Dorothy Menasco

From: ROBERTS.BRENDA [ROBERTS.BRENDA@leg.state.fl.us]

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To: Filings@psc.state.fl.us

Cc: Administrative Procedures Committee; Beth Keating; Charles Gauthier; Dianne Triplett; James M. Walls; James W. Brew; John Burnett; John McWhirter; John Rogers; Karin S. Torain; Lisa Bennett; mike.halpin@dep.state.fl.us; Mike Twomey; Paul Lewis; R. Alexander Glenn; Schef Wright

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Electronic Filing

a. Person responsible for this electronic filing:

Joseph A. McGlothlin, Associate Public Counsel
Office of Public Counsel
c/o The Florida Legislature
111 West Madison Street, Room 812
Tallahassee, FL 32399-1400
(850) 488-9330
mcglothlin.joseph@leg.state.fl.us

b. Docket No. 070052-EI

In re: Petition by Progress Energy Florida, Inc. to recover costs of Crystal River Unit 3 uprate through fuel clause.

c. Document being filed on behalf of Office of Public Counsel

d. There are a total of 40 pages.

e. The document attached for electronic filing is Citizens' Post-Hearing Statement of Positions and Post-Hearing Brief.

(See attached file: 070052.brief.doc)

Thank you for your attention and cooperation to this request.

Brenda S. Roberts
Office of Public Counsel
Telephone: (850) 488-9330
Fax: (850) 488-4491

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition by Progress Energy Florida, Inc. to recover costs of Crystal River Unit 3 uprate through fuel clause	)))) /	Docket No. 070052-EI Filed: August 28, 2007

CITIZENS' POST-HEARING STATEMENT OF POSITIONS AND POST-HEARING BRIEF

Pursuant to Order No. PSC-07-0390-PCO-EI, the Citizens of the State of Florida, by and through the Office of Public Counsel, hereby submit their Post-Hearing Statement of Positions and Post-Hearing Brief.

Preliminary Comment On Organization: OPC has combined its Post-Hearing Statement of Positions and its Post-Hearing Brief into a single document. Each position statement will be set off with asterisks.

Because OPC will offer the identical argument in support of several positions related to Issue 1, OPC has chosen to begin with a detailed general argument. Then, rather than duplicate that argument in its entirety, in response to individual sub-issues OPC will adopt the general argument by reference, and include only an abbreviated version within the discussion of the issue.

STATEMENT OF BASIC POSITION

Because PEF has an ample opportunity to prepare and file a base rate case if current base rates are not adequate to cover the costs of the uprate project, Order 14546 is inapplicable to PEF's situation. To avoid requiring customers to pay the uprate costs through the fuel clause at the same time base rates are adequate to absorb some or all of those costs, and to avoid severe intergenerational inequities associated with withholding fuel savings from customers' bills for 10 years or more, the Commission should deny PEF's request.

SUMMARY OF ARGUMENT

The Commission should deny PEF's proposal to recover the costs of its CR3 uprate project through the fuel cost recovery clause for the following reasons:

1. *The costs do not qualify for inclusion in the fuel cost recovery clause under Order 14546.* PEF relies on Item 10 of Order No. 14546. PEF's reliance is misplaced. Implicit in that item is the assumption that, absent a departure from the principle that base rate-related costs such as costs of generation assets should be recovered through base rate revenues, the utility would be unable to recover costs timely and therefore would have a disincentive to expend capital dollars to lower fuel costs. That is not the case here. PEF has ample time and a full opportunity to prepare and submit a request for a base rate increase if it has reason to believe that current base rates are insufficient to absorb the uprate costs. A recent decision makes OPC's point. In Order No. PSC-05-12525-FOF-EI, the Commission rejected an attempt by FPL to invoke Item 10 of Order 14546 and flow the costs of sleeving steam generator tubes of its St. Lucie Unit 2 nuclear unit through the fuel clause. The Commission based its denial on the grounds that FPL was aware of the sleeving project at the time of its most recent base rate case and had the opportunity to build the costs into the minimum filing requirements. Similarly, PEF has time and the opportunity to prepare a base rate proceeding if it deems one necessary. While in the FPL order the Commission pointed to the utility's most recent base rate

case, the reasoning of the Commission in the FPL sleeving order applies with full force to PEF's request.

Further, in its effort to apply Order No. 14546 PEF would have the Commission ignore that part of the order that reserves to the Commission the ability to review requests for clause recovery on a case by case basis. That ability is significant, for PEF's proposal differs in scope and materiality from the cases in which the Commission agreed to depart from the base rate mechanism. This is particularly true with respect to the comparison between the FPL Turkey Point uprate, which cost $10 million and sent lower fuel costs to customers' bills immediately, and PEF's proposal, which will cost $400+ million and would consume the vast majority of savings until 2016—and possibly later.

2. *PEF's proposal would circumvent the overall review of its financial condition that is necessary to avoid a PEF windfall paid by customers.* Between base rate proceedings, utility revenues can grow significantly. PEF's revenues grew to the point that PEF absorbed the cost of its Hines Unit 3 without a corresponding increase in base rates. That base revenues may grow between now and 2012 to the point that they are sufficient to absorb some or all of the costs of the uprate is therefore a practical, not a theoretical, possibility. PEF's request for clause recovery would avoid the overall analysis needed to identify whether and to what extent base rates are adequate to cover some or all of the uprate costs. To the extent base revenues are adequate, granting PEF's request would impose double recovery on customers. They would be paying rates high enough to cover the uprate costs at the same time they would be paying a fuel factor made higher by the inclusion of the uprate costs. The result: unfair and unreasonably high bills.

3. *PEF's proposal would unfairly and inequitably skew the delivery of benefits toward the utility and away from the customers.* PEF proposes to apply all of the fuel savings to pay for the costs of the uprate project until it has completely recovered those costs. By its calculations, and assuming the preliminary estimates of project costs do not increase, customers' bills would not reflect meaningful decreases in fuel costs until 2016. PEF's proposal would create severe intergenerational inequities.

4. *PEF's proposal would require customers to pay unreasonably high capital costs.* PEF proposes to apply a return on equity of 11.75% to the investment in uprate assets. That return, derived from an overall cost of capital, assumes the risk of non-recovery that is characteristic of the base rate process. However, because the fuel cost recovery clause incorporates a true-up feature, PEF would not be subject to that risk if the Commission were to grant its request. Unless the return applied to capital items flowing through the clause is lowered to reflect the utility's significantly lower investment risk, customers would be required to pay unreasonably high rates for the uprate project.

5. *PEF's proposal would deprive customers of the benefit of deferred taxes.* When a utility places a plant investment in rate base and assigns a recovery period equal to its useful life in the normal fashion, the difference between the taxes it collects and the lower taxes it owes initially due to accelerated depreciation for tax purposes provides a source of cost-free capital that benefits customers. That advantage would be lost under PEF's proposal, with the result that the revenue requirement borne by customers would be higher than with normal ratemaking.

GENERAL ARGUMENT IN SUPPORT OF POSITIONS ON

ISSUES 1A, 1B, and 1C

In the Statement of General Position that OPC wrote for the Prehearing Order, OPC urged the Commission to consider the "bigger picture" when weighing PEF's request to provide PEF a massive "incentive" to proceed with the planned Crystal River "uprate project." PEF wants the Commission to allow it to roll some $400+ million of capital investment in nuclear generating capacity through the fuel cost recovery clause instead of recovering the investment through base rates in the normal fashion. OPC submits that an analysis of the bigger picture will reveal that the request would circumvent the comprehensive review of the company's financial condition that is needed to avoid a windfall borne by customers and to ensure that customers and utility are treated fairly.

