

The Bird in Hand: stipulated settlements and electricity
regulation in Florida

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Abstract

In the last two decades many major regulatory issues in Florida have been resolved by means of stipulated settlements between the utilities and interested parties, notably the Office of Public Counsel, instead of by the traditional method of hearings and litigation before the Public Services Commission. This paper investigates the extent, nature and effects of these stipulations in the electricity sector there. They have now largely superceded the litigated process. Their purpose is not to save costs, which are orders of magnitude less than the revenues at stake. Stipulations have brought reductions in electricity revenues worth over \$3 billion, mainly during the last decade. These reductions are greater than would have otherwise occurred: about three quarters might never have occurred at all. In some cases a change in the method of rate reduction favoured industrial consumers but other customers are nonetheless likely to have benefited despite this. Some benefits were outside the scope of the commission to confer. Other benefits reflected a more flexible accounting policy. Most importantly, there has been a shift from conventional rate of return regulation, and from earnings sharing schemes with profits caps, to prices fixed for specified periods of time with revenue-sharing incentive arrangements. Stipulations have transformed the regulatory landscape in the Florida electricity sector, and their use seems worth considering elsewhere.

JEL classification: L51 Economics of regulation, L97 Utilities general, L94 Electric utilities, L 95 Gas utilities, pipelines, water utilities.

Key words: stipulations, settlements, consumer advocate, regulation

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1. Introduction

US public utility regulation has traditionally involved decisions by the regulatory commission following litigation of cases at public hearings. Over the last quarter century some US public utility commissions have replaced or supplemented this process by endorsing settlements (sometimes called stipulations or stipulated settlements) that have been negotiated and agreed in previous discussions between the utilities and other interested parties (or „intervenor“) and their appointed representatives. But relatively little seems to be known about the extent of settlements, and their purpose and effect. How important are they, and what if any difference do they make?

Initially, settlements were seen as a means of speeding up decisions (notably to reduce the backlog at the Federal Power Commission) and reducing costs and uncertainty. More recently there is a recognition that settlements may reflect more accurately the views of the parties, and allow more innovative and creative solutions that the regulatory commissions may not be able to achieve by litigation. Thus, settlements are not so much, or not only, a way of reducing the transactions costs of achieving the same outcome as litigation. Rather, they are a means of achieving a different outcome than litigation, and one that is preferred by the parties involved.¹ Wang (2004) has documented this feature of settlements at FERC. Doucet and Littlechild (2006a) find similar results at the National Energy Board in Canada.

Previous papers (Littlechild 2003, 2006) present evidence from the experience of the Florida Public Service Commission (FPSC) and the Office of Public Counsel (OPC) in Florida, particularly on the extent and effect of the stipulations and settlements negotiated and signed by OPC after its creation in 1974. During 1976-2002, over 30 per cent of earnings reviews in the telephone, gas and electricity sectors were settled by stipulations involving the Office of Public Counsel but only 5 per cent of other cases. Over three quarters of the rate reductions associated with earnings reviews derived from these stipulations, and in the decade 1976-86 the proportion was over 95 per cent. The average value of a rate reduction was seven times higher with a stipulation than without. Only 1 per cent of the rate increases associated with company requests derived from these stipulations. On average a stipulation provided for a lower proportion of the requested rate increase than a litigated outcome did (about one third compared to one half).

These findings are consistent with the findings of Holburn and Spiller (2002) that participation of consumer advocates (like OPC) in regulation leads to lower allowed rates of return and less initiation of rate reviews by utilities. (See also Holburn and Vanden Bergh (2006) on the creation of such bodies.) However, those studies do not explore the role of such advocates in settlements versus litigation, nor do they look at the nature and content of any settlements.

¹ Doucet and Littlechild (2006b) trace the development of legal and economic thinking. For more detailed discussion, see for example Morgan (1978), Krieger (1995), Buchmann and Tongeren (1996) and Schultz (1999). Littlechild and Skerk (2004a,b) show how users rather than the regulatory body have been responsible for transmission network development in Argentina.

