State of Florida

Public Service Commission

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

DATE: MAY 3, 2001

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (SLEMKEWICZ, P. LEE, KUMMER, MAUREY)
DIVISION OF LEGAL SERVICES (ELIAS)
DIVISION OF POLICY ANALYSIS AND INTERGOVERNMENTAL LIAISON (TRAPP)
DIVISION OF SAFETY AND ELECTRIC RELIABILITY (JENKINS)

RE: DOCKET NO. 001148-EI - REVIEW OF FLORIDA POWER & LIGHT COMPANY'S PROPOSED MERGER WITH ENTERGY CORPORATION, THE FORMATION OF A FLORIDA TRANSMISSION COMPANY ("FLORIDA TRANSCO"), AND THEIR EFFECT ON FPL'S RETAIL RATES.

AGENDA: 05/15/01 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE ON ISSUES 1 AND 3 ONLY

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\001148.RCM

CASE BACKGROUND

This docket was opened on August 15, 2000, to review Florida Power & Light Company's (FPL or the company) proposed merger with Entergy Corporation (Entergy), the formation of a transco (Regional Transmission Organization) and their effects on FPL's rates and earnings. On April 2, 2001, FPL Group, Inc. announced that the agreement to merge with Entergy had been terminated. The proposed transco, GridFlorida, has been approved by the Federal Energy Regulatory Commission (FERC) and is scheduled to become operational by the end of the year.

At the current time, FPL is operating under a three year revenue sharing plan that was part of a stipulation with the Office

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of Public Counsel, the Florida Industrial Power Users Group, and the Coalition for Equitable Rates. The stipulation was approved in Order No. PSC-99-0519-AS-EI, issued March 17, 1999, in Docket No. 990067-EI. In addition to setting a revenue cap, the stipulation provided for a $350 million annual rate reduction, a reduction in the authorized midpoint for return on equity (ROE) from 12% to 11%, the discretionary amortization of up to $100 million annually to reduce nuclear and/or fossil production plant and various other items. As a result of the revenue cap, FPL refunded $22.8 million during 2000 and expects to refund in excess of $87.8 million, plus interest, during June 2001. The revenue sharing plan ends on April 14, 2002.

Despite the revenue cap, the $350 million annual base rate reduction and the discretionary amortization write-off, FPL's achieved "FPSC Adjusted" ROE has exceeded the maximum of its authorized ROE range every month since the inception of the revenue sharing plan in April 1999. This recommendation is being filed to initiate a base rate proceeding to address the high level of FPL's earnings to become effective with the expiration of the revenue sharing plan.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission order Florida Power & Light Company to file Minimum Filing Requirements?

RECOMMENDATION: Yes. The Commission should order FPL to file Minimum Filing Requirements (MFRs) by August 15, 2001, based on a projected calendar year 2002 test year. (SLEMKEWICZ, P. LEE, KUMMER, MAUREY, TRAPP, JENKINS)

STAFF ANALYSIS: Staff is recommending that MFRs be filed to initiate a base rate proceeding due to concerns about the continuous nature of the high level of FPL's earnings. In the stipulation approved in Order No. PSC-99-0519-AS-EI, it was explicitly recognized that, during the term of the stipulation, FPL's "...achieved return on equity may, **from time to time**, be outside the authorized range..." (emphasis added). Every month since the inception of the revenue sharing plan in April 1999, however, FPL's achieved "FPSC Adjusted" ROE has exceeded the maximum of its authorized ROE range. Over this 23 month period, FPL's achieved ROE has exceeded the 12% ROE ceiling by a range of 4 to 157 basis points through February 2001. On average during this period, FPL's reported ROE has been 49 basis points above the top of the authorized ROE range. This is a conservative figure since it does not reflect the possibility certain adjustments related to items such as the Florida Municipal Power Agency (FMPA) settlement and executive compensation.

FPL has maintained this high level of earnings despite the imposition of the revenue cap and its related refunds, the $350 million annual base rate reduction, the $100 million discretionary production plant amortization write-off, the inclusion of a $69 million settlement with FMPA in November 1999 and the December 2000 recording of one-time costs, including substantial executive compensation expenses, of $62 million related to the failed merger with Entergy. Staff is concerned that, once the revenue sharing plan ends on April 14, 2002, FPL's earnings will continue to exceed its authorized maximum ROE ceiling of 12% with no protection provided for the ratepayers from these high earnings.

