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DATE: November 19, 2010

TO: Office of Commission Clerk (Cole)

FROM: Office of the General Counsel (Saylor, Bennett)
Division of Economic Regulation (Barrett, Lester)

RE: Docket No. 100001-EI – Fuel and purchased power cost recovery clause with generating performance incentive factor.

AGENDA: 11/30/10 – Regular Agenda – Post-hearing recommendation; Participation is limited to Commission and Staff.

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Skop

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: This recommendation should be considered prior to the PEF Mid-course correction recommendation.

FILE NAME AND LOCATION: S:\PSC\ECR\WP\100001.RCM.DOC

Case Background

Progress Energy Florida, Inc. (PEF) experienced an unplanned outage at its Crystal River Nuclear Unit 3 (CR3), starting in mid-December 2009. PEF expects CR3 to return to service in the fourth quarter of 2010. PEF has incurred replacement power costs as a result of the extended outage. PEF is seeking to recover in its 2011 fuel factor all the replacement fuel costs not covered by the Nuclear Electric Insurance Limited (NEIL) policy. PEF provided pre-filed testimony and E-Schedules in support of its proposed 2011 factor. As a result of lower natural gas prices and at the request of staff, PEF's provided revised schedules showing its 2011 fuel factor with and without the costs associated with the outage. Whether PEF should recover the

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replacement power costs was identified as an issue for consideration during the November 2010 fuel clause hearing (Issue 1D).

At the request of staff during the fuel clause hearing, PEF supplied an updated exhibit (Exhibit 71) with revised positions, fuel factors, and E-Schedules based on lower natural gas prices. Exhibit 71 also showed the revised 2011 fuel factor with and without the CR3 outage costs. After some review, PEF and the parties stipulated to admitting this exhibit into the record as a basis for the Commission to preliminarily establish PEF's 2011 fuel factor. In addition, the Commission ordered PEF to file a mid-course correction petition and provide E-Schedules that provide a range of recoverable amounts related to CR3 (100 percent, 50 percent, and zero percent). The Commission deferred its decision on whether to allow PEF to recover the CR3 outage costs in the 2011 factor until the November 30, 2010, Commission Conference.

In deferring its decision, the Commission asked the parties to brief the issues related to the CR3 extended outage and specifically address whether PEF should recover some or all of these costs prior to a prudence determination on the underlying cause of the extended outage. On November 8, 2010, PEF filed its post-hearing brief, Florida Industrial Power Users Group (FIPUG), the Office of the Attorney General (AG), the Office of Public Counsel (OPC), and the Florida Retail Federation (FRF), collectively, Intervenor, filed a joint post-hearing brief, and White Springs Agricultural Chemicals, Inc. d/b/a PCS Phosphate – White Springs (PCS) filed its post-hearing brief.

This post-hearing recommendation addresses PEF's request to recover replacement power costs for its CR3 through the fuel adjustment clause outage prior to the Commission's determination in a separate docket as to the prudence of PEF's actions related to the outage. The issue of prudence will be addressed in Docket No. 100437-EI, a "spin-off" docket.¹ PEF's mid-course correction petition is the subject of another recommendation also filed for the November 30, 2010, Commission Conference. The Commission has jurisdiction over this subject matter pursuant to the provisions of Chapter 366, Florida Statutes (F.S.), including Sections 366.04, 366.05, and 366.06, F.S.

¹ Order No. PSC-10-0632-PCO-EI, issued October 25, 2010, in Docket No. 100001-EI, "spun-off" the issue of prudence to a separate proceeding and Docket No. 100437-EI, In re: Examination of the outage and replacement fuel/power costs associated with the CR3 steam generator replacement project, by Progress Energy Florida, Inc., was established to review the prudence of the cause and costs of the CR3 outage.

Discussion of Issues

Issue 1: Should Progress Energy Florida, Inc., be permitted to collect through the fuel clause, amounts related to replacement power due to the extended outage at Crystal River Unit 3 prior to the Commission's determination of the prudence of such costs in a separate docket?

Recommendation: Yes, PEF should be permitted to collect, subject to refund, replacement power costs due to the extended outage at CR3 prior to the Commission's determination of the prudence of such costs in a separate docket. These costs should be incorporated into the calculation of the 2011 fuel factor. The prudence of such costs will be analyzed in Docket No. 100437-EI. (Sayler, Bennett)

Positions of the Parties:

PEF: PEF did not provide a position in its post-hearing brief. PEF's prehearing position is as follows:

Yes. This legal issue was resolved in Order Number PSC-07-0816-FOF-EI, issued October 10, 2007, in which the Commission held that utilities recover reasonable fuel and capacity charges each year in the fuel docket without a determination of prudence during the fuel clause hearings. Specifically, the Commission noted: "As stated in Order 12645, the fuel clause is a comparison of a utility's projected fuel costs to the costs actually expended. It is not a prudence review." (Order at p. 15, emphasis added). Thus, the collection of replacement power costs in this instance is consistent with Commission precedent and practice.

INTERVENORS: No. Ratepayers should not be required to pay for such costs prior to the presentation of evidence and a determination by the Commission in the separate docket regarding PEF's actions related to the CR3 that outage expenditures are reasonable and prudent. Due process requires that the Commission make a determination of the reasonableness and prudence of PEF's actions before ratepayers' property interests, i.e., ratepayer monies, are adversely affected and they are saddled with an additional rate increase. Allowing recovery before the presentation of evidence related to actions associated with the CR3 outage puts the cart before the horse.

PCS: No. Interim cost recovery in the fuel factor is not warranted at this time. Progress is not entitled to interim recovery and the prevailing state of the Florida economy militates against such recovery prior to the Commission's CR3 prudence determination.

