75 percent of the benchmark.(TR 257-263)

FIPUG believes a stockholder incentive is not appropriate and therefore did not offer a specific proposal for incentives.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission eliminate the 20 percent shareholder incentive set forth in Order No. 12923, issued January 24, 1984, in Docket No. 830001-EU-B?

STAFF RECOMMENDATION: Yes, the shareholder incentive should be eliminated because: 1) the objectives of Order No. 12923 have been met; 2) many factors which affect the magnitude of non-separated sales are outside a utility's control; 3) utilities have expanded the application of Order No. 12923 without prior Commission approval; and, 4) the incentive may be duplicative of the Generating Performance Incentive Factor.[HARLOW, BOHRMANN]

POSITION OF PARTIES

FPC: No, the Commission should continue its policy of providing shareholder incentives to encourage economy sales. Now that these sales have shifted to more competitive off-broker markets, with new non-utility participants who retain 100% of the profits, the Commission's incentive policy should be updated to reflect current market conditions.

FPL: No. The Commission provided for stockholder incentives to encourage non-separated, non-firm wholesale sales. The Commission's decision in 1984 was sustained by the Florida Supreme Court. No disputed fact or factual showing has been identified that would sustain the burden of reversing the Commission's policy.

GULF: No. The FPSC incentive for economy energy sales was established in 1984 due to the overall benefit from increased economy sales. Today's more competitive wholesale market makes utility economy sales more difficult to achieve, therefore increasing the importance of the incentive to encourage continued participation in the economy energy market.

TECO: No. The Commission should adhere to its existing policy of providing shareholder incentives to encourage non-separated, non-firm wholesale sales. Such incentives may provide greater benefits to ratepayers now than when they were first adopted by the Commission. No party has provided any basis for abandoning the Commission's present incentive policy.

FIPUG: Yes. The Commission should not provide an additional incentive, beyond the current incentive of a guaranteed return and a captive customer base, for utilities to perform their required managerial duties.

OPC: Yes. Other factors are serving as far stronger incentives for Florida IOU's to maximize their wholesale sales. The one-sided 20 percent incentive simply requires consumers to pay a second time for services for which they are already paying full costs.

STAFF ANALYSIS: Staff agrees with OPC, FPC, FPL, TECO and Gulf in the general concept that incentives may be used to prompt a positive response.(TR 33, 129, 244, 273, 302) However, staff agrees with Gulf Witness Howell that the true question in this proceeding is not whether incentives work, but to what extent? (TR 180,188) Staff also agrees with FPC Witness Wieland that incentives should only be put in place if the Commission believes there will be a net benefit to ratepayers.(TR 158) Witness Wieland acknowledged that the gains on sales to which the incentive is applied would have to increase by more than 20 percent for there to be a net benefit to ratepayers.(TR 159) Mathematically, a 20 percent stockholder incentive requires a 25 percent increase in gains in order for ratepayers to see a net increase in the credit to the fuel clause. FPL's sliding scale proposal, and TECO's 40 percent incentive for in-state sales, would require an even higher increase in gains in order for ratepayers to benefit. The concept of ratepayers benefitting due to incentives increasing the 'size of the pie' was touted by the investor-owned utilities' (IOUs') witnesses during the hearing.(TR 33,129,180-181,244,302) However, none of the IOUs performed **any** analysis to determine whether ratepayers would gain net benefits from retaining or increasing the shareholder incentive. (TR 81,110,159,232; EXH 8) No studies by the utilities or other research organizations were presented.

FPL, FPC, TECO, and Gulf contend that there was no evidence presented at hearing that warrants a change in Commission policy. Staff disagrees because the record contains persuasive evidence that: 1) the objectives of Order No. 12923 have been met; 2) many factors which affect the magnitude of non-separated sales are outside a utility's control; 3) utilities have expanded the application of Order No. 12923 without prior Commission approval; and, 4) the incentive may be duplicative of the Generating Performance Incentive Factor. Each of these points is discussed below.

1) The Objectives of Order No. 12923 have been met: Prior to the issuance of Order No. 12923, in 1984, the revenues from the sale of economy energy were considered in each investor-owned utility's general rate proceeding.(TR 179-180) Order No. 12923 removed these revenues from base rates, and flowed the revenues through the Fuel and Purchased Power Cost Recovery clause.(Order No. 12923,p.3) The Order states on page 2, "The chief reason for this proposed treatment was to eliminate the potential for over- or under-recovery of revenues associated with economy energy sales." The IOUs were authorized to keep 20 percent of the gains on these sales as an incentive to "maximize the amount of economy sales and provide a net benefit to the ratepayer." (Order No. 12923, p. 2)

Eliminating the potential for over- or under-recovery of revenues associated with economy energy sales: The potential for over- or under-recovery of revenues was eliminated immediately when the revenues associated with economy sales were removed from base rates and flowed through the Fuel and Purchased Power Cost Recovery clause. As stated in Order No. 12923, "The difficulty in projecting economy sales profits is due to uncertainty associated with fuel prices, weather, and forced outages of generating units and transmission lines." (Order No. 12923, p. 2) All of these are events over which the utility has little control. Staff agrees with OPC Witness Dismukes that in order for utility incentives to be effective, "incentive based regulatory mechanisms should be placed upon decisions that can be both influenced and measured." (TR 258) TECO Witness L. Brown also agreed with this statement.(TR 317)

