State of Florida

Public Service Commission

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

DATE: August 2, 2007

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Lee, Colson, Lester, Slemkewicz)
Office of the General Counsel (Brown, Bennett)

RE: Docket No. 060162-EI – Petition by Progress Energy Florida, Inc. for approval to recover modular cooling tower costs through environmental cost recovery clause.

AGENDA: 08/14/07 – Regular Agenda – Posthearing Decision – Participation is Limited to Commissioners and Staff

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Carter

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\060162.RCM.DOC

Case Background

On February 24, 2006, Progress Energy Florida, Inc. (PEF or Company) petitioned the Commission for approval to recover the costs of its modular cooling tower project through the Fuel and Purchased Power Cost Recovery Clause (the Fuel Clause). On July 13, 2006, after discussions with staff, PEF filed an amended petition to recover the costs of the project through the Environmental Cost Recovery Clause (ECRC) rather than the Fuel Clause. With its amended petition, the Company also filed the revised direct testimony of Thomas Lawery and Javier Portuondo describing the scope, benefits and proposed cost recovery associated with the project.

PEF implemented this project on June 9, 2006, to comply with wastewater discharge standards required by the Florida Department of Environmental Protection (FDEP).[1] These standards are codified in Chapter 62-620, Florida Administrative Code, entitled "Wastewater Facility and Activities Permitting." PEF's wastewater discharge permit, issued initially in 1988 and renewed most recently on May 9, 2005, limits the temperature of discharge water in the discharge canal at PEF's Crystal River plants to 96.5 degrees Fahrenheit. Because of increased inlet water temperature from the Gulf of Mexico into the plant during the summers of 2004 and 2005, PEF has been forced to temporarily reduce the output of both Crystal River Units 1 and 2 to remain in compliance with its water discharge permit. PEF asserts that installing modular cooling towers along the discharge canal will provide additional cooling capacity, allowing the company to remain in compliance with its FDEP permit.

Section 366.8255, Florida Statutes, authorizes the Commission to review and decide whether a utility's environmental compliance costs are recoverable through an environmental cost recovery factor. Electric utilities may petition the Commission to recover projected environmental compliance costs required by environmental laws or regulations, and not included in base rates or other cost recovery clauses. Environmental laws or regulations include "all federal, state, or local statutes, administrative regulations, orders, ordinances, resolutions, or other requirements that apply to electric utilities and are designed to protect the environment." Section 366.8255(1)(c), Florida Statutes. A utility may submit a petition to the Commission describing its proposed environmental compliance activities and projected costs, and if the activities are approved, the Commission "shall allow recovery of the utility's prudently incurred environmental compliance costs, including the costs incurred in compliance with the Clean Air Act, and any amendments thereto or any change in the application or enforcement thereof . . . ." Section 366.8255(2), Florida Statutes.

At its August 29, 2006, Agenda Conference, the Commission heard comments from staff, the company, and the Office of Public Counsel (OPC) regarding the company's cooling tower project. OPC objected to the proposal to pass the costs of the project through either the ECRC or the Fuel Clause instead of recovering them through base rate revenues. After deliberation, the Commission decided to schedule this matter directly for a formal administrative hearing. Order No. PSC-06-0771-PCO-EI, issued September 18, 2006, determined that the broad issue to be considered at the hearing was whether PEF's cooling tower project is eligible for recovery of the costs associated with the project either through the ECRC or the Fuel Clause. A hearing was held on May 1, 2007. By stipulation of the parties the Commission entered the prefiled direct and rebuttal testimony and exhibits of all witnesses into the record, along with a stipulated exhibit of discovery documents prepared by staff. The parties waived cross examination. Following the hearing, each party filed a post-hearing brief and statement of issues and positions. Staff's post-hearing recommendation on the issues is provided below. The Commission has jurisdiction over the subject matter pursuant to section 366.8255, Florida Statutes.

[1] In the 2006 ECRC proceeding, the Commission approved a stipulation to include the costs of the modular cooling tower project in PEF's 2007 ECRC factors subject to refund including interest pending resolution of this docket. Order No. PSC-06-0972-FOF-EI, issued November 22, 2006, p.8.

Discussion of Issues

Issue 1: What is the appropriate mechanism to recover the prudently incurred costs of Progress Energy's temporary cooling tower project?

(A) Should PEF recover costs for the Crystal River Units 1 and 2 cooling tower project through the Environmental Cost Recovery Clause?

(B) Should PEF recover costs for the Crystal River Units 1 and 2 cooling tower project through current base rates?

(C) Should PEF recover costs for the Crystal River Units 1 and 2 cooling tower project through the Fuel Cost Recovery Clause?

