

FLORIDA PUBLIC SERVICE COMMISSION

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Tallahassee, Florida 32399-0850

M E M O R A N D U M

January 26, 1995

TO : DIRECTOR, DIVISION OF RECORDS AND REPORTING [BAYO]

FROM : DIVISION OF ELECTRIC AND GAS [DUDLEY, BASS] ^{FD} Rob
DIVISION OF LEGAL SERVICES [JOHNSON] ^{WJ} NCB
DIVISION OF AUDITING AND FINANCIAL ANALYSIS [MAUREY] ^{ALM} APC

RE : DOCKET NO. 950001-EI - PETITION OF TAMPA ELECTRIC COMPANY
FOR RECOVERY OF PEABODY COAL CONTRACT BUY-OUT COSTS. ¹⁰¹ JDJ

AGENDA: 1/31/95 - REGULAR AGENDA - PROPOSED AGENCY ACTION -
INTERESTED PERSONS MAY PARTICIPATE ^{2/7}

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: I:\PSC\AFA\WP\950001.RCM
ATTACHMENT IS NOT AVAILABLE

CASE BACKGROUND

On December 23, 1994, Tampa Electric Company (TECO) filed a petition to recover costs associated with the buy-out of the Peabody Coal Sales, Inc. (Peabody) coal contract. The company proposes to recover the retail portion of a \$25.5 million buy-out payment, plus carrying costs, through the Fuel and Purchased Power Cost Recovery Clause beginning with the April through September 1995 fuel adjustment period. As a result of the contract buy-out, the company estimates that TECO's ratepayers will realize \$88 million in cumulative nominal savings through the year 2004.

On July 8, 1983, TECO and Peabody entered into a twenty year coal contract. Over the years the contract underwent several provision changes. Beginning in 1994, TECO became increasingly concerned about Peabody's ability to reliably ship the contract tonnages. Therefore, on July 8, 1994, TECO indicated their concerns to Peabody and requested some assurances. Peabody did not respond, and on August 11, 1994, TECO sent Peabody an additional letter indicating that they viewed the contract as being cancelled. Peabody then took the matter through several levels of litigation

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until it was successfully resolved by Peabody and TECO agreeing to terminate the disputed contract. TECO and Peabody mutually agreed to terminate the original contract on December 31, 1994, and to replace it with two new contracts beginning January 1, 1995. In addition to obtaining adequate assurances of reliable coal supplies, TECO was also able to obtain significant price reductions that will produce substantial savings over the original contract price.

Once termination of the original contract had been resolved, TECO began negotiating the terms of the two replacement coal contracts with Peabody. The first replacement contract will replace 250,000 tons/yr of the original 750,000 tons/yr and will continue until 2004, the full term of the original contract. The second replacement contract will make-up the remaining 500,000 tons/yr, but will only last until 1999. After 1999, TECO will have to purchase supplemental coal from the spot market to balance out the original 750,000 tonnage requirement. In addition, TECO will also purchase supplemental spot market coal to equate the replacement coal with the original contract on a BTU basis.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission approve TECO's petition to recover costs associated with the buy-out of the Peabody coal contract?

RECOMMENDATION: Yes, the Peabody coal contract buy-out appears to produce substantial savings to TECO's ratepayers. Therefore, the Commission should allow TECO to recover the \$25.5 million buy-out cost plus carrying costs through the Fuel and Purchased Power Cost Recovery clause beginning April 1995. (Dudley)

