



Public Service Commission  
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-M-E-M-O-R-A-N-D-U-M-

DATE: FEBRUARY 21, 2002

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYO)

FROM: DIVISION OF ECONOMIC REGULATION (HARLOW, BOHRMANN, BREMAN, LEE) *RL*  
OFFICE OF THE GENERAL COUNSEL (ELIAS) *RVE matt JOJ wbm*

RE: DOCKET NO. 011365-EQ - PETITION FOR APPROVAL OF AN AMENDMENT TO COGENERATION CONTRACT WITH THE BAY COUNTY RESOURCE RECOVERY FACILITY, BY FLORIDA POWER CORPORATION

AGENDA: 03/05/02 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\SER\WP\011365.RCM

CASE BACKGROUND

On June 17, 1988, by Order No. 19509, the Commission approved a contract for the purchase of capacity and energy between Florida Power Corporation (FPC) and Bay County (County). The negotiated contract provides FPC with 11 megawatts of capacity and associated energy from the County's Resource Recovery Facility. The contract expires on December 31, 2022. The contract provided for early capacity payments to Bay County by applying the capacity and O&M payments from the out years (2013 to 2022) to the County in the first seven years of the contract (1988 to 1995) on a present-valued, levelized basis. Years 2013 through 2022 of the contract provide firm energy with no capacity payments. A series of capacity buy-down options are also included in the contract. Consistent with Rule 25-17.0832(3)(c), Florida Administrative Code, the contract establishes a contingent liability for the County to

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reimburse FPC for early capacity payments if a capacity buy-down option is exercised or in the event of a default.

On October 16, 2001, FPC filed a petition for approval of an amendment to its purchased power contract with the Bay County Resource Recovery Facility. The amendment: 1) terminates the contract in 2006 rather than 2022; 2) eliminates the County's contingent liability; 3) requires FPC to pay consulting fees of \$610,000 incurred by Bay County; and, 4) provides Bay County with the option to reduce capacity by 1 MW beginning in 2005, with no charge to Bay County from the liability account. FPC requests approval of the Amendment to the current contract for cost recovery purposes.

On December 26, 2001, staff filed a recommendation on FPC's petition which was scheduled for the January 8, 2002, Agenda conference. FPC requested that this item be deferred to allow additional discussions between the parties. Staff subsequently withdrew the original recommendation and met with representatives of FPC, Bay County, and the Office of Public Council. This recommendation includes details of these discussions, and is substantially revised compared to the recommendation filed on December 26, 2001.

Jurisdiction in this matter is vested in the Commission by various provisions of Chapter 366, Florida Statutes, including Sections 366.04, 366.05, 366.06, and 366.051, Florida Statutes.

**Issue 1:** Should Florida Power Corporation's petition for approval of an amendment to the purchased power contract with the Bay County Resource Recovery Facility be approved?

**Recommendation:** No. The amendment will: 1) Increase ratepayer costs by \$610,000, immediately, in exchange for estimated benefits that do not occur until 2007; 2) Remove the benefit of zero capacity payments for firm energy from 2013 through 2022; 3) Immediately eliminate Bay County's contingent liability, currently valued at \$21.1 million, which was designed to reimburse ratepayers for early capacity payments in the event Bay County did not perform; and, 4) Expose ratepayers to the uncertainties of the wholesale market from 2007 through 2022. Given these facts, the expected benefits, which are based on replacement power cost estimates through 2022, are not large enough to provide ratepayers with reasonable assurances that savings will actually materialize.

**Staff Analysis:**

**The Existing Contract:** FPC's negotiated contract with Bay County for the purchase of 11 megawatts of firm capacity and energy is a 34 year value of deferral contract beginning in 1988 and expiring on December 31, 2022. The pricing structure of the Bay County contract is very unusual because it includes early capacity payments for the cogenerator in exchange for a ten year period of firm energy with no capacity payments during the final years of the contract. Bay County received early capacity and O&M payments, which began seven years earlier than the in-service date for the statewide clean coal technology avoided unit used in pricing FPC's standard offer contract. A high capital cost coal unit was used as the avoided unit because at the time, utilities and the Commission believed that the price of natural gas would escalate faster than coal. As this prediction did not materialize, the capacity costs of the Bay County contract are currently higher than market.

