Review of Florida's Wholesale Electricity Market

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Summary

Florida should proceed slowly with any changes to its electric industry. Making the transition from a fully regulated market to a competitive market is complicated, uncertain, and risky. It is too early to know the effect of electric competition in other states. Additionally, the Federal Energy Regulatory Commission (FERC) is developing new market power tests and mitigation mechanisms, and is modifying its policy on regional transmission organizations. At this point, the Legislature should only authorize construction of merchant plants in Florida and clarify the issues relating to plant transfer and review authority.

Background

In recent years, Congress and FERC have been encouraging competition in the wholesale electricity market.[1] Several states have taken steps to deregulate their wholesale and retail electricity markets, and Independent Power Producers (IPPs) have increased construction of power plants across the country.[2]

In Florida, several IPPs announced their intention to build and operate wholesale power plants. One IPP was a co-applicant for a determination of need and a permit to build a plant. The Florida Public Service Commission (PSC) found a need for the plant but the Florida Supreme Court overturned the PSC. The Court held that the PSC could determine a need for a proposed plant only if the proposed output was fully committed to use by Florida retail customers, thus a wholesale generator could not be a proper applicant.[3]

Subsequently, during the 2000 Regular Session of the Florida Legislature, a bill was filed to create a study commission on electric industry issues.[4] The bill did not pass, but Governor Bush used it as a model to create the Energy 2020 Study Commission (the Study Commission) by executive order.[5] The purpose of the Study Commission is to determine what Florida's electric energy needs will be over the next 20 years and how best to supply those needs in an efficient,

[1] FERC's primary method of encouraging wholesale competition has been by encouraging opening of electricity transmission systems through Regional Transmission Organizations (RTOs). Basically, an RTO is an independent operator of the electricity transmission system(s) of a utility or group of utilities. While RTO issues will impact the wholesale market, development of RTOs will be done pursuant to FERC requirements and requires no Florida legislation. As such, RTO issues are not considered in this report.
[2] An IPP in a non-utility power generating entity that typically sells the power it generates to electric utilities at wholesale prices. These plants are typically referred to as merchant plants.
[3] For a discussion of *Tampa Electric Co. v. Garcia*, see section IV A of Findings.
[4] SB 2020, by Senator Tom Lee (2000 Regular Session).
[5] Executive Order #2000-127 (2000).

affordable, and reliable manner that will ensure adequate electric reserves.

Although not required to do so, the Study Commission filed an interim report with the Legislature and the Governor on February 6, 2001. Included in the interim report was a proposal that the Investor Owned Utilities (IOUs) transfer their existing plants and plants under construction to their unregulated affiliates at book value, with no monetary exchange. One of the consequences of these transfers would be a shifting of regulatory jurisdiction from the PSC, which regulates retail utilities, including all integrated functions, to the FERC, which regulates the wholesale market. A number of members of the Senate Regulated Industries Committee had concerns about potential harm to ratepayers as a result of the transfer at book value and the loss of PSC regulation.

Subsequently, the President of the Florida Senate directed committee staff to review and evaluate the current wholesale electricity market and formulate recommendations for the Legislature as to what statutory changes are necessary to best ensure an efficient, affordable, and reliable supply of electricity with consistent and fair treatment of those proposing to build power plants.

Methodology

Staff continued to monitor the Governor’s Energy 2020 Study Commission and reviewed and evaluated its final report; met with representatives of the Florida Public Service Commission, the investor owned utilities, those companies gaining or seeking entrance into Florida’s wholesale market, and other interested parties; reviewed developments in other jurisdictions; and reviewed current Florida statutes, Florida case law, and relevant federal law and orders.

Findings

I. Current Situation

Florida's existing regulated, integrated electricity system is working well. Although the system does not provide guarantees as to specific results, it provides a very high level of assurance that both ratepayers and utilities will have certain benefits. All customers will have someone to supply them with electricity; the supply will be reliable, even during peak demand periods or unplanned plant outages; and the rates will be relatively low and without volatility. Utilities will have a captive customer base within a service territory; will recover all costs, including any increases in fuel costs; and will almost always earn a profit within a specified range.

The Study Commission found that:

- Florida has an adequate supply of reasonably priced electricity (page 21);
- There are numerous participants in Florida's energy market, including 56 electric utilities, consisting of five IOUs, 17 cooperatively owned utilities, and 34 municipally owned utilities, and approximately 60 non-utility generators (cogenerators and peakers) (page 21);
- Electric rates have been stable in Florida for more than a decade and, when adjusted for inflation, have declined by 38 percent since 1984 (page 25);
- Florida's average electric rate of 7.1 cents per kilowatt hour (KWH) is slightly above the national average of 6.7 cents per KWH (page 25);
- Florida's electric utility industry has provided reliable service at reasonable prices, despite the fact that Florida produces no generating fuels and all fuels must be transported long distances to the Florida plants and the fact that Florida had rapid growth over the last ten years (page 25);
- Based on current utility plans and projections, for the summer of 2002 Florida will have a total of 48,611 megawatts (MW) of generating assets available in Florida to serve a total firm peak demand of 39,469 MW, giving Florida a 23 percent reserve margin (page 33);[6] and
- While peak demand will increase by over 9,700 MW over the next ten years, peninsular Florida electric utilities plan to build or acquire approximately 15,200 MW of new generating capacity during that time (page 33).