Staff Analysis:

At the conclusion of the November 1-2, 2010 fuel clause hearing, the Commission asked the parties to brief the various options available to the Commission as it relates to PEF's request for recovery of the replacement power costs associated with the CR3 outage. Specifically, the Commission requested that the following options be discussed: (1) recovery of CR3 replacement power costs prior to a prudence review; (2) recovery of CR3 replacement power costs only after a prudence review has been conducted by the Commission; and (3) partial recovery of CR3 replacement power costs in the 2011 factors and partial recovery at a later time. In addition, the Commission asked the parties to brief the following orders and their applicability to the instant case: Order Nos. PSC-97-0359-FOF-EI,² PSC-97-0608-FOF-EI,³ PSC-98-0049-FOF-EI,⁴ (three orders relating to the 1997 CR3 outage for which the Commission approved recovery of outage costs), and Order No. PSC-07-0816-FOF-EI⁵ (relating to the PEF coal refund docket).

As noted in the briefs filed by the parties to this proceeding, the decision whether to allow recovery in the 2011 fuel factor of the replacement power costs associated with the CR3 outage involves both legal and regulatory policy considerations. The parties discussed the three options in their briefs. PEF argues that prior Commission Order Nos. 12645 and PSC-07-0816-FOF-EI require the Commission to approve current recovery of the replacement power costs in the 2011 factor. In the Intervenor's brief, the Intervenor contend that PEF has not met the burden of proving the costs are reasonable as required by Order Nos. PSC-97-0359-FOF-EI and PSC-98-0049-FOF-EI. The Intervenor conclude that the Commission must deny recovery of the CR3 replacement power costs prior to a prudence review. The Intervenor and PCS contend that the Commission has discretion to allow all, some, or none of the costs prior to a prudence review. PEF argues the Commission lacks the discretion to disallow all or a part of the replacement power costs.

Staff's recommendation specifically examines whether the Commission has the discretion to allow the recovery of the costs as argued by PEF, to defer the recovery of the costs as argued by the Intervenor and PCS, or to allow a partial recovery of the costs as suggested by the Intervenor and PCS. Staff has reviewed the parties' arguments and the orders referenced and concludes that all three options are available to the Commission in this docket. At the conclusion of its examination of the parties' arguments and the review of the prior orders, staff will provide the Commission with staff's recommendation.

² Order No. PSC-97-0359-FOF-EI, issued March 31, 1997, in Docket No. 970001-EI, In re: Fuel and purchase power cost recovery clause and generating performance incentive factor.

³ Order No. PSC-97-0608-FOF-EI, issued May 28, 1997, in Docket No. 970001-EI, In re: Fuel and purchase power cost recovery clause and generating performance incentive factor.

⁴ Order No. PSC-98-0049-FOF-EI issued January 7, 1998, in Docket No. 971513-EI, In re: Establishment of additional filing requirements in the fuel and purchased power cost recovery clause when certain threshold levels are met.

⁵ Order No. PSC-07-0816-FOF-EI, issued October 10, 2007, in Docket No. 060658-EI, In re: Petition on behalf of Citizens of the State of Florida to require Progress Energy Florida, Inc. to refund customers \$143 million.

Option 1: Allow Recovery Subject to Refund.

PEF contends that if it meets the requirements of existing orders, the Commission does not have discretion to postpone all or a portion of the recovery of replacement power costs for CR3 in the 2011 fuel factors. PEF asserts that the fuel clause is an ongoing proceeding where the reasonableness of underlying fuel costs sought for recovery is analyzed on an ongoing basis. (PEF BR at 2) PEF argues that allowing utilities to recover fuel costs subject to a subsequent prudence review by the Commission prevents regulatory lag and is consistent with prior Commission decisions. (PEF BR at 8-9) PEF argues that Order 12645, and other Commission orders, allow interim recovery of fuel costs subject to refund. (PEF BR at 9) The allowance of interim recovery of costs, subject to refund, is the *quid pro quo* exchange which the utility makes with the Commission for the uncertainty as to whether those costs will be determined to be prudent. (PEF BR at 9-10) PEF asserts that a regulated utility, in exchange for having its rates set by the regulator, is allowed to recover its reasonable and prudent costs. (PEF BR at 10) PEF argues that because of that regulatory compact, the Commission cannot use its discretion to deny the utility the benefit of timely recovering interim fuel costs which are subject to refund. (PEF BR at 10) According to PEF, the Commission should not deviate from its own policies with no record foundation for doing so. (PEF BR at 10) It is the long standing policy of the Commission to allow recovery if the proper showing for recovery is made. (PEF BR at 10) PEF asserts that it would be arbitrary and capricious if the Commission attempted to disallow interim recovery. (PEF BR at 11)

Staff Analysis of Order No. 12645

Whether a utility may recover fuel costs, subject to refund, prior to a prudence determination requires a discussion of Order No. 12645, issued November 3, 1983, in Docket No. 830001-EU, In re: Investigation of Fuel Adjustment Clauses of Electric Utilities, the order establishing the basis for when the Commission conducts a prudence review in the annual fuel and purchased power cost recovery clause (fuel clause) hearing. This order established that the Commission does not conduct a prudence review of costs in the annual fuel clause hearing unless prudence of a cost is raised as an issue ahead of time. Order No. 12645 at 23 “Although the burden of proving the prudence of its actions will remain with the utility, the question of prudence will arise only as facts regarding fuel procurement justify scrutiny.” *Id.* at 23-24. As the Commission stated, “[q]uestions of prudence require careful and often prolonged study. When a question arises as to the prudence of a utility's expenditures, proper time should be taken to fully analyze the question and resolve the matter on all of the facts available.” *Id.* at 23. Until there are facts and evidence in the record, and time to fully analyze those facts and evidence, no determination of prudence can be properly made. *Id.* at 23-24. In the fuel clause hearing, the Commission will:

accept any relevant proof a utility chooses to present at true-up, but [the Commission] will not adjudicate the question of prudence, nor consider [itself] bound to do so until all relevant facts are analyzed and placed before [it]. [The Commission] will be free to revisit any transaction until [it] explicitly determine[s] the matter to be fully and finally adjudicated.