Maximizing the amount of economy sales to provide a net benefit to the ratepayer: Prior to the issuance of Order No. 12923, the buying and selling of economy energy was a peripheral function of the system dispatcher.(TR 124) Most economy energy transactions were accomplished over the Florida Energy Broker Network (Broker).(TR 123-124,207) After meeting their requirements for firm load, the buying and selling utilities would enter quotes determined by decremental and incremental production costs. A computer program would then match buyers and sellers with the greatest cost savings. (TR 123-124,207) The transaction price was based on a split-the-savings methodology. In essence, the Broker functioned as simple cost-based market for short-term excess energy within Peninsular Florida. Buyers and sellers benefitted equally from each transaction made over the Broker due to the split-the-savings pricing methodology.(TR 208)

Staff agrees with the parties that the wholesale market in Florida is more competitive today than when Order No. 12923 was issued.(TR 33-35,123,185,208,268) Changes to the wholesale market were prompted by the Public Utilities Regulatory Policy Act; the Energy Policy Act of 1992; FERC Orders 888 and 889; and other federal and state regulatory policy initiatives.(TR 208,268) These regulatory changes have resulted in a more robust wholesale market in Florida, with additional buyers and sellers.(TR 185) Greater potential therefore exists today for a utility to lose a wholesale sale if its wholesale rates are higher than those of competitors. (EXH 7) In addition, as noted by OPC Witness Dismukes, utilities have greater concern today for keeping retail rates low in order to retain retail customers. Large retail customers have greater options to self-generate today.(TR 260) Also, keeping retail rates low reduces the pressure for the state to adopt retail competition.(TR 261)

Staff agrees with OPC Witness Dismukes that the movement toward competition has prompted additional efforts on the part of Florida's utilities to participate in the wholesale market.(TR 260) Staff also agrees with Witness Dismukes that, "No utility today can afford to not participate agressively in wholesale markets."(TR 258) For example, utilities have substantially augmented the trained staff in their marketing departments in recent years.(TR 35,204-205) The buying and selling of energy has now become the primary function of a specific group of employees, rather than the peripheral function of the system dispatcher.(TR 35,124) In addition, in various manners, the IOUs have linked the compensation of these employees to wholesale transactions.(EXH 3) Staff believes that this clearly points to a corporate culture which encourages participation in the wholesale market. FPC Witness Wieland stated that these marketing expenses are reported on the monthly surveillance reports.(TR 131) Staff notes that the IOUs have not received approval to include these increased marketing expenses in base rates. However, each utility's marketing department has many more functions than making economy sales. For example, according to FPL Witness Stepenovitch, FPL's marketing department is "involved in all purchases, sales and transportation components of both fuel and power."(TR 46) The utilities offered no evidence that they were earning below their Commission-approved rate of return range as a result of expenses incurred to market wholesale power. Therefore, staff can only surmise that these costs are being recovered due to cost reductions in other areas or customer growth. If the utilities believe there is an under recovery for these costs, staff believes that it may be more appropriate for the utilities to raise that issue in a limited

scope rate proceeding, or discuss it as an issue in the Fuel and Purchased Power Cost Recovery proceeding, rather than use an incentive as a proxy recovery method.

The record shows that these increased efforts have produced results. Table 1, below, displays the gains by IOUs on non-firm, non-separated wholesale sales for 1994 through 1999.(EXH 2,4,5,7,8,10) (Only FPC's data includes firm sales.) As a whole, the data indicates that utilities have generally increased their presence in the wholesale market, thus fulfilling the second objective of Order No. 12923. TECO stated that the decline in its gains in 1999 was due to a lack of capacity resulting from the explosion at its Gannon Station last April.(TR 231)

TABLE 1
GAINS ON NON-SEPARATED SALES

	FPL	FPC	Gulf	TECO
1994	$12,200,000	$1,862,700	$320,845	$6,514,995
1995	$7,100,000	$3,193,810	$157,890	$8,462,340
1996	$11,600,000	$1,643,960	$86,760	$11,339,297
1997	$19,100,000	$4,075,910	$740,760	$8,781,795
1998	$62,300,000	$12,768,855	$926,775	$7,519,783
1999	$59,200,000	$13,934,910	$889,550	$892,725

The record indicates that FPC, FPL, and TECO did not apply the 20 percent shareholder incentive to the vast majority of their non-separated sales for the period shown in Table 1. FPL Witness Stepenovitch stated that the sales to which FPL does not apply an incentive have increased significantly.(TR 44) FPC, FPL and TECO received an incentive on sales associated with only 2.1%, 0.2%, and 6.8% of the gains for 1999, respectively.(EXHS 2,6,7,10,11) As stated above, Gulf applied the incentive to the gains for all non-firm, non-separated wholesale sales.(EXH 8; TR 194)

The record indicates that the increase in the gains is the result of both increased efforts to make sales and the ability to charge market-based rates. For example, FPL Witness Stepenovitch stated that "FPL has increased the number of contracts from approximately 63 to over 400 in the past three years."(TR 34) FPL

received authority from FERC to charge market-based rates out-of-state in 1998, the same year in which there is a dramatic increase in the gains reported by FPL.(TR 80) FPL has increased the number of market-priced sales, even though FPL is not applying an incentive to these sales.(TR 84) This behavior is consistent with Gulf Witness Howell's statement that Gulf would make sales with the highest price, indicating the highest gain, rather than a sale with the highest stockholder incentive.(TR 199) Gulf Witness Howell also stated that the greater flexibility in market-based pricing can allow a utility to achieve greater gains than under a split-the-savings pricing methodology.(EXH 8) Based on the IOUs' actions, staff concludes that it must be in the best interest of the IOUs to make these sales, particularly the market-priced sales, even in the absence of a shareholder incentive.