Recommendation: The appropriate mechanism to recover the prudently incurred costs of Progress Energy's temporary cooling tower project is through the Environmental Cost Recovery Clause, not through the fuel clause or in base rates. The project meets the eligibility requirements for ECRC recovery and is in the public interest. Recovery of project costs through the ECRC is reasonable and consistent with prior Commission decisions. Cost recovery should be reviewed annually as part of the Commission's ongoing proceedings in the ECRC. If the Commission denies cost recovery through either clause, the project costs should be recovered through base rates. (Lee, Lester, Colson, Slemkewicz, Brown, Bennett)

Position of the Parties:

PEF: (A) PEF should recover costs of the Project either through the ECRC or the Fuel Clause. The Project meets the criteria for recovery under the ECRC, Section 366.8225, F.S., as interpreted in Order No. 94-0440-FOF-EI. The need for the Project was triggered by the unusually high inlet water temperatures during the summer of 2005 which required PEF to de-rate the Crystal River units in order to comply with the permit limit for the temperature of cooling water discharged from the plant. Project costs are being prudently incurred after April 13, 1993. The activity is legally required to comply with a governmentally imposed environmental regulation whose effect was triggered by the unanticipated high inlet water temperatures after PEF's last ratemaking proceeding. The costs are not being recovered through some other cost recovery mechanism or base rates.

(B) No. As explained in PEF's positions to Issues 1(A) and (C), the costs for the Project meet the criteria for recovery through the ECRC and through the Fuel Clause under the flexible policy established in Commission Order No. 14546 and applied in subsequent orders. The costs for the Project were not anticipated at the time PEF's base rates were established/approved and therefore are not recovered in base rates.

(C) PEF should recover costs of the Project either through the ECRC or the Fuel Clause. The Project meets the criteria for recovery of unanticipated fuel-related costs set forth in Order No. 14546 and applied in subsequent orders. Specifically,

the Project will result in fuel savings and Project costs were not recognized or anticipated in the cost levels used to determine current base rates. Accordingly, under the policy established in Order No. 14546, recovery of reasonably and prudently incurred costs for the Project is appropriate through the Fuel Clause. Because the Project was necessitated by unanticipated climatic conditions that are beyond PEF's control, contrary to OPC's argument, the Project is not the type of operation and maintenance costs (including costs incurred during planned or unplanned outages) which are recognized and anticipated when base rates are determined.

OPC: (A) No. These costs do not qualify as ECRC costs pursuant to the Commission's policy defined in Order No. PSC-94-0044-FOF-EI. To qualify costs for recovery through the ECRC, a utility must demonstrate that the costs were prudently incurred after April 13, 1993, the activity is legally required to comply with a government-imposed environmental regulation that was enacted or became effective, or whose effect was triggered after the company's last test year upon which rates are based, and the costs are not recovered through some other cost recovery mechanism or through base rates. The cooling towers are intended to help PEF comply with a requirement that predated the passage of the ECRC statute and the company's last rate case. Accordingly, the effect of the requirement was not "triggered" after PEF's last rate case. The "triggering event" language in the Commission's policy refers to changes in regulatory requirements, not operating conditions. The "triggering event" provision would be applicable, for instance, in a regulation that was enacted in 2003 but imposed requirements that take effect in 2009 and require money to be spent in 2008 to comply with the 2009 criterion. Thus, the costs do not satisfy the Commission's eligibility criteria and are ineligible for the ECRC.

This result does not mistreat PEF, as it will recover the costs, as it recovers all costs other than those that qualify for the exceptional treatment of a specific recovery mechanism, through base rate earnings. The effect will be negligible-- the stand-alone impact on the company's earned rate of return during the first, high-cost year is less than 9/10 of 1%--and may be offset by growth in revenues or declines in other costs.

(B) Yes. The costs are of the type that are properly considered operation and/or maintenance costs. They do not satisfy the eligibility criteria of separate cost recovery mechanisms. To include them in the cost recovery clause notwithstanding their ineligibility would impose an unwarranted rate increase on customers. Accordingly, they should be recovered in base rate revenues. To require PEF to collect the costs through base rate revenues is appropriate, because this specific increase in O&M is but one of a myriad of changing costs, revenues, investments, and other dynamics that affect earnings during the period following the conclusion of a rate case. The impact of the costs on rate of return is negligible, and may be offset by declines in other costs and/or increases in revenues in any event.

(C) No. The modular cooling tower costs are not fossil-fuel related and are well-removed from the fuel process. Secondly, Paragraph 10 in Order 14546 was meant to encourage utilities to spend money that they might not otherwise choose to spend to save fuel costs. When the utility cannot operate base load units at full capacity, costs borne by customers are increased above the norm. Measures designed to return base load units to normal, economic operations are not "savings" as contemplated by the Commission in Paragraph 10. These costs are necessary to enable PEF to generate units at full capacity when they are the most economical resources available to serve customers. They therefore differ from an opportunity to lower fuel costs. OPC believes the Commission did not contemplate that such operation and maintenance costs would be flowed through the fuel cost recovery clause. Further, if one accepts PEF's fuel savings argument, then by extension all costs incurred in planned or unplanned outages of any lower-fuel cost plant would qualify for the fuel clause—an absurd proposition. These types of costs are properly considered operation and/or maintenance costs. They belong in base rates.