Id. at 24-25. Pursuant to Order No. 12645, the Commission may approve fuel clause related costs prior to a prudence determination. These costs are subject to further review and refund. Id. at 22. Staff believes this order does not address the issue of how a Commission allows costs to be recovered once a cost is called into question. This order is also silent as to Commission discretion to allow some or all of the costs prior to a prudence determination.

Staff Analysis of Order No. PSC-07-0816-FOF-EI

The Commission's practice to approve fuel clause related costs prior to a prudence determination was reaffirmed by Order No. PSC-07-0816-FOF-EI, issued October 10, 2007, in Docket No. 060658-EI, In re: Petition on behalf of Citizens of the State of Florida to require Progress Energy Florida, Inc. to refund customers \$ 143 million. In this docket, the Commission conducted a prudence review of certain coal purchases made by PEF and an affiliate company. Although this docket came about in response to a motion made in the 2006 fuel clause proceeding, the Commission made clear that it was a "spin-out" consideration. In this Order, the Commission cited Order 12645, discussed above, as the rationale for examining prudence separately from fuel cost recovery clause consideration. This Order stated:

The fuel clause is a comparison of a utility's projected fuel costs to the costs actually expended. It is not a prudence review. We will consider prudence of fuel expenditures when the issue is brought to us by the parties.

Order No. PSC-07-0816-FOF-EI at 15. As reaffirmed by this order, a fuel cost recovery clause proceeding is generally not the venue for a prudence review except when the prudence of a cost being recovered is highlighted as a separate issue for the Commission to determine.

Staff believes that Order No. PSC-07-0816-FOF-EI is not dispositive of the issue of whether the Commission has discretion to postpone recovery of costs when the prudence of those expenditures is called into question. That order affirms Order 12645 in that the Commission may go back to review the prudence of expenditures approved and recovered in the fuel clause. An analysis of the Commission's discretion to allow or defer recovery is found in Order No. PSC-97-0359-FOF-EI, discussed here and again below.

Staff Analysis of Order No. PSC-97-0359-FOF-EI

In Order No. PSC-97-0359-FOF-EI, when considering whether to allow the utility to collect replacement power costs prior to the Commission's prudence review, the Commission stated:

We are confronted with two options to resolve this matter. If we permit recovery now, we can later order a refund of these costs, with interest, if we determine the costs were imprudently incurred. We may also deny recovery at this time, until we have investigated the outage and assessed the reasonableness of management's actions, both before and after the outage occurred. If we delay recovery of these costs until it is determined that all or a significant portion were prudently incurred, however, we may be putting a significant burden on

customers at some future period. That burden will be heightened by interest which will accumulate on the unrecovered costs.

Id. at 14-15. By this Order, the Commission indicates that it has discretion to either allow costs to be recovered prior to a prudence review, or wait until it makes a determination of the prudence of the utility's conduct and then allow those costs to be recovered. In allowing recovery subject to refund, the Commission based its decision on regulatory policy. The Intervenor and PCS also cited Order No. PSC-97-0359-FOF-EI in support of their positions to defer recovery. This Order will be discussed in further detail below.

Option 2: Disallow Recovery Until After a Prudence Review.

Intervenor asserts that the Commission clearly has authority to and should deny recovery of replacement fuel costs until there has been a determination of prudence in the separate proceeding. (Intervenor BR at 1) Intervenor asserts that pursuant to Order No. PSC-97-0359-FOF-EI at 13, as clarified in Order No. PSC-98-0049-FOF-EI, a utility seeking replacement power costs must preliminarily and affirmatively demonstrate two things: 1) that the actions or events that gave rise to the need for the replacement power were reasonable; and 2) that the costs of the replacement power were reasonable. (Intervenor BR at 3-4) Intervenor asserts that PEF only provided sufficient evidence to satisfy the second prong, and failed to provide sufficient evidence to satisfy the first prong. (Intervenor BR at 4) Intervenor argues PEF understood that the Commission required a showing of reasonableness of the actions or events that caused the purchase of replacement power and failed to do so. (Intervenor BR at 5) Intervenor asserts that the Commission should not vitiate or recede from the two-pronged test in Order No. PSC-97-0359-FOF-EI. (Intervenor BR at 6-7) As such, Intervenor asserts that PEF should not be allowed to recover any replacement costs in advance of the subsequent prudence determination. (Intervenor BR at 7)

PEF asserts that it has provided evidence to support the reasonableness of its fuel costs through its regular filings in the fuel clause. (PEF BR at 3) PEF argues that the "actions and events" requirement in Order No. PSC-97-0359-FOF-EI no longer applies because the "actions and events" requirement was not mentioned in Order Nos. PSC-97-0608-FOF-EI and PSC-98-0049-FOF-EI, which the Commission decided subsequently, nor mentioned in any other interim rate recovery proceedings. (PEF BR at 3-4) PEF asserts that Order Nos. PSC-97-0608-FOF-EI and PSC-98-0049-FOF-EI establish that reasonableness of projected costs, as determined by comparing a utility's projected fuel costs to the costs actually expended, is what is required for recovery through the fuel clause. (PEF BR at 4-5)

Staff believes that the three orders referenced by the parties, Orders Nos. PSC-97-0359-FOF-EI, PSC-97-0608-FOF-EI, and PSC-98-0049-FOF-EI, when read together, give guidance to the Commission in the present case.