Staff agrees with OPC that the market is providing incentives for IOUs to make these sales in order to keep rates low.(TR 258-261,273) In a time of increased wholesale and potential retail competition, utilities must take action to reduce rates in order to retain customers.(TR 260-261) Utilities must also develop trained marketing departments to both purchase and sell in the wholesale market, in order to prepare for potential competition.(TR 260-261) For FPC, FPL, and TECO, the record shows that this has occurred without the carrot of a shareholder incentive on market-priced sales.(EXH 2,3,4,5,7,10) Therefore, staff agrees with OPC that providing a shareholder incentive in addition to the current market incentives is unnecessary and will create a 'free rider' effect.(TR 270) In other words, a shareholder incentive will reward utilities for taking actions they are already taking. Staff believes that it is immaterial to discover which market force is the determining factor in encouraging Florida's IOUs to increase participation in the wholesale market. The record shows that Florida's IOUs have significantly increased their presence in the wholesale market, thereby meeting the second objective of Order No. 12923, and obviating the need for a shareholder incentive.

2) Many factors which affect the magnitude of non-separated sales are outside a utility's control: The Commission has previously recognized that there are many factors outside a utility's control which determine the magnitude of economy sales. At page 2 of Order No. 12923, the Commission stated, "The difficulty in projecting economy sales profits is due to uncertainty associated with fuel prices, weather, and forced outages of generating units and transmission lines. These variables affect not only how much a

utility can sell and at what price, but also how much other utilities will buy at different prices."

Staff agrees with TECO and OPC that in order for utility incentives to be effective, incentives should be placed only on those items over which a utility has control.(TR 317) Staff recognizes that FPC, FPL, and TECO have control over the sales efforts made by their employees. Each of these utilities has linked a portion of their marketing department's salaries to wholesale sales in order to prompt greater sales efforts.(EXH 3) However, as recognized in Order No. 12923, there are many other factors outside the utility's control which affect these sales. For example, these sales cannot be made if the capacity is unavailable. FPL Witness Stepenovitch recognized that the availability of excess capacity is necessary in order to provide ratepayers with a net benefit, stating, "there's only so much excess generation to go around."(EXH 2) TECO stated that the decline in its gains in 1999 was due to a lack of capacity resulting from the explosion at its Gannon Station last April.(TR 231) As recognized by Gulf Witness Howell, selling utilities also have little control over the availability and actions of buyers.(TR 184) A completed transaction also requires the availability of a willing buyer with decremental production costs higher than the incremental production costs of the seller.(TR 214-215)

Staff believes that an incentive is particularly ineffective for Gulf because the record shows that Gulf has virtually no control over wholesale sales efforts. Gulf has no marketing department of its own.(TR 190) Rather, Gulf's parent corporation, the Southern Company (Southern) maintains a marketing department and acts as the selling and purchasing agent for each of its affiliates.(TR 190) Southern also dispatches the generating units of its affiliates to facilitate these sales.(TR 191; EXH 8) Gains from these sales are then allocated to Southern's affiliates based on weighted load.(TR 191; EXH 8) Gulf comprises approximately six percent of Southern's load.(TR 191) Staff agrees with OPC that an incentive placed on only six percent of Southern's load is not sufficient to prompt additional sales efforts by Southern on behalf of Gulf.(TR 190-192)

3) Utilities have expanded the application of Order No. 12923 without prior Commission approval: Order No. 12923 states, "Economy transactions represent the sale of energy between electric companies. Gains are realized by the selling company as a result of the **split-the-savings** methodology used to calculate the selling

price of economy energy." (Order No. 12923, p. 1, emphasis added) Most of these sales were made between two Florida utilities over the Florida Broker Network.(TR 123-124,207) At page 5 of Order No. PSC-99-2512, the Commission, in establishing this docket, found that the incentive should be applied uniformly by the IOUs. However, according to testimony provided by the IOU's, Order No. 12923 has been interpreted differently.(TR 270, EXH 3) FPC has had the strictest interpretation of Order No. 12923, applying the stockholder incentive only to Schedules C and X sales made over the Broker.(TR 144) FPL has historically applied the incentive to Schedule C and Schedule X sales. FPL has recently discontinued Schedule X sales.(TR 71) According to FPL's response to a staff interrogatory, the incentive was applied only to those sales made on the Broker.(EXH 2) However, FPL Witness Stepenovitch stated in the hearing that the incentive is also applied to Schedule C sales made outside the Broker.(TR 42) TECO has applied the incentive to Schedules C and X sales made both on and off the Broker. (EXH 10) Gulf currently applies the incentive to all non-separated non-firm sales, including market-priced sales.(EXH 8, TR 194) The IOU's implementation of the current incentive is summarized on Attachment 1. None of the IOUs received Commission approval for any changes to the application of the stockholder incentive. Therefore, staff would recommend that the IOUs no longer be authorized to apply a stockholder incentive in the future. The disparate treatment of the shareholder incentive could continue to be an issue if the stockholder incentive is expanded, as discussed in Issue 2.