Staff Analysis: The pertinent facts regarding PEF's modular cooling tower project and the benefits of the project are not disputed, and the reasonableness of the project is not disputed. The primary issue in the case is what is the appropriate cost recovery mechanism for the project. (OPC BR 5, TR 51, TR 41) PEF believes the project is eligible for recovery either through the ECRC or the Fuel Clause. OPC believes the project is not eligible for recovery through the ECRC or the Fuel Clause. While OPC and PEF differ in their legal and policy interpretations of the allowable recovery under the two clauses, they agree that if the costs of the project are not recoverable through a clause, they would be recovered through base rates. (TR 55, TR 62, TR 68)

The Modular Cooling Towers Project and Projected Savings

At PEF's coal burning Crystal River Units 1 and 2, permanent cooling towers are used to condense the turbine exhaust steam to water, using water drawn from the Gulf of Mexico as the cooling agent. In this process, heat is transferred from the steam to the cooling tower water, which is then discharged into a canal leading back to the Gulf. (OPC BR 6, TR 33) The industrial wastewater permit for the Crystal River Plant includes a thermal limit of 96.5 degrees Fahrenheit on the cooling water discharge from the plant, which has been in effect continuously since 1988. (OPC BR 6, TR 42-43, EXH 6) Because the discharge temperature limit must always be met, the cooling capacity of the permanent cooling towers is affected by the temperature of the inlet cooling water at the time it is drawn from the Gulf. The higher the intake Gulf water temperature, the smaller the quantities of water that can accept heat from the steam and remain below 96.5 degrees Fahrenheit. (TR 24, 25, 33, 34, OPC BR 6) Once the cooling capacity of the towers is reached, the only immediate option is a temporary reduction in the output, or derate, of a generating unit. Because Crystal River Units 1 and 2 are base-load coal units, whenever those units are derated PEF must replace the lost generation by using more expensive oil or gas-fired units, or by purchasing higher-cost power on the open market. (TR 33)

PEF states that the temperature of the inlet water into the Crystal River site has increased significantly in recent years due to hotter weather, especially in the summer of 2005. As a result,

more derates were necessary to comply with the thermal limit of 96.5 degrees Fahrenheit for the discharge water. (TR 34) In order to minimize the derates, PEF initiated this project, which involves the lease, installation and operation of modular cooling towers in the summer months. (TR 32) The company asserts that the resulting reduction in derates will restore generating unit availability to its pre-existing level. Utilizing leased modular towers will allow the company to evaluate whether the increase in Gulf water temperatures and the resulting derate situation is a temporary or cyclical problem before considering a permanent solution. (TR 35) The modular cooling towers were placed in service in June 2006, after the submittal of PEF's petition for cost recovery. (TR 35) PEF incurred $516,000 capital costs and $4.6 million in Operations and Maintenance (O&M) costs for the project during 2006. Future costs are estimated to be approximately $3 to $4 million annually. (TR 37)

Based on PEF's calculation, the project has yielded net fuel savings of $3,743,963 in 2006. (TR 37) Witness Lawery explained in his direct testimony that the net fuel savings were calculated based on an industry standard unit commitment dispatch model. The model compares generating unit commitment between the actual case and the modeled case for each event where de-rates were avoided; the fuel cost differences between the cases were then calculated to arrive at the gross benefit of reduced fuel costs associated with avoided de-rates as a result of the modular cooling towers. Using this methodology, the calculation of gross benefits from avoided de-rates yields a total of $4,033,020. The value of additional auxiliary loads to power the modular cooling towers is $289,057. The net of the two numbers yields net savings of $3,743,963. (TR 37) This demonstrates that additional fuel costs of $3,743,963 would otherwise be passed on to PEF's customers through the fuel clause in 2006 if the modular cooling towers had not been installed. (PEF BR 3)

(A) ECRC Recovery

As stated in the case background above, Section 366.8255, Florida Statutes, authorizes the Commission to review and decide whether a utility's environmental compliance costs are recoverable through an environmental cost recovery factor. Electric utilities may petition the Commission to recover projected environmental compliance costs, required by environmental laws or regulations, not included in base rates or other cost recovery clauses. Environmental laws or regulations include "all federal, state, or local statutes, administrative regulations, orders, ordinances, resolutions, or other requirements that apply to electric utilities and are designed to protect the environment." Section 366.8255(1)(c), Florida Statutes. A utility may submit a petition to the Commission describing its proposed environmental compliance activities and projected costs, and if the activities are approved, the Commission "shall allow recovery of the utility's prudently incurred environmental compliance costs, including the costs incurred in compliance with the Clean Air Act, and any amendments thereto or any change in the application or enforcement thereof. . . ." Section 366.8255(2), Florida Statutes. The statute provides that:

> 'Environmental compliance costs' includes all costs or expenses incurred by an electric utility in complying with environmental laws or regulations, including, but not limited to:
>
> 1. Inservice capital investments, including the electric utility's last authorized rate of return on equity thereon;

2. Operation and maintenance expenses;

3. Fuel procurement costs;

4. Purchased power costs;

5. Emission allowance costs;

6. Direct taxes on environmental equipment; and

7. Costs or expenses prudently incurred by an electric utility pursuant to an agreement entered into on or after the effective date of this act and prior to October 1, 2002, between the electric utility and the Florida Department of Environmental Protection or the United States Environmental Protection Agency for the exclusive purpose of ensuring compliance with ozone ambient air quality standards by an electrical generating facility owned by the electric utility.

Section 366.8255(1)(d), Florida Statutes. Finally, the statute provides that any costs recovered in base rates may not also be recovered in the ECRC. Section 366.8255(5), Florida Statutes.