Staff Analysis of Order No. PSC-97-0359-FOF-EI

In September of 1996, the CR3 unit went offline for an extended period of time. In the 1997 Fuel Clause proceeding, PEF (then doing business as Florida Power Corporation or FPC) sought to recover the replacement power costs associated with the extended CR3 outage. The

following excerpts from Order No. PSC-97-0359-FOF-EI, issued March 31, 1997, in Docket No. 970001-EI, are relevant to the instant case:

We have a great deal of difficulty with allowing recovery of these [replacement power] costs. . . . In the past, we have permitted utilities to recover costs on a preliminary basis, subject to audit, 'true-up' with interest and an after-the-fact prudence review.

...

We are confronted with two options to resolve this matter. If we permit recovery now, we can later order a refund of these costs, with interest, if we determine the costs were imprudently incurred. We may also deny recovery at this time, until we have investigated the outage and assessed the reasonableness of management's actions, both before and after the outage occurred. If we delay recovery of these costs until it is determined that all or a significant portion were prudently incurred, however, we may be putting a significant burden on customers at some future period. That burden will be heightened by interest which will accumulate on the unrecovered costs.

Id. at 14-15. From the order, the Commission displayed some reticence about allowing the utility to recover the 1997 CR3 outage costs. The Commission considered the benefits and burdens to the customers when it considered whether to allow recovery subject to refund of the 1997 CR3 outage replacement power costs prior to a determination of prudence. Ultimately, the Commission allowed the utility cost recovery and initiated a separate docket to determine the prudence of management actions related to the CR3 outage and the replacement power costs.⁶ When considering its two options, the Commission did not cite to any orders; the Commission presumed that it had the discretion to allow or deny the interim recovery.

While the amount of the costs being sought by the utility in 1997 was not mentioned, the amount appears to be significant enough to cause the Commission to require something more than what the utility had provided to the Commission in that fuel clause proceeding. The Commission stated:

. . . In the future, however, when a utility seeks to recover costs which have a significant impact on the utility's fuel adjustment factor, the utility must affirmatively demonstrate prior to approval for recovery that the actions or events that gave rise to the need for the recovery and the underlying costs are reasonable.

Id. at 14. The two additional filing requirements of Order No. PSC-97-0359-FOF-EI can be summarized as follows: 1) "the utility must affirmatively demonstrate prior to approval for recovery that the actions or events that gave rise to the need for the recovery. . . are reasonable," and 2) "demonstrate . . . the underlying costs are reasonable." Id. at 14. While the Commission

⁶ The determination of prudence was spun-out to Docket No. 970261-EI. Ultimately, the parties agreed to a stipulation and settlement approved by this Commission by Order No. PSC-97-0840-S-EI, issued July 14, 1997. The order approving the stipulation and settlement does not have any bearing on the additional filing requirements established by Order No. 97-0359-FOF-EI.

did not define what was required to satisfy the two additional filing requirements in this order, staff believes that subsequent Order Nos. PSC-97-0608-FOF-EI and PSC-98-0049-FOF-EI provide insight into the Commission's intent, as discussed below.

Staff Analysis of Order No. PSC-97-0608-FOF-EI

On April 2, 1997, OPC filed for reconsideration of the PEF replacement power decisions rendered in Order No. PSC-97-0359-FOF-EI. FIPUG joined in OPC's motion. By Order No. PSC-97-0608-FOF-EI, issued May 28, 1997, in Docket No. 970001-EI, the Commission denied OPC's reconsideration. OPC argued in its motion that the Commission erred in allowing recovery because the utility "brought no evidence to the commission in this docket explaining whether, or to what extent [the utility's] replacement fuel costs were prudently, or reasonably incurred." Id. at 3-4. The utility countered, arguing that evidence of prudence was not required as "the Commission has made no final decision with respect to the recovery of replacement fuel costs . . .", because prudence was to be determined in a separate docket. Id. at 4.

The Commission rejected OPC's assertion that the Commission erred in allowing recovery without a showing of prudence, finding that at the time it issued Order No. PSC-97-0359-FOF-EI, "we did not have the issue of prudence . . . before us." Id. at 5. The Commission reinforced this point in stating that "because we have not yet determined whether the [outage] expenditures were prudent, evidence thereon is not required." Id. at 5.

The Commission went on to describe what evidence is needed to show that the underlying costs are reasonable. The Commission stated:

The evidence to be adduced for prospective fuel cost recovery is the reasonableness of the utilities' cost projections. The standard for approval of projected fuel costs is a showing that the projections are reasonable in amount. What is required is a showing that the projected kilowatt-hour sales and projected costs for fuel are reasonable.

Id. at 4. The Commission stated that the utility presented evidence of the reasonableness of its projected fuel costs by proffering into the record "its Schedule E1-B which establishes its fuel cost of system net generation for the period of October 1996 through March 1997. . . ." Id. at 4. The Commission noted that this schedule included the replacement fuel costs associated with the CR3 outage and was discussed by the utility witness' prefiled testimony. Id. at 4. As a result, the Commission determined that there was competent substantial evidence in the record to sustain its finding of reasonableness of the projected fuel costs associated with the outage. Id. at 4. The Commission also noted that none of the parties offered any evidence that alleged the utility's kilowatt-hour sales and fuels costs were not reasonable in amount. Id. at 4. In rejecting OPC's motion for reconsideration, staff believes the Commission explained what evidence is needed to show that the underlying costs associated with an outage are reasonable.

Staff Analysis of Order No. PSC-98-0049-FOF-EI

Because there was some confusion about when the additional filing requirements of Order No. PSC-97-0359-FOF-EI applied, the Commission initiated Docket No. 971513-EI to address its decision in Order No. PSC-97-0359-FOF-EI. By Order No. PSC-98-0049-FOF-EI, issued January 7, 1998, in Docket No. 971513-EI, In re: Establishment of additional filing requirements in the fuel and purchased power cost recovery clause when certain threshold levels are met, the Commission clarified the meaning of “significant impact” which would trigger the additional filing requirements established by Order No. PSC-97-0359-FOF-EI.