There is another factor that could contribute to higher future earnings. As part of FPL's current revenue sharing plan, the annual nuclear decommissioning and fossil dismantlement accruals have been capped at the 1995 prescribed levels and FPL's depreciation rates were capped at their prescribed 1999 levels. FPL filed an updated nuclear decommissioning study at the end of

2000 which is under Staff review. Staff anticipates filing a recommendation for consideration at the November 5, 2001, Agenda Conference. The currently approved nuclear decommissioning annual accruals are $84,024,335 on a retail basis. The annual accruals resulting from FPL's updated decommissioning studies are $81,549,724 on a retail basis. This represents a $2,474,611 decrease in the annual accrual amount. FPL is proposing to maintain the currently prescribed annual accrual level rather than decreasing the level to the amount supported by its decommissioning studies. Under the stipulation, the decommissioning accrual cannot be increased. If the accrual is decreased, it would increase FPL's earnings for 2001 and the remaining period of the stipulation.

Inextricably related to the assessment of earnings is the amount of common equity capital on which the ROE is measured. FPL's equity ratio, while addressed in the Stipulation and Settlement (Stipulation) approved by the Commission in Order No. PSC-99-0519-AS-EI, still remains an ongoing concern. In Section 4 of the Stipulation, FPL agreed to cap its equity ratio at 55.83% on an adjusted basis for surveillance purposes. Although the amount is small, FPL's adjusted equity ratio has consistently exceeded this cap since March 2000. FPL's actual equity ratio, the level upon which earnings are measured, of approximately 65% continues to be well above the average equity ratio for AA-rated electric utilities. This docket will afford the Commission the opportunity to address what an appropriate equity ratio should be for ratemaking purposes after the expiration of the revenue sharing plan.

In addition to the reasons for an earnings investigation outlined above, full MFRs are necessary to ensure proper rate making and cost allocations between rate classes to reflect changes that have occurred since the company's last rate case. FPL's most recent fully allocated cost of service study was filed in 1981 for a projected 1983 test year. Since that time, significant changes have taken place in the company's operations as well as the cost shifting among rate classes that takes place over time.

One of the most significant changes that has occurred since the company's last rate case that will have immediate impacts on Florida consumers is FPL's proposed participation in the GridFlorida RTO. The planned implementation of GridFlorida RTO in December 2001 calls for GridFlorida rates to be filed with FERC in October, 2001. FPL has filed with FERC its intent to divest all of its transmission assets to GridFlorida. FPL will pay the GridFlorida rate determined by FERC for transmission service to

both its wholesale and retail ratepayers. There are a number of issues that are raised by this decision.

Prudence - The first issue to be addressed is the prudence of subjecting its retail and wholesale load to GridFlorida. Up to this point, the FPSC has been foreclosed from addressing whether FPL's decision to voluntarily participate in forming an RTO is prudent, cost-effective, and in the best interests of FPL's ratepayers. In Order No. 2000, FERC stated:

> "Based on the wide array of comments received, which we discuss next, and the voluminous record compiled in this rulemaking proceeding, we conclude that a voluntary approach to RTO formation represents a measured and appropriate response to the technical impediments to competition that have been identified as well as the lingering discrimination concerns that have been raised. We believe that voluntary formation of RTOs will address the fundamental economic and engineering issues which confront the industry and the Commission, and will help eliminate any actual or perceived discriminatory conduct by entities that continue to control both generation and transmission facilities. Further, we believe that the voluntary process adopted in this rule, in conjunction with the innovative transmission pricing reforms that we will permit RTOs to seek, will be successful in achieving widespread formation of RTOs in a timely manner. Our adoption of a voluntary approach to RTO formation in this Final Rule does not in any way preclude the exercise of any of our authorities under the FPA to order remedies to address undue discrimination or the exercise of market power, including the remedy of requiring participation in an RTO, where supported by the record."
> (Order No.2000, pages 100-101)

Although all the Joint Applicants maintain that FERC required them to join an RTO, Order 2000 clearly says the formation of an RTO is voluntary and no Florida utility has filed a formal challenge to FERC's authority in this area. One might suspect that FPL succumbed to the threat, real or imagined, that the FERC would not have approved the now defunct FPL-Entergy merger without the merging parties specifically addressing their participation in an RTO. This, however, does not justify imposing unnecessary or imprudent costs on FPSC jurisdictional ratepayers.