STAFF ANALYSIS: Exhibit #3 to TECO's filing is an analysis of the projected savings associated with the buy-out. As indicated on the exhibit, TECO projects that the original contract, minus replacement coal cost, simple amortization of the \$25.5 million payment and carrying costs at 13.47%, will provide positive net savings in every year through 2004. Attachment 1 to the recommendation is Staff's analysis of TECO's method and three additional scenarios under which recovery of the buy-out cost could occur. The first is as filed by TECO and as detailed on Exhibit #3. The second scenario has the \$25.5 million payment amortized through 1999, when the second contract ends and TECO begins relying heavily on spot market coal, and carrying costs based on the 90-day commercial paper rate which is also used to calculate fuel adjustment true-up amounts. The third scenario reduces the \$25.5 million plus carrying costs, based on the 90-day commercial paper rate, by the amount of the annual fuel savings until it is fully amortized. However, this scenario offers no benefit to the ratepayer until the fourth year, when the fuel savings begins to outweigh the remaining principal balance. The final scenario, accumulates carrying charges at the rate proposed by TECO, 13.47%, but reduces the amortization period to five years. Though the remaining issues in this recommendation will suggest the appropriate amortization period and interest rate, it should be noted that all four scenarios provide for positive cumulative savings over the projected period.

Because the original contract will be primarily replaced with two new contracts, the only variable component of the projected savings is supplemental spot market coal. As mentioned above, TECO will partially rely on this supplemental spot market coal from 1995 through 1999 and projects to substantially rely on spot market coal beyond 1999. At first, Staff was concerned that TECO may have understated the rate at which the price of spot market coal will

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ISSUE 2: What is the appropriate period for amortizing the \$25.5 million Peabody coal contract buy-out cost?

RECOMMENDATION: Staff recommends TECO be allowed to recover the \$25.5 million Peabody coal contract buy-out cost, plus carrying costs, on a straight line basis over a 5-year period. (Maurey)

STAFF ANALYSIS: Staff has reviewed four options regarding how TECO should be allowed to recover the \$25.5 million Peabody coal contract buy-out cost plus carrying costs. The options are a straight line amortization over a 10-year period with interest at a 13.47% rate of return on the unamortized balance, straight line amortization over a 5-year period with interest at 13.47%, straight line amortization over a 5-year period with interest at the 90-day commercial paper rate consistent with the true-up methodology in the fuel adjustment recovery clause, and a breakeven (variable) amortization over 42 months with interest at the 90-day commercial paper rate.

In its petition, TECO requests that the \$25.5 million buy-out cost, plus carrying costs, be amortized on a straight line basis over the period from April 1995 through December 2004. TECO is requesting that the company be allowed to earn a return of 13.47% on the unamortized balance of the buy-out cost over the 10-year recovery period. The amortization period is based on the years remaining on the canceled contract. The proposed 13.47% before tax rate of return is based on the embedded capital ratios of investor sources of capital approved in the company's last rate case in Order Nos. PSC-93-0165-FOF-EI and PSC-93-0664-FOF-EI (Docket No. 920324-EI), the return on equity of 11.35% approved in Order No. PSC-94-0337-FOF-EI (Docket No. 930987-EI), and the current embedded cost of long-term debt and preferred stock as reported in the company's October 1994 Rate of Return Surveillance Report.

There is precedent for the regulatory treatment requested by TECO. In Order No. 20133 (Docket No. 880001-EI), the Commission approved Gulf Power Company's (Gulf) petition to recover the \$60 million Peabody coal contract buy-out cost, plus carrying costs, through the fuel adjustment recovery clause. The Commission approved a straight line amortization over a 10-year period at a before tax rate of return of 14.69%. The amortization period was tied to the years remaining on the canceled contract. The rate of return Gulf was allowed to earn on the unamortized balance was based on a capital ratio of 58.3% long-term debt at a cost rate of

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9.2% and 41.7% common equity at a cost rate of 13.75%.

In support of its request, TECO reports that because "the canceled contract has been replaced with two contracts at significantly lower coal prices, fuel savings in excess of the buy-out cost are guaranteed." The company also notes that "the fuel savings associated with the new contract coal in the first five years alone exceeds the buy-out cost." The first 5-year period is relevant because it coincides with the expiration of the larger of the two replacement contracts. The first new contract provides 250,000 tons of coal per year from 1995 through 2004. The second new contract provides 500,000 tons of coal per year from 1995 through 1998 and then provides 375,000 tons per year in 1999. Although fuel savings in excess of the buy-out cost are guaranteed over the first 5 years, the actual fuel savings after 1999 will depend on the cost of the replacement coal the company must purchase after the second new contract expires.