The Study Commission also found that:

- Florida's customer mix is somewhat unusual in that residential customers use approximately 47 percent of all electricity produced, commercial customers approximately 33 percent, industrial customers approximately 10 percent, and 10 percent used for street lighting and other purposes. The national average industrial use is 31 percent. With regard to the number of customers as opposed to level of usage, 89 percent of customers are residential. (page 25)

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[6] Reserve margin is extra generation capacity that is not needed under normal conditions but is necessary in instances of unforeseen power plant outages, unusual weather, maintenance of power plants, and unexpected customer growth.
Non-firm demand is 2,795 MW of this reserve margin. Without it, the reserve margin is 6,347 MW or 15%. Non-firm demand refers to an agreement between utilities and certain customers that during peak demand the utility can interrupt electric service. In return, the customer receives a credit or a discounted monthly rate.
As the system allows utilities to reduce demand instead of increasing supply, they can build fewer power plants. The Study Commission report notes at page 35 that through this process, the equivalent of ten modern, gas-fired power plants have been avoided.

- The fuel mix for Florida power plants in 2000 was 16.6 percent nuclear, 32.2 percent coal, 16.7 percent oil, and 18.6 percent natural gas, with the remainder being non-utility or imported generation. (page 28)

II. Need for Change

It is argued that wholesale competition would produce greater benefits than the current integrated, regulated system. The IPPs argue that the power plants necessary to satisfy the increasing demand for electricity should be built by unregulated generators. They argue that if regulated utilities build the plants in rate base, the ratepayers bear all the cost and risk, while if competitive generation companies build the plants, the ratepayers do not bear risks associated with the capital costs. The IPPs also argue that they can build less expensively and charge lower wholesale prices.

The IOUs argue that to obtain the full benefits of competition, they must be allowed to divest their plants so that all generation is in the competitive wholesale market. They argue that this maximizes the number of competitive sellers in the market and thereby maximizes the effect of the market forces of supply and demand.

The Study Commission states its view on page 54 of the report: “Implemented correctly, competition in the wholesale market should spark innovation and lead to greater efficiencies and lower prices than a regulated market would produce.”

III. Analysis of the Study Commission’s Recommendations

A. Summary of the Recommendation

The Study Commission's goal is to transition to a competitive market by allowing retail utilities to acquire power from a variety of suppliers through contracts with varying lengths and through the spot market. As a result, retail utilities and their ratepayers would no longer be making 20-30 year or more commitments to specific power plants and would no longer bear risk associated with long-term capital costs. The proposed method for accomplishing this transition is to allow IPPs to participate in Florida's wholesale market and allow IOUs to divest existing power plants.

The recommended method for allowing IPPs into Florida is abolishing the determination-of-need process.[7] The Study Commission recommends authorizing

[7] To build a power plant, a generation company would still have to establish that the proposed power plant would meet environmental and local land use and zoning requirements.

the IOUs to divest of their existing power plants in one of two ways. First, they could transfer a plant to an "affiliate" at book value, with no actual cash sale.[8] Second, they could sell a plant to a third party in a cash sale. Divestment of power plants would be optional. Any retained power plants would remain in rate base and remain subject to PSC jurisdiction in traditional cost-based regulation.

The recommendation deals with "stranded investments" associated with divestments through the voluntary nature of divestment, through sharing of profits from plant sales under specified conditions, and through transition contracts.

The theory of "stranded costs" is that when a utility has incurred costs under regulation that it cannot recover under restructuring, a regulatory taking for which the utility should be compensated has occurred. The Study Commission rationalized that by making divestment optional, there is no mandated transfer to a regulatory system in which stranded costs cannot be recovered and therefore there can be no taking. As such, any stranded costs are borne by the utility and its shareholders, not the ratepayers.

There are two types of "stranded benefits," first the excess of market price over book value and second the loss to the ratepayers of the benefits of low cost generation. The recommendation deals with the first type of stranded benefits through sharing of profits from sales in specified circumstances. Sales by an IOU or an affiliate to a third party are to be actual cash sales at market value. When an IOU sells to a third party, or when an affiliate sells a plant that is still subject to a transition contract to a third party, any profit (stranded benefits) are to be shared among the IOU's shareholders and its ratepayers, with a recommendation that the ratepayers receive 50 percent of any profits. When an affiliate sells a plant that is no longer subject to a transition contract, either because it has expired or been cancelled, there are no stranded benefits issues. Additionally, when an IOU transfers a plant to an affiliate, this is done at book value, with no cash exchange. As the transfer is at book value, no stranded investment issues arise.

