State of Florida

Public Service Commission

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-M-E-M-O-R-A-N-D-U-M-

DATE: February 4, 2020

TO: Adam J. Teitzman, Commission Clerk, Office of Commission Clerk

FROM: John Hightower, Public Utility Analyst II, Division of Accounting & Finance

RE: Docket Nos. 20200001-EI, 20200002-EG and 20200007-EI

Please file the attached PowerPoint presentation for the Workshop Regarding the Proposed Methodology to Calculate the Weighted Average Cost of Capital in Clause-Recovery Dockets on February 6, 2020, in the above-referenced docket.

Thank you for assistance in this matter.

Attachments

Florida Public Service Commission

Division of Accounting and Finance

Workshop Regarding the Proposed Methodology to Calculate the Weighted Average Cost of Capital in Clause-Recovery Dockets

February 6, 2020

PURPOSE

- The purpose of this workshop is to discuss the Joint Motion filed on August 21, 2019, (Document No. 08312-2019) to modify the methodology for calculating the weighted average cost of capital (WACC) applicable to clause-related investments that was approved in Order No. PSC-2012-0425-PAA-EI (the Order), referred to herein as the **"2012 Method."**

- The WACC is used as the rate of return on clause recoverable capital investment in the following cost recovery clause dockets:
  - Fuel and purchased power cost recovery clause with generating performance incentive factor (20XX0001-EI)
  - Energy conservation cost recovery clause (20XX0002-EG)
  - Environmental cost recovery clause (20XX0007-EI)
  - Storm Protection Plan cost recovery clause (20XX0TBD-EI)

WHY IS MODIFICATION NECESSARY?

- An inconsistency exists between the 2012 Method and the Internal Revenue Service (IRS) Normalization Rules whereby the Order is prescriptive regarding the time period of the WACC that will be applied to clause-related investments.

- The Order does not allow for utilities to modify the methodology used to calculate the WACC, or use an alternative Earnings Surveillance Report (ESR) from a different time period to avoid a potential IRS Normalization violation.

TOPICS FOR DISCUSSION

- Depreciation Related - ADITs
- IRS Normalization Rules
- Current methodology to determine the WACC in cost recovery clauses (2012 Method)
- Joint Motion to modify the calculation of the WACC
- Staff Concerns
- Comments and Discussion

DEPRECIATION-RELATED ADITS

- Depreciation-related accumulated deferred income taxes (ADITs) are created by timing differences between book depreciation and tax depreciation resulting from capital investment in plant additions.

- Deferred taxes are created when the depreciation rate used to calculate the depreciation expense for income tax purposes is greater than the depreciation rate used to calculate the depreciation expense on a utility's books for rate making purposes.

- In Florida, ADITs are included as zero-cost capital in a utility's Capital Structure and effectively lower the WACC used to set rates, which benefits the ratepayers.

IRS NORMALIZATION RULES

The IRS Normalization Rules require public utilities to implement consistency and apply a proration formula to compute the depreciation-related ADIT balance to be included in the Capital Structure for ratemaking purposes when a forecasted test period is used to set rates – unless the Limitation Provision is met or exceeded.

IRS CONSISTENCY RULE

- Internal Revenue Service (IRS) private letter ruling (PLR) 104580-17, states that under Internal Revenue Code (IRC) §168(i)(9)(B), Normalization Rules are not satisfied if the utility, for ratemaking purposes, uses a procedure or adjustment which uses an estimate or projection of tax expense, depreciation expense or a reserve for deferred taxes unless such estimate or projection is also used with respect to the other two items and with respect to rate base.

- If a projected year clause-filing is used, a utility must use a forecasted Earnings Surveillance Report (ESR) from the same time period if the Limitation Provision is not met.

- The Limitation Provision is not met when the depreciation-related ADIT balance in the <u>projected clause-filing year</u> is less than the depreciation-related ADIT balance in the current year.

LIMITATION PROVISION

- The Limitation Provision is met or exceeded when the depreciation-related ADIT balance used in ratemaking is less than would have been used under the IRS Consistency Rule.

- This means if the ADIT balance in the current period is less than or equal to the ADIT balance projected for the future period in which the new rates would take effect the Limitation Provision is met.

- In this scenario, the 2012 Method complies with the IRS Consistency and Normalization Rules.