One justification cited for forming GridFlorida is that economic benefits could be derived for Florida consumers by

providing access to more economical generation sources. GridFlorida is unlikely to achieve this goal unless Florida reinforces its internal generation market by allowing merchant plants to construct and operate new generation facilities and sell their generation in Florida's wholesale marketplace. Until the restriction on siting merchant plants in Florida is lifted, it is not clear that FPL can expect any "enhanced competition" benefits from GridFlorida.

Another benefit cited for the formation of GridFlorida is that the transmission owners of the Transco could achieve lower long-run transmission costs by developing a more organized, more centralized, and larger transmission network. At present, however, no GridFlorida participant or stakeholder has quantified the potential savings or benefits that would result from the creation of GridFlorida. In fact, no party has disputed that costs of transmission are likely to increase, at least initially, as a result of participation in GridFlorida due to the cost of the GridFlorida organization itself. FPL has not quantified the benefits it expects to realize for its ratepayers.

With regard to benefits that may be created through economies of scope and scale, FPL has not provided any information on the synergies and savings that may be created by its participation in GridFlorida or how those savings would be passed on to its retail ratepayers. Only in the context of a full base rate proceeding can all of these areas be adequately addressed. Until the Commission makes a finding of prudence on FPL's participation in GridFlorida, Florida ratepayers should not incur any additional costs.

Costs - In addition to questions of prudence, FPL's decision to promote a separate and for-profit RTO and to transfer its transmission assets to that RTO raises a number of questions pertaining to the costs, benefits, and potential impact on ratepayers. While the stakeholder discussions which have taken place in the development of the GridFlorida RTO are a necessary and important undertaking, these discussions have not addressed many of the important public policy issues or specific rate or rate structure issues. In fact, there have been numerous disagreements on what costs properly belong to the transmission operation and how any difference between a utility's embedded transmission cost and costs for GridFlorida services should be recovered.

The economic costs of forming GridFlorida include start-up costs, an initial public offering (IPO), salaries and staffing, administration, and security coordination. On March 8, 2001, FERC approved FPL's request to defer the start-up costs. The FPSC has

not addressed the accounting treatment of these start-up costs. Nevertheless, for retail jurisdictional purposes, the company is currently including these start-up costs as above-the-line rate base adjustments for surveillance purposes. Absent a showing of prudence, it is not clear that it is appropriate for the company to include start-up costs in rate base. Staff would recommend that until such time as FPL demonstrates that volunteering to participate in the formation of GridFlorida is likely to convey a net benefit to FPL's customers, the costs associated with forming GridFlorida should be accumulated in a non-interest bearing non-rate base account so that retail rates are not affected. Further, GridFlorida costs should be excluded from the company's surveillance reports.

The GridFlorida stakeholders have also conceded that there will be winners and losers once GridFlorida is operational due to cost-shifting. The issue of cost-shifting arises because GridFlorida intends to charge a single, statewide average uniform access rate within the region it serves. Cost-shifting occurs because of two changes associated with the GridFlorida wheeling rate. The first is the elimination of pancaked rates mandated by the FERC. Pancaked rates occur when a buyer and seller pays more than one transmission charge to transport power from the point of generation to the point of use. Under Order No. 2000, only one transmission charge may be applied to a transaction, no matter how many utilities it traverses. As a result, utilities will lose some of the revenue they now receive. A second cost-shift involves a single, statewide rate. Transmission increases and decreases to individual utilities are certain to occur depending on how the embedded costs of transmission owners compare to the uniform access rate. Again, the filing of MFRs is needed to identify the extent to which FPL will experience increased costs, or decreased costs, associated with cost-shifting. How these cost-shifts are to be born by the different retail rate classes must also be identified in a fully allocated cost of service study