The recommendation deals with the second type of stranded benefits through

[8] An IOU affiliate is essentially an IPP owned by the same holding company as the IOU: Florida Power & Light Group owns both Florida Power & Light Company, the Florida regulated utility, and Florida Power & Light Energy, a generation company unregulated in Florida and currently building merchant plants in other states; Progress Energy owns both Florida Power, the Florida regulated utility, and Progress Ventures, a generation company unregulated in Florida and currently building merchant plants in Florida and other states; TECO Energy owns both Tampa Electric, the Florida regulated utility, and TECO Power Services, a generation company unregulated in Florida and currently building merchant plants in other states; and Southern Company owns both Gulf Power, the Florida regulated utility, and Southern Power, a generation company unregulated in Florida and currently building merchant plants in other states.

transition contracts of up to six years. The transition contracts are not subject to PSC review. The transition contract for any given plant begins with the transfer or sale of that plant and runs for six years or until cancelled by the IOU. The transition contracts must require the acquiring company to make the plant's generation available to the divesting utility at cost-based rates. The IOU could cancel the contract during the six-year transition period if it could acquire power at a lower price than that specified in the contract, ensuring that the utility and its ratepayers have the lowest priced power. However, cancellation of the transition contract also terminates the requirement to share any profits upon a sale of the plant to a third party.

When a retail load-serving utility (LSU) acquires new energy, it must do so at the lowest cost. Energy would be acquired through competitive bidding (requests for proposals for new capacity needs), negotiated bilateral contracts, and the short-term or spot market. Bidding would be optional except in situations where the LSU purchases electricity from its affiliate. Acquisitions are subject to a PSC prudence review in which, before allowing the utility to pass-on the cost to retail customers, the utility would have to show that the acquisition was prudent and at the lowest cost. In addition to prudence reviews of acquisitions, the PSC could do retail rate reviews and reviews of other costs recovered through cost recovery clauses, such as fuel costs and environmental costs.

Under the recommendation, the PSC also would monitor competition. The Study Commission determined that the state has a vital interest in the functioning of the wholesale market as wholesale prices are a part of retail prices, and excessive wholesale prices can have an adverse impact on all retail customers and on the ability to attract new businesses for economic development. Because of this interest, the Study Commission recommends that the PSC monitor the market and market power.[9] It would have access to books and records and could investigate any potential market abuse. If any market abuse could not be resolved through informal means, such as mediation, the PSC could petition FERC for administrative remedies.[10]

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[9] Market power is discussed in section IV C in Findings.

[10] FERC regulates the wholesale market. It requires that wholesale rates be just and reasonable. Sales are made either under a FERC-approved tariff schedule or bilateral contract or under market-based rates. Market-based rates are prices negotiated between the seller and the buyer and not FERC approved. To obtain market rate authority, a generator must not have, or must have mitigated, market power. Generally, neither blanket market rate authority nor a market-based tariff applies to affiliate transactions. Market-based rates have been allowed in affiliate transactions where the seller can show that there is no potential for disadvantage to ratepayers. Market-based rate authority has been given, for example, where the sale price is pursuant to a market-based tariff that is established independently of seller or buyer (an open market price or a regional price index), or where an offer to buy or sell at the same price, terms, and conditions is

The PSC would continue to have regulatory authority over reliability. The Study Commission notes that in competitive markets, the market forces of supply and demand determine the quantity of a particular good or service produced. This generally leads to a cycle between periods of under-supply with high prices and over-supply with low prices. This could be exacerbated by the fact that electricity cannot be stored. Accordingly, the PSC is authorized to obtain necessary reliability information from load-serving utilities, the regional transmission organization, and the generators. If the PSC determines that there was a potential problem with future reliability, it could order an LSU to acquire additional energy. As a last resort, the PSC could order an LSU to build a power plant.

The PSC would also have access to books and records of affiliates and the ability to prescribe codes of conduct regarding affiliate transactions to prevent cross-subsidization to protect consumers and to prevent unfair competition.

B. Analysis of the Recommendation

The Study Commission's goal is to provide retail utilities with as many sources of electricity as possible, so they can choose from among various alternatives to hedge and minimize costs. Its recommendation would have the potential to get the maximum number of power plants into the competitive market in the shortest time in that it both opens the market to IPPs and allows IOUs to divest all their plants. In making these sweeping changes, however, it creates unnecessary risk.