Under the negotiated contract, the coal unit based capacity and O&M payments for 2013 through 2022 were paid to Bay County in 1988 through 1994, on a present-valued, levelized basis. Capacity payments for 1995 through 2013 under the contract are lower than those for the standard offer contract. As stated in Order No. 19509, at the time the negotiated contract was signed, the cumulative present value benefit to FPC's ratepayers was projected to be \$1,843,000 over the 34 year term of the contract when

compared to the coal unit based standard offer contract. Because Bay County received early capacity payments relative to the standard offer contract, FPC's ratepayers did not begin receiving cost reduction benefits from the contract until 1995. These benefits occur partially due to the reduced capacity payments in years 1995 through 2013. However, the primary ratepayer benefit occurs due to the zero capacity payments in years 2013 through 2022.

As stated in Section 6 of the contract, "The parties recognize that capacity payments paid prior to January 1, 1995, are in the nature of "early payment" for a future capacity benefit to the Company." The contract establishes a contingent liability for Bay County to reimburse FPC in the event of a default or certain buy-down provisions, in order to ensure that FPC will receive a capacity benefit for which early capacity payments have been made. This liability is represented by a Capacity Account that keeps a cumulative balance of all early capacity payments paid prior to the in-service date of the statewide unit. After January 1, 1995, the Capacity Account is debited for the difference between the capacity payments under the contract and those under the standard offer contract. Interest accrues to the Capacity Account in the amount of 10.72 percent per year. The balance in the Capacity Account, representing Bay County's contingent liability, is \$21.1 million as of December 2001, growing to \$44.1 million by 2012. FPC provided a graph of the capacity account balance over the life of the contract, which is included as Attachment A. As can be seen in Attachment A, the balance of the Capacity Account continues to increase until capacity payments cease in 2013.

Section 8.5 of the existing contract contains several buy-down provisions which are relevant to the proposed contract amendment. Prior to Jan 1, 2005, Bay County may buy-down up to 5 megawatts of capacity. After January 1, 2005, Bay County may buy-down up to the entire 11 megawatts. These amendments require notice of 6 months for under 6 megawatts and 36 months for greater than 6 megawatts. The capacity must be used to provide steam sales to other members of the industrial park in which the QF is located. According to the contract, if Bay County exercises any of the buy-down provisions, FPC must be reimbursed for early capacity payments. Bay County is liable for the balance of the Capacity Account multiplied by the percentage of total capacity reduction.

**The Proposed Contract Amendments:** FPC provided a letter agreement between FPC and Bay County which outlines the proposed contract modifications. FPC did not provide a type and strike copy of the existing agreement.

The modifications include:

- The contract will expire on December 31, 2006, rather than December 31, 2022.
- The balance of the Capacity Account will be eliminated immediately, removing Bay County's liability for default or specified capacity buy-downs.
- FPC will pay \$610,000 to Bay County to cover the County's consulting fees associated with the contract amendment. A representative of FPC stated that this is estimated to cover all of Bay County's consultant costs.
- Bay County will have the option to reduce capacity by 1 megawatt beginning in 2005. This capacity reduction will not require a payment by Bay County to FPC of a portion of the liability account, as required by the current contract.