4) An incentive may be duplicative of the incentive provided by the Generating Performance Incentive Factor: The IOUs receive an incentive through the Generation Performance Incentive Factor (GPIF) for running certain generating units more efficiently. (TR 159) This incentive was authorized by the Commission to benefit ratepayers due to the reduction in fuel costs created by generating unit efficiency improvements.(TR 159-160) Dispatching and maintaining the generating system more efficiently provides utilities with added low-cost energy to sell on the wholesale market.(TR 160) Therefore, staff shares OPC's concern that the IOUs are already receiving a stockholder incentive that increases their ability to participate in the wholesale market.(TR 270) Staff believes that providing a shareholder incentive in addition to the GPIF provides utilities with a double incentive for one action, i.e., running their generating units more efficiently.

Conclusion: For the reasons discussed above, staff believes the record shows that a stockholder incentive on non-separated wholesale sales is no longer necessary or appropriate in today's wholesale market.

ISSUE 2: If the Commission decides to maintain the 20 percent shareholder incentive in Issue 1 or approves a new incentive, what types of non-separated, non-firm, wholesale sales should be eligible to receive the shareholder incentive?

STAFF RECOMMENDATION: If staff's recommendation in Issue 1 is approved, this issue is moot. If staff's recommendation in Issue 1 is denied, at a minimum the Commission should clarify Order No. 12923 to state that only Schedules C and X are eligible for a shareholder incentive. If the Commission decides to expand the current shareholder incentive, then the incentive should apply to all non-separated sales with the exclusion of emergency sales. [HARLOW, BOHRMANN]

POSITION OF PARTIES

FPC: In FPC's case, all sales under interchange schedules reported on Fuel Adjustment Schedule A-6 should qualify, with the exception of Schedule A (emergency), and Schedule B (short-term firm).

FPL: These incentives should be expanded. All opportunity sales should be eligible for a shareholder incentive. All of these sales, other than emergency, have the same characteristics as the sales under the Energy Broker. The policy established in 1984 continues to apply and there is no basis to discriminate.

GULF: At a minimum, the 20% shareholder incentive for economy sales should be applied to all non-separated wholesale economy energy sales regardless of whether they are made "off-broker" or through the EBN. The 20% shareholder incentive should continue to be applied to all of Gulf's non-separated wholesale economy energy sales.

TECO: All non-separated, non-firm wholesale sales should qualify for the shareholder incentive as they all have the same beneficial effect of reducing the costs that the selling utility's retail customers would otherwise have to bear. They also provide savings to the retail customers of the purchasing utility.

FIPUG: The current incentive should be eliminated. If an incentive is permitted (which FIPUG disputes), it should apply *only* to Broker sales, as this Commission originally ordered.

OPC: None. There are no wholesale sales to which the 20 percent incentive should apply.

STAFF ANALYSIS: All the IOUs take the position that the current stockholder incentive should be expanded.(EXH 3) This is discussed below. OPC and FIPUG reargue the "no incentive" position as discussed in Issue 1.

Order No. 12923 states, "Economy transactions represent the sale of energy between electric companies. Gains are realized by the selling company as a result of the **split-the-savings** methodology used to calculate the selling price of economy energy."(Order No. 12923, p. 1, emphasis added) At the time Order No. 12923 was issued, most economy transactions were "cost-based, next-hour sales and purchases involving two Florida utilities."(TR 207) These sales were made using the FERC approved Schedules C or X tariffs. Schedule C sales are one-hour economy sales priced with a split-the-savings methodology.(EXH 9) Schedule X sales are similarly priced, however, in general, the term of the transaction may last up to one week.(EXH 9) Most of these sales were made between two Florida utilities over the Florida Broker Network.(TR 123-124,207) Therefore, staff believes the current incentive logically applies only to Schedule C and Schedule X sales.

As discussed in Issue 1, each of the IOUs has applied the previously approved incentive in a different manner.(EXH 3) This previous behavior indicates the potential for any future incentive to also be applied inconsistently by the utilities. For example, at the time Order No. 12923 was issued, Gulf's economy sales were priced exclusively using a split-the-savings methodology.(EXH 8) Gulf received authority from the Federal Energy Regulatory Commission (FERC) to charge market-based rates in 1996, and immediately began applying the incentive to these sales.(EXH 8) In essence, Gulf is claiming that the Commission issued a blank check in 1984 for all economy transactions in the future. If the Commission votes to continue the status quo without clarifying the appropriate application of Order No. 12923, FPC, FPL, and TECO may interpret this decision as implicit permission to follow Gulf's lead. Therefore, at a minimum, the Commission should clarify Order No. 12923 to state that the original incentive should only apply to Schedule C and Schedule X sales.

If the Commission decides to expand the current stockholder incentive beyond Schedules C and X, then the incentive should apply to all non-separated sales with the exclusion of emergency sales. Staff agrees with Witness Wieland that in today's wholesale market it is difficult to differentiate between various levels of firmness.(TR 149) In today's market, if an incentive is authorized, it will be impossible to prevent the incentive from

being applied to sales with a certain degree of firmness. For example, it is difficult to differentiate between firm and non-firm sales due to the fact that many sales are made with various levels of firmness.(TR 127, 149) Staff also agrees with FPC and FPL that if an incentive is expanded, it should apply to both current and future approved FERC schedules, as long as the sales made under these schedules are non-separated sales.(EXH 3, TR 144) Staff agrees with FPC Witness Wieland that defining an incentive based on current FERC schedules will be difficult for the Commission to administer in the future.(TR 144) Over time, utilities may petition the FERC for changes to existing FERC schedules and for new schedules as the market changes. Staff agrees with FPC, FPL, TECO and Gulf that emergency sales should be excluded from an incentive.(TR 40,127,228; EXH 3) As stated by FPC Witness Wieland, emergency sales are "made upon the request of the buyer, not marketed by the seller."(TR 127) Therefore emergency sales are less under a seller's control than economy sales. Emergency sales are primarily determined by the buyer's need for power, rather than the potential for cost savings. An incentive based on all non-separated sales, excluding emergency sales, will be administratively more efficient for both the Commission and the parties. The discussion above highlights the potential problems of addressing incentives on a piecemeal basis. While not discussed at the hearing, the Commission may wish to explore overall performance-based ratemaking in a separate proceeding.