While a fully functional competitive market typically brings more supply, lower prices, and more innovation, there are some important distinctions here that merit consideration. First, electricity is not a typical product. It is a necessity, and one that cannot be stored, so demand is relatively inelastic. Second, this is not a new market in which competition is developing around a new product or service; it is a switch from a well-developed, integrated, relatively closed, regulated market to an unbundled, open, competitive market. Care must be taken in making such changes. Costs and benefits must be projected and weighed.

However, there was no such process here. When Senator Lee, a member of the Study Commission, asked if there were any projections on potential gains to customers in the proposed competitive market as compared with the customer benefits in the current regulated system, representatives of the IOUs answered that the question could not be answered, that there has to be faith that true competition will deliver the best price.[11]

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simultaneously made to non-affiliates. See pages 73-76 of the Study Commission report for more details on market monitoring and FERC remedies.

[11] August 29, 2001, Meeting Minutes, Florida Energy 2020 Study Commission, Task Force on Stranded Investment.

On page 54 of the Study Commission report, one general study on competition in electricity is briefly discussed as support for the benefits of competition. However, this study was never mentioned or discussed at any Study Commission meeting and so could not have been a factor in the Study Commission's recommendations. Additionally, it appears that Florida, under regulation, has lowered its rates more than the national average as reported in this study. The study was done for the Electric Power Supply Association (the EPSA) by one of its supporting members, Boston Pacific Company, Inc.[12] The study found that inflation-adjusted electricity prices decreased over the period of 1985-1999, with the average reduction in price being 30 percent for residential customers and 36 percent for industrial and commercial customers.[13] But the Study Commission itself found that Florida's inflation-adjusted rates decreased by 38 percent since 1984.[14] Finally, in an article that discussed the EPSA study, a spokesperson for the EPSA indicated that it is still too soon to analyze the effects of competition in the electricity industry because it has not been given full effect yet in any state.[15]

Also, other experts have not favored competition in electricity. A study conducted by the Consumer Federation of America determined that market forces do not work well in electricity markets as demand is fairly constant and is not significantly affected by price increases, which makes market power problems inevitable.[16] The report states that this conclusion is evidenced in a number of markets that have restructured, not just California. Pennsylvania, New York, Massachusetts, and Montana have all seen price increases.[17] Even the United Kingdom, "the longest running major electricity restructuring in the world," changed its pricing mechanism last year after failing for a decade to eliminate market power abuse.[18]

The study determined that competitive electricity markets function well only if all

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[12] EPSA membership details are available at http://www.epsa.org/about/index.cfm?section=about by clicking on "membership" and then "members". The board members of the Electric Power Supply Association include Calpine Corp., Constellation Power Source, Duke Energy of North America, Dynegy, Inc., El Paso Merchant Energy, Enron Corp., Mirant Corp., Reliant Energy, TECO Energy Inc., and Williams Energy Marketing & Trading.

[13] *Assessing the "Good Old Days" of Cost-Plus Regulation*, page 10, Boston Pacific Company, Inc.

[14] *Florida … Energywise! A Strategy for Florida's Energy Future*, Florida Energy 2020 Study Commission, page 22.

[15] *Bills Higher in Open Power Markets*, Tampa Tribune, September 1, 2001.

[16] Cooper, Mark, *Electricity Deregulation and Consumers: Lessons from a Hot Spring and a Cool Summer*, page 16 (Consumer Federation of America, August 31, 2001).

[17] *Id*, at 1-4.

[18] *Id*. at 3.

generators are equal in size and if there is a substantial reserve margin.[19] Additionally, the costs of restructuring may result in higher prices than under regulation due to "excess capacity, excessive scarcity rents and windfall profits, raising the cost of capital, and de-integration increasing transaction costs."[20] Excess capacity costs are the cost of building not just enough reserve margin to meet emergencies but also enough to prevent market power abuses; not just a 15-20 percent reserve margin but perhaps as high as 40 percent. Excessive scarcity rents is the ability of generators to charge higher prices when demand is higher than supply instead of increasing supply. Windfall profits also includes the issue of stranded benefits due to excess of market value of plants over their book value. Raising the cost of capital relates to the difference between capital recovery expectations under competition and regulation. Under regulation, capital recovery is related to the useful life of the plant, with supply and demand coordinated to ensure continued demand and use of the plant. Under competition, generators have no guarantee of continued useful life of a plant and expect and try to recover capital costs in three years. De-integration increasing transaction costs relates to the idea that with more entities involved, there are more transactions and less cooperation, with more administrative costs, additional physical facilities, and many new transaction costs.

The Consumer Federation report recommended that states that have not restructured not do so, and said that if a state was to move forward, competition in the wholesale market is a reasonable starting point.[21] Additionally, states should retain control over generation and transmission assets as long as possible.

Thus reports on competition in other states and elsewhere are in conflict.