Per staff's request, Bay County provided copies of the presentation on the proposed amendment made to the Bay County Commissioners on September 11, 2001. This presentation includes a discussion of an environmental retrofit to the facility which is necessary in order to meet Clean Air Act requirements. The retrofit must be in place prior to December 31, 2005. On September 14, 2001, Bay County signed a contract to complete the retrofit. The total estimated cost of the retrofit is \$15.7 million, plus a construction cost overrun contingency of \$1.7 million. Due to the retrofit, there is the potential for a derating of the facility to approximately 10 MW in 2005. The materials provided by Bay County also include a summary and staff analysis of the proposed contract amendment from the County's point of view. Bay County's staff expects a maximum expected benefit of \$2 million in savings to the County if the contract is terminated in 2006 and the unit's capacity and energy are sold in the wholesale market. Bay County's staff states, "The main advantages for amending the Florida Power contract is to forgive the \$23,000,000 debt (or contingent liability) and to provide the opportunity to sell electricity in the open market after 2006."

**FPC's Analysis of the Impact to Retail Ratepayers:**

FPC provided its estimated net present value analysis of the cost savings to FPC's customers if the amendment to the existing contract is approved. FPC's calculation is included as Attachment B. FPC estimates net present value savings to ratepayers of \$4.4 million by comparing the capacity and energy costs of the current contract to: 1) the capacity and energy costs of the contract until 2006; 2) the cost of replacement capacity and energy from 2007 through 2022; and, 3) the \$610,000 immediate payment from FPC to Bay County to cover Bay County's consultant fees.

FPC views the amendments as an opportunity to shift ratepayer savings from the later years of the contract (2013 through 2022) to 2007 through 2012. According to FPC, these savings occur because the capacity and energy costs of the existing contract are higher than estimated market costs for 2007 through 2012. Ratepayer costs would increase in 2002 (\$610,000 payment to Bay County) and in 2013 through 2022. Market costs of replacement power are expected to be higher in 2013 through 2022 because FPC pays no capacity costs for these years under the existing contract.

At a recent meeting with staff, FPC also provided a graph displaying FPC's estimated costs of the proposed amendment compared to costs associated with the remaining life of the existing contract. This is included as Attachment C. The graph highlights the timing of the expected costs and benefits to FPC's ratepayers of the amendment compared to the current contract, with: 1) an initial payment of \$610,000 in 2002; 2) savings from 2007 through 2012; and, 3) increased costs from 2013 through 2022. Also included in the graph are expected cents per kWh cost differentials between the current contract and the proposed amendment. FPC shows an expected 6 to 9.5 cent per kWh savings for ratepayers for the years 2007 through 2012, with an expected 3.5 cent per kWh added cost for ratepayers during the final ten years of the contract. The graph displayed in Attachment C does not include the \$21.1 contingency that Bay County is required to refund to FPC if Bay County were to buy down the contract's capacity or fail to perform. In essence, FPC's analysis assumes that Bay County would meet the requirements of the current agreement until 2022.

As illustrated by Attachment C, FPC expects replacement power costs to remain relatively flat from 2006 until 2022. These costs were modeled using PROSYM software, which estimates replacement

costs based on FPC's current and expected future generation resources, along with outside purchases. FPC stated that the expected replacement costs would be approximately seven percent higher if modeled on Hines 3. (Why FPC expects building Hines Unit 3 to be 7 percent higher than market is not at issue in the instant docket.) FPC estimates that this would decrease the expected ratepayer savings of the amendment to approximately \$2.5 million NPV. FPC also stated that a sensitivity test completed by the company showed that a 30 percent increase in the expected replacement costs would be necessary to reduce the NPV of the proposed amendment to zero.

**Staff's Analysis of the Impact to Retail Ratepayers:**

Staff agrees with FPC that the proposed amendments will allow FPC to go to the market sooner to replace the contract's capacity and energy with a potentially less expensive power source in years 2007 through 2012. However, staff notes that the proposed amendments to FPC's contract with Bay County will impose the following costs on FPC's ratepayers:

- FPC proposes to recover a \$610,000 payment made to Bay County in 2002. Recovery through the fuel clause will result in an immediate rate impact. The payback period for these costs does not occur until 2007.
- FPC's ratepayers will lose the benefits of the latter years of the contract. Years 2013 through 2022 provide firm energy with no capacity payments. FPC estimates that market costs for replacement power will exceed the contract costs in these years. As stated above, at the time the negotiated contract was signed, the cumulative present value benefit to FPC's ratepayers was \$1,843,000 over the 34 year term of the contract when compared to the standard offer contract. The bulk of these benefits were expected to occur in 2013 through 2022, due to the lack of capacity payments. If FPC's estimates for replacement power are understated, the value of these capacity-payment free years to FPC's ratepayers is increased.
- The contract amendments would release Bay County from its contingent liability immediately upon Commission approval of FPC's petition. As explained in Order No. 19509 and consistent with Rule 25-17.0832(3)(c), F.A.C., this liability

was established to reimburse FPC's ratepayers for early capacity payments received by Bay County in the event of a capacity buy-down or default. FPC's estimate of the benefits from the proposed amendments neglects to properly include the potential loss of this liability to its ratepayers. The contract amendments negate this liability immediately, placing FPC's customers at risk of losing any payout from this liability in the event of any capacity buy-down or default occurring prior to 2006. Staff agrees with FPC that this will allow FPC to obtain potentially less expensive replacement power from 2007 through 2012. However, in the event of a buy-down or default under the current contract, FPC would still have the flexibility to go to market sooner, with the added bonus of any payout from the liability account. Staff therefore believes there is an issue of fairness to FPC's ratepayers involved in relieving Bay County from its contingent liability prior to the contract's end.

Bay County's liability is estimated at \$21.1 million as of December 2001. The liability is estimated at \$29.5 million as of December 2006, the proposed contract expiration date. The liability account will grow to a maximum of \$44.1 million in 2012, and will then decrease each year, resulting in a zero balance in May, 2021. The value of this liability is greater today than the \$17.2 million net present value of the capacity payments (2007 through 2012) FPC's ratepayers would be relieved of under the amendment. Order No. 19509 assigns any payments from this liability to FPC's ratepayers in order to guarantee that ratepayers are reimbursed for early capacity payments, stating, "...we find that all liquidated damages collected pursuant to this contract shall be completely credited to FPC's fuel adjustment account."

- Under the amendment, Bay County may reduce capacity by 1 MW in 2005, without a payout from the liability fund. Under the current contract, this payout would be approximately \$2.3 million. This section of the amendment was included to protect Bay County in the event that complying with the unit's environmental requirements degrades the unit's capacity. Bay County stated at a meeting with staff that additional energy could be purchased from Gulf Power to meet the unit's needs, thus releasing more capacity to FPC if necessary.



Staff further notes that the capacity costs under the current contract are fixed in nature, while it is quite difficult to estimate replacement power costs up to 2022. As discussed previously, FPC estimates that a seven percent increase in these costs will reduce expected NPV savings by \$2 million to \$2.5 million. The degree of sensitivity of the proposed amendment's potential savings is caused by the unusual nature of the payments under the current contract, which includes a ten year period of firm energy with no capacity payments. Because of this, any increase in replacement costs will not only reduce the benefits to ratepayers in the near term years (2007 to 2012), but it will increase the value to ratepayers of receiving firm energy with no capacity payments in the out years.

Staff recommends that FPC's petition for approval of the amendment to the purchased power contract with Bay County be denied in its present form. Staff believes the expected benefits, which are based on replacement cost estimates through 2022, are not large enough to provide ratepayers with reasonable assurances that savings will actually materialize. FPC's ratepayers will experience an immediate cost increase of \$610,000 in exchange for estimated benefits that do not occur until 2007, and will lose the benefit of free capacity in the latter years of the contract. FPC's ratepayers will also lose the benefits from any buy-down of capacity or default on the part of Bay County under the current contract. Any payments from this contingent liability by Bay County were guaranteed to FPC's ratepayers by Order No. 19509 to compensate ratepayers for early capacity payments made to Bay County.

Staff met with representatives of FPC, Bay County, and the Office of Public Council in an attempt to resolve some of staff's concerns. Staff offered the following settlement proposals which would improve potential ratepayer outcomes due to a contract amendment.