What comprises this bigger picture? The analysis of PEF's request must include the recognition of the advantages that PEF enjoys as a monopoly, and the obligations to retail customers that its favored monopoly status necessarily entails. Even more importantly, to appreciate the extent to which PEF's proposal would advance PEF's financial interests to the detriment of customers' pocketbooks, the Commission must take into account the respective roles of base rates and special cost recovery clauses in the "bigger picture" of ratemaking.

The advantages and obligations of a regulated monopoly. Under regulation in Florida, PEF has no competition in its retail service area. If a person or business wants electric service, that person or business must obtain it from PEF, as must all other --

100%-- of retail customers in PEF's service area. If a new retail customer's location or circumstances require PEF to make an investment in facilities to initiate service of a size that, based on expected revenues from usage, would cause the revenues-to-investment relationship of the new customer to fall outside of a standard measurement of profitability, PEF can insist that the customer pay a contribution in aid of construction (CIAC) to lessen PEF's required investment as a condition of providing service. Rule 25-6.064, Florida Administrative Code. PEF can recover 100% of its fuel expenses from its customers on a current basis, dollar-for-dollar, and if the fuel factor set by the Commission proves inadequate, PEF can collect any shortfall with interest. PEF can collect costs of complying with environmental regulations through a surcharge outside base rates. Section 366.8255, Florida Statutes. If, despite prudent business decisions and reasonable expense levels, PEF's rates result in a return on investment lower than that which the Commission deems fair and reasonable, PEF can request an increase in rates sufficient to provide it the opportunity to earn that fair rate of return—without fear of being undercut by a competing electric provider in its service area. PEF can fashion such a request for an increase in rates based on forward-looking projections of future costs. (TR 259) If PEF is earning less than the floor of its last authorized rate of return, PEF can include in its rate petition a request for an interim increase in rates, and if it does the Commission must act on that request within 60 days. Section 366.0671, F.S. Following seasons of major storms, the Commission has authorized PEF to collect the extraordinary costs of repairing its system through a surcharge on customers' bills. Order Nos. PSC-05-0748-FOF-EI, PSC-06-0772-PAA-EI In short, under regulation PEF enjoys a myriad of business advantages.

Given all of these advantages, OPC believes it is appropriate to view with healthy skepticism the claim that "incentives" are needed to prompt a utility into doing diligently and well that which it is already obligated-and *paid-* to do. As a basic proposition, if a utility enjoying a protected and favored monopoly status sees a cost-effective opportunity to lower costs borne by customers, prudence (from ratepayers' perspective) and a recognition of its statutory obligations should lead the utility to undertake such measures without additional inducements. The obligation to provide service at the least cost is reflected in the Commission's ability to disallow costs that are unreasonable or imprudent. It is implicit in the requirement that PEF obtain a "determination of need" for the project that includes a finding that the proposal is the most cost-effective available. Section 403.519, F. S. In fact, it would be inconsistent, and contrary to PEF's statutory obligations, for PEF to represent to the Commission that the uprate is needed within the meaning of the pertinent statutes and then attempt to condition its plan to proceed on a proposed "incentive."[1]

Commissioner Argenziano correctly posed the obligation to serve at lowest cost to PEF witness Portuondo. His answer was not responsive: Quoting from TR 321:

> COMMISSIONER ARGENZIANO: "Madam Chair, if I could just bring it back to the question, because you (referring to Mr. Portuondo) said a lot in there. And I guess what I am asking you, and I may ask it one more time—I think you partially answered it. I just don't remember now from what you first said. According to witnesses that testified from PEF, you're

[1] Asked to comment on whether PEF would proceed with the CR3 uprate project if it is directed to recover the related costs through base rates, Mr. Portuondo said he could not answer on behalf of senior management, but alluded vaguely to PEF's need to prioritize its capital projects. (TR 317-318) His answer implies a relationship between the pending request and the amount of available capital. However, it is clear from later testimony that PEF will have to finance the construction of the uprate project, regardless of whether it recovers its costs through base rates or through the fuel clause. (TR 600-601) To the extent PEF contends its request for accelerated recovery of its investment is related to the prioritizing of projects, OPC observes that (while OPC would oppose the concept in either "venue") PEF is as free to propose recovery periods shorter than useful lives in a base rate proceeding as it is in fuel cost recovery proceedings.

still saying that you would think that PEF is under an obligation to obtain the lowest cost in whatever you pursue?"

THE WITNESS (Portuondo): "The lowest cost purchase of fuel, yes."

But PEF's obligation is not limited to the lowest cost purchase of fuel. It extends to all facets of the service that PEF provides to its customers.

Regulation already provides PEF both the obligation and the appropriate incentive to pursue the uprate. Regulation provides utilities the appropriate incentive, in the form of the opportunity to earn a return (profit) on investment devoted to service. This case provides a good illustration. For ease of calculation, assume the "uprate project" will cost PEF $400 million, which it will add to its rate base (the investment in plant devoted to utility service on which PEF is entitled to an opportunity to earn a fair return) in the normal way. Assume, for purposes of illustration, that 40% of the investment will be funded from equity (shareholders' investment). That means that PEF's shareholders could expect PEF to receive an opportunity to earn its authorized return on equity (currently 11.75%) on $160 million of investment, or approximately $18,800,000 in the first year in which the full investment is in service. After the first year, the opportunity to earn the authorized return on equity would extend each year to the undepreciated portion of the investment, through the year 2036.[2] The only plausible basis for perceiving the lack of an incentive would be a situation in which the timing of the investment would not permit PEF the opportunity to earn a fair return on its

[2] Utilities earn a return on capital investment. They do not earn a return on fuel costs. Nuclear generation is the most capital-intensive form of generation. The opportunity to earn a return is accordingly greater with nuclear generation than with other generating technologies, a bigger portion of whose costs are fuel-related.

investment in the uprate project. However, for reasons that will be developed below, that situation is not present here.

Given the advantages of PEF's position of a monopoly, given the obligations that are entailed with those advantages, and given the opportunity to profit from its investment in the CR3 uprate project that already exists, OPC submits PEF is overreaching when PEF requests clause recovery. Further, PEF's proposal would circumvent the basic tool with which the Commission appraises the financial condition of utilities and ensures that customers' total bills are not providing a windfall to the utility above and beyond the fair return to which they are entitled. Citizens will demonstrate that this situation does not fit into the limited exception of Order No. 14546 to the requirement that "base rate-related" costs be recovered through base rates, NOT through the fuel cost recovery clause.

The "bigger picture" of ratemaking. PEF's request to include CR3 uprate costs in the fuel cost recovery clause cannot be considered in isolation of the overall, larger ratemaking process. As OPC witnesses Patricia Merchant and Dan Lawton explained, the fuel cost recovery clause is only one component of that process—in fact, it is an exception to the normal ratemaking procedures. (TR 392, 460)

OPC's witnesses explained the different techniques underlying the base rate mechanism and the fuel cost recovery clause, as well as the different purposes and functions of each. (TR 391-396; 459-464). Before setting base rates the Commission conducts a comprehensive analysis of the utility's total business and financial posture. Using the "representative test year" as a tool, the Commission dissects the utility's expenses and investments, culls ("disallows") those that are imprudent or unreasonably high, and arrives at levels of investment, expenses, and revenues that are representative of the condition in which rates will be operative in the future. The Commission identifies the fair return that the utility should have the opportunity to earn. For this purpose it defines a "range of reasonableness", any point in which the utility's earned rate of return will be deemed to be fair and reasonable. Having determined the expenses reasonably necessary to operate the business, the value of property devoted to utility service, and the fair rate of return the utility should have the opportunity to earn, the Commission quantifies the total annual revenues the utility should be permitted to collect from customers and designs rates to generate that amount.