Turning to an analysis of the potential benefits of restructuring in Florida, it appears that competition would be limited. As is discussed in the Study Commission report, and as is illustrated in the supply stack diagram on page 29 of the report, fuel prices and economic dispatch play an important part in what energy is actually purchased. Clearly, oil and older gas-fired plants are too expensive and inefficient to compete with the new technology combined cycle gas-fired plants that the IOUs are building and that the IPPs would like to build. On the other extreme, the fuel for nuclear plants is so cheap that nothing can compete with it. Coal is cheap enough that gas-fired generation is unlikely to be competitive with it for the foreseeable future. It is likely that competition will be among the newer combined cycle gas-fired plants.

The likely results are: oil and older gas-fired plants will be largely displaced; with an abundant power supply, the market price will be set at something close to the

[19] *Id*. at 13.
[20] The discussion of these costs is on pages 13-25 of the report.
[21] *Id*. at 27.

cost of production in new technology gas plants; and the price for nuclear and coal generation will increase to just below that market price.

The situation could be drastically altered if there isn't an abundant supply. The Study Commission report acknowledges that an abundant supply and low prices generally are not concomitant; typically sellers produce more when prices are higher and cut back on production as prices decrease. Nonetheless, the Study Commission's recommendations seem to be based on the conflicting assumptions that competition will result in lower prices and that the PSC will be able to require LSUs to acquire an abundant supply of power.

An additional complication to supply and price considerations is the reserve margin requirement. Currently, part of the price of electricity is payment to the utilities to build more generation capacity than they generally need, and therefore having that capacity sit idle at times. However, without this "premium" for a safety reserve margin, there would be power supply problems in times when there is unusual weather or an unforeseen power plant outage, possibly resulting in blackouts. This extra capacity for reserve margin has to be paid for through higher prices at some point, either through higher average prices or price spikes during times of peak demand or shortfalls due to circumstances such as power plant outages.

Adding to this risk is the shift in regulatory authority from the PSC to the FERC. The PSC is here in Florida, is intimately familiar with industry developments, and can react quickly. In contrast, there have been a number of complaints about the lack of FERC enforcement, for example in California and the West. FERC now has a new Chairman and enforcement appears to have improved, but FERC's ultimate role is uncertain at this time.

Another concern with the Study Commission recommendation is how it treats stranded benefits. The recommendation deals with stranded benefits that are due to the loss to the ratepayers of the benefits of low cost generation through six-year, cost-based transition contracts. Whether the 6-year contract term is adequate is subject to question, as the report discusses on page 71. Many of the plants may continue to produce low-cost generation well past the end of the six-year period, and the better policy may be to allow ratepayers to continue to receive this benefit for a longer period. Based on information extracted from the Ten Year Site Plan, none of the IOUs have indicated that they will be retiring any plants of significant size over the next ten years. The biggest plant currently scheduled to be retired is an 80 MW plant to be retired in December 2003. It was placed in service in October 1956.

The recommendation deals with stranded benefits that are due to the excess of market value over book value by requiring that profits from sales to third parties

be split among the IOUs' shareholders and their ratepayers. But there is no recognition of any potential for stranded benefits in cash-less transfers to affiliates, which could be the method of divestment for most plants. This allows the affiliates to realize any and all benefits instead of ratepayers.[22]

Finally, one of the Study Commission members pointed out a potential for manipulation of the process if an affiliate sells to a third party after the divesting IOU has cancelled the transition contract. The member illustrated the potential problem through a hypothetical in which a holding company could make a profit of $50 million dollars if its LSU cancelled a transition contract with its affiliate, the affiliate sold the plant for a $100 million profit, all of which it could then keep, and the LSU acquired more expensive replacement power, on which it has a $50 million loss as a result of the subsequent prudence review.

It does not appear that the PSC has any review or approval authority on contract cancellation decisions. When the report states on page 72 "to protect customers from the possibility that a load-serving utility might terminate a transition contract when doing so would not be in the customers' best interest, the PSC would have the ability, as part of its ongoing regulatory responsibilities, to approve or deny the load-serving utility's decision, including prior to the actual termination of the transition contract," it appears that this refers to PSC authority over the decision to acquire replacement power, not the decision to cancel the contract.

IV. Alternatives to the Study Commission's Recommendations

A. Do Nothing

Although it may seem that doing nothing would be risk-free and leave Florida with the historical status quo, this is not so. There have been several changes in industry practices even without any changes in current law.

First, questions have been raised about the Florida Supreme Court's decision in the Duke – New Smyrna case, *Tampa Electric Co. v. Garcia*, 767 So.2d 428 (Fla. 2000). In this case, Duke Energy New Smyrna Beach Power Company Limited

[22] Since buying an existing plant is the only way an IPP can get a merchant steam generation plant, they are sometimes willing to pay a premium price, a part of which is the price of entry into the Florida market. This should disappear if IPPs are allowed to build modern technology merchant plants in Florida.
What will not disappear is additional value of a plant site attributable to existing capability for expansion, existing pollution permits and local government approval, and existing transmission connections. Also, some plants may have additional value from being located in areas with transmission constraints.