Expanding incentives to sales other than Schedules C and X could impact reliability. As stated above, it is difficult if not impossible to distinguish between various degrees of firmness of wholesale sales.(TR 127,149; EXH 7) It is important to note that utilities are also requesting expanding the incentive to cover sales up to a year.(EXH 3) Further, there is nothing in the record to indicate what happens at the end of a contract; utilities may not be prohibited from renewing a one year contract indefinitely. Clearly, it is more difficult to forecast available capacity as the term of the contract is expanded.(TR 150) Of course, utilities may mitigate any impact on reliability by taking one of three actions: 1) purchasing power; 2) paying a financial penalty to avoid its contractural commitments; or, 3) employing load management or controlling load to certain types of interruptible customers.(TR 140-141,163-164) These increased purchased power costs or the financial penalty to exit a contract may be recovered from ratepayers through the fuel clause. At the same time, ratepayers may be losing a share of the gains on the non-separated sale. If service to load management or interruptible customers is

interrupted more frequently than in the past, utilities are at risk of losing this resource.

It is important to note that the Commission has previously addressed applying incentives to firm sales. In Docket No. 880001-EI, FPC requested a 20 percent shareholder incentive on Schedules D, F and J sales. These sales include firm sales of capacity as well as energy, and differ from Schedule C economy sales. In Order No. 20271, issued November 7, 1988, the Commission denied FPC's request, and agreed with FIPUG that, "granting the proposal would invite other utilities to claim entitlement to similar 'incentives' under a myriad of transactions." In addition, the Commission stated, "We are confident that FPC, as a reasonably and prudently managed utility will continue to exercise its best efforts to market this capacity and energy through Other Power Sales irrespective of whether it receives an additional incentive for doing so."

Conclusion: Based on the foregoing staff recommends that, if staff's recommendation in Issue 1 is denied, at a minimum the Commission should clarify Order No. 12923 to state that only Schedules C and X are eligible for a shareholder incentive. If the Commission decides to expand the current shareholder incentive, then the incentive should apply to all non-separated sales with the exclusion of emergency sales.

ISSUE 3: If the Commission decides to maintain the 20 percent shareholder incentive in Issue 1 or approves a new incentive, how should the incentive be structured?

PRIMARY STAFF RECOMMENDATION: If staff's recommendation in Issue 1 is approved, this issue is moot. If the Commission decides to expand the current incentive, a three-year moving average of the gains on the types of sales approved in Issue 2 should be used to set a threshold for the incentive. Gains made above this threshold should be split 80/20 between ratepayers and shareholders, respectively, from the date of a final Commission order.[HARLOW]

ALTERNATIVE RECOMMENDATION: If staff's recommendation in Issue 1 is approved, this issue is moot. If the Commission decides to expand the current incentive in Issue 2, the Commission should allocate the gain on the eligible sales on a 95/5 percent basis between the ratepayers and shareholders, respectively, from the date of a final Commission order.[BOHRMANN]

POSITION OF PARTIES:

FPC: The Commission should apply the 80/20 sharing mechanism to all non-separated economy sales transactions. The sharing mechanism should be applied symmetrically to both profits and losses from economy sales.

FPL: FPL believes that consideration should be given to increasing the percentage for shareholder incentives. For example, a sliding scale such as outlined in FPL's testimony could be used. By using a sliding scale, the utility is compensated and the customer benefits by a lower fuel charge.

GULF: At a minimum, the policy of allowing the 20 percent shareholder incentive for all economy sales established by Order No. 12923, issued 1/24/84, should be continued. The incentive for economy sales should be applied to all non-separated wholesale economy energy sales whether made "off-broker" or through the EBN.

TECO: The incentive should apply to all non-separated, non-firm wholesale sales and to both demand and energy components of such gains, with sharing between customers on an 80/20 basis for out-of-state sales and a 60/40 basis for in-state sales, with calculation details such as described by witness Deirdre Brown.

FIPUG: It is FIPUG's position that the 20% incentive should be eliminated; no incentive should be provided. If the Commission approves an incentive, it should be even-handed and provide for a

penalty as well as a reward. Otherwise, the utilities receive all the benefit with no risk if they do not provide ratepayer benefits.

OPC: Any incentive structure that provides a reward for superior effort should also impose a penalty for substandard performance. Just as utilities would be offended by a penalty-only incentive plan, the customers should no longer be saddled with the current process that provides a positive reward for even substandard performance.

PRIMARY STAFF ANALYSIS: The five proposals presented at hearing for the appropriate structure of an incentive are summarized in the Case Background section and Attachment 1.