Once new base rates become effective, they do not change until the Commission modifies them in the next base rate proceeding. While these constant, unchanging base rates are in effect, new plant will be added, and some items of existing plant will be fully depreciated and/or retired. Some new expenses will arise, others will cease altogether; levels of existing expenses will increase and/or decrease. Revenues will fluctuate with changes in weather, numbers of customers, and changing consumption patterns. Because investments, expenses, and revenues are certain to vary from test year assumptions during the period the fixed base rates are in effect, this means that the earned rate of return—which is a function of the level of investment, on the one hand, and the difference between revenues and expenses, on the other[3]-- will fluctuate over time. As Ms.

[3] To calculate earned rate of return, one divides net operating income by the value of the rate base investment. If base rate – related expenses are artificially removed from the calculation and are instead added to amounts flowing to customers' bills through the fuel clause, the effect will be to increase the earned rate of return, just as would a decrease in expense; however, in this scenario, the expense has not decreased. Instead it has been added to the fuel cost recovery factor and will increase customers' bills by the amount of the relocated expense. The recognition of this relationship, which is critical to an

Merchant testified, all other things being equal, an increase in a base rate-related cost (or a decrease in base revenues) will tend to lower earnings and thereby lower rate of return. All other things being equal, an increase in revenues (or a decrease in expenses) will increase earnings and also increase the earned rate of return. As long as the earned rate of return falls within the range approved by the Commission, it is, by definition, fair and reasonable—even if it moves lower in the range. (TR 393)

Because fuel costs are volatile, the base rate process is not well suited to them. The Commission established a separate cost recovery mechanism to accommodate them. Unlike base rates, into which are built a myriad of costs from across the spectrum of investments and operations (base rate—related costs), the fuel cost recovery factor is limited to volatile fuel and fuel-related costs. Unlike base rates, which remain fixed and constant while the expenses, revenues, and investment that determine earned rate of return fluctuate, the fuel factor is designed to change periodically to the extent necessary to track and collect the dollars spent on fuel and fuel-related costs with absolute dollar-for-dollar precision.

Base rates are designed and intended to collect the "base rate-related costs" identified in a base rate proceeding, *including the cost of generation assets*. The fuel cost recovery clause is designed and intended to collect the fuel and fuel-related costs. Each component of the utility's overall rate structure is well designed to accomplish its intended function. However, customers are impacted adversely when classifications of costs are not enforced and a utility passes a "base rate-related" cost through the fuel clause.

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evaluation of the windfall issue addressed by OPC's witnesses, is developed further in the following paragraphs.

Ms. Merchant provided an illustration that makes the point well. In her example, an increase in a base rate-related expense in the amount of $1 million would have the effect of decreasing the hypothetical utility's earned rate of return from 10% to 9.9%, both of which values fall within its "range of reasonableness;" because base rates are constant, and the fuel clause is not affected when the utility absorbs a base rate cost in base rate revenues, customers' total bills would not change. If the utility instead moves the expense to the fuel cost recovery factor, it would avoid the necessity of absorbing the increase through base rate revenues and would therefore maintain the return at 10%, but it would accomplish this insulation of earnings by adding the base rate-related cost to the fuel facto, thereby increasing customers' total bills by $1 million—even though it would continue to earn a fair return if it absorbed the expense in base rates. (TR 395-396)

To summarize, the mathematical relationships of the bigger ratemaking picture are straightforward. Fundamentally, revenues generated by base rates are intended to pay for base rate-related costs, a prime example of which are the costs of generation assets. Because so many variables are involved, the target of base rates is necessarily an area, not a point. The Commission establishes a range within which an earned rate of return is fair and reasonable. If costs increase, the earnings left after base rate revenues have been applied to defray those costs decrease, and the earned rate of return decreases. If costs decrease, the earnings left after base rate revenues pay for the costs increase and the earned rate of return increases.[4] If a utility absorbs an increase in a base rate—related cost within base rates, *as the design of the base rate mechanism contemplates*, then

[4] Revenues generated by base rates also fluctuate, based on changes in weather, customer growth, and other factors. If revenues increase, the difference between revenues and expenses (earnings) increases, and the earned rate of return calculated by relating earnings to investment increases. However, to these authors' knowledge, no utility has proposed to pass an unanticipated increase in revenues back to customers through the fuel cost recovery clause.

(holding other things equal) base rate expenses go up, earnings are reduced, and the earned rate of return goes down—while base rates remain fixed and customers' bills don't change.

However, if the utility instead adds the new or higher base rate-related expense to the amounts collected through the fuel clause, then earnings remain at the same level, the earned return is preserved, but customers' total bills go up by the amount added to the fuel clause recovery. (TR 395-396)

As for-profit enterprises, the utilities naturally have an incentive to pour as many base rate-related cost items through the fuel clause as possible, because their earnings will be higher—*but so will customer's bills be higher.* (TR 395-396) If base rate earnings are sufficient to absorb the new cost and still yield a fair return, then passing the base rate-related cost through the fuel clause results in an unwarranted, "back door" base rate increase to customers—whose total bills will become higher then necessary to pay for the service they receive. The result can fairly be viewed as a form of double recovery. The customers would be paying base rates adequate to recover the costs of the investment at the same time they must pay a fuel charge into which the costs of the investment have been built.

In this regard, the testimony of FIPUG witness Jeffry Pollock is significant. Mr. Pollock noted that in the current settlement agreement PEF absorbed the $300 million cost of Hines Unit 3 without an increase in base rates. (TR 347;354) His observation establishes that the possibility of a windfall to PEF in the event the Commission grants its request for clause recovery of the uprate project is a real, not a theoretical, concern. Mr. Pollock calculated that current base rates will lead to increases in base rate revenues (relative to current levels) amounting to $240 million between now and the time the uprate project will begin commercial service. (TR 338) A base rate proceeding conducted at that time would take the significantly increased revenues into account when assessing whether PEF requires an increase in base rates to enable it to recover the costs, including a fair return, of the uprate project. If the Commission were to consent now to PEF's request to instead recover the costs of the uprate project through the fuel cost recovery clause, the decision would enable PEF to circumvent the process through which the Commission would determine whether and to what extent PEF's current base rates are sufficient to cover the uprate costs without the clause surcharge sought by PEF.

PEF says it is merely invoking the precedent of Order No. 14546 when it asks permission to flow the costs of the uprate project through the fuel cost recovery clause. PEF's argument fails, for many reasons.

First and foremost, with the exception of the relatively small portion of the uprate that is scheduled for the 2007 outage, the uprate work will be performed in 2009 and 2011, the phases then coming on line in 2010 and 2012, respectively. This timing constitutes a critical difference between the situation contemplated by the Commission in Order No. 14546 and PEF's case. Unlike the situation contemplated by the Commission in Order 14546, PEF has ample time and a full opportunity to file a base rate case, if it believes one is warranted, and (only to the extent necessary in light of all considerations, including revenue growth that takes place between now and the time when the uprate would be placed in service), build increased costs into revised base rates. Because this opportunity is present, PEF has no *disincentive* (in the form of an inability to recover costs through base rates) to keep it from undertaking the project, and the limited exception intended in Order No. 14546 is not applicable to PEF's situation.

Next, in Order 14546 the Commission stated explicitly that utilities desiring to flow base rate – related items through the fuel cost recovery clause would have to approach the Commission and justify their requests on a case-by-case basis. The Commission reserved to itself the ability to examine the facts and circumstances of each situation. With its argument, PEF conspicuously attempts to read the case-by-case language out of the order, and wrongly attributes to the past Commission the intent to write a "blank check" that customers would pay upon presentment, regardless of circumstances.