(Duke) was a co-applicant with the Utilities Commission of the City of New Smyrna Beach (New Smyrna) for a determination of need and a permit to build a plant. The plant would have had a net capacity of 514 MW, with 30 MW to be sold to New Smyrna and the remaining 484 MW available to be sold in the wholesale market, primarily, but not exclusively, in Florida. The application was contested by Tampa Electric Company (TECO), Florida Power Corporation (FPC), and Florida Power and Light Company (FPL). The PSC found a need for the plant, and that determination of need was appealed to the Florida Supreme Court. The Court found that the determination of need statute "was not intended to authorize the determination of need for a proposed power plant output that is not fully committed to use by Florida customers who purchase electrical power at retail rates." *Tampa Electric*, at 435. The Court stated "the Legislature must enact express statutory criteria if it intends such authority for the PSC." *Id*.

Since this decision, questions have been raised as to: how much capacity must be committed; for how long it must be committed; and what happens when the contracts expire?[23] To illustrate, Calpine Construction Finance Company, Inc. (Calpine), and Seminole Electric Cooperative, Inc. (Seminole), filed a joint petition for a determination of need for a plant to be built and operated by Calpine.[24] The plant would have a net capacity of 529 MW, with 350 MW committed to Seminole under a 5-year contract, with extensions available in 5-year increments through May 22, 2020. The petition was not contested. The PSC found that Seminole was a proper applicant, that Calpine a proper co-applicant, and that a firm commitment for 350 MW out of 529 MW was sufficient to meet the *Tampa Electric* requirement of fully committed for use by Florida retail customers and therefore granted the determination of need.

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[23] It has been argued that the "fully committed" requirement of *Tampa Electric* requires that for an IOU to obtain a determination of need for a proposed power plant, it must have fully committed all of the proposed capacity to current need of retail customers. December 6, 2001 oral arguments, *Panda Energy International, Inc. v. E. Leon Jacobs, Jr.*, Florida Supreme Court Docket No. SC01-284. This argument seems contradictory to the requirements of building in advance of need to keep an adequate supply and reserve margin.

The facts of this case were as follows. In the determination of need process, the PSC found that 130 MW of the capacity of a proposed 530 MW plant are needed to reach a 20 percent reserve margin in the winter of 2003/04. I*n re: Petition for determination of need for Hines Unit 2 Power Plant by Florida Power Corporation*, PSC Docket No. 001064-EI, Order No. PSC-01-0029-FOF-EI, Issued January 5 2001, page 6. The additional capacity was driven largely by economics, with the PSC noting "FPC is projected to grow into the capacity to be provided by Hines 2, particularly given the projected attrition in FPC's residential load management program."

[24] *In re: Petition for determination of need for the Osprey Energy Center in Polk County by Seminole Electric Cooperative and Calpine Construction Finance Company, L .P.*, PSC Docket No. 001748-EC, Order No. PSC-01-0421-FOF-EC, Issued February 21, 2001.

Second, the decision apparently caused IPPs to focus on building plants under the Siting Act exclusions (with no steam or with steam generation of less than 75 MW) that do not have to go through the Siting Act process. Even an IOU affiliate, DeSoto County Generating Co., a subsidiary of Progress Energy and a sister company to FPC, is building a peaker plant outside the Siting Act.[25] The power plants built outside the Siting Act use single-cycle combustion turbines, which are not as efficient as the combined cycle plants that can be built within the Act, so optimal results are not produced for the citizens of this state.[26]

Third, another IOU began building a plant in rate base and later decided to transfer it to an unregulated affiliate.[27] Gulf Power began building its Smith Unit 3 plant then later filed a petition with the PSC in which it proposed to transfer the plant to Southern Power Company, an affiliated subsidiary of Southern Company, and to buy back the electricity generated at the plant. Gulf did not seek approval of the transfer. It sought approval of passing on to retail customers the costs of buying back the power, under the purchased power cost recovery clause. During the discovery process, the petition was withdrawn without explanation. This situation, however, raised uncertainty about the legal authority of the IOUs to transfer existing generating and transmission assets and the authority of the PSC to review and approve such proposed transfers.

These developments make clear that even if the law is not changed to restructure the wholesale market, Florida will not have the historic status quo. They also make it clear that there is no structured, coherent policy to guide the industry in its future actions. Doing nothing is not an option.

B. "Merchants-only"

The initial incentive for a study commission was to address *Tampa Electric* and allow IPPs to build merchant plants under the Siting Act. As debate expanded to include proposals allowing the IOUs to divest existing plants, the original approach became know as "merchants-only."