Although fuel savings is a major issue in determining if the contract buy-out is in the public interest, Staff believes consideration must also be given to the ramifications of creating an additional long-term regulatory asset. In a special report titled "Deferred Charges Revisited" released by Fitch Research on January 9, 1995, the rating service discussed the issue of deferred charges and regulatory assets in light of the new competitive environment. The report stated:

With competition in the electric market, investors are wary of utilities' deferred assets. The capitalization of utilities' expenses as assets depends on two underlying assumptions: utilities will continue to operate in a monopoly marketplace; and regulatory commissions can and will determine utility revenues based on costs. However, these assumptions are now in question. Regardless of how the future electric power market evolves, it is unlikely that investors will be able to rely on previous regulatory arrangements as an assurance that deferred assets will be recovered.

The implication from the Fitch report is that as the electric industry moves towards increased competition, the utilities with

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higher deferred asset concentration and higher electric production costs will face greater risk that future revenue may not be sufficient to recover prior investments in regulatory assets and deferred charges. Given that the new contracts "lock-in" fuel savings during the first 5 years which exceed the 25.5 million buy-out cost and given the evolving nature of competition in the electric industry, Staff considered additional options involving shorter amortization periods.

Although TECO has requested recovery of the buy-out cost over a 10-year period and contends that a long-term rate of return is appropriate for recovery of this investment, there is precedent for using the rate of return consistent with the true-up methodology in the fuel adjustment recovery clause when the buy-out cost is amortized over a shorter period of time. In Order No. 18670 (Docket No. 880001-EI), the Commission approved TECO's petition to recover the \$49 million Pyramid coal contract buy-out cost, plus carrying costs, through the fuel adjustment recovery clause. In its Pyramid petition, TECO requested a fuel savings sharing plan which involved recovery of fixed amounts over a 45-month period rather than a straight line amortization. The company also requested to earn interest on the unamortized balance "at the actual commercial paper rate in effect from time to time consistent with the true-up methodology set forth in the fuel adjustment filings." However, in Order No. 18670 the Commission found "having considered the methodologies proposed by TECO and the Staff, we conclude that the simplest method would be a four-year, straight line amortization of the \$49 million buy-out costs. This will provide for recovery of a fixed amount during each fuel adjustment period with interest accruing at the rate approved for fuel adjustment proceedings."

TECO contends the regulatory treatment granted Gulf is warranted in this case rather than the treatment granted in TECO's Pyramid contract buy-out. Staff believes because there is precedent for using different rates of return based on the length of the amortization period, the question is actually which amortization period is most appropriate under the current circumstances in the instant case.

Staff conducted a sensitivity analysis of the fuel savings over a 10-year time horizon under several scenarios. Exhibit 3 from TECO's petition was used as the basis for this analysis. Using the company's forecast of annual fuel savings and varying

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only the amortization period and rate of return assumptions associated with recovery of the buy-out cost, Staff was able to determine the annual net fuel savings and cumulative present value savings under the four scenarios presented. Attachment 1 of this recommendation details Staff's analysis. Also provided as Attachment 2 is a graph of the annual fuel savings in nominal dollars under each scenario.

Before Staff explains the results of its analysis, it should be noted that although Staff discusses the options in terms of 5-year and 10-year periods, the actual amortization amounts are calculated over 57 and 117 month periods, respectively. This was done because the amortization will begin in April 1995 and the underlying contracts on which the amortization periods are based will expire in December 1999 and December 2004, respectively.

The net fuel savings over each of the first 5 years is greatest under the 10-year amortization scenario. This translates to the lowest rates for ratepayers in the near-term. However, the cumulative present value savings over the 10-year horizon under this scenario of \$29.4 million is the lowest of the four options presented.