In Order No. PSC-98-0049-FOF-EI, the Commission established five percent as the “significant impact” threshold for triggering the additional filing requirements. *Id.* at 4. The Commission noted that while the other parties did not object to five percent being the “significant impact” threshold, OPC and FPC had some concerns with setting the threshold at five percent. *Id.* at 2. Both OPC and FPC offered alternative proposals which the Commission discussed and rejected. *Id.* at 2-4. In addition to establishing five percent as the threshold, the Commission also made the following determinations:

Therefore, we find that prior to interim recovery, utilities must demonstrate in their prefiled testimony, the reasonableness of costs that exceed the threshold for increases in fuel adjustment factor filings as set forth herein. The threshold requirement of Order No. PSC-97-0359-FOF-EI will be triggered whenever fuel costs will result in an increase of 5% or more of the utility’s six-month fuel adjustment factor for the projection period. . . . A 5% or more standard is reasonable and can be administered fairly to all investor-owned utilities, regardless of the level of its fuel adjustment factor. . . .

The preliminary proof of reasonableness required by this Order is not intended to be a substitute for a full prudence review nor does it abridge parties’ rights or obligations in fuel adjustment or prudence proceedings.

Id. at 4. Order No. PSC-98-0049-FOF-EI established the five percent threshold and reiterated that utilities must demonstrate *in prefiled testimony* the reasonableness of costs that exceed the threshold requirement prior to interim recovery. While this order was silent on the “actions or events” requirement in Order No. PSC-97-0359-FOF-EI, it reaffirms the reasonableness of underlying costs requirement.

Staff believes that when these three orders are read together and applied to the current docket, PEF has met the filing requirements. Because the replacement power costs exceeded five percent, PEF was required to show that it was reasonable. The showing of reasonableness was defined by the Commission as the reasonableness of the utilities’ cost projections. The standard for approval of projected fuel costs is a showing that the projections are reasonable in amount. What is required is a showing that the projected kilowatt-hour sales and projected costs for fuel are reasonable. As it did in 1997, PEF submitted testimony and its E1-B schedules to support the reasonableness of the actual and projected fuel costs associated with the outage. Remaining for the Commission in this docket, as it had before it in the 1997 docket, is a policy decision to allow or disallow recovery of replacement power costs prior to a prudence review.

Option 3: Allow a Portion of the Recovery in 2011 Fuel Factors

At the November fuel hearing, the Commission also asked that the parties and staff discuss the Commission's authority to allow a portion of the replacement power costs to be recovered in the 2011 factors and a portion of the costs in a subsequent year.

PEF asserts that the Commission should not arbitrarily apportion the amount of the preliminary costs that PEF may recover. (PEF BR at 11). PEF asserts the Commission has never "split the baby" on the issue of interim recovery and there is no logical grounds to do so. (PEF BR at 11) Instead, the Commission has always allowed the interim recovery of reasonable costs in their full amounts. (PEF BR at 11) To apportion the recovery amount would lead to arbitrary and unreasonable results and cause significant confusion among the Commission, utilities, and customers. (PEF BR at 11)

PCS asserts that the question whether to permit interim cost recovery pending the CR3 prudence review, while described as a legal issue, is in fact a Commission policy issue. (PCS BR at 3) PCS asserts that it is firmly settled that the Commission has the full legal authority to determine whether to permit or deny recovery for some or all of the CR3 outage costs based on the Commission's responsibility to ensure that rates charged to consumers are fair, just and reasonable. (PCS BR at 3) PCS asserts that it is the utility's burden to prove the reasonableness of costs it is seeking to recover from a consumer in rates. (PCS BR at 3) The decision to allow interim recovery falls within the discretion and sound judgment of the Commission. (PCS BR at 3)

PCS also asserts that the Commission should consider the economic circumstances facing the Florida ratepayer. (PCS BR at 5) PCS asserts that the timing of the cost recovery, whether now or after a prudence determination, is important. (PCS BR at 5) PCS asserts it would be a burden on the PEF customer to allow PEF to recover CR3 outage costs in advance of a prudence determination. (PCS BR at 5) The struggling Florida economy should weigh heavily in the decision whether to allow interim recovery. (PCS BR at 5) PCS asserts that the economy along with PEF's failure to offer a *prima facie* demonstration for recovery argue strongly against authorizing CR3 replacement cost recovery in the 2011 fuel factor.

PEF contends that the Intervenors' argument that the Commission should wait to allow preliminary recovery until after a prudence review because the economy is bad is contrary to established Commission policy. (PEF BR at 7) PEF asserts that a "bad economy" is ambiguous and virtually indefinable, and that it should not be considered by the Commission. (PEF BR at 7) PEF asserts Commission policy is to protect customers from a potentially significant burden of later paying recovery costs with interest; instead, PEF asserts that the utility should bear the burden of added interest. (PEF BR at 7-8)

Staff believes that PCS is correct that it is within the Commission's discretion to allow partial recovery of the costs in the 2011 fuel factor. A review of some recent mid-course correction orders gives examples of the Commission exercising its discretion to extend recovery of costs over more than a one-year period. The following is a brief discussion of two orders relating to the Commission's discretion to approve all or a portion of the requested recovery.