CONSISTENCY AND PRORATION ADJUSTMENT

- If the Limitation Provision is not met, an adjustment must be made to the depreciation-related ADIT balance included in Capital Structure to reflect:

  (1) The depreciation-related ADIT balance so that it is equal to the balance in the time period of the projection filing (Consistency Adjustment), and

  (2) The depreciation-related ADIT balance by applying the Proration Formula prescribed in Treasury Regulation Section §1.167(l)-1(h)(6)(ii).

- The purpose of the Consistency and Proration Adjustment is to prevent a flow-through of the benefits of accelerated depreciation to ratepayers at a rate greater than that realized by the regulated utility.

CLAUSE-FILING TIMELINE

2012 Method			
	File Date	January – June	July – December
Projection	Aug / Sep 2019	May 2019 ESR	May 2019 ESR
Act. / Est. True-Up	Aug / Sep 2020	May 2019 ESR	May 2020 ESR
Final True-Up	Apr / May 2021	May 2019 ESR	May 2020 ESR

2019 Proposed Method			
	File Date	January – June	July – December
Projection	Aug / Sep 2019	2019 FESR	2019 FESR
Act. / Est. True-Up	Aug / Sep 2020	2020 FESR	2020 FESR
Final True-Up	Apr / May 2021	December 2020 ESR	December 2020 ESR

2012 METHOD

Projection Filing

- For the Projection Filing the May ESR WACC for the calendar year in which the filing is made is used.
- For example, the 2020 Projection which was made in August/September of 2019, the May 2019 ESR was used.

2012 METHOD

Actual/Estimated True-up Filing

- For the period January – June of the year being trued-up (Actual), the May ESR WACC from the prior calendar year is used.
- For the period July – December of the year being trued-up (Estimated), the May ESR WACC of the year being trued-up is used.

- For example, the 2020 Actual/Estimated True-up Filing which is made in August/September 2020, the May 2019 ESR would be used for January – June and the May 2020 ESR would be used for July – December.

2012 METHOD

Final True-up Filing

- Regarding a particular calendar year, the same WACCs that are used for the Actual/Estimated True-up Filing regarding that same particular calendar year is used.

- For example, the 2020 Final True-up Filing which is made in April 2021, the May 2019 ESR would be used for the period January – June and the May 2020 ESR would be used for the period July – December.

JOINT MOTION METHOD

- In the Joint Motion, the utilities propose to use an alternate methodology if the Limitation Provision is not met or exceeded.

- If the Limitation Provision is met, the utilities propose to continue to use the 2012 Method.

- The determination of whether each utility meets or exceeds the Limitation Provision for each clause projection filing will be documented and available for review by the Commission and interveners as needed.

JOINT MOTION METHOD

Proration Formula

- Treasury Regulation Section §1.167(l)-1(h)(6)(ii), requires that if a future period is used to set rates, the limit on the amount of depreciation-related ADIT for the period is the amount at the beginning of the future period, plus a pro rata adjustment for any increase or decrease during that period.

- A specific Proration Formula must be applied to project any changes in the depreciation related ADIT balance in the future period.

JOINT MOTION METHOD

Proration Formula

- The pro rata portion of any increase to be credited or decrease to be charged during a future period shall be determined by multiplying any such increase or decrease by a fraction.
  - The numerator is the number of days remaining in the period at the time of the increase or decrease to be accrued.
  - The denominator is the total number of days in the period.

2020 Clause Projection Filing

2018 YE Surveillance (13-month average) at ROE % midpoint and adjusted to 48% Equity Ratio

	Sys Per Book	Retail Per Book	Pro Rata Adj	Specific Adj.	Adj'd Retail	Cap Ratio	Reallocation to 48% Equity Ratio	Revised Cap Ratio	Cost Rate	Weighted Cost
Common Equity	196,492,147	196,492,147	(15,734,543)	-	180,757,604	60.87%	116,363,775	39.19%	10.19%	3.99%
Long Term Debt	49,701,551	49,701,551	(3,979,962)	-	45,721,589	15.40%	93,464,979	31.48%	2.48%	0.78%
Short Term Debt	17,333,345	17,333,345	(1,388,006)	-	15,945,339	5.37%	32,595,778	10.98%	1.08%	0.12%
Cust Dep Active	3,314,935	3,314,935	-	-	3,314,935	1.12%	3,314,935	1.12%	2.73%	0.03%
Cust Dep InActive	-	-	-	-	-	0.00%	-	0.00%	0.00%	0.00%
Invest Tax Cr	-	-	-	-	-	0.00%	-	0.00%	0.00%	0.00%
Deferred Inc Tax	50,913,259	50,913,259	-	293,375	51,206,634	17.24%	51,206,634	17.24%	0.00%	0.00%
Total	317,755,237	317,755,237	(21,102,511)	293,375	296,946,102	100.00%	296,946,102	100.00%		4.92%
	-	-	-	-	-				pretax WACC	6.33%