The Study Commission heard testimony that Florida is the only state that does not allow IPPs to build merchant plants. This is particularly incongruous as IPPs both

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[25] *Utility Enters Merchant Market*, St. Petersburg Times, July 10, 2001.

[26] However, the situation is better than it could be as either type of gas-fired generation is much cleaner and more efficient than the oil-fired and older gas-fired generation that it displaces.

[27] *In re: Gulf Power Company's petition for approval of purchased power arrangement regarding Smith Unit 3 for cost recovery through recovery clauses dealing with purchased capacity and purchased energy*, PSC Docket 010827-EC, Petition filed June 8, 2001.

can buy existing plants and operate them as merchants and can build merchant peaker plants under the exclusions to the Siting Act. When Pat Wood, now Chairman of FERC, then Chairman of the Texas PSC, testified at a Study Commission meeting, he recommended undoing *Tampa Electric* and getting supply into Florida as soon as possible.

Allowing IPPs to obtain a determination of need under the Siting Act would be beneficial for Florida. The method to accomplish this would be either to abolish the determination-of-need process or to amend the Siting Act to allow IPPs to obtain a determination of need, with the latter being the recommended method.[28]

Allowing construction of merchant plants would shift long-term capital cost risks for these plants from ratepayers to IPPs' shareholders. It would increase both the amount of generation and the number of generators, resulting in more reliability. There should be lower wholesale prices, resulting in lower retail prices. There would be environmental benefits as oil-fired plants, which produce more pollutants, are displaced.

Allowing IPPs to build merchant plants also would be a good way to begin the transition to competition. It would capture some benefits of competition, would begin the process towards broader competition, and would greatly reduce the risks associated with the potential for market abuse and the shift from PSC to FERC regulation.

The argument against the merchants-only approach is that it would not let the affiliates of those IOUs that have market power sell at market rates under FERC rules.

[28] The Florida Supreme Court has indicated a potential problem with a statewide need basis for a determination of need. *Nassau Power Corp. v. Beard*, 601 So2d 1175, fn. 9 (Fla. 1992). In this case, the Court said that an argument that the PSC isn't required to determine need on a utility-specific basis is not consistent with the requirement that the PSC determine the cost-effectiveness of a proposed power plant. The Court stated "this requirement would be rendered virtually meaningless if the PSC were required to calculate need on a statewide basis without considering which localities would actually need more electricity in the future." However, the case involved an application by a cogenerator, which can be distinguished from the issue at hand of statewide need for merchant plants. Cogeneration involves a utility being forced to buy power from a non-utility generator under specified conditions. If the utility has no need, there is no reason to force it to buy the non-utility generator's power. Merchant plants, on the other hand, offer power for sale on the statewide wholesale market, with the only restriction being any transmission constraints. This should be a sufficient factual distinction to avoid application of the Court's prior interpretation on statewide need.

C. "Merchants-only" Plus Divestment

To address the market power/market rates issue, it has been suggested that any proposal to allow building merchant plants in Florida include broad authority for any IOU with market power under FERC rules to divest enough power plants to divest this market power status. This proposal has recently been made more complicated.

FERC allows market-based rates only if the seller and its affiliates do not have, or have adequately mitigated, market power. In the past, FERC's test for market power calculated the market share of installed and uncommitted generation of an applicant for market-based pricing in a particular market. The benchmark for market power was a market share in excess of 20 percent of the market.

Recently, FERC adopted an interim test to be used while it conducts rulemaking to develop a more permanent method of assessing markets and market power.[29] The interim test changes the prior test in two ways. First, in determining the geographic market, the interim test considers transmission constraints, providing a more accurate determination of what supply can reach the buyers in the applicant's market and so compete with the applicant. Second, in determining whether the size of the applicant's market share creates market power concerns, the threshold is whether an applicant is pivotal in the market. This is determined by whether the applicant's capacity exceeds the market's surplus of capacity above peak demand, or the market's supply margin (reserve margin).

If an applicant is found to have market power, it must adequately mitigate the market power to obtain market price authorization. FERC's interim mitigation mechanism prevents withholding of generation to drive up prices by requiring generators with market power to offer all uncommitted capacity for spot market sales. The order mandates use of a "split-the-savings" pricing formula. Basically, the sale price is the seller's cost of production plus one-half of the difference between this cost and the buyer's cost of production.