Previous research findings, and economic (public choice) theory generally, suggest certain broad predictions about stipulations. The transactions costs of these stipulations are presumably not significant relative to the benefits, and they must embody gains from trade that both parties prefer to the likely outcome of regulation. The stipulations therefore depend upon commitments from the parties that the Commission is unable to give, and/or they embody different values and decisions than those of the Commission. Nevertheless, the stipulations must be sufficiently acceptable to the Commission that it decides to approve rather than reject them.

The present paper looks in more detail at the content of the stipulations that have been agreed in the electricity sector in Florida. The aim is to understand why they were made and to identify differences in outcome compared to what would have happened had the decisions been left to the Commission and staff through the litigated process. This includes assessing whether the agreed rates are higher or lower than they otherwise would have been, whether one class of customer benefited more than another, whether the stipulations differ in other respects from regulatory decisions, how the utilities were enabled to agree rate reductions and what benefits the companies derived from the stipulations.

Section 2 gives some background on utility regulation in Florida and on the electricity sector there. Section 3 examines the costs of litigation that might be saved by settlements. Section 4 summarises the main benefits to customers in the dozen settlements in the electricity sector, and assesses how far these benefits would have been achieved otherwise. Section 5 examines the method of rate reductions and the impact on the distribution of these benefits and whether industrial users benefited disproportionately. Section 6 looks at the potential benefits of stipulations to utilities, including the possibility of actions outside the scope of the FPSC. Section 7 reviews the changes to FPSC accounting policy that stipulations have embodied. Section 8 traces the evolution from rate of return regulation to revenue sharing incentive plans. Section 9 discusses rate structure and quality of supply issues. Section 10 concludes.

2. Background

2.1 Regulation in Florida

The Florida Public Service Commission (FPSC) regulates the telephone, natural gas, electric power and water industries in that state. In 2001 the PSC regulated 5 electric companies, 7 natural gas utilities and 207 water/waste water utilities, all investor-owned, and had more limited regulatory oversight over the telecommunications sector. It had 386 authorised staff positions and an annual budget of approximately \$27 million for fiscal year 2001-2. Littlechild (2006) provides more detail on the regulatory framework in Florida.

The State of Florida set up the Office of Public Counsel (OPC) in 1974. Its duty is to represent the citizens of Florida in utility matters, mainly before the PSC. The Public Counsel is appointed or reappointed annually. After three appointments as Public Counsel in the first four years, a single incumbent (Mr Jack Shreve) held office for over 25 years, until June 2003. The OPC presently has a staff of about 15, and an annual budget of about \$2.5 m. This means that the OPC has less than one twentieth

the staff of the PSC, and its budget is about one tenth that of the PSC. Consultants and expert witnesses are taken on for each case as needed.²

Normal regulatory procedure includes a process of hearings and litigation. The utility may apply for a rate increase or the FPSC may decide to review the situation with a view to a possible rate decrease. The OPC and other interested parties such as customers or competitors can also apply to FPSC for a review. Once FPSC opens a docket, the utility and the OPC and other parties that are accepted as intervenors normally file and counter-file testimony. There is provision for the recognised parties to seek further information. In the absence of a settlement there is a formal hearing involving cross-examination of witnesses, after which FPSC makes its decision on the evidence presented. If a settlement is agreed, this normally happens just before the hearing. FPSC has to approve or reject the settlement. In both cases decisions are taken in the light of advice from staff.