The Commission first implemented the provisions of section 366.8255 by Order No. PSC-94-0044-FOF-EI, issued January 12, 1994, in Docket No. 930613-EI, In re: Petition to establish an environmental cost recovery clause pursuant to Section 366.8255, Florida Statutes (Gulf Order). There the Commission identified the criteria required to demonstrate eligibility for cost recovery under the ECRC. The Commission interpreted the statute to prescribe three eligibility requirements for recovery of environmental compliance costs through the clause: the costs had to have been incurred after April 13, 1993, the effective date of the statute; the costs had to have been incurred to comply with a governmentally imposed environmental requirement, not a voluntary, discretionary environmental activity; and the costs could not already be included in base rates or another cost recovery mechanism. At the time, the Commission focused its concern on avoiding the possibility that utilities would recover costs through the ECRC that they were already recovering through base rates, because the Gulf proceeding was the first time the Commission was faced with separating the two. (Gulf Order, pps. 6-7) Staff believes that concern is the focus of the second and third eligibility criteria. The Commission said:

Upon petition, we shall allow the recovery of costs associated with an environmental compliance activity if:

1. such costs were prudently incurred after April 13, 1993;

2. the activity is legally required to comply with a governmentally imposed environmental regulation enacted, became effective, or whose effect was triggered after the company's last test year upon which rates are based; and,

3. such costs are not recovered through some other cost recovery mechanism or through base rates.

The Gulf Order also included other findings that are relevant to the decision to be made in this case. The Gulf Order allowed recovery through the ECRC of Gulf's Environmental Auditing Program even though no specific environmental regulation mandated such a program, because the program ensured the efficient management of approved environmental programs. (Gulf Order p. 19) It also allowed recovery for general air quality costs and emission monitoring costs associated with changes in the scope of compliance both with existing environmental regulations and with new environmental regulations. (Gulf Order p. 17) The Gulf Order demonstrates that from the beginning of its administration of section 366.8255, the Commission has applied the statute and its criteria on a case-by-case basis, not formalistically, but with enough flexibility to respond reasonably to complex and variable circumstances. This approach is consistent with the broad language of the statute, which provides that the Commission shall allow recovery of prudently incurred environmental compliance costs, including costs such as operations and maintenance costs typically included in base rates.

For other examples of the manner in which the Commission has viewed ECRC eligibility, see Order No. PSC-99-1954-PAA-EI, issued October 5, 1999, in Docket No. 990667-EI, In re: Petition by Gulf Power Company for approval of Plant Smith Sodium Injection System as new program for cost recovery through environmental cost recovery clause, where the Commission approved the project both to comply with new Clean Air Act Amendment (CAAA) Phase II requirements and to maintain compliance with existing air permit requirements. See, also, Order No. PSC-98-1764-FOF-EI, issued December 31, 1998, in Docket No. 980007-EI, In re: Environmental Cost Recovery Clause, where the Commission approved Gulf's additional groundwater monitoring equipment to continue to comply with an existing environmental requirement, because greater treatment capacity was needed. In that order the Commission also approved two additional coal crushers for TECO's Gannon station, even though it could not specifically determine whether the crushers were necessary to comply with the CAAA. The Commission said: "We do not know if the additional Gannon coal crushers were initially intended as part of TECO's overall NOx compliance strategy for Phase II of the CAAA. . . . However, it appears that additional crushers at the Gannon Station will contribute in the overall efforts to achieve lower NO_x emissions if TECO continues to use PRB coal at Gannon." Order No. PSC-98-1764-EI, p.17.

Order No. PSC-02-1421-PAA-EI, issued October 17, 2002, in Docket No. 020648-EI, In re: Petition for approval of environmental cost recovery of St. Lucie Turtle Net Project for period of 4/15/02 through 12/31/02 by Florida Power & Light Company, also demonstrates the Commission's common sense approach to the eligibility of environmental compliance costs for recovery through the ECRC. Florida Power & Light's (FPL) Nuclear Regulatory Commission (NRC) license to operate the St. Lucie nuclear power plant includes Appendix B, which contains environmental requirements associated with non-radiological requirements, including those for the protection of endangered species. Appendix B imposed certain requirements on FPL to protect several species of endangered sea turtles from entrapment in the cooling water intake canals of the plant. The NRC requirements included installation and maintenance of a five inch mesh barrier net across the intake canal. Although the NRC requirements had not changed, FPL requested recovery of the costs for a new turtle net project through the ECRC.[2] The new project

[2] Appendix B was modified in 2002, but there was no change made to the earlier requirements regarding the turtle net.

included installation of a new net of sturdier material and support structures, conducting a bottom survey of the intake canal, maintenance dredging the canal in the vicinity of the net, and installing a sand pump near the net. These additional activities were not specifically required by Appendix B, but FPL explained that they were necessary to ensure that the net worked properly so that it could continue to comply with its NRC license. The Commission approved the project even though the environmental requirement had not changed and even though the environmental requirement did not mandate the specific engineering steps FPL proposed to take, finding that by requiring installation of a turtle net with no other engineering details " . . . the license impliedly requires that FPL take whatever measures are necessary to make the net work properly." The project was ". . . within the scope of work authorized by the license, because it is needed to ensure that the net functions properly." Order No. PSC-02-1421-PAA-EI at p. 5.