**1) End the contract and the contingent liability in 2002:** Ending the contract in 2002 would relieve Bay County of the \$21.1 million liability immediately and allow FPC to obtain alternative capacity sooner. This would increase potential ratepayer benefits because the Bay County capacity is priced higher than current wholesale prices. Wholesale prices, and the resulting savings, in the near term are also more certain than more distant wholesale prices.

**2) Continue the contingent liability until the proposed end of the contract in 2006:** Under this proposal, FPC's ratepayers would continue to pay the existing contract capacity payments until 2006. Bay County's contingent liability would remain in place until 2006 to reimburse ratepayers for early capacity payments in the event of a default or buydown. Staff recognizes that a payout of this liability may require litigation by FPC should Bay County fail to provide the contracted capacity.

**3) FPC guarantees the projected ratepayer savings by capping replacement costs for 11 MW at the level provided in FPC's cost-effectiveness analysis:** This settlement proposal entails approving the proposed amendment with a shift of risk of future wholesale market prices from FPC's ratepayers to FPC's stockholders. Staff offered a reward/penalty system in which FPC's stockholders would retain the difference if wholesale prices are lower than FPC's projections. Conversely, if wholesale prices are higher than FPC's projections, FPC stockholders would absorb the difference. The details of this reward/penalty system would have to be developed further.

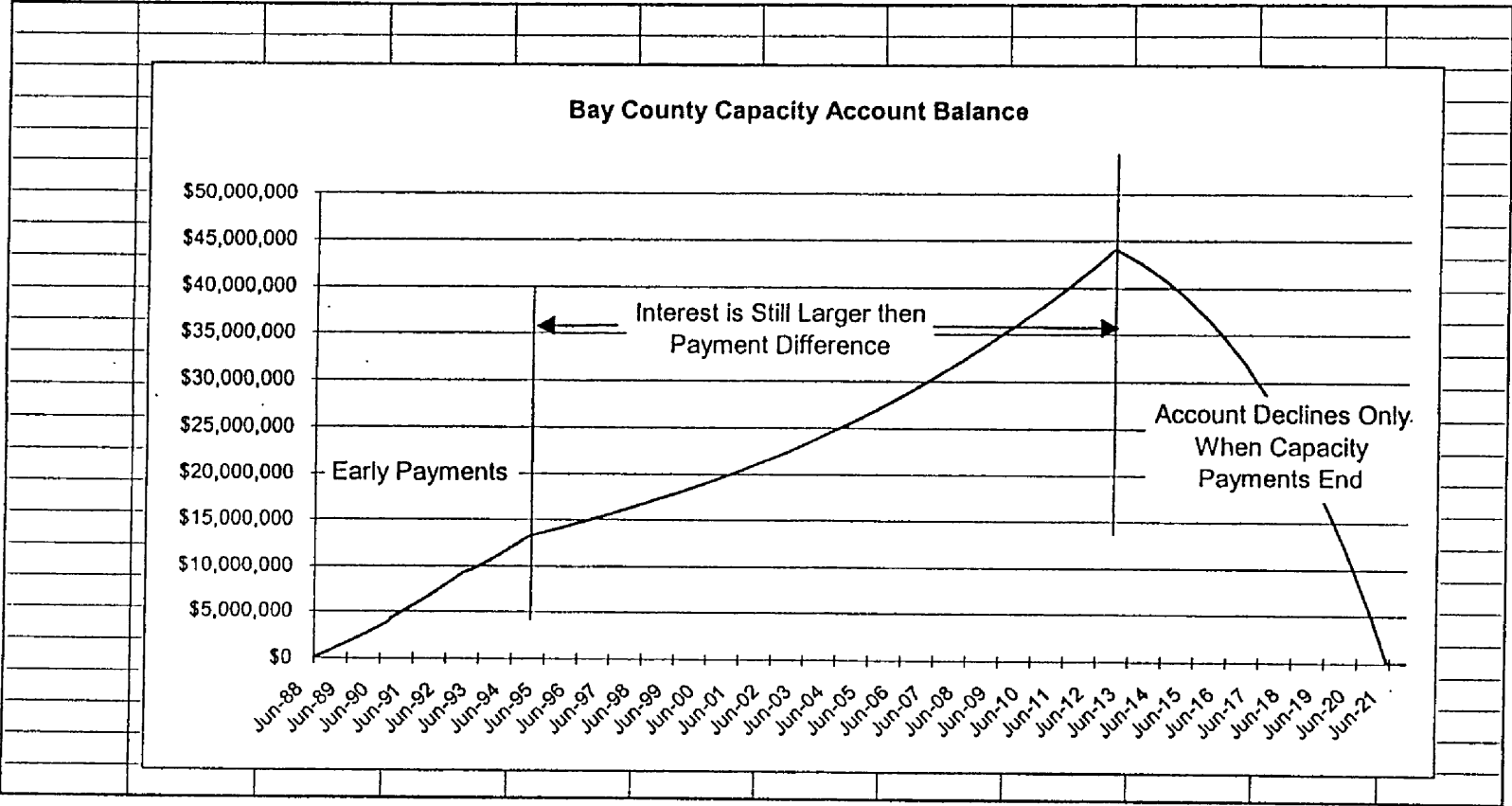
As of this writing, the parties have not agreed on changes to the proposed amendment which would increase the potential benefits to FPC's ratepayers.