FPSC's policy has been to encourage settlements. For example, in FPC 1987 it quoted Florida law as encouraging settlement.³ It argued that approval of the parties was "highly instructive" in assessing the public interest.⁴ Parties were periodically encouraged to consider settlement.⁵

2.2 The impact of stipulations

Figure 1 shows the nominal base rate increases and decreases approved by the FPSC over the last 35 years.⁶ The figure covers the electricity, gas and telephone sectors, with electricity accounting on average for nearly half the amounts involved. Rate increases gradually rose from a negligible level in the mid-1960s to a peak around 1980 then fell back to a negligible level in the mid-1990s. Rate decreases were at a very low level in the 1960s and 1970s but rose sharply by the end of the period.

² In June 2003 the OPC issued a report on its activities over the period up to Mr Shreve's retirement. State of Florida Public Counsel *Activity Report*, June 30 2003. Of the 26 pages, 3 ½ refer to its activities concerning telephone utilities, 7 to electricity and gas utilities, and 15 ½ to water and wastewater utilities.

³ "It is the policy of the law to encourage and favour the compromise and settlement of controversies when such settlement is entered into fairly and in good faith by competent parties, and is not procured by fraud or overreaching. ... It is in the interest of the state as well as the parties themselves that there should be an end to litigation." 10 Fla. Jur. 2d Compromise, Accord and Release, § 9.

⁴ "To the above criterion we must add: Is the Stipulation in the public interest and are the resulting rates fair and reasonable?" It noted that "in cases such as this, the interests of the ratepayers and the utility encompass our primary concern". In this case the five parties to the Stipulation well represented those interests. "Their separate determinations that approval of this Stipulation is in their best interest is highly instructive, because they, in a broad sense, collectively represent the public interest this Commission is charged with protecting."

⁵ E.g. "You need to know that my philosophy, and the philosophy of the Commissioners, as articulated in every order that we've issued in this case, is that resolution in an informal fashion serves the public interest. So I hope that you will take every opportunity to explore the feasibility of settlement on some of these issues." Chairman Jaber, Prehearing conference February 15, 2002, p. 7, in GPC 2002 (docket 010949).

⁶ Before 1978, all allowed rate increases and required rate reductions were in principle of a permanent nature. From 1978 onwards, there were numerous one-time rate reductions that variously took the form of refunds, rate base reductions, and applications to storm damage reserves, environmental clean-up costs, debt refinancing costs or an escrow account. To enable comparisons between decisions, and for ease of discussion, the figures cited for rate reductions comprise the permanent reductions plus one-quarter times the one-time reductions. The figures are total for each five year period in nominal terms.