With respect to the application of the three eligibility criteria in the Gulf Order (pages 7-8 above) in this case, the parties agree that the project meets the first criterion; its costs were incurred after April 13, 1993. There is a disagreement over whether the MFRs offer sufficient evidence to support PEF's contention that the project complies with the third requirement that the costs are not recovered through some other cost recovery mechanism or through base rates. (TR 58-59) Citing general cost recovery principles, OPC argues that base rates are designed to recover operation and maintenance costs. (OPC BR 16, TR 51-56) OPC's position that the Commission should deem the project costs as having been recovered in base rates reflects its concern that utilities have an incentive to pass operation and maintenance costs normally recovered in base rates directly to customers through the recovery clauses rather than through the usual rate setting process (TR 56, OPC BR 16-17) PEF contends that the project itself was not contemplated when the MFRs providing the basis for its rate case settlement with OPC were filed, and that the project's operation and maintenance costs are not appropriate for base rate recovery because the project is not designed to replace or repair existing cooling tower facilities due to normal wear and tear. (TR 73-75)

There is no record support for OPC's contention that the project's costs are recovered through base rates. PEF's evaluation of the modular cooling tower project was prompted by record high temperatures and derates in the summer of 2005. The analysis occurred in the last quarter of 2005, and PEF's decision to install the modular cooling towers was not made until February 2006. (TR 74) The company provided data from its last rate case, showing that the costs of this project were not anticipated in the last rate case and were not included for cost recovery within base rates. (EXH 3, EXH 4, TR 74-75) Staff recommends that the costs of the project are not being recovered through base rates or another recovery mechanism, and therefore the project meets the Gulf Order's third eligibility criterion.

The main dispute over eligibility of the modular cooling tower costs for recovery through the ECRC focuses on the second criterion of the Gulf Order, that: "The activity is legally required to comply with a governmentally imposed environmental regulation enacted, became effective, or whose effect was triggered after the company's last test year upon which rates are based." According to the parties, the meaning of the phrase "whose effect was triggered" is the crux of the issue.

The thermal limit of 96.5 degrees Fahrenheit on the cooling water discharge imposed by the FDEP's industrial wastewater permit has been in place and has not changed since 1988, which predates PEF's last rate case. (TR 43, OPC BR 9) OPC argues that only a change in the terms of the underlying environmental regulation could "trigger" additional compliance costs eligible for recovery through the ECRC. OPC's witness Hewson suggested that an example of this interpretation would be a case where the environmental requirements are phased in over time following the original date of enactment of a regulation. (TR 44) OPC argues that since there has been no change in the environmental requirement since 1988, before the company's last rate proceeding, the additional cooling tower costs are not eligible for ECRC recovery. OPC contends that the Commission's use of the disjunctive "or" in the language of the Gulf order indicates that an environmental requirement cannot be both effective before the most recent test year and have its effect triggered after the most recent test year. Witness Hewson argues that the warmer inlet water temperature is not a change in a governmental requirement but a change in operating conditions. He contends that PEF's broad interpretation would suggest that any future changes in fuel market conditions that would trigger different environmental compliance measures should also qualify for ECRC treatment. (TR 44)

PEF's interpretation of the second eligibility criterion is broader than OPC's and includes changes in environmental conditions that trigger a change in the scope of activity necessary to comply with existing regulations. PEF argues that the effect of the wastewater discharge license was triggered after its last rate case, because the unanticipated high inlet water temperatures in 2005, and the prospect that high water temperatures will continue in the future, required additional measures to remain in compliance with the permit without derating its baseload plants. (PEF BR 3, TR 25, EXH 5, TR 69-70)

Staff does not agree with OPC's interpretation of the language in the Gulf Order's second eligibility criterion for ECRC cost recovery. Staff believes the language contemplates a variety of circumstances and times when a utility would incur costs to comply with environmental requirements. The criterion ("The activity is legally required to comply with a governmentally imposed environmental regulation enacted, became effective, or whose effect was triggered after the company's last test year upon which rates are based.") would include an environmental requirement enacted after the utility's last test year on which rates were based. It would include an environmental requirement that had been enacted before the utility's last test year but was not effective until after the test year. It would also include a requirement enacted and effective before the last test year, but whose effect had changed over intervening years necessitating a change in the scope of activity required to remain in compliance with the regulation.[3] This interpretation encompasses both OPC's example of a regulation that phases in its requirements over time and PEF's example of a change in real world environmental conditions that necessitates the increased costs.