OPC submits that the example that the Commission provided in Order No. 14546 is instructive. Item 10 of the order was intended to address situations such as the short-term leasing of an oil storage facility to enable a utility to take advantage of an opportunity to purchase oil on favorable terms. PEF will argue that the Commission did not intend the example to be exhaustive. OPC believes it is illustrative of the nature and scope of the situations that the item was intended to address at the time the Commission recognized the exception.

In addition, in the early portion of Order 14546, the Commission observed that there may be times when disparate results are warranted, even though situations may bear similarities:

> 1. When similar circumstances, exist, the Commission should attempt to treat, for cost recovery purposes, specific types of fossil fuel-related expenses in a uniform manner among the various electric utilities. At times, however, it may be appropriate to treat similar types of expenses in dissimilar ways.

Utilities therefore were on notice from the outset that in Order No. 14546 the Commission was careful to reserve its discretion and its ability to take all relevant circumstances into account.

In this regard, questions posed by PEF's counsel to OPC witness Dan Lawton are revealing. Subsequent to Order 14546, said PEF's lawyer, the Commission "developed" the policy articulated in 14546 in later orders. (TR 506, 507) His questions acknowledge that in Order No. 14546 the Commission did not preordain the outcome of every application involving fuel savings-- yet that is the argument on which PEF's request chiefly relies. It is true that in the orders cited by PEF, the Commission allowed the utilities to include base rate-related costs in the fuel cost recovery mechanism based on a demonstration of fuel savings. This does not mean that the answer to the utility's request was a foregone conclusion, or that any of those past orders constitutes grounds for approving PEF's outlandish proposal. In fact, the list of orders cited by PEF supports OPC's view of the intent underlying Order No. 14546, for individually and in the aggregate the much smaller scope of the projects demonstrates the CR3 uprate to be foreign to anything contemplated by the Commission -- at the time it issued Order No. 14546, or afterwards. For example, FPL's coal-oil mixture project of Order No. 9224 involved $8.8 million of capital costs that FPL wanted to flow through the clause; Florida Power Corporation's conversion of Debary, Bartow, and Suwanee units to natural gas cost $7.5 million in the aggregate (Order No. PSC-97-0359-FOF-EI); FPL's modifications to Cape Canaveral Units 1 and 2, Fort Myers 2, Riviera 3 and 5, and Sanford 3,4, and 5, all of which were designed to enable the units to burn a more economic grade of residual oil, cost $2.75 million in the aggregate (Order No. PSC-95-

0450-FOF-EI) FPL's orimulsion conversion project was projected to cost $72 million (Order No. PSC-94-1106-FOF-EI); Florida Power's conversion of certain Intercession City units to natural gas cost $2.5 million (Order No. PSC-95-1089-FOF-EI); the conversion of Intercession City peaking units P8 and PP10 cost $2.6 million (Order No. PSC-96-0353-FOF-EI). [5]

Further, in recent decisions the Commission has demonstrated an intent to scrutinize closely efforts to treat base rate-related items through the fuel clause. In Order No. PSC-05-12525-FOF-EI, dated December 23, 2005, FPL sought to invoke Item 10 of Order No. 14546 in support of its request to pass the costs of sleeving tubes in the steam generator of its St. Lucie 2 nuclear unit on the grounds that the repair would enable the unit to operate at full power, thereby generating fuel savings. However, the Commission ruled that FPL had not carried its burden to demonstrate that it had no opportunity to build the costs into base rates when it prepared its minimum filing requirements for its most recent rate case. It denied FPL's request. Here, too, PEF has a clear opportunity to anticipate the costs of its uprate project prior to the work being done and to build those costs into a base rate proceeding. It would therefore be fully consistent with the order on FPL's sleeving project to deny PEF's request in this case.

PEF pins its hopes largely on the fact that in Order No. PSC-96-1172-FOF-EI the Commission allowed Florida Power & Light Company to pass $10 million, the cost of an uprate at its Turkey Point nuclear plants, through the fuel clause viewed in overall context. Viewed in the context of the many orders on the subject of Item 10, OPC regards the FPL uprate decision as anomalous in terms of its distance from fossil fuel

[5] These examples also demonstrate a far closer nexus between the expenditures and the cost of fossil fuels than does the proposed uprate. FPL's Turkey Point uprate is an exception to the pattern, but as is explained in subsequent paragraphs, the FPL uprate shares the lack of materiality with these other examples.

costs. OPC submits it is explained by the immaterial (and therefore less controversial) amounts in question. In that regard, PEF's case is clearly distinguishable. In the case of FPL, customers would begin receiving benefits in the form of reductions to their bill immediately; here, PEF's most optimistic scenario indicates material benefits would not flow to customers until 2016.[6] In the FPL situation, the uprate cost $10 million, which in FPL's case would not warrant a base rate proceeding and would not constitute a material increase to customers' rates. Indeed, the order reflects that the timing of FPL's uprate project was such that there would have been no opportunity to conduct a base rate proceeding prior to the incurring of the costs at the time of FPL's 1996 request, because the savings were to begin in 1997. In the case of PEF's planned uprate, the cost (including AFUDC) will be about 45 times as great, and clause recovery could result in a huge windfall to PEF.

An illustration will display the fallacy in PEF's contention that the FPL order constitutes "precedent" that supports its request. A Tallahassee family's teen-age son asks permission to attend a dance across town. The parents say "yes". The son spends $3.50 of the family's money on gasoline to attend the dance and is home by 11:30 p.m. that evening. A week later, the son asks permission to attend a dance in Dallas, Texas, half a continent away. The air fare would cost $550, a night's lodging would add $150,

[6] The projection of the point in time at which PEF will have recovered its costs by retaining all fuel savings associated with the uprate is a function of the accuracy of its estimates of costs and of its projections of fuel costs. Both variables are subject to error, and possibly significant error. For instance, PEF acknowledges that its estimates are preliminary placeholders, and that it has not even completed the studies that will determine its real estimates. (TR 248) PEF's exhibits reflect that PEF intends to replace the steam generator of CR3 during the same 2009 outage in which it will undertake certain portions of the uprate. From the time PEF made its first estimate of steam generator replacement, its projection of related costs has increased by approximately 40%. (TR 249-250) Projections of future fuel costs are notoriously difficult. PEF's calculation of fuel savings extends through 2036; in arriving at that value, PEF had to contend that its corporate projections of yearly fuel prices do not exceed 20 years. (TR 146). PEF provided no calculations showing the sensitivity of its 2016 assumption to forecasting errors of differing magnitudes; it provided only a single scenario.

and the son would have to miss a day of school. The son reminds the parents that they said "yes" to a dance a week earlier, and calls on them to be consistent. Are they bound by precedent?

The appropriate response to PEF's effort to invoke the "precedent" of the decision in the Turkey Point case is as evident as the answer to the question posed above. The very different facts and circumstances in PEF's case compel a different regulatory response. The FPL situation involved an expenditure of $10 million which, in FPL's case, was a relatively small amount; one that would not justify filing a base rate proceeding. By contrast, PEF expects to invest $400+ million (including AFUDC), and, given the preliminary nature of PEF's estimates, there is a clear risk that this amount may grow significantly. Furthermore, PEF has an ample opportunity to request an increase in base rates to incorporate the costs of the uprate project if current base rates are insufficient to absorb them and yield a fair return. To protect ratepayers from a potentially large and unwarranted "back door" increase, there is a compelling need to ascertain whether and to what extent growth in base rate revenues between now and 2009-2011 will be sufficient to absorb the cost of the uprate and thereby mitigate the need to saddle customers with the cost of the investment through the fuel clause.