Rates - As GridFlorida becomes operational, it will submit a filing with the FERC for approval of rates. As stated above, FPL has stated its intent to divest its existing transmission facilities to GridFlorida. Retail rates which currently include a cost component to recover transmission facility costs must be reconciled with the removal of the transmission costs from regulated books and the imposition of new wholesale transmission rates charged FPL by GridFlorida. Rates charged by GridFlorida, including a GridManagement charge, are likely to be greater than embedded transmission costs. If the rates charged under the FERC tariff exceed the amount currently recovered through bundled base

rates, FPL has indicated it may seek to collect the difference through some type of automatic cost recovery clause.

One option to allow the FPSC to maintain oversight of the transmission costs included in retail rates is to unbundle base rates and specifically identify the cost associated with transmission. Depending on the ratemaking treatment approve by the Commission for the transmission component of unbundled retail rates, the Commission could either (1) estimate costs associated with purchasing transmission service from GridFlorida and roll these costs back into base rates on a going forward basis; or (2) establish a new cost recovery mechanism to separately recover these unbundled costs. In any event, as a starting point for this process, MFRs are necessary to determine what transmission costs are currently included in base rates. Any rate recovery, however must be predicated on a finding that FPL's actions in joining GridFlorida were prudent before any costs associated with transmission above those currently born by ratepayers should be allowed to be recovered through retail rates. If the decision to join GridFlorida is shown to be imprudent, all costs associated with GridFlorida should be included below-the-line in the surveillance reports of the company. If the decision to join GridFlorida was to primarily to achieve corporate objectives, shareholders should bear the cost.

These issues are far to complex and interwoven to be addressed in a piecemeal basis. Only with full revenue requirements proceeding with full MFRs including a fully allocated cost study, can this Commission fulfill its obligation to protect Florida ratepayers and ensure that the decision to join the RTO was prudent and that costs are properly assigned and recovered

For all of the reasons stated above, it is Staff's opinion that FPL should be required to file MFRs by August 15, 2001 (approximately 90 days from the date of the vote). Such a filing would have an eight month deadline for placing new base rates into effect by April 15, 2002, the expiration date of the existing revenue sharing plan. It is also Staff's belief that a filing date of August 15, 2001, provides sufficient time to incorporate the effects of any deregulation legislation that might be passed during the current session of the Florida Legislature. Staff is recommending a sooner filing date for FPL than FPC in Docket No. 000824-EI because FPL does not have the additional complication of trying to incorporate the effects on its operations of a recently completed merger into its MFR schedules.

ISSUE 2: Should the Commission order Florida Power & Light Company to place money subject to refund?

RECOMMENDATION: No. The Commission should recognize the terms of the stipulation regarding the mechanism for addressing excessive earnings during the three year period covered by the stipulation. (SLEMKEWICZ)

STAFF ANALYSIS: Although neither the Commission nor the Staff is a party to the stipulation or is bound by its terms, the stipulation was approved by the Commission in Order No. PSC-99-0519-AS-EI. One provision of the stipulation provides that the revenue sharing plan is to be the parties' "exclusive mechanism" to address any excessive earnings that might occur during the term of the stipulation. It is Staff's opinion that this provision provides some measure of protection for the ratepayers and should be recognized by the Commission. For these reasons, Staff recommends that no money be placed subject to refund during the pendency of the proceeding if the recommended filing date in Issue 1 is approved by the Commission.

FPL reported an achieved "FPSC Adjusted" ROE of 12.04% for February 2001. As discussed in Issue 1, however, there are certain expenses included in its Monthly Surveillance Report for February 2001 that might not be appropriate for ratemaking purposes. These are deferred revenues of $87.8 million, discretionary accelerated amortization of $92.6 million and $62 million of one-time merger-related costs. These represent approximately 302 basis points of return on equity. This would increase the reported achieved ROE of 12.04% to approximately 15.06%, well above the authorized 12.00% ROE ceiling.

ISSUE 3: Should this docket be closed?

RECOMMENDATION: No. This docket should not be closed. (ELIAS)

STAFF ANALYSIS: This docket should remain open for the investigation of FPL's earnings and the filing of its MFRs.