Admittedly the language of the Gulf Order is somewhat ambiguous, but staff believes that the interpretation it recommends is consistent with prior Commission decisions, and with the intent of section 366.8255, Florida Statutes, which permits recovery of a wide variety of costs

[3] Staff would add that there may be other factual circumstances as well that would be eligible for recovery in the future, given the fact intensive, case-by-case nature of the Commission's review of ECRC projects.

associated with compliance with governmentally imposed environmental requirements, if the costs were incurred after section 366.8255 was enacted, and if the costs are not being recovered in base rates or another cost recovery mechanism. Staff understands OPC's concern that utilities have the incentive to pass ineligible costs through cost recovery mechanisms, and the Commission should be attuned to that fact, but that cannot lead the Commission to restrict the eligibility of environmental costs beyond what the statute contemplates. With respect to ECRC recovery, staff believes that OPC's position does restrict the eligibility of environmental costs beyond what the statute contemplates.[4] Further, staff is not persuaded that a decision to approve the eligibility of the modular cooling towers project would lead to the scenario OPC's witness Hewson describes, as long as the Commission continues to require a direct nexus between the project, its compliance costs, and the relevant environmental requirement.

For the reasons mentioned above, staff recommends that PEF's modular cooling tower project meets the requirements of section 366.8255, Florida Statutes, and ECRC recovery of the associated, prudently incurred costs is reasonable and consistent with prior Commission precedent.

(B) Base Rate Recovery

As described above, OPC's position that the Commission should deem the project costs as having been recovered in base rates reflects its concern that utilities have an incentive to pass operation and maintenance costs normally recovered in base rates directly to customers through the recovery clauses rather than through the usual rate setting process, where the utilities' return on investment could be adversely affected. (TR 51-56, 62) Staff believes that if the modular cooling tower costs were to be recovered in a rate case, they would be considered separately from normal operation and maintenance activities, because the project is not designed to replace or repair existing cooling tower facilities due to normal wear and tear. (TR 73) Section 366.08255, Florida Statutes, permits such costs to be recovered through the ECRC. The costs of the project are being incurred to continue to comply with an environmental requirement.

In addition, staff believes that ECRC clause recovery is appropriate and more beneficial to customers due to the temporary nature of the project. As Witness Merchant testified, there is no true-up provision in base rate recovery. (TR 54) The project is not a permanent solution because the inlet water temperature effect may be temporary or cyclical. (TR 33) Under the scenario that PEF does not need to continue to incur the project costs subsequent to the expiration of the lease of these modular cooling towers, clause recovery would be more beneficial to customers because only the actual project costs will be recovered by the company. Base rate revenues, however, are not trued-up based on actual costs after the base rates are set. (TR 52)

As Witness Merchant testified, if the Commission denies clause recovery, the project costs will be absorbed by PEF's current base rate revenues until the company files a rate case for adjustment in base rates. (TR 62-63) Whether PEF may file a rate case is subject to its 2005 rate

[4] "An administrative agency has no power to act in a manner that enlarges, modifies, or contravenes the authority that the legislature has delegated to it." 2 Florida Jur 2d, Administrative Law, § 31, p.47-48.

case settlement in Docket No. 050078-EI. The 2005 rate case settlement allows PEF to amend its base rates if PEF's retail base rate earnings fall below a 10% ROE as reported on a Commission-adjusted or pro-forma basis on a PEF monthly earnings surveillance report during the term of the stipulation.[5] This provision does not limit PEF from any recovery of costs otherwise contemplated by the stipulation, including ECRC costs.

(C) Fuel Clause Recovery

In his testimony, PEF witness Portuondo states that the modular cooling towers project will prevent derates of Crystal River Units 1 and 2. As a result, he states, the project will create fuel savings, and he estimates cumulative net fuel savings of approximately $45 million. (TR 28-29; TR 103)

OPC witnesses Hewson and Merchant testify that the Commission should not allow PEF to recover the cost of the cooling towers project through either the ECRC or the fuel clause. (Hewson TR 41, Merchant TR 65) Witness Hewson states the cooling towers costs should not be recovered through the fuel clause because the costs are not "fossil fuel related" as required by Order No. 14546. (TR 45) Witness Hewson states the following:

> This project will not have any direct effect on the Crystal River units' delivered coal prices. Like many operation and maintenance projects, it is specifically designed to improve station performance, not lower fuel prices. (TR 45)

Witness Hewson states the fuel savings from the project are indirect and outside the Commission's intent for projects that can be recovered through the fuel clause. He notes that if the Commission used general fuel savings as the test for fuel clause inclusion, most O&M projects would qualify since the intent of these projects is to improve unit performance and availability. (TR 46-47)

Witness Merchant testifies that utilities recover costs through base rates and specific cost recovery clauses. She notes that, after base rates are set, the future relationship between costs and revenues will change from those used to set rates. (TR 51-52) Regarding the appropriate gauge for determining the reasonableness of base rates, witness Merchant states the following:

> The Commission sets rates using the mid-point of the authorized rate of return on equity (ROE) and then establishes a range for the ROE. If the utility earns within the range, generally set at 100 basis points on either side of the mid-point, then the utility is earning a fair return on its investment and is recovering its prudent operating costs. If the utility is earning above or below the range on its ROE, then it is over- or under-earning, respectively. (TR 53)

[5] See Order No. PSC-05-0945-S-EI, issued September 28, 2005 in Docket No. 050078-EI, In re: Petition for rate increase by Progress Energy Florida, Inc. The Stipulation is effective for a term of four years – the first billing cycle in January 2006 (implementation date) through the last billing cycle in December 2009; however, PEF may extend the term of the Stipulation through the last billing cycle of June 2010, upon written notice to the parties to the Stipulation and to the Commission, on or before March 1, 2009. (Paragraph 1)