Staff Analysis of Order Nos. PSC-08-0494-PCO-EI and PSC-08-0495-PCO-EI

On May 30, 2008, PEF filed a request for mid-course correction to its fuel cost recovery factor, alleging an under-recovery of approximately \$213 million in 2008. On June 3, 2008, FPL filed a separate petition for a mid-course correction to its fuel adjustment factors, alleging an under-recovery of approximately \$746 million in 2008. PEF and FPL requested their mid-course corrections pursuant to the procedures established by prior Commission orders.⁷ By Order Nos. PSC-08-0494-PCO-EI and PSC-08-0495-PCO-EI, issued Aug 5, 2008, in Docket No. 080001-EI (respectively the FPL and PEF mid-course correction orders), FPL and PEF were granted half of their under-recovery in 2008 with the remaining under-recovery being deferred for recovery in their 2009 fuel factors. Staff believes the Commission's reasoning in these two orders is applicable to the instant case.⁸

At the July 1, 2008, Agenda Conference, the Commission allowed the parties and interested persons to address the requested mid-course correction, and concerns were raised about the rate shock consumers would experience in 2008. See Order No. PSC-08-0495-PCO-EI at 6. The Commission stated that “[w]hile the utility is permitted to recover its fuel costs, the Commission retains the discretion to evaluate the rate impact of a mid-course correction upon customers and set rates appropriately.” Id. at 11. The Commission specifically considered the “stability of the fuel factor” and “rate effects and bill impacts” of deferrals when making its decision.⁹ Id. at 11. In discussing the stability of the fuel factor, the Commission stated:

If fuel costs vary significantly from original projections, then fuel factors will be less representative of costs and customers will not receive accurate price signals regarding the cost of electricity. In the case of actual and projected fuel costs being higher than original projections, an under-recovery will result and, if not corrected, will affect the calculation of subsequent year fuel factors. In times of rising fuel prices, such an under-recovery can compound the rate impact in that the subsequent year's fuel factors would reflect higher fuel prices and the under-recovery. In addition, interest would accrue on the under-recovery. Another aspect of deferred under-recoveries is the concept of intergenerational inequity. If a cost is deferred, even a year or portion of a year, a slightly different set of customers will be charged for collection of the costs incurred.

⁷ See Order No. 13694, issued September 20, 1984, in Docket No. 840001-EI and Docket No. 840003-GU, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor; In re: Purchased gas cost recovery clause, and Order No. PSC-98-0691-FOF-PU, issued May 19, 1998, in Docket No. 980269-PU, In re: Consideration of change in frequency and timing of hearing for the fuel and purchased power cost recovery clause, capacity cost recovery clause, generating performance incentive factor, energy conservation cost recovery clause, purchased gas adjustment (PGA) true-up, and environmental cost recovery clause, and Order No. PSC-07-00333-PAA-EI, issued April 16, 2007, in Docket No. 070001-EI.

⁸ Staff notes that the Commission's reasoning for allowing the deferral of half of the under-recovery is nearly identical in both instances. Except where otherwise noted, staff's analysis will cite to Order No. PSC-08-0495-PCO-EI, the PEF mid-course correction order. The one difference between the two orders is that “At [the] Agenda Conference, FPL stated that it agreed that recovery of 50% of its under-recovery in 2008 and 50% in 2009 was acceptable.” See FPL mid-course order at 7. PEF's mid-course correction order is silent on whether PEF agreed or disagreed that 50 percent recovery in 2008 and 50 percent in 2009 was acceptable.

⁹ For a discussion of rate stability, see Order No. PSC-98-0691-FOF-PU, page 4. For a discussion of the impacts of deferrals and mid-course corrections, see Order No. PSC-03-0382-PCO-EI, pages 8 and 9.

Id. at 11. The Commission also noted that it was “balancing the goals of achieving a stable annual fuel factor with the goal of sending accurate price signals to customers.” Id. at 11.

In considering the rate effects and bill impacts, the Commission requested that PEF provide four estimated bill impacts and associated rates/factors options.¹⁰ Id. at 12. In evaluating the four options, the Commission considered whether to approve the entire requested under-recovery in 2008, defer the entire under-recovery until 2009, allow 50 percent in 2008 and defer 50 percent to 2009 (50-50 option), or spread the under-recovery evenly over 17 months (17-month option). Id. at 12. The Commission stated that the four options provided a “reasonable range of alternatives from which to consider possible rate adjustments and bill impacts.” Id. at 12.

After weighing its various options, and by a 3-2 vote in both the FPL and PEF mid-course correction orders, the Commission selected the 50-50 option, stating that “because of the unique economic conditions facing Florida, [it] is in the best interest of ratepayers and the utility alike. The utility will still be permitted to recover its fuel costs and consumers will have additional time to adjust their budgets for the increased rates.” Id. at 12-13. In approving 50 percent recovery in 2008, the Commission was cognizant that it could result in a higher 2009 bill for PEF’s customers than if the entire amount was recovered in 2008. Id. at 13. However, the Commission found that a “stepped increase” would give PEF’s customers a better opportunity to adjust budgets for an expected increase the following year. Id. at 13.

Two Commissioners dissented from the majority’s decision in FPL and PEF mid-course correction orders; one dissented with opinion.¹¹ The dissent opined that deferring a significant portion of an enormous under-recovery could pose substantial risks to ratepayers in the subsequent year if fuel costs continued to escalate. Id. at 15 (McMurrian, *dissent*). The dissent also noted that deferring a portion of the under-recovery, while mitigating immediate rate impact, could increase the severity of the rate impact in the near future. Id. at 16 (Commissioner McMurrian, *dissent*).

Conclusion Regarding Commission Discretion

Based upon a review of the orders discussed above, staff believes that the Commission has the following three options before it to consider as it relates to PEF’s request for recovery of the replacement power costs associated with the CR3 outage: 1) Allow PEF to recover all replacement power costs, subject to refund, prior to the determination of prudence; 2) Defer recovery of the replacement power costs until after prudence has been determined; or 3) Allow a partial recovery of the replacement power costs prior to the prudence determination. Staff believes that the exercise of its discretion is a matter of regulatory policy and not law. For the reasons set forth below, staff believes the Commission should select the first option and allow

¹⁰ The Commission asked FPL to supply four estimated bill impacts and associated rates/factors options. See Order Nos. PSC-08-0494-PCO-EI at 11.