It has been suggested that the company may contend it should be allowed to earn 13.47% on the unamortized balance regardless of whether the amortization period is 10 years or 5 years. Holding the rate of return of 13.47% constant but shortening the amortization period to 5 years produces minor fuel savings in 4 of the first 5 years. The cumulative present value savings of \$31.9 million is greater than the cumulative savings provided under the 10-year option but there is negative savings in 1996. Negative savings in any year means the ratepayers are funding a portion of the buy-out cost in that particular period.

Under the breakeven (variable) amortization option, the net fuel savings are zero over the first 3 years as the annual amortization amounts with interest are matched to fuel savings in each year. However, after 42 months the net fuel savings increases appreciably producing cumulative present value savings over the 10-year horizon of \$36.4 million.

Although the net fuel savings are marginally less over the first 5 years under the 5-year amortization scenario with interest at the commercial paper rate compared to the fuel savings indicated

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under the 10-year amortization scenario, the \$25.5 million buy-out cost is fully recovered and net fuel savings are experienced in each of the first 5 years. As was the case under the breakeven and the other 5-year amortization options, once recovery of the buy-out cost is complete the fuel savings increases appreciably. The cumulative present value savings under this scenario is \$36.6 million, the greatest cumulative amount of savings of the four scenarios presented.

The 10-year amortization option provides the greatest net fuel savings over the first 5 years. From the stand point of pending competition, this option would result in the lowest rates over the near-term. The breakeven amortization option does not allow for any fuel savings over the first 42 months but does provide greater cumulative present value savings over the 10-year horizon. While this option would remove the regulatory asset from the company's books in the shortest amount of time, the variable amortization would increase the administrative burden during true-up in the fuel recovery proceedings.

Based on its analysis, Staff believes the 5-year amortization option with interest on the unamortized balance at the commercial paper rate is a reasonable approach. Staff's recommended treatment allows for greater net fuel savings to be realized and passed on to ratepayers in the near-term than under the breakeven option or the other 5-year amortization scenario and allows for greater net fuel savings to be realized and passed on to ratepayers in the long-term than under the 10-year amortization option. Although Staff's recommended treatment means the regulatory asset will be on the company's books approximately 15 months longer than under the breakeven amortization option, it will be written off 5 years sooner than under the 10-year option. Finally, based on the company's fuel savings forecast, the 5-year option recommended by Staff will produce \$7.2 million more in cumulative present value savings than under the 10-year option and \$4.7 million more than under the 5-year option with interest at 13.47%.

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ISSUE 3: What is the appropriate rate of return TECO should be allowed to earn on the unamortized balance of the Peabody coal contract buy-out cost?

RECOMMENDATION: If a 5-year amortization period as recommended by Staff in Issue 2 is approved, the rate should be the actual commercial paper rate in effect from time to time consistent with the true-up methodology set forth in the fuel adjustment filings. If a 10-year amortization period as recommended by TECO is approved, the rate should be 13.47%. This rate should remain in effect until the Commission issues another order revising the capital ratios and/or the cost rates. (Maurey)

STAFF ANALYSIS: Please see Staff Analysis in Issue 2.

ISSUE 4 : Should this Docket be closed?

RECOMMENDATION: No. The Fuel and Purchased Power Cost Recovery Clause docket should remain open. (Dudley)

STAFF ANALYSIS: This Proposed Agency Action Order shall become final if no protest is filed within 21 days of the issuance of the Order.

TECO Exhibit #3 (13.47% Carrying Cost, 10 yr amrt., \$000)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Total
Amortization, 10yr	0	2,028	2,704	2,704	2,704	2,704	2,704	2,704	2,704	2,704	2,705	26,369
Carrying Costs @ 13.47%	0	2,563	3,098	2,733	2,369	2,005	1,640	1,276	911	547	182	17,323
Total Buy-Out Costs	0	4,591	5,802	5,438	5,073	4,709	4,345	3,980	3,616	3,251	2,887	43,692
Annual Fuel Savings	1,613	7,142	7,641	8,081	7,497	7,871	8,453	8,922	9,747	10,259	10,792	88,018
Net Fuel Savings	1,613	2,551	1,839	2,644	2,424	3,162	4,109	4,942	6,131	7,008	7,905	44,326
Cumulative Net Savings	1,613	4,164	6,002	8,646	11,070	14,232	18,340	23,282	29,413	36,421	44,326	
Present Value @ 8.28% (1995)	1,747	2,551	1,698	2,255	1,909	2,300	2,760	3,066	3,513	3,709	3,863	29,371
Cumulative Present Value	1,747	4,297	5,995	8,250	10,159	12,459	15,220	18,286	21,799	25,508	29,371	