2018 YE Surveillance with ADFIT Consistency and Proration Adjustments adjusted to 48% Equity Ratio

	System Per Sys Per Book	Consistency & Proration Adj.	System Per Books Adj'd	Retail Per Books	Pro Rata Adj	Specific Adj	Adjusted Retail	Cap Ratio	Reallocation to 48% Equity Ratio	Revised Cap Ratio	Cost Rate	Weighted Cost
Common Equity	196,492,147	719,316	197,211,464	197,211,464	(15,734,543)	-	181,476,920	61.11%	116,826,839	39.34%	10.19%	4.01%
Long Term Debt	49,701,551	181,947	49,883,498	49,883,498	(3,979,962)	-	45,903,536	15.46%	93,836,918	31.60%	2.48%	0.79%
Short Term Debt	17,333,345	63,454	17,396,799	17,396,799	(1,388,006)	-	16,008,793	5.39%	32,725,491	11.02%	1.08%	0.12%
Cust Dep Active	3,314,935		3,314,935	3,314,935		-	3,314,935	1.12%	3,314,935	1.12%	2.73%	0.03%
Cust Dep InActive	-	-	-	-	-	-	-	0.00%	-	0.00%	0.00%	0.00%
Invest Tax Cr	-	-	-	-	-	-	-	0.00%	-	0.00%	0.00%	0.00%
Deferred Inc Tax	50,913,259	(964,717)	49,948,542	49,948,542		293,375	50,241,918	16.92%	50,241,918	16.92%	0.00%	0.00%
Total	317,755,237	-	317,755,237	317,755,237	(21,102,511)	293,375	296,946,102	100.00%	296,946,102	100.00%		4.94%
	-	-	-	-	-	-	-				pretax WACC	6.36%

Proration Adjustment and Consistency Adjustment to Reflect Projected ADFIT Consistent with Projection Year

	Month	ADIT Bal	Deprec-Relatec ADFIT Bal *	Deprec-Related ADFIT Activity	Days to Prorate	Future Days in Period	Prorated Deprec-Related ADFIT Activity	Prorated Deprec-Related ADFIT Bal
projected	Dec-19	50,204,098	50,204,098					50,204,098
projected	Jan-20	50,169,766	50,169,766	(34,332)	31	336	(31,518)	50,172,580
projected	Feb-20	50,131,932	50,131,932	(37,834)	29	307	(31,735)	50,140,845
projected	Mar-20	50,090,596	50,090,596	(41,336)	31	276	(31,172)	50,109,674
projected	Apr-20	50,045,757	50,045,757	(44,839)	30	246	(30,137)	50,079,536
projected	May-20	49,997,416	49,997,416	(48,341)	31	215	(28,397)	50,051,139
projected	Jun-20	49,945,573	49,945,573	(51,843)	30	185	(26,205)	50,024,934
projected	Jul-20	49,890,228	49,890,228	(55,345)	31	154	(23,287)	50,001,647
projected	Aug-20	49,831,380	49,831,380	(58,848)	31	123	(19,777)	49,981,870
projected	Sep-20	49,769,030	49,769,030	(62,350)	30	93	(15,843)	49,966,027
projected	Oct-20	49,703,178	49,703,178	(65,852)	31	62	(11,155)	49,954,872
projected	Nov-20	49,633,824	49,633,824	(69,354)	30	32	(6,064)	49,948,808
projected	Dec-20	49,536,467	49,536,467	(97,357)	31	1	(266)	49,948,542
		49,919,173	49,919,173	(667,631)	366		(255,556)	49,948,542
2018 YE Surv Bal.		50,913,259	50,913,259				13 Mo Avg Bal	49,919,173
Consistency Adjustment		(994,086)	(994,086)				Proration Adj.	29,369
Proration Adjustment			29,369					
Total Adjustment			(964,717)					

JOINT MOTION METHOD

Projection Filing

- For the Projection Filing use the mid-point ROE WACC calculation from the Forecasted Earnings Surveillance Report (FESR) for the calendar year in which the filing is made.
- For the 2020 Projection which is made in August/September of 2019, the 2019 FESR is used.
- A consistency and proration adjustment is made to the ADIT balance to reflect the time period the ADITs are accrued during the year.