¹¹ In both the FPL and PEF mid-course orders, Commissioner McMurrian dissented with opinion and Commissioner Argenziano dissented without opinion; thus, it is unknown whether Commissioner Argenziano concurred with Commissioner McMurrian’s dissent.

PEF to recovery all replacement power costs, subject to refund, prior to the determination of prudence.

Pursuant to Order Nos. 12645 and PSC-07-0816-FOF-EI, staff believes that the Commission has the inherent authority to approve, subject to refund, the recovery prior to a prudence determination. Since the determination of prudence associated with the CR3 outage has been “spun-off” to a separate proceeding, staff believes that prudence is not ripe for consideration at this time. However, staff believes the issue of whether the Commission should allow recovery of the outage costs is ripe.

Staff disagrees with PEF’s argument that the Commission cannot defer a portion of the requested replacement power costs. In agreement with the Intervenors and PCS, staff believes that the Commission has the discretion to defer all or a portion of the requested recovery amount prior to the determination of prudence. As noted in Order Nos. PSC-08-0494-PCO-EI and PSC-08-0495-PCO-EI, the Commission considered fuel factor stability, ratepayer impact, and price signal accuracy when it considered four options for the under-recovery. Two of the options, the 50-50 option and the 17-month option, expressly considered apportioning the under-recovery amount over two different time periods. Thus, staff believes it is clear from Order Nos. PSC-08-0494-PCO-EI and PSC-08-0495-PCO-EI that the Commission has the discretion to apportion and defer some or all of the requested under-recovery to a later period prior to the determination of prudence. Staff also agrees with the Intervenors and PCS that whether the Commission exercises this discretion is a matter of regulatory policy and not law. Staff notes that if the Commission approves a partial or full deferral of the requested recovery amount, PEF’s customers would bear the burden of paying the carrying charges on the deferred amount if PEF is later deemed prudent.

Staff disagrees with the Intervenors and PCS’ arguments that the Commission cannot permit PEF to recover the CR3 outage costs subject to refund. Staff believes that Order Nos. PSC-97-0359-FOF-EI, PSC-97-0608-FOF-EI, and PSC-98-0049-FOF-EI must be read together *in pari materia*. While the Commission did not define the additional filings requirement in Order No. PSC-97-0359-FOF-EI, staff believes that the Commission subsequently clarified its intent for the filing requirement by Order Nos. PSC-97-0608-FOF-EI and PSC-98-0049-FOF-EI. As discussed above, the additional filing requirements in Order No. PSC-97-0359-FOF-EI are triggered when the outage costs exceed the five percent threshold established by Order No. PSC-98-0049-FOF-EI. Since none of the parties dispute whether the CR3 outage costs exceed the five percent threshold, the following will analyze the additional filing requirements and whether PEF satisfied them.

When there is a significant event affecting the fuel factor by more than five percent, Order No. PSC-97-0359-FOF-EI requires that the utility must affirmatively demonstrate two things to permit recovery of costs in the fuel factor: 1) that the “actions or events” that gave rise to the need for the recovery are reasonable, and 2) that the underlying costs are reasonable. Order No. PSC-97-0359-FOF-EI, however, does not define how the utility must demonstrate the reasonableness of those things. In Order No. PSC-97-0608-FOF-EI, which described what evidence is necessary to show that the underlying costs associated with an outage are reasonable, the Commission did not discuss the two additional filing requirements. In Order No. PSC-98-

0049-FOF-EI, which clarified the five percent threshold requirement, the Commission mentioned the second of the two additional filing requirements but was silent as to the first. While Order No. PSC-98-0049-FOF-EI affirmatively requires that the utility demonstrate the reasonableness of the underlying costs in pre-filed testimony, it does not affirmatively require that the utility demonstrate reasonableness of “actions or events” in pre-filed testimony. Other than quoting the additional filing requirements, Order No. PSC-98-0049-FOF-EI is silent as to how and when a utility must demonstrate the reasonableness of “actions or events” requirement. Because the Commission was silent on the first requirement, it does not mean that the Commission receded from it, as implied by PEF, nor does it mean that it must be demonstrated in pre-filed testimony as argued by the Intervenors and PCS. Staff disagrees with these interpretations for the following reasons.

Staff believes that the reasonableness of “actions or events” requirement is something a utility must demonstrate, but only when the utility is seeking a determination of prudence on the cause of the costs. Staff believes that the requirement for demonstrating the reasonableness of “actions or events” giving rise to an outage is akin to the evidentiary requirement for a prudence determination. As noted by Order Nos. 12645 and PSC-07-0816-FOF-EI, the Commission does not conduct a prudence review of costs in the fuel clause proceeding unless it is specifically raised as an issue. While none of the three CR3 outage orders explain what was required for the first requirement, staff believes logically it applies in the annual fuel clause hearing only when the utility is seeking *both* recovery for costs and a determination of prudence. If it was the intent of the Commission to require that the utility provide pre-filed testimony as to the reasonableness of “actions or events,” then logically the Commission could make a determination of prudence on the cause of the costs. Staff believes that if the Commission is not satisfied with the explanation of the utility seeking recovery of significant costs in the fuel factor, the Commission can always order a separate proceeding to determine the reasonableness and prudence of the “actions or events” giving rise to the costs. See Order No. PSC-97-0359-FOF-EI. For these reasons, staff believes the Commission intended to require reasonableness of “actions or events” be demonstrated in pre-filed testimony only in instances where the issue of prudence is being determined.