As evidenced by the parties' various proposals, there are potentially an unending number of ways to devise an incentive. Further, as FPC Witness Wieland conceded, there is no "magic number" for an appropriate incentive level. (TR 154) To sort through these options, staff found it helpful to focus on a guiding principle for developing an effective incentive mechanism. Specifically, as stated in Issue 1, an effective incentive mechanism should not incent behavior which is already occurring. Therefore, the incentive must be based on some type of threshold determined using past data on the gains on these sales. Any incentive given for gains below this threshold will create the potential for a free rider effect, rewarding utilities for behavior which is taking place for reasons other than the incentive. (TR 270) Staff disagrees with the utilities that an appropriate threshold cannot be determined because these sales are difficult to predict. Staff notes that FPC, FPL, and TECO employ some type of sales standard in determining the compensation of marketing employees. (EXH 3; EXH 7, p.16; TR 79, 143, 216-218) (As previously noted, Gulf has no marketing department, and Southern acts its agent for these sales.) As TECO Witness L. Brown testified, while it is difficult to establish these standards, it is nevertheless done. (TR 219)

The record evidence indicates that the yearly gains on these sales may be erratic due to changes in capacity, or other factors beyond a sellers' control, such as the needs of buyers. (TR 184,231) Staff agrees with OPC that it is appropriate to use a moving average to determine the threshold to reduce the impact of individual years. (TR 263-64) Staff recommends a three year moving average for two reasons. First, FERC Orders 888 and 889 have substantially affected the wholesale market in the past three years. (TR 208,268-69) Second, Florida's two largest IOUs, FPL and FPC, have received FERC approval for out-of-state market-based rates within the past three years. (TR 80-81; EXH 7, p.10) TECO has also received approval to make both in-state and out-of-state

market-priced sales. (TR 229) As OPC Witness Dismukes testified, and as demonstrated by the data in Table 1 (page 7), these factors have substantially impacted the potential gains for the IOUs. (TR 269-70) These two factors have caused a systemic change in the wholesale market in Florida, as displayed in Table 1. As stated above, OPC has proposed a five year moving average used in its proposed reward/penalty methodology. (TR 263) Staff disagrees that five years is an appropriate period. Including years prior to FERC's Order 888 and the utilities' ability to charge market-based rates fails to recognize the market changes caused by these events and would set the incentive threshold too low. Thus, this approach would reward utilities for normal effort, rather than superior effort to make these sales.

Staff therefore recommends that if the current incentive is expanded, a three-year moving average of the gains on non-separated sales be used to set a threshold for the incentive. Further, staff recommends that gains made above this threshold should be split 80/20 between ratepayers and shareholders, as proposed by Witnesses Wieland and Howell. (TR 125,178) Staff agrees with Witness Wieland that the 20 percent figure is subjective in that there is no scientific basis used in selecting that percentage. (TR 154) However, a 20 percent incentive is consistent with Order No. 12923, reasonable, and should provide utilities an adequate incentive. (TR 125,178)

Table 2, below, provides a comparison of incentive mechanisms proposed in this docket. First, the values in the row labeled "Actual" represent the amounts that each utility's shareholders received in 1999 under the current incentive mechanism. The next two rows illustrate the amounts that each utility's shareholders would have received in 1999 under primary staff's and alternative staff's recommendations. The last row shows the amount that each utility's shareholders would have received under the respective utility's proposal. Both primary and alternative staff note that only FPC's data included firm non-separated sales. (EXH 3) The incentives for FPL, Gulf, and TECO would have been higher under staff's recommendation if firm sales were included. TECO reported a drop in gains in 1999 due to a lack of available capacity. (TR 231) Therefore, under primary staff's recommendation, TECO would not have passed the necessary threshold in order to receive a shareholder incentive in 1999. The data was not available in the record to calculate the impact of OPC's proposal for 1999. However, OPC's results for 1999 would be substantially lower than the other proposals, because OPC would only apply an incentive to Broker sales.

Table 2
PROPOSED INCENTIVE RESULTS FOR 1999

1999 Incentive	FPL	FPC	Gulf	TECO
Actual	$8,332	$57,620	$177,910	$12,203
Primary Staff	$5,640,000	$1,554,400	$60,957	$0
Alternative Staff	$2,960,000	$696,746	$44,478	$44,636
IOUs' Proposal	$21,600,000	$2,786,982	$177,910	$316,814

Source: EXH 2,3,4,5,7,8,10

Staff disagrees with FIPUG and OPC that any incentive approved by the Commission should include a penalty for substandard performance. Staff believes that the incentive approach described above is sufficient to encourage performance. The evidence is persuasive that it would be inappropriate to impose a penalty which would potentially counteract an incentive. As several witnesses noted, a utility that does not make an adequate effort to make these sales is experiencing the opportunity cost of forgone profits. (TR 229, 290-91, 323) Further, the existing shareholder incentive approved in Order No. 12923 did not include a penalty. Thus, including a penalty would represent a significant change in Commission policy, a change which has not been adequately justified.

Staff also disagrees with FPL's sliding scale approach. Staff is not persuaded that utility shareholders should receive a higher percentage incentive as gains increase. FPL Witness Dubin stated that the levels of FPL's sliding scale were subjective and not based on any analysis. (TR 110) Witness Dubin also stated that these levels should apply to FPL alone, and other levels should be developed for other utilities. (TR 110) Thus, using a sliding scale approach places the Commission in the difficult position of developing the gain levels for the scale for each utility. Further, a moving average approach, as recommended by staff, will automatically adjust to changes in the market over time.