JOINT MOTION METHOD

Actual/Estimated True-up Filing

- For the Actual/Estimated True-up Filing the mid-point ROE WACC calculation from the current year FESR is used.

- For example, the 2021 Actual/Estimated True-up Filing which is made in August/September 2021, the 2021 FESR would be used.

JOINT MOTION METHOD

Actual/Estimated True-up Filing

- If the depreciation-related ADIT balance in the Projection Filing was over-estimated, the Proration Formula adjustment must be reduced to reflect the difference between the originally projected and prorated depreciation-related ADIT balance and the re-projected depreciation-related ADIT balance.

- The resulting mid-point ROE WACC calculation will be used to calculate a monthly return on clause investments on the books and records of the utility consistent with this methodology.

JOINT MOTION METHOD

Final True-up Filing

- For the Final True-up Filing regarding a particular calendar year the actual December ESR mid-point ROE WACC calculation of the year being trued-up is used.

- For example, the 2022 Final True-up Filing which is made in April 2022, the actual December 2021 ESR would be used.

JOINT MOTION METHOD

Final True-up Filing

- The Proration Formula adjustment must be carried forward from the Projection Filing into the Final True-up Filing.
- If the ADIT balance in the Projection Filing was over-estimated, the Proration Formula adjustment must be reduced to reflect the difference between the originally projected and pro rated ADIT balance and the final ADIT balance.
- The resulting mid-point ROE WACC calculation will be used to calculate a monthly return on clause investments on the books and records of the utility consistent with this methodology.

STAFF CONCERNS

- Using the 2012 Method may result in a higher than necessary revenue requirement.
- Best Regulatory Practice - Consistency.
- Rate Stability - potential for large year-to-year rate fluctuations.
- Using two different methodologies is somewhat confusing and more difficult to track.
- Verification of whether a utility meets or exceeds the Limitation Provision.
- Regulatory practice of using ADITs to reduce rate base.

STAFF CONCERNS

Potential High Revenue Requirement

- Only occurs when using the 2012 Method.

- If the ADIT balance in the 2020 projected clause filing year is significantly greater than the ADIT balance in the historic May 2019 ESR, all else being equal, the IOU could earn a higher rate of return on capital investments than it would if the forecasted ESR WACC was applied.
  - A larger ADIT balance in the Capital Structure will lower the WACC if all other capital components are held constant.

- This is caused by a mismatch of the period used to calculate the WACC (May 2019) and the period used to calculate the return on the clause investments (CY 2020).

STAFF CONCERNS

Rate Stability

- Rate fluctuations are caused by changes in the revenue requirement from year-to-year.

- The 2012 Method uses mismatched time periods which could cause higher than actual revenue requirements in the projection filing year when large capital investment creates a large increase in ADITs.

- The revenue requirement is then adjusted in the final true-up year.

- The potential for an undesirable magnitude of rate changes exists when using the 2012 Method if large increases in plant investment are common.

STAFF CONCERNS

Multiple Methods are Confusing

- Using the 2012 Method when a utility meets or exceeds the Limitation Provision or using an alternate method when it doesn't is more difficult to track and monitor.

- 4 electric utilities filing in 4 clauses annually, plus the gas utilities' riders, could mean 20 or more different methods each year.
  - The method could change year-to-year for each utility based on the ADIT balance.

- Staff would be required to spend additional time and resources to verify the WACC for each clause for each company.