Here, PEF has requested recovery subject to refund and, instead of waiting for the Commission to order a separate proceeding to determine prudence, PEF specifically requested that the Commission establish a separate proceeding to determine the prudence of PEF’s actions related to the cause of the outage as well as the costs associated with the outage.¹² Therefore, staff believes since a determination of prudence is not being made at this time, then the first additional filing requirement does not apply.

Staff, however, believes that the second additional filing requirement to demonstrate that the underlying costs are reasonable does apply to PEF’s request for recovery, and that Order No. PSC-97-0608-FOF-EI described how a utility should demonstrate that its underlying costs are reasonable. In rejecting OPC’s motion for reconsideration of Order No. PSC-97-0359-FOF-EI, the Commission determined there was competent substantial evidence in the record to support the reasonableness of the costs being requested. The Commission articulated that to establish the

¹² See Order No. PSC-10-0632-PCO-EI, issued October 25, 2010, in Docket No. 100001-EI.

preliminary proof of reasonableness of the projected costs, the utility should include projected costs in its prefiled testimony and E1-B schedule. This explanation of reasonableness helps describe what is necessary to satisfy the second additional filing requirement. Thus staff believes that the second additional filing requirement could be satisfied if projected costs are included in the utility's prefiled testimony and E1-B schedule.

In its September 2010 filing, PEF provided the parties and this Commission its E1-B schedule and referenced the CR3 outage in prefiled testimony by Witness Olivier. PEF's estimated CR3 replacement power costs were embedded within its September filing and through the process of discovery provided additional schedules showing its fuel factor with and without the CR3 outage costs. On November 1, 2010, during the fuel clause hearing, PEF provided a hearing exhibit (Exhibit 71) reflecting lower natural gas prices and the resulting lower fuel factor with and without the CR3 outage costs.¹³ The parties stipulated to Exhibit 71. During the hearing, no evidence was presented by the parties which questioned the reasonableness of PEF's requested 2011 fuel factor nor the reasonableness of the costs associated with the CR3 outage.

Staff has reviewed Exhibit 71, including the revised positions and supporting "E-Schedules" that reflect lower natural gas prices and revised estimates for replacement power costs. The exhibit presents the original September positions for the Generic Fuel Adjustment Issues, as well as sets of schedules that include or exclude the most current forecasted information for replacement power costs. After reviewing Exhibit 71, staff believes that it contains the evidence necessary to demonstrate that PEF has supported the reasonableness of its system costs as required by Order Nos. PSC-97-0359-FOF-EI, PSC-97-0608-FOF-EI, and PSC-98-0049-FOF-EI.

Staff also believes that the Commission has discretion to approve the recovery of a portion of the replacement power costs for the CR3 outage. In prior proceedings regarding mid-course corrections, the Commission has weighed several policies to determine whether to require a mid-course correction to extend longer than the current year. The Commission has the discretion to consider and apply regulatory policy to the recovery of the costs of the CR3 outage.

Recommendation

The Commission's practice in fuel clause proceedings has been to allow recovery of projected costs, which are then subject to true-up adjustments based on actual costs incurred. Subsequently, the Commission may disallow costs based on a determination of prudence. This practice allows cost recovery in a timely manner while protecting ratepayers by conducting a separate review for potential disallowance, as demonstrated in the recent PEF coal refund case (See Order No. PSC-07-0816-FOF-EI). This practice allows the utilities relatively quick recovery of costs and allows them the cash flow to pay volatile fuel expenses. In exchange, the Commission can conduct a prudence review of fuel costs going back a number of years without having established interim rates or holding money subject to refund.

¹³ PEF filed a petition for mid-course correction on November 10, 2010, and included schedules that show the 2011 fuel factor recovering all, fifty percent, and none of the CR3 outage costs.

Staff believes it was reasonable for PEF to incur replacement power costs due to the CR3 outage. PEF has supported the reasonableness of its request in its initial (September) filing of testimony and exhibits, and in subsequent filings. Staff has reviewed these filings and believes PEF has demonstrated reasonableness for cost recovery purposes.

While the Commission has the discretion to defer recovery of a portion of the costs, such deferral has been generally done to relieve rate shock associated with large increases in fuel factors. The appropriate goal in setting fuel factors, however, is to minimize over-recoveries or under-recoveries (i.e., true-up amounts), by matching rates to costs as closely as possible, and to do so as the costs are being incurred. Otherwise, an under-recovery or deferral of costs coupled with rising fuel prices could exacerbate a future increase in fuel factors. Further, deferring fuel costs, while perhaps appropriate to relieve rate shock, causes additional interest expense. Therefore, staff believes the existing practice of allowing recovery of costs subject to a subsequent determination of prudence is appropriate. Staff notes that the recovery of the CR3 replacement power costs will occur during a time of decreasing fuel rates, and will therefore not create a situation of rate shock, as was the case with the previously discussed 2008 mid-course orders for FPL and PEF. With or without the CR3 replacement power costs, the 2011 fuel factor will be lower than the 2010 fuel factor.

Staff recommends that PEF should be permitted to collect, subject to refund, replacement power costs due to the extended outage at CR3 prior to the Commission's determination of the prudence of such costs in a separate docket. These costs should be incorporated into the calculation of the 2011 fuel factor. The prudence of such costs will be analyzed in Docket No. 100437-EI.

Docket No. 100001-EI
Date: November 16, 2010

Issue 2: Should this docket be closed?

Recommendation: No. The Fuel and Purchased Power Cost Recovery Clause docket is an ongoing docket and should remain open. (Sayler, Bennett)

Staff Analysis: No. The Fuel and Purchased Power Cost Recovery Clause docket is an ongoing docket and should remain open.