Staff also disagrees with TECO's position that a higher incentive should apply to in-state sales. (TR 209, 215, 229, 240, 246, 323) The record evidence shows that approximately 95 percent of TECO's non-separated wholesale sales revenues are currently

earned on in-state sales. (TR 230) Further, unlike FPL and FPC, TECO is authorized to make market-based sales in-state. (TR 230) Thus, providing a higher incentive on these sales would reward TECO for behavior that is already taking place. Staff believes that providing a higher incentive on in-state sales could also result in a perverse incentive for utilities to make sales with the highest shareholder incentive, rather than the highest gain. Gulf Witness Howell stated that Gulf would pursue those sales with the highest gain, regardless of the location of the buying utility. (TR 199; EXH 8, p. 33) Sales with the highest gain benefit the seller's ratepayers the most by resulting in the highest credit to the fuel clause.

Staff also disagrees with the deadband approach proposed by OPC Witness Dismukes. Witness Dismukes calculates a benchmark based on a five-year moving average of sales made on the Broker. Under this approach, a utility would credit 100 percent of the gains to ratepayers when the current year's sales fall between 75 and 125 percent of this benchmark. If a current year's sales exceed 125 percent of this benchmark, a utility could retain for its shareholders up to 20 percent of those incremental gains. Conversely, if a current year's sales do not reach 75 percent of this benchmark, the utility would incur a penalty up to 20 percent of the shortfall. (TR 263-266) Witness Dismukes proposed the deadband in part to reduce the possibility that utilities will be rewarded for actions beyond their control. (TR 266) As discussed above, there is persuasive evidence that a 20 percent incentive based on a three year moving average would address these concerns. Further, the deadband could potentially reduce the impact of a shareholder incentive in encouraging these sales. (TR 312) Thus, primary staff believes that the deadband is unnecessary and inappropriate.

In summary, if the Commission believes a shareholder incentive should be expanded, primary staff recommends a 20 percent incentive on the gains above a three-year moving average. This will reduce the free-rider effect of providing an incentive for behavior which is already taking place.

ALTERNATIVE STAFF ANALYSIS: If the Commission decides to expand the current incentive, alternative staff recommends that the Commission allocate gains from eligible wholesale energy sales on a 95-5 percent basis between ratepayers and shareholders, respectively.

In Order No. 12923, in Docket No. 830001-EU-B, issued January 24, 1984, the Commission stated:

> We believe the Staff's witness was correct in stating that "a positive incentive will preserve current levels of economy sales and may result in increased sales and that the 20% incentive is large enough to maximize the amount of economy sales and provide a net benefit to the ratepayer." (EXH 1)

In their post-hearing briefs, FPL and TECO have suggested that the Commission rely upon the wisdom of Staff Witness C.K. Hvostik who advocated the current 20 percent shareholder incentive in testimony filed in Docket No. 830001-EU-B. A Commissioner asked Witness Wieland during cross-examination how the Commission chose 20 percent as the "magic number" for an incentive in its decision in Order No. 12923. In response, he stated:

> [T]here was no scientific basis for that....I guess at that point in time the Commission felt that that was a reasonable number. There is no one that could say that 10 percent is a better number or 30 percent is a better number. (TR 154)

In this docket, the utilities have not presented any quantitative evidence to indicate that their proposals would provide a net benefit to their retail customers. (TR 81; 110; 159; 232; EXH 2, Int.25; EXH 7, Int.25; EXH 8, Int.22; EXH 11, Int.25) In the absence of any quantitative evidence in the record, alternative staff believes that any allocation of the gains from these wholesale energy sales between ratepayers and shareholders is necessarily subjective. While the evidence presented in the Commission's 1983 proceeding may have supported 20 percent as a reasonable number, the evidence adduced in this proceeding persuades alternative staff that 20 percent is too high and is thus no longer reasonable. Although alternative staff's recommendation is no less subjective than any other allocation of gains between a utility's ratepayers and shareholders, alternative staff believes that the Commission should provide more, not less, of these gains to the ratepayers for the following reasons.

As discussed in Issue 1, conditions in the wholesale energy market have changed since the Commission issued Order No. 12923 in 1984. In light of these changes and the utilities' responses to these changes, i.e., the utilities' increased participation and success in the market for the types of sales to which an incentive did not apply, alternative staff believes that the 20 percent shareholder incentive level is unreasonably high and no longer appropriate. Furthermore, if the Commission decides to expand the

current incentive, as shown in Table 2 (page 19), the smaller 5 percent shareholder incentive level applied to a larger base of eligible wholesale energy sales would generally yield a larger incentive for utilities as compared to the current incentive mechanism. As noted above, with a 20 percent incentive utilities would have to increase gains by 25 percent to yield a net ratepayer benefit. Mathematically, a 5 percent incentive would lower the minimum increase in gains required to achieve net ratepayer benefits.