In a dissenting opinion, Commissioner Breathitt wrote that while she shared the concern about the prior test, she could not support the interim test and its accompanying newly created mitigation mechanisms as they "have been cobbled

[29] United States of America Federal Regulatory Commission, AEP Power Marketing, Inc., AEP Service Corporation, CSW Power Marketing, Inc., CSW Energy Services, Inc., and Central and South West Services, Inc. Docket Nos. ER96-2495-015, ER97-4143-003, ER97-1238-010, ER98-2075-009, and ER98-542-005 (Not consolidated); Entergy Services, Inc. Docket No. ER91-569-009; Southern Company Energy Marketing L.P. Docket No. ER97-4166-008, Order on Triennial Market Power Updates and Announcing New, Interim Generation Market Power Screen and Mitigation Policy, (Issued November 20, 2001).

together very quickly." She wrote that she has no confidence that the test is the best method of assessing market power or that the commission can predict the effect the mitigation mechanisms will have on wholesale competition and the development of markets.

The order has been appealed.

As a consequence of these developments, this approach also creates unnecessary risks. The intended outcome of any action taken now may vary drastically from the actual outcome under new FERC tests and mitigation requirements.

V. Conclusions

Florida should proceed slowly with any changes to its electric industry. While a fully functional competitive market typically brings more supply, lower prices, and more innovation, electricity is not a typical product. As the Study Commission report points out: "Electricity is no ordinary commodity. It is the single most important product that drives Florida's economy, maintains our standard of living, and keeps us comfortable."[30] Additionally, transitioning from a well-developed, integrated, relatively closed, regulated market to an unbundled, open, competitive market is an uncertain and difficult process.

Many factors mandate a slower, more deliberate approach. The ultimate effect of electric competition in other states is not yet known. Moreover, there may not be sufficient mechanisms in place to assist in the transition. Even FERC does not know what the ultimate market power test or mitigation measures will be and how they might affect Florida and its electric industry. The formation of a regional transmission organization is also uncertain; Florida may have GridFlorida or it may be forced to join a geographically broader RTO. Additionally, both the nation and Florida are in the middle of a recession. Finally, no one knows what affect the collapse of Enron will have on the developing competitive markets, on electricity trading and transmission, and on the capital supply for the industry. It has caused the postponement of consideration of a federal electric deregulation bill in the House Energy and Commerce Committee[31] and has caused credit rating agencies to downgrade the credit rating of Dynegy Inc. and Calpine Corp., with companies on negative credit watch including from Standard & Poor's Ratings Group or Moody's including Allegheny Energy, Inc., Calpine, Duke Energy Trading and Marketing, LLC., a unit of Duke Energy Corp., Dynegy, NEG Energy Inc., and Reliant Resources, Inc.[32]

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[30] *Florida … Energywise!*, page 13.
[31] *US House Panel Shelves Electricity Bill Amid Enron Worries*, Reuters, December 17, 2001.
[32] *Rating Agencies Crack Down on Utilities*, Wall Street Journal, December 18, 2001.

Accordingly, the first step should be to allow IPPs to build merchant plants in Florida under the Siting Act using a statewide determination of need. Allowing construction of merchant plants would shift long-term capital cost risks for these plants from ratepayers to IPPs' shareholders. It would increase both the amount of generation and the number of generators, resulting in more reliability. There should be lower wholesale prices, resulting in lower retail prices. There would be environmental benefits as oil-fired plants, which produce more pollutants, are displaced. It will take three years to build these plants and to begin a competitive market. In the meantime, many of the uncertainties listed above should be resolved. At that point, the Legislature can make more informed decisions on IOU divestment of plants.

Additionally, the Legislature should expressly require that the IOUs obtain PSC approval prior to any proposed transfers of power plants or power lines, with the PSC to ensure that the transfer would not be detrimental to ratepayers as to factors such as rates, stranded benefits, and reliability. This not only clarifies the authority of the PSC, but also clarifies that IOUs can divest plants, when appropriate and in an orderly, deliberate fashion. This will assist with divestment of market power.

Although this may appear to be detrimental to the IOUs, it is not necessarily so. Any divestment proposal should contain a requirement for cost-based buy-back transition contracts, such as that proposed in the Study Commission recommendations. Under the Study Commission proposal, for example, divested plants would not be able to enter the competitive market for a minimum of six years anyway. As such, there can be no detrimental impact on the ability of the IOUs or their affiliates to compete for at least that time period. While the ultimate outcome is uncertain, this is a much more deliberate, informed process.

Recommendations

The Florida Legislature should amend the statutes to allow merchant plants to obtain a determination of need under the Siting Act, with the PSC to use a statewide need basis for the determination.

To ensure that the same rules apply to all similarly situated parties and to preserve an orderly process, the Legislature should expressly require that the IOUs obtain PSC approval prior to any proposed transfers of power plants or power lines, with the PSC to ensure that the transfer would not be detrimental to ratepayers as to factors such as rates, stranded benefits, and reliability.

Appendices

Appendix A: Electric Power Supply Association Report -- Assessing the "Good Old Days" of Cost –Plus Regulation

Appendix B: Consumer Federation of America -- Electricity Deregulation and Consumers: Lessons From a Hot Spring and a Cool Summer