STAFF CONCERNS

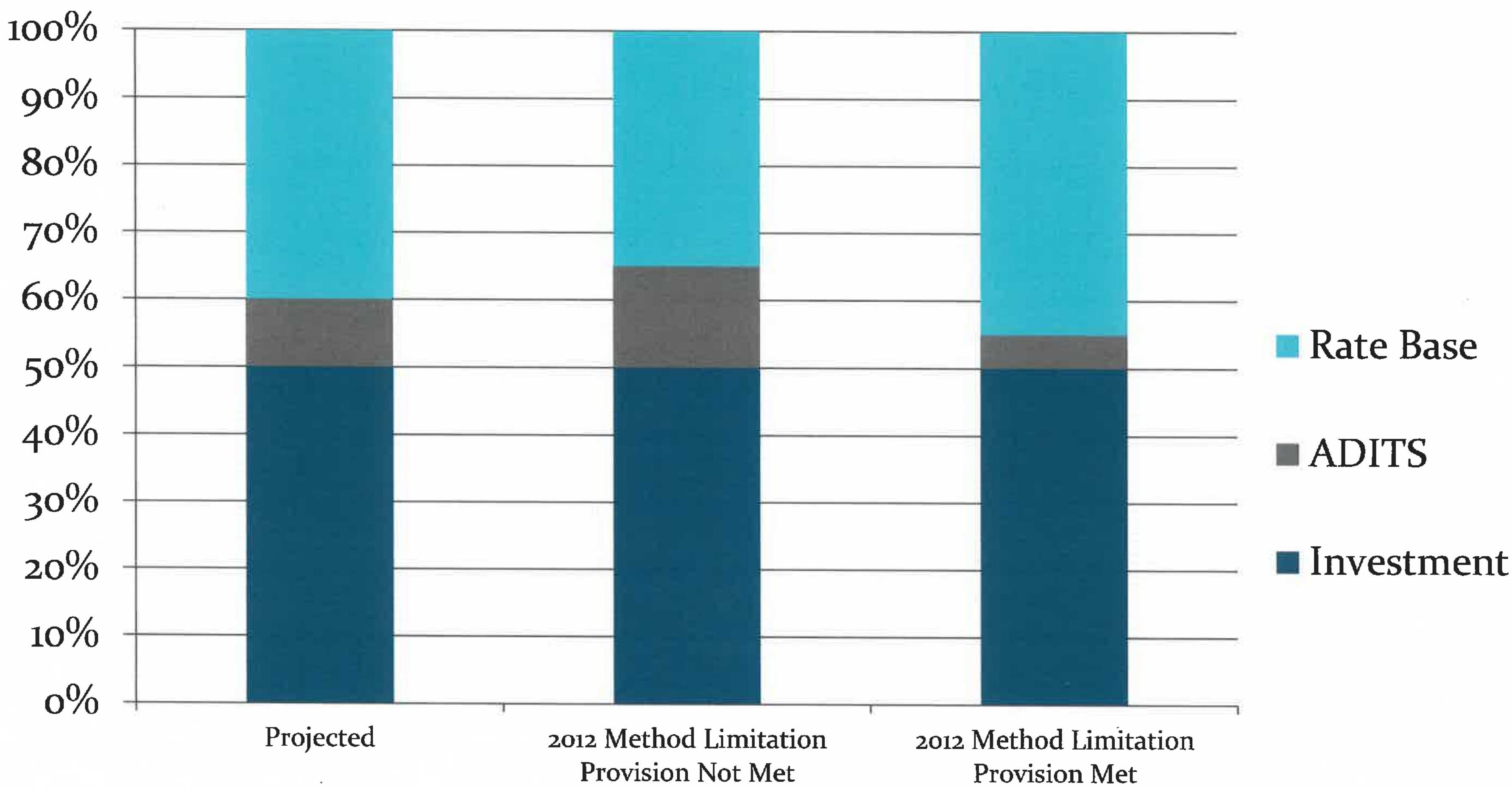
Limitation Provision Determination

- The petitioners indicate documentation for the determination of whether a utility meets or exceeds the Limitation Provision will be available for review.

- Staff believes the documentation should be filed with the Commission for staff's review.

STAFF CONCERNS

ADITs Reduce Rate Base



STAFF CONCERNS

EXAMPLE IF ADITs REDUCE RATE BASE

- Using the MACRS asset class life of 30 years and a general depreciation recovery period of 20 years.
- Plant Investment = $1,000,000,000
- ADITs generated = $3,434,970

STAFF RECOMMENDATION

- Discontinue use of the 2012 method.
  - Eliminate using a historic ESR to calculate the WACC for a projected clause filing year.
- Use the modified WACC calculation methodology regardless of whether or not a utility meets or exceeds the Limitation Provision.
  - *This will not cause an IRS Normalization Violation if the Consistency and proration adjustments are made appropriately.*
- Use the Forecasted ESR for the same year as the Projected clause filing.
- Use the actual December ESR for the same year as the true-up filing.

COMMENTS & DISCUSSION

- Comments should be filed by March 6, 2020 in

Docket No. 20200001-EI

Docket No. 20200002-EG

Docket No. 20200007-EI