Witness Merchant also states:

> Because special cost recovery clause treatment enables the utility to avoid absorbing the expense through base rate earnings, the utility has a powerful financial incentive to steer as many costs as possible through recovery clauses. For this reason, the Commission should be ever vigilant for claims that new or unusual costs belong in a cost recovery clause as opposed to being absorbed in base rates. (TR 56)

Witness Merchant notes that, if the Commission does not allow clause recovery, the effect on PEF's earnings will be slight. (TR 62; EXH 10, p. 1) She believes PEF's base rates are sufficient to absorb the costs of the cooling towers. (TR 63) She disagrees with witness Portuondo regarding proof that the cooling towers' costs are not part of PEF's base rates. She believes the MFR schedules presented by witness Portuondo lack supporting detail. She notes that base rate costs can change from the rate case calculation and still be recovered through base rates. (TR 58)

Regarding recovery of the cooling towers through the fuel clause, witness Merchant notes the cooling towers costs are not fossil-fuel related. She further notes that paragraph 10 of Order No. 14546 was meant to encourage utilities to reduce fuel costs by investing in projects they otherwise might not choose to invest in. Like witness Hewson, she observes that PEF's fuel savings argument by extension would allow all costs associated with planned and unplanned outages to be recovered through the fuel clause. She also observes that the cooling towers' costs are not volatile and that the Commission has approved project costs for fuel clause recovery on a case by case basis. (TR 60-62)

Witness Merchant believes including the cooling towers' costs in the fuel clause would violate PEF's 2005 rate settlement. According to witness Merchant, the 2005 rate case settlement order prevents PEF from recovering unanticipated but normal operating costs which are typically recovered through base rates. She notes that witness Portuondo relies on paragraph 10 of Order No. 14546, which refers to "Fossil-fuel related costs normally recovered through base rates." (TR 63-64)

In rebuttal, regarding the earnings test recommended by witness Merchant, witness Portuondo states that the Commission rejected an earnings test for ECRC recovery in the Gulf Order. He notes that Order No. 14546 does not establish an earnings test. He further notes that double-recovery is avoided by considering only costs not anticipated when base rates were set. (TR 68)

Witness Portuondo disagrees with witness Merchant on whether the cooling towers' costs were included in PEF's base rates. He states the decision to implement the project was not made until February 2006. He states that the MFR schedules he provided in his direct testimony show that PEF budgeted no rental expense through 2006 and did not incur capital costs for modular cooling towers before 2006. This would indicate the costs were unanticipated at the time base rates were set and were not included in the calculation of base rates. (TR 26, 74-75; EXH 3, p.2;

EXH 4, p.2) Witness Portuondo also disagrees with witness Merchant's contention that clause recovery of the modular cooling towers' costs would violate the 2005 rate case settlement. He notes that the cooling towers costs are newly incurred costs that would be recovered through an existing recovery clause, not a new surcharge such as is prohibited by the rate settlement agreement. (TR 76)

Witness Portuondo disagrees with witness Hewson's contention that a project, to qualify for fuel clause recovery, must have a direct effect on fossil fuel prices. According to witness Portuondo, the Commission's policy is flexible. Witness Portuondo notes that the Commission allowed uprate costs of FPL's Turkey Point nuclear plant to be recovered through the fuel clause. The uprate costs were not fossil fuel-related but resulted in net fuel savings. (TR 72-73; Order No. PSC-96-1172-FOF-EI, p. 9)

Witness Portuondo disagrees with witness Hewson's contention regarding O&M projects and fuel savings. Witness Portuondo notes that O&M projects would be anticipated and appropriately recovered through base rates. Also, fuel savings from most O&M projects would not exceed project costs. (TR 73-74)

Staff agrees with witness Portoundo on two points. First, the Commission has not applied an earnings test for cost recovery in either the ECRC or the fuel clause. In the Gulf Order, at page 4, the Commission specifically rejected an earnings test for ECRC eligibility because the ECRC was established by statute and the Legislature clearly intended for defined environmental compliance costs to be recovered through the clause. Order No. 14546, which addresses fuel-related cost recovery, did not specifically address an earnings test for cost recovery.

Second, staff agrees with witness Portuondo the rate settlement would not be violated if the cooling towers' costs were considered appropriate for recovery through a clause. However, staff disagrees with PEF that the cost of the cooling towers project is appropriate for recovery through the fuel clause, because, as witnesses Hewson and Merchant argue, the cooling towers are not directly related to fossil fuel or reducing the cost of coal for Crystal River Unit 1 or 2. The guideline in Order No. 14546 is as follows:

> Fossil fuel-related costs normally recovered through base rates but which were not recognized or anticipated in the cost levels used to determine current base rates and which, if expended, will result in fuel savings to customers. Recovery of such costs should be made on a case by case basis after Commission approval. (Order No. 14546, p. 5)

When testifying as to the meaning of paragraph 10 of Order 14546, witness Merchant refers to page 3 to help explain what the Commission meant in paragraph 10. According to witness Merchant, costs normally recovered through base rates may be recovered through the fuel clause. This allows the utility to take advantage of a cost effective transaction. The above paragraph from Order No. 14546 was meant to encourage utilities to invest in projects that reduce fuel costs in which they might not otherwise invest. (TR 61; Order No. 14546, p. 3)