PEF argued that OPC is attempting to create an "earnings test" for Item 10 of Order 14546 that the Commissioners did not include in the order. (TR 563) Quite the contrary is true. As Mr. Lawton testified, absent a perceived financial advantage of one over the other PEF would be indifferent as to whether it collects the costs of the uprate through base rates in the normal fashion or whether it passes those costs through the fuel cost recovery clause. (TR 488) (PEF clearly is not indifferent!) Mr. Lawton's testimony demonstrates how rolling the costs through the fuel cost recovery clause would increase earnings by enabling the utility to avoid netting those costs against base rate revenues in the calculation of earned return. As Ms. Merchant said during cross-examination, it is PEF, not OPC, who initiated an "earnings test" — PEF is proposing an avenue that departs from normal ratemaking for the purpose of achieving earnings above what normal ratemaking would provide. (TR 424-425)

<u>Issue 1</u>: Should the Commission authorize clause recovery in lieu of base rate recovery of the prudently and reasonable costs of the following:

<u>A. Phase 1 of the CR3 Uprate Project?</u>

Recovery of the MUR portion of the CR3 Uprate Project is inappropriate through the fuel clause under Item 10. The MUR project costs are non-volatile, non-fuel related costs which belong in base rates. Further, base rates are designed to absorb increases in investment costs between base rate proceedings. The MUR would have only a de minimus impact on PEF's earnings.

OPC incorporates by reference its general argument on Issues IA, IB, and IC above.

Phase I of the CR3 nuclear uprate is related to plant instrumentation and associated calculations to allow measurement uncertainty recovery (MUR) which is scheduled to be constructed in 2007. (TR 390) According to PEF, the MUR is expected to add 12 thermal megawatts (MWe) for a cost of $6.5 million. (TR 390) The MUR instrumentation and associated costs are plant and represent an investment in plant by PEF.

Base rates are the normal and traditional method for a utility to recover its investment in plant. Base rates are designed to allow the utility the opportunity to recover all of its prudent operating costs and a reasonable rate of return on its investment in utility plant. (TR 391) While the costs of the MUR project were not specifically included in the last base rate proceeding according to PEF, as OPC witness Merchant noted, base rate design fundamentally anticipates that costs and revenue levels will fluctuate over time from those used in setting the rates. (TR 392) All of the costs in the proposed MUR uprate are non-fuel base rate costs and are properly included in base rates.

Order No. 14546 (Order) is the primary order that outlines the basis for fuel cost recovery. Item 10 of the Order which provides an exception to the normal fuel type cost as follows:

> 10. 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.

The Commission did not set forth a blanket acceptance associated with the fuel saving exception to the fuel rule, witness Lawton observed, but rather stated that the Commission would consider a request on a case by case basis. (TR 468) As witness Merchant testified, the case-by-case basis provides the Commission discretion to treat different utilities differently given the circumstances. So, even though the Commission approved the FPL St. Lucie ($10 million dollar in total) uprate, the Commission is not bound to that decision, because cases are examined based on the facts and circumstances as they exist when the cases arrive. (TR 432) The magnitude of the total costs of the complete CR3 project ($400+ million), as compared versus the total cost of the FPL project ($10 million), is significant.

Unlike the FPL St. Lucie project, the cost savings associated with the project will not be realized by the customers in the first years of implementation. As witness Lawton testified, based on PEF's requested shortened amortization lives (1 year for the MUR) net savings do not begin to materialize for at least 10 years. (TR 479, Hearing Exhibit 15, DJL-5) Moreover, the proposed savings associated with the MUR phase of the CR3 project are subject to possible change. Witness Roderick admitted that until NRC approval, PEF would be required to remain at current power levels even if that approval came after the November 2007 outage is complete. (TR 67) According to witness Roderick the current cost saving analysis assumes the availability of the MUR megawatts at the end of the November 2007 outage. (TR 67) So, if the NRC approval is delayed beyond to the November 2007 outage, the cost savings would be delayed. (TR 68)

In this instance, the costs of the MUR portion of the CR3 project would have a de minimus impact on PEF's earnings ($1.05 million annually) witness Merchant testified. (TR 400) However, customers would be harmed because they would have to pay a fuel adder for the MUR project which they otherwise would not have to pay given that PEF's earnings would have covered the cost. (TR 401) As witness Lawton stated, even under the Company's inappropriate cost recovery request for the MUR (where $6.45 million of the investment is recovered in one year – 2008), the total 2008-2009 MUR-related revenue requirement would be $8.67 million. (TR 459) If the utility was required to recover the $8.67 million through base rates, the utilities equity return would only change from 10.90% to 10.50% based on PEF's recent return reports. (TR 459) Thus, it is inappropriate for the MUR project to be recovered through the clauses.

B. Phase 2 of the CR3 Uprate Project

* Recovery of the Phase 2 of the CR3 Uprate Project is inappropriate through the fuel clause under Item 10. The Phase 2 project consists of generation plant costs which belong in base rates. PEF has the opportunity to seek an increase in base rates if one is needed. Granting PEF's request would expose customers to double recovery of uprate costs.*

OPC incorporates by reference its General Argument on Issues 1A, 1B, and 1C.

Phase II of the CR3 uprate project involves replacement of the turbine line components to take advantage of greater steam efficiencies in the turbines and electrical generator. (TR 390) This phase is expected to be placed in service during the 2009 CR3 refueling outage. PEF says it will add an estimated 28 MWe at a preliminary cost estimate of $88 million. (TR 390) Again, the turbine line replacements are investments in plant made by the utility. Phases II and III are linked together because the new turbine will allow PEF to take advantage of the increased steam efficiencies created by the redesign of the nuclear core. (TR 47) Witness Roderick testified that the Balance of Plant (BOP) phase II improvements would be sized to support the Extended Power Uprate (EPU) phase III. Phase III maximizes the output of the reactor and phase II modifications to their ultimate capacity. (TR 47)

1. Base rate recovery appropriate and available

Base rates are the normal and traditional method used for utilities to earn a fair rate of return on their investment in plant. Principles of base rate design contemplate that costs and revenues will fluctuate between base rate proceedings. (TR 391) As long as the utility is earning within its authorized range, the utility is deemed to be recovering its costs and earning a fair ROE, as described by witness Merchant. (TR 393) If, hypothetically, the utility is earning less than the bottom of the range of its authorized rate of return, then the utility's appropriate recourse is – not to abuse the clause – but to avail itself of the opportunity afforded it by statute to seek an adjustment to base rates. (TR 412) If the utility avails itself of a base rate proceeding, according to witness Merchant, then customers and the Commission will have an opportunity to assess the company's condition on an overall basis. Ultimately, the responsibility belongs solely with the utility's management to consider the need to seek base rate relief. (TR 412) But, so long as the return level stays within a reasonable range - generally 100 basis points above and below the midpoint - it is assumed that base rates are functioning properly. (TR 393)

Order No. 14546, Item 10, which PEF attempts to invoke, was designed to address situations in which a utility that initiated a cost-saving measure would have no ability to reflect the costs of the activity in base rates timely. (TR 399) It is clear in Order No. 14546 that the Commission wanted to provide recovery through the fuel clause of volatile fuel costs and delineate those non-volatile, non-fuel related costs that belong in base rates. (TR 399-400) The Item 10 exception which allows recovery of base rate, non-volatile, non-fuel related costs through the fuel clause implicitly recognizes that at times there may be a timing issue regarding base rate recovery which should be considered as part of the Commission's case-by-case analysis.