**Issue 2:** Should this docket be closed?

**Recommendation:** Yes, if no protest is filed within 21 days of the issuance of the order.

**Staff Analysis:** If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order.

Graph



**Exhibit C**

**Bay County Early Termination Comparison**

Based on PROSYM Analysis

Year	Existing Capacity	Existing Energy	Existing Total	Modified Capacity	Modified Energy	Replacement and Added Costs	Modified Total	Savings/(Cost)
2002	\$2,483	\$1,673	\$4,156	\$2,483	\$1,673	\$610 *	\$4,766	-\$610
2003	\$2,639	\$1,693	\$4,332	\$2,639	\$1,693		\$4,332	\$0
2004	\$2,803	\$1,783	\$4,586	\$2,803	\$1,783		\$4,586	\$0
2005	\$2,979	\$1,245	\$4,224	\$2,979	\$1,245		\$4,224	\$0
2006	\$3,165	\$1,264	\$4,429	\$3,165	\$1,264		\$4,429	\$0
2007	\$3,363	\$1,283	\$4,646			\$2,567	\$2,567	\$2,079
2008	\$3,575	\$1,307	\$4,882			\$2,229	\$2,229	\$2,653
2009	\$3,798	\$1,323	\$5,121			\$2,539	\$2,539	\$2,582
2010	\$4,036	\$1,337	\$5,373			\$2,256	\$2,256	\$3,117
2011	\$4,290	\$1,350	\$5,640			\$2,487	\$2,487	\$3,153
2012	\$4,569	\$1,367	\$5,936			\$2,468	\$2,468	\$3,468
2013		\$1,377	\$1,377			\$2,623	\$2,623	-\$1,246
2014		\$1,391	\$1,391			\$2,569	\$2,569	-\$1,178
2015		\$1,405	\$1,405			\$2,680	\$2,680	-\$1,275
2016		\$1,423	\$1,423			\$2,621	\$2,621	-\$1,198
2017		\$1,433	\$1,433			\$2,742	\$2,742	-\$1,309
2018		\$1,447	\$1,447			\$2,690	\$2,690	-\$1,243
2019		\$1,462	\$1,462			\$2,809	\$2,809	-\$1,347
2020		\$1,481	\$1,481			\$2,792	\$2,792	-\$1,311
2021		\$1,491	\$1,491			\$2,972	\$2,972	-\$1,481
2022		\$1,506	\$1,506			\$2,859	\$2,859	-\$1,353
							NPV @ 8.94%	\$4,367
							Sum	\$3,501

\* Denotes the added up front costs for 2002 of \$610,000.

# Bay County Early Termination