OPC argues in its brief that the units were designed to function at a specific capacity. According to OPC the increase in water temperature, which was an anomaly, caused the plants to be unable to operate at their standard capacity, and thereby caused a derate. OPC states that the result is the customer pays more than it normally would for power. OPC alleges that the modular cooling towers merely bring the generating units back up to their normal capacity, allowing the plant to return to its regular operating status. OPC concludes that there are no fuel savings to customers by returning the plant to status quo. Fuel savings are those types of transactions which allow the utility to take advantage of cost effective transactions. (OPC BR at 15) Staff believes OPC's conclusion has merit as it applies to fuel savings, but the Commission need not reach a conclusion about fuel savings because, by statute, costs associated with complying with environmental laws are recoverable through the ECRC as discussed above.

Witness Portuondo is correct that the Commission allowed FPL to recover the cost of a thermal uprate for its Turkey Point Units 3 and 4 nuclear power plants, which is not directly related to fossil fuel. However, almost all of the projects that have qualified for fuel clause recovery under the above paragraph from Order No. 14546 have been specific to fossil fuel costs. A review of orders cited by witness Portuondo indicates the projects typically involve enhancements to existing fossil fuel plants that allow a more economical fossil fuel to be burned. Also, the Commission has approved fuel clause recovery of rail cars, which lowered the delivered price of coal. (EXH 2, pp. 2-4)

Order No. 14546 notes that the Commission will determine the eligibility of a project for fuel cost recovery on a case by case basis. The Commission will consider the merits of each individual case. Staff considers the case of uprates for FPL's nuclear units to be an exception to the Commission's general policy of approving fossil fuel related costs associated with specific fossil fuel plants.

Staff believes the cooling towers project is not directly related to lowering the delivered price of coal to Crystal River Units 1 and 2; nor does the project allow a different type of fossil fuel to be burned at the units. Therefore, for this case, staff recommends that the Commission not allow PEF to recover the cost of the cooling towers project through the fuel clause.

Conclusion

The main issue in this case is which of the three cost recovery methods listed in sub issues (A), (B) and (C), is the most appropriate for recovery of the costs associated with PEF's modular cooling tower project at this time. Staff recommends that the Fuel Clause is not the appropriate method for recovery of the modular cooling towers project costs. The modular cooling tower project provides a reasonable means to respond to the change in the scope of activity necessary to remain in compliance with its wastewater discharge permit, and therefore, consistent with prior Commission decisions, the project costs are eligible for recovery through the ECRC.

OPC points out that the customers' base rates would not increase if the project costs are absorbed by PEF's current base rate revenues, and notes that the principle at stake, unchecked expansion of the cost recovery clauses, is more significant than the dollars involved in this case. (OPC BR 17, TR 62) It is undisputed, however, that the project costs are environmental

compliance costs. (TR 62) Staff believes ECRC treatment for the project is consistent with the intent of section 366.8255, Florida Statutes, Commission eligibility standards, prior Commission decisions, and the public interest. The project is a compliance option that has been shown to reduce the fuel costs that would otherwise be passed on to PEF's customers if PEF was forced to derate its baseload power plants. For these reasons, staff recommends that the Commission approve this project as recoverable through the ECRC. If the Commission denies cost recovery through either clause, the project costs should be recovered through base rates.

Issue 2: How should the Commission's decision on Issue 1 be implemented?

Recommendation: If ECRC recovery is approved on Issue 1, project costs are included in the annual cost recovery factors in accordance with prior Commission practice and precedent, subject to prudence review and true-ups. If base rate recovery is approved on Issue 1, the 2006 costs included in the ECRC clause should be refunded in the 2007 ECRC docket true-up process with interest added. (Lee, Lester, Slemkewicz)

Position of the Parties:

PEF: Subject to prudence review and true-up in the annual cost recovery proceedings, project costs should be included in the annual cost recover factors in accordance with prior Commission practice and precedent.

OPC: The estimated 2006 costs included in the ECRC clause should be removed in the 2007 ECRC docket true-up process with interest added. The 2006 actual costs incurred and any 2007 and other future costs associated with this project should be recorded as regular O&M expenses, to be absorbed in base rate revenues.

Staff Analysis: The implementation depends on the Commission's decision on Issue 1. If ECRC or fuel clause recovery is approved on Issue 1, project costs are included in the annual cost recovery factors in accordance with prior Commission practice and precedent, subject to prudence review and true-ups. If base rate recovery is approved on Issue 1, the 2006 costs that have already been included in the ECRC clause for recovery should be refunded in the 2007 ECRC docket true-up process with interest added. The 2006 actual costs incurred and any 2007 and other future costs associated with this project should be recorded as regular O&M expenses, to be absorbed in base rate revenues. If fuel clause recovery is approved on Issue 1, no refund of the 2006 ECRC recovery is necessary.

Issue 3: Should this docket be closed?

Recommendation: The docket should be closed after the time for filing an appeal has run. (Brown, Bennet)

Staff Analysis: The docket should be closed 32 days after issuance of the order, to allow the time for filing an appeal to run.