Revised TECO Exhibit #3 (6.03% Carrying Cost, 5 yr amrt., \$000)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Total
Amortization, 5yr	0	4,087	5,450	5,450	5,450	5,450	0	0	0	0	0	25,887
Carrying Costs @ 6.03%	0	1,079	1,151	822	493	164	0	0	0	0	0	3,711
Total Buy-Out Costs	0	5,167	6,601	6,272	5,943	5,614	0	0	0	0	0	29,598
Annual Fuel Savings	1,613	7,142	7,641	8,081	7,497	7,871	8,453	8,922	9,747	10,259	10,792	88,018
Net Fuel Savings	1,613	1,975	1,040	1,809	1,554	2,256	8,453	8,922	9,747	10,259	10,792	58,421
Cumulative Net Savings	1,613	3,588	4,628	6,437	7,991	10,248	18,701	27,623	37,370	47,629	58,421	
Present Value @ 8.28% (1995)	1,747	1,975	961	1,543	1,224	1,641	5,679	5,536	5,585	5,429	5,274	36,594
Cumulative Present Value	1,747	3,721	4,682	6,225	7,449	9,091	14,770	20,305	25,890	31,310	36,594	

Revised TECO Exhibit #3 (6.03% Carrying Cost, 42 mnth amrt., \$000)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Total
Amortization, 42 month	0	6,108	6,648	7,516	5,615	0	0	0	0	0	0	25,887
Carrying Costs @ 6.03%	0	1,034	993	566	127	0	0	0	0	0	0	2,720
Total Buy-Out Costs	0	7,142	7,641	8,081	5,742	0	0	0	0	0	0	28,606
Annual Fuel Savings	1,613	7,142	7,641	8,081	7,497	7,871	8,453	8,922	9,747	10,259	10,792	88,018
Net Fuel Savings	1,613	(0)	0	(0)	1,755	7,871	8,453	8,922	9,747	10,259	10,792	59,412
Cumulative Net Savings	1,613	1,613	1,613	1,613	3,368	11,239	19,692	28,614	38,361	48,620	59,412	
Present Value @ 8.28% (1995)	1,747	(0)	0	(0)	1,383	5,726	5,679	5,536	5,585	5,429	5,274	36,358
Cumulative Present Value	1,747	1,747	1,747	1,747	3,129	8,855	14,534	20,069	25,655	31,084	36,358	

Revised TECO Exhibit #3 (13.47% Carrying Cost, 5 yr amrt., \$000)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Total
Amortization, 5yr	0	4,163	5,551	5,551	5,551	5,551	0	0	0	0	0	26,369
Carrying Costs @ 13.47%	0	2,455	2,618	1,870	1,122	374	0	0	0	0	0	8,439
Total Buy-Out Costs	0	6,618	8,170	7,422	6,673	5,925	0	0	0	0	0	34,808
Annual Fuel Savings	1,613	7,142	7,641	8,081	7,497	7,871	8,453	8,922	9,747	10,259	10,792	88,018
Net Fuel Savings	1,613	523	(528)	660	824	1,945	8,453	8,922	9,747	10,259	10,792	53,210
Cumulative Net Savings	1,613	2,136	1,608	2,268	3,092	5,037	13,490	22,412	32,159	42,418	53,210	
Present Value @ 8.28% (1995)	1,747	523	(468)	563	649	1,415	5,679	5,536	5,585	5,429	5,274	31,912
Cumulative Present Value	1,747	2,270	1,782	2,345	2,994	4,409	10,088	15,624	21,209	26,638	31,912	