Expenditures associated with Phase II consist of projected costs to be placed into service during 2009. (TR 400) This is important because the utility has the opportunity and capability of then returning to the Commission for base rate relief, if and when, it determines that such base rate relief is necessary. (TR 400) Thus, the cost of Phase II can be captured appropriately through a base rate proceeding that could occur in the 2009 time frame without the utility incurring the potential loss of return in the interim. As witness Merchant testified, Item 10 simply is not applicable to this situation, in which the utility is not exposed to any lag in recovering cost of a worthwhile project. (TR 400) This fact obviates the need for an "incentive" in the form of a departure from fundamental ratemaking, and distinguishes PEF's situation from that addressed in Order No. 14546.

2. Phase II fuel cost recovery inappropriate and flawed

While special cost recovery mechanisms have their places, they are not intended to replace the base rate process in which the Commission reviews the utility's overall operation. (TR 394) Since cost recovery clause treatment enables the utility to avoid absorbing the expense through base rate earnings, witness Merchant testified, the utility has a powerful financial incentive to steer as many increased costs as possible through recovery clauses. (TR 396) Under the fuel adjustment mechanism, with true-up and reconciliation, a utility is guaranteed 100% cost recovery. In other words, a utility would recover all costs and a guarantee of its authorized return under fuel clause recovery while in a base rate proceeding, the utility is allowed to recover the costs plus an opportunity, not guaranteed, to earn its cost of capital. (TR 465)

As Mr. Lawton testified, given the two methods a rational company will vote for the guaranteed return – especially if that return is not adjusted to reflect the much lower risk associated with a true-up mechanism witness. However, witness Lawton pointed out that allowing cost recovery through a fuel clause is unfair to customers. (TR

466) Allowing base rate costs - Phase II items – to be recovered through the fuel cost recovery clause may result in excess earnings; once through the fuel costs and a second time through the existing base rate charges. (TR 466) Without a base rate proceeding, it would be impossible to determine precisely whether a utility's earnings are falling outside the authorized ROE when the utility's overall circumstances are considered. (TR 466)

Another flaw with PEF's proposal is the shortened lives it proposes for the projects, which skews the benefits to the utility and its shareholders at the expense of customers. For Phase II of the CR3 project, PEF proposes to use a 10 year amortization period. (TR 470) As witness Lawton testified this depreciation proposal does not match costs and benefits over the useful life of the asset and therefore gives rise to intergenerational inequities. (TR 470) He pointed out that the today's ratepayers would be required to pay for the total cost of the uprate plant in 10 years even though it will provide benefits to current and future ratepayers over the next 29 years. (TR 470) The inequity is created due to the fact that some of today's customers that pay too much will not be around in 15 years and new customers who connect in 15 years will receive the benefits at no incremental costs. Normal ratemaking requires recovery of investment over the useful life of the facility to eliminate intergenerational inequities and to comply with traditional matching principles. (TR 471)

The next flaw is that the artificially shortened recovery period for Phase II to 10 years denies the customers the benefits of deferred taxes. (TR 475) Witness. Lawton explained that, due to the utility's proposal to shorten the book depreciation life, there are no upfront tax benefits, in the form of deferred tax balances, to lower the utility's capital costs for customers. (TR 476) Witness Lawton testified that PEF's proposal creates an upfront cost to customers and increases revenue requirements. (TR 476) Thus, under PEF's proposal, customers would pay about $3.9 million NPV in additional revenue requirements because of the impact of accelerated depreciation on deferred taxes. (TR 476)

Moreover, placing Phase II generation plant through the fuel clause would lead to $54 million (NPV basis) excessive revenue requirement due to the requested return on investment. (TR 477) The utility requested an 11.75% return on equity for the uprate assets. This proposed equity return includes a risk premium over and above debt costs to compensate for the risk of not earning the full return—a risk associated with base rate recovery. But, as witness Lawton testified, under PEF's proposal there would be no additional risk, since the full amount ultimately authorized will be reconciled and collected through the fuel clause. (TR 477) As witness Lawton explained, there would be no basis for including an equity return of 11.75% when all the risk has been removed by the fuel clause recovery. (TR 477) Witness Lawton adjusted the weighted average cost of capital to 7.5% by substituting 5.73% for debt cost to reflect the lack of risk in a fuel clause recovery scenario. (TR 507)

C. Phase 3 of the CR3 Uprate Project, including:

1. Nuclear Core Modifications, Secondary Systems, and Other Project-related Plant Additions/Modifications?

* Recovery of the Phase 3 of the CR3 Uprate Project is inappropriate through the fuel clause under Item 10. The Phase 3 project costs generation plant costs which belong in base rates. PEF has the opportunity to seek an increase in base rates if one is needed. Granting PEF's request would expose customers to double recovery of uprate costs.*

OPC incorporates by reference its General Argument on Issues 1A, 1B, and 1C.

Phase III of the CR3 project will increase the power or thermal MWe produced in the reactor core by making plant modifications to allow for use of more highly enriched uranium. (TR 390) Phase 3 is expected to add 140 MWe to be placed into service by 2011 at an estimated cost of $199 million. (TR 390) As noted above, this Phase represents an investment in plant.

Base rate relief appropriate and available

Again, the timing of the plant modification to the nuclear core will be done after the expiration of the base rate settlement at the end of 2009. (TR 400) Because of the in service timeframe for Phase III modifications, witness Merchant noted that the utility has the opportunity and capability of seeking base rate relief, if the utility determines that such base rate relief is necessary. (TR 400) As noted above, base rate relief is designed to allow an opportunity for the utility to earn a fair rate of return on its investment. (TR 400)

Fuel clause recovery inappropriate and flawed

Item 10 of Order 14546 provides an exception to the base rate mechanism to allow recovery of fossil fuel-related costs normally recovered through base rates but which were not recognized or anticipated in base rates and if expended would result in fuel saving to customers. (TR 398) As discussed in the previous issue, passing Phase III through the fuel clause is inappropriate and has many flaws. For Phase III, as in Phase II, the utility has sufficient time to file a base rate case to incorporate these costs into base rates. (TR 400) Order No. 14546, Item 10 exception is simply not applicable to this situation where the utility is not exposed to lag in recovering costs and no "incentive" is needed to overcome a lag between the time the utility expends monies and the time base rates can be modified to reflect the investment.. (TR 400, 404)

In addition to the savings flaw discussed below (which applies equally to Phase II of the project), the shortened amortization period of 10 years will create severe intergenerational inequities. As witness Lawton testified, the intergenerational inequity is due to the fact that today's ratepayers would be required to pay for the total cost of the uprate plant in 1 to 10 years that will provide benefits to current and future ratepayers over the next 29 years. (TR 470) Along with the intergenerational inequity, customers lose the benefit of the deferred taxes as discussed in Phase II. (TR 475)

Moreover, there is no certainty as to the overall proposed savings, because savings values estimated further out into the future are less reliable. (TR 480) As witness Lawton observed, the near term planning horizon (2007-2015) when projected values are probably more accurate, customers receive no net savings; rather they are assigned a net loss associated with the proposed uprate. (TR 480) PEF's witness Roderick conceded that PEF just received bids for the work to be done for Phases II and III work. (TR 74) While some of the bids included fixed pricing, witness Roderick admitted that the labor contracts for the 2011 outage for phase III were not subject to fixed pricing. (TR 74, 77) He further conceded that there may be exposure to higher costs than currently estimated even under a fixed contract. (TR 78)

Under the utility's proposal to recover the CR3 cost through the fuel clause, it is not until 2016 that the proposal provides a net savings in nominal dollars for customers. The front end loading of expenses along with the back end loading of saving dramatically reduces the net present value savings for customers over the entire life but clearly highlights the "softness" in the utility's entire presentation for net savings witness Lawton noted. (TR 480) What is certain from the utility's proposal is that the utility will recover its costs on an accelerated basis compared to traditional ratemaking, while customers will be forced to wait for savings that may not come at the proposed level. (TR 480)