Alternative staff agrees with primary staff's analysis of the parties' various shareholder incentive proposals. However, alternative staff would supplement primary staff's comments about Public Counsel's proposal. There is persuasive evidence to indicate that establishing a benchmark would be problematic for several reasons. First, Public Counsel's proposal is limited to sales made only through the EBN. (TR 263) However, as discussed previously, the EBN currently represents only a small subset of the short-term wholesale energy market. (TR 136, 269-270, 322) Second, as discussed in Issue 1, many factors which impact the level of short-term wholesale energy sales are beyond the control of the selling utility. Thus, a benchmark comprised of actual data from previous years, may not accurately reflect a "normal" or "expected" level of sales for the current year. For this same reason, alternative staff also disagrees with primary staff's recommendation. Third, the width of the deadband proposed by Public Counsel makes it very difficult for a utility to achieve an incentive. (TR 312) A utility should not need to exceed its benchmark by 25 percent before the first dollar of gains are credited to its shareholders. (TR 312) Fourth, Public Counsel's proposal is punitive. (TR 312-313) Its proposal penalizes a utility if a current year's sales fall short of the benchmark. (TR 263) If a utility does not reach 75 percent of its benchmark, the utility would credit more dollars to its ratepayers through its fuel clause than it collected for selling this short-term wholesale energy. As discussed previously, many factors impacting the level of a utility's short-term wholesale sales are beyond the control of the utility. Thus, alternative staff believes this aspect of Public Counsel's proposal is neither fair nor reasonable.

In summary, alternative staff believes the evidence in this proceeding supports a 95-5 percent allocation of the gains from eligible wholesale energy sales between ratepayers and shareholders as fair, just, and reasonable.

PROPOSED AGENCY ACTION:

ISSUE 4: How should the gains on non-separated sales discussed in Issues 2 and 3 be calculated?

STAFF RECOMMENDATION: Total gains should be the transaction price less fuel, O&M, SO2, transmission, and capacity charges. [BOHRMANN]

STAFF ANALYSIS: This issue was not raised at hearing. However, staff is raising it as a PAA issue because the record indicates that the IOUs calculate total gains differently for similar types sales.(TR 139, 238-239,270;EXHS 1,5,7,8,11)

the record indicates that the IOUs calculate total gains differently for similar types sales.(TR 139, 238-239,270;EXHS 1,5,7,8,11) Staff notes that a utility sells short-term wholesale energy based upon its willingness and ability to sell at or above its incremental costs. Therefore, the utility should measure the costs of these sales on an incremental basis. Staff recommends that the utility shall measure the gain from these sales by subtracting the sum of its incremental costs from the revenue received for the sale. However, the record indicates that the IOUs calculate total gains differently for similar types sales.(TR 139, 238-239,270;EXHS 1,5,7,8,11) Therefore, staff recommends that a consistent calculation of incremental costs shall include, but not be limited to: incremental fuel cost, incremental SO_2 emission allowance cost, incremental O&M cost, and separately-identified transmission or capacity charges.(TR 238; EXHS 1,5,7,8,11)

Staff further recommends the following regulatory treatment for the revenues and expenses associated with these sales:

1. A utility shall credit its fuel and purchased power cost recovery clause for an amount equal to the incremental fuel cost of generating the energy for the sale; (TR 238)

2. Except for Florida Power, a utility shall credit its environmental cost recovery clause for an amount equal to the incremental SO_2 emission allowance cost of generating the energy for the sale. Florida Power which does not have an environmental cost recovery clause shall credit this cost to its fuel and purchased power cost recovery clause; (TR 238; EXHS 8,11)

3. A utility shall credit its operating revenues for an amount equal to the incremental operating and maintenance (O&M) cost of generating the energy for the sale; (TR 238;EXH 8,11)

4. By Order No. PSC-99-2512-FOF-EI, Docket No. 990001-EI, issued December 22, 1999, the Commission ruled that a utility shall credit its capacity cost recovery clause for an amount equal to any transmission revenues or separately identifiable capacity revenues. (EXH 1,5,7,8,11)

ISSUE 5: Should this docket be closed?

STAFF RECOMMENDATION: The docket should be closed after the time for filing an appeal on Issues 1, 2, and 3 has run or upon issuance of a consummating order on Issue 4, whichever occurs later. [C. KEATING]

STAFF ANALYSIS: If no person whose substantial interests are affected by the Commission's proposed action in Issue 4 timely files a protest, the docket should be closed after the time for filing an appeal on Issue 1, 2, and 3 has run or upon issuance of a consummating order on Issue 4, whichever occurs later. If a person whose substantial interests are affected by the Commission's proposed action in Issue 4 timely files a protest, the issue should be addressed as part of the Commission's Fuel and Purchased Power Cost Recovery proceedings, and this docket should be closed after the time for filing an appeal on Issues 1, 2, and 3 has run.

Attachment 1
Docket No. 991779-EI

SUMMARY OF CURRENT AND UTILITY PROPOSED INCENTIVE TREATMENT

	FPC	FPL	GULF	TECO
Current Treatment of Incentives	20% on 'split-the-savings' Broker sales	20% on 'split-the-savings' Broker and Off-Broker Schedule C sales	20% on all non-separated sales, including 'split-the-savings' and market-priced sales	20% on all 'split-the-savings' economy sales made both on and off the Broker.
Applicable Schedules (current)	C, X	C	C, Market Based Rate Power Sales	C, X
Proposed Treatment of Incentives	20% on all non-separated, except emergency (A,B)	sliding scale on all 'opportunity' sales except emergency (AF, DF); 20% on $20 million gains; 40% on $20-$40 million gains; 50% on > $40 gains	20% on non-separated, non-firm, economy sales	All non-separated, non-firm sales 20% on out-of-state; 40% on in-state sales; Excludes Schedules A and B
Applicable Schedules (proposed)	C, X, CR-1, MR-1, OS [All non-separated except Schedules A and B]	C, Tariff No. 1; Market-based tariff	C, Market Based Rate Power Sales	C, X, J, G, Market-Priced [Currently]

Source: EXH 3; TR 71-72, 143-145, 194, 228-229