2. The "point of discharge" cooling solution?

* Since the "point of discharge" solution is necessitated by the Phase III increases in generation and Phase III is inappropriate for fuel clause recovery, the POD should not be through the fuel clause under Item 10.*

The point of discharge (POD) costs associated with the increased capacity of Phase III of the CR3 project is estimated at $51 million. (TR 390) Essentially, according to the utility's analysis, the 140 MWe increase associated with Phase III will increase the temperature. The proposed POD facilities are necessary to reduce the incremental temperature increase to the temperature level prior to the uprate. (TR 482) The cost estimates are extremely preliminary and may change significantly, especially since the utility has yet to determine the most cost effective option to accomplish the goal of reducing the temperature. (TR 483) PEF witness Roderick admitted that PEF was still looking at the options and getting bids. (TR 76)

Along with the fact that the POD solution has not been determined, inclusion of the POD in the fuel clause creates the same flaws as discussed for Phases II and III. The POD cost should be included in base rates for the following reasons, witness Lawton testified. First, the costs can easily be included in base rates since the projects will be completed in the 2009- 2011 time period. (TR 483) Second, the utility has failed to identify a reasonable cost estimate or even the option it will employ to address the POD issues. The utility will have sufficient time to identify the appropriate POD option and associated costs and benefits prior to a base rate proceeding. (TR 483) Finally, the POD solution does not comprise facilities that should be recovered through the fuel clause. They are not fossil-fuel related facilities and the related costs are not volatile. (TR 483)

3. Transmission upgrades associated with the CR3 Uprate Project

* Since the transmission upgrades associated with the CR3 project are due to safety and reliability issues and are not associated with any fuel saving, recovery is inappropriate through the fuel clause under Item 10.*

The transmission projects necessary to accommodate the increased capacity of CR3 are estimated at $104 million. (TR 483) Again, the reason articulated for Phase II and III regarding effects of the shortened amortization period, deferred taxes, and skewing of benefits to the utility and shareholders applies here.

Thus, the transmission investment is necessary for reliability reasons. (TR 483-484) As witness Roderick admitted in deposition from a transmission standpoint, the change - of Crystal River becoming the largest single load or generator in Florida due to the increase in CR3 output – means that the utility would have to have the capability to respond to the loss of that single largest load or single largest generation unit within the stability of the grid. (TR 484) Witness Roderick admitted that PEF was still in the process of conducting a formal study to validate potential solutions and options to address transmission. (TR 76) Witness Roderick also clarified that irrespective of the type of fuel used, so long as the plant addition created the single largest load or generator, the additional transmission would have to be added. (TR 75)

The transmission upgrades are not necessarily due to the output of CR3, but rather Crystal River Plant becoming the largest single load or generator in Florida and grid stability. As witness Lawton opined, the need for transmission reliability investment is collateral to the uprate issue. These transmission costs should not qualify for inclusion in the fuel clause. (TR 484)

4. Other costs associated with phase 3 of the CR3 Uprate Project?

PEF has demonstrated no justification for including any portion of the costs of Phase 3 of the uprate project in the fuel clause.

For the reasons discussed in subsections 1-3 above, Citizens do not believe any costs associated with Phase 3 of the uprate projects should be recovered through the fuel clause.

ISSUE 2: If the Commission authorizes clause recovery of the CR3 Uprate Project, which cost recovery clause, fuel or capacity, is appropriate for capitalized costs attributable to the uprate?

* No position.*

ISSUE 3: If the Commission authorizes clause recovery of the CR3 Uprate Project, what capital recovery periods should the Commission prescribe for the asset?

* To accomplish a fair matching of the costs of the uprate project and the benefits to be derived, the recovery period should coincide with the useful lives, expected to last through 2036. Each year in which the uprate is operational, customers would pay a pro rata share of the costs of the project and receive the fuel savings associated with the project. By contrast, PEF's proposal would create severe intergenerational inequities to enable the utility to recoup its investment before meaningful fuel savings reach customers' bills. There is no justification for an approach so skewed to favor PEF at customers' expense.*

Irrespective of the methodology of collection for the CR3 project, the capital recovery period for the assets should be the useful lives of those assets. PEF has proposed to assign a 1-year amortization "life" for the CR3 MUR uprate investment. (TR

467) This 1 year life assumes that 100% of the investment will be recovered in the first year of service, which, witness Lawton observed, is an inappropriate assumption. (TR 467) As noted in previous issues, the life expectancy for the MUR investment is 29 years. (TR 467) PEF has also proposed to collect the remainder of the CR3 project costs over a 10 year period. (TR 407) Witness Merchant observed that these projects are designed to last until 2036, or at least 25 years. (TR 408)

As witness Merchant noted, the Uniform System of Accounts, Section 22A, provides that allocation of the service value of depreciable property must be over the service life of the property. (TR 408) Even under the account that PEF proposes to use for its project, the USOA description states that the distribution of the book cost of each investment should be as even as may be over the period of its benefit to the utility. (TR 409) In other words, the amortization expense should be evenly spread over the useful life of the asset, not the period over which fuel savings provide recovery of the costs. (TR 409-410) While witness Merchant noted that the USOA requirements can be waived by the Commission, she stressed that PEF has not shown in this case why a deviation is proper or sound regulatory policy. (TR 410)

For the reasons discussed regarding Phase II and others, the shortened lives also result in severe intergeneration inequities. (TR 408) As witness Merchant testified, the Commission should require that the utility employ the proper regulatory treatment and recover the CR3 project through base rates over the lives of the assets. (TR 412)

<u>ISSUE 4</u>: **Based on the recovery periods prescribed for the CR3 Uprate Project assets, what ratemaking adjustments, if any are necessary?**

Whether PEF recovers the costs of the uprate through base rates or through the clause, the Commission should set the recovery periods to correspond with the expected useful lives. If it allows PEF to use the artificially accelerated lives that the utility proposes, the Commission should make those ratemaking adjustments needed to compensate customers for the loss of the net present value benefits of deferred taxes that they would receive with the application of the standard useful life concept.

As stated in Issue 3, the utility should be required to set the recovery periods of the CR3 uprate projects to the useful lives of the assets. The CR3 assets are expected to be in service until 2036. (TR 408) Thus, the amortization period should be adjusted to reflect the useful lives from date in service to 2036. (TR 408)

However, even if the artificially accelerated lives were used for some or all portion of the projects, the Commission should make those ratemaking adjustments needed to compensate customers for the loss of the net present value benefits of deferred taxes that they would receive with the application of the standard useful life concept. As discussed under Phase II, the proposed shortened lives under PEF's proposal would cause customers to pay about $3.9 million NPV in additional revenue requirements because of the impact of accelerated depreciation on deferred taxes. (TR 476) The customers should be held harmless in this regard should the Commission decide to deviate from normal regulatory treatment regarding the lives of regulatory assets.

Issue 5: **If the Commission authorizes PEF clause recovery of the CR3 Uprate Project, what return on investment should the Commission authorize PEF to include?**

If the Commission denies PEF's proposal, as Citizens urge, this issue will become moot. PEF's proposal to earn 11.75% on its investment in assets flowing through the clause overstates its costs, because the proposed return contemplates the risk of non-recovery associated with base rate treatment, whereas the clause is virtually risk-free as a result of the true-up process. If the Commission were to grant PEF's request for clause treatment, it should authorize a return no greater than the cost of debt. (Citizens recognize that the existing settlement agreement addresses the return on capital items that the Commission permits PEF to flow through clause items during the term of the agreement.)

PEF proposes to apply to the uprate investment the 11.75% return on equity that corresponds to an *overall* cost of capital. That cost of capital reflects the risk of non-recovery associated with items that are built into base rates. With respect to such items, the base rates are designed to provide an *opportunity* to earn the return established as fair and reasonable, but there is no guarantee that the environment in which they operate will be such that the target return will be earned. (TR 465) By contrast, PEF proposes to roll the investment costs into a special cost recovery mechanism that incorporates a "true-up" feature. Because the true-up will ensure that the dollars calculated to be the prudent and reasonable, costs of the project will be recovered, either initially or during the true-up rollover (in which case any shortfall will be collected with interest), the risk contemplated by the 11.75% return on equity sought by PEF would be non-existent if the Commission would grant PEF's request for clause recovery. As witness. Lawton delineated in his testimony, the effect would be to overstate PEF's capital costs, resulting in unfair and unreasonable charges to customers. (TR 478) If the Commission agrees to allow PEF to recover the investment costs of the uprate project through the fuel cost recovery clause, it should limit the return on equity applicable to the investment to reflect the absence of any risk of non-recovery.

PEF points to past orders in which the Commission allowed a utility to apply its overall cost of capital to capital investment items that it permitted the utility to flow through the fuel clause. This is simply an acknowledgment that, perhaps because the amounts generally were for less material, the analysis of the appropriate return on equity to apply to clause-destined capital items was not as refined as that which has been developed by expert testimony in this case. There can be no dispute that the utility's overall cost of capital incorporates the base rate-related risk of non-recovery normally applicable to costs of generation assets, or that the clause would eliminate that risk. It is equally beyond any credible dispute that the application of the 11.75% would overstate the return that is commensurate with the reduced risk or that the application of the 11.75% return to quantify the adder to the fuel factor would overcharge customers follows as a mathematical certainty.

At one point, PEF witness Portuondo asserted that Mr. Lawton was advocating the use of 100% debt financing to the uprate project. (TR 599) As he quickly seemed to acknowledge, his statement was a mischaracterization of Mr. Lawton's testimony. (TR 599) The development of an appropriate return on equity typically involves a "risk premium" to reflect that equity is riskier than debt. That situation is not present when a capital investment passes through a risk-free cost recovery clause.[7] Witness. Lawton appropriately used the cost of debt to represent the return that should be applicable to an equity investment that involves no risk of non-recovery. (TR 477) Witness. Portuondo also argued that the use of a return lower than 11.75% would discourage, not encourage, utilities to undertake projects such as the uprate. However, the utility is entitled only to a return that is fair. A fair return is one that is commensurate with the degree of risk to which the investment is exposed. The Commission should not—indeed, can not—prescribe rates that by definition are unfairly and unreasonably high. PEF cannot have it both ways. It cannot seek the guarantee of a cost recovery clause *and* the higher return

[7] OPC refers here to the risk that a cost deemed prudent and reasonable may not be recovered because of the nature of base rate recovery. PEF may argue that it still faces "risk of a finding of imprudence" with the clause recovery it seeks. That argument does nothing to support its request of 11.75%, because any return the Commission authorizes, in any setting, is applicable only to those amounts that the Commission has determined to be prudent and reasonable.

that is justified by the risk of non-recovery. To the extent a utility wants the certainty of recovery associated with passing a base rate-related investment through a special cost recovery clause (instead of recovering the investment through base rates in the normal fashion), it must anticipate that the return on that investment will reflect the reduced risk that is one of the attractions of the clause to begin with. [8]

ISSUE 6: **If the Commission authorizes clause recovery of the CR3 Uprate Project, how should the costs associated with the project be allocated between wholesale and retail jurisdictions for rate recovery purposes?**

If the Commission denies PEF's proposal, as Citizens urge, this issue will become moot Whether PEF recovers the costs of the uprate through base rates or the fuel cost recovery clause, retail customers should pay for only the portion of the unit that is devoted to retail service. At this point, Citizens have not addressed the specific methodology for accomplishing the appropriate allocation.

ISSUE 7: **If the Commission authorizes clause recovery of the CR3 Uprate Project, what reports, if any, should PEF be required to file with the Commission?**

*If the Commission denies PEF's proposal, as Citizens urge, this issue will become moot. Alternatively, PEF must be required to file a report that clearly identifies the timing and level of all claimed costs incurred along with the corresponding timing and level of cost recovery. Further, PEF must demonstrate the prudence of its expenditures for all investments that would normally nave been given base rate treatment and would have been subject to standard prudence review in a base rate case.

ISSUE 8: **Should this docket be closed?**

[8] OPC acknowledges that the current stipulation agreement provides for the application of 11.75% to plant items that flow through the clause while the stipulation is in effect. The stipulation expires at the end of 2009 unless PEF extends it for 6 months. As a practical matter, this means that, if the Commission allows (over OPC's objections delineated herein) the MUR phase to pass through the clause, the terms of the stipulation regarding the 11.75% would apply to it until the stipulation expires.

The docket should be closed if the Commission denies PEF's petition, as Citizens urge the Commission to do. If the Commission authorizes PEF to collect any of the uprate-related costs through the clause, it should close the docket only if all related issues of updated estimates, prudence of actual expenditures, and implementation are preserved and can be raised in other dockets.

Respectfully submitted,

Charles J. Beck
Interim Public Counsel

s/ Joseph A. McGlothlin
Joseph A. McGlothlin
Associate Public Counsel
Florida Bar No. 163771

Patricia Christensen
Associate Public Counsel
Florida Bar No. 989789

Office of Public Counsel
c/o The Florida Legislature
111 West Madison Street, Room 812
Tallahassee, Florida 32399-1400
(850) 488-9330
Fax: (850) 488-4491

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CERTIFICATE OF SERVICE

I, HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by electronic mail and U.S. Mail on this 28th day of August, 2007, to the following:

Paul Lewis
Progress Energy Florida, Inc.
106 E. College Ave., Suite 800
Tallahassee, FL 32301-7740

John T. Burnett/R. Alexander Glenn
Post Office Box 14042
St. Petersburg, FL 33733

Administrative Procedures Committee
Room 120 Holland Building
Tallahassee, FL 32399-1300

Dept. of Community Affairs
Charles Gauthier
Division of Community Planning
2555 Shumard Oak Blvd.
Tallahassee, FL 32399-2100

Department of Environmental Protection
Michael P. Halpin
2600 Blairstone Road MS 48
Tallahassee, FL 32301

Lisa Bennett
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

James M. Walls/Dianne M. Triplett
P.O. Box 3239
Tampa, FL 33607-5736

John McWhirter
McWhirter Reeves Law Firm
400 N. Tampa Street, Ste. 2450
Tampa, FL 33602

Mike Twomey
P.O. Box 5256
Tallahassee, FL 32314

Beth Keating
106 E. College Ave. Ste. 1200
Tallahassee, FL 32301

Fla. Cable Communications Assoc.
246 E. 6th Avenue, Ste. 100
Tallahassee, FL 32303

Robert Scheffel Wright
225 S. Adams Street, Ste. 200
Tallahassee, FL 32301

James W. Brew
Brickfield, Burchette, Ritts & Stone, P.C.
1025 Thomas Jefferson St., NW
Eighth Floor, West Tower
Washington, DC 20007-5201

Karin S. Torain
PCS Administration (USA), Inc.
Suite 400
1101 Skokie Boulevard
Northbrook, IL 60062

s/ Joseph A. McGlothlin
Joseph A. McGlothlin
Associate Public Counsel