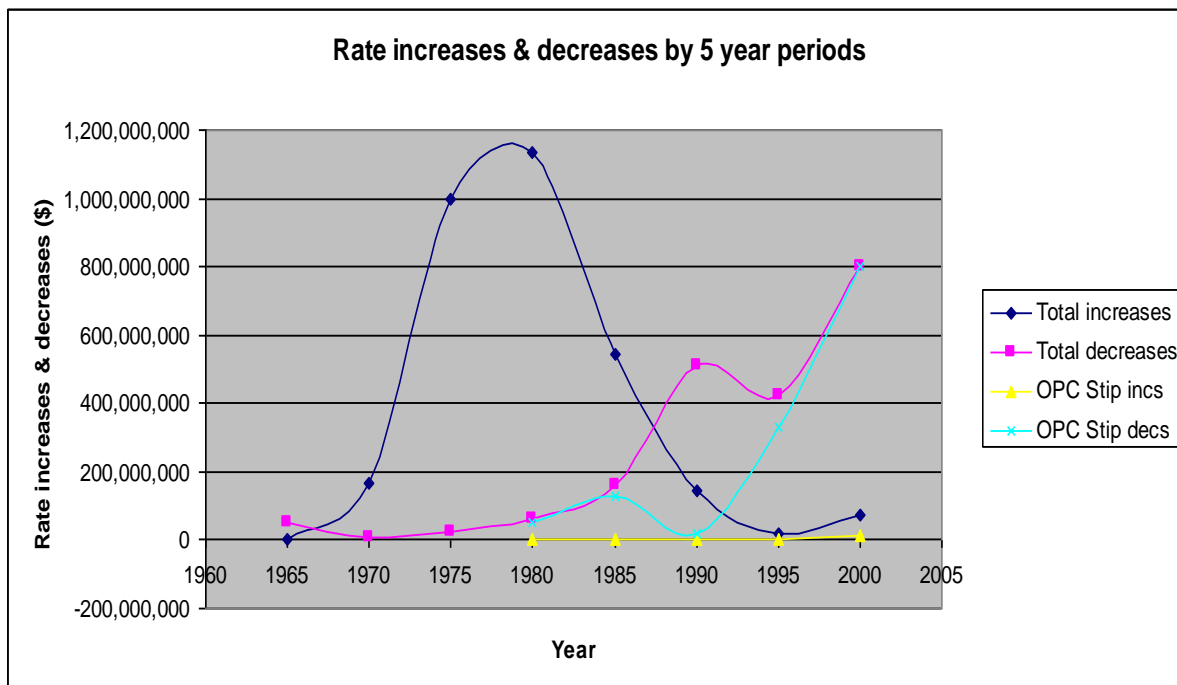


Figure 1 Base rate increases and decreases in Florida utility sector, 1965-2000
Source: Littlechild (2006)

The graph also shows the contribution of the three dozen stipulations in which the OPC participated.⁷ These accounted for virtually none of the rate increases but for almost all of the rate decreases.⁸ Two questions naturally arise. Would the outcomes have been the same in the absence of stipulations involving the OPC? And if the OPC secured greater rate reductions than would otherwise have been achieved, why did the utilities agree to these settlements, and what did the utilities get out of the process?

Since the meetings of interested parties are confidential, there is no public knowledge of what is said therein. However, the stipulations specify the terms of the agreement and sometimes contain some indication of why the parties think the proposal is reasonable. There is usually a written record of the analyses and recommendations of staff. FPSC, which has to be satisfied that the proposed settlement is just and reasonable, will give some explanation of the reasons for its decision. It is possible to look at previous FPSC decisions and actions (or inactions), and sometimes possible to compare the stipulated outcomes with the initial positions of the parties. This paper explores all these sources.

2.3 Structure of the electricity sector in Florida

The electricity market is not open to competition in Florida. The four main companies are vertically integrated, with their own generation plant as well as transmission and distribution lines.⁹ The rate cases examined here are taken from a database

⁷ Until the mid-1970s, PSC staff and companies negotiated many settlements that appeared simply as amounts in a subsequent order of the PSC. Other participants were seldom involved. There was no signed document and usually no reference to any meetings or agreements. After the creation of the OPC the process was formalised and the settlements embodied in written agreements called stipulations.

⁸ The major disparity around 1990 was accounted for by a single large telephone case (Southern Bell Telephone 1988, docket 871401) where the parties attempted a settlement but failed to achieve it.

⁹ The fifth company, Florida Public Utilities Co, owns distribution assets only, in two separate locations (Fernandina Beach and Marianna).

maintained at FPSC that refers primarily to base rates.¹⁰ Base rates cover the costs of building and operating generation plant, and transmission and distribution lines. Base rates exclude fuel costs (which are subject to pass-through arrangements). Over time, other elements such as conservation costs, power purchase costs, certain environmental costs and new security costs have also been excluded from base rates.

Table 1 gives some measures of the different sizes of the five investor-owned electric utilities in Florida. The largest company is Florida Power and Light (FPL). It would typically be involved in base rate increases or reductions measured in hundreds of millions of dollars. The next three companies are Florida Power Corporation (FPC) now known as Progress Energy Florida (PEF), Tampa Electric Company (TECO) and Gulf Power Company (GPC). They would be dealing in tens of millions of dollars. The smallest company (Florida Public Utilities Company) had no case involving more than one million dollars until recently. It has not participated in any settlements and is not considered further herein.

Table 1 Relative sizes of the electricity companies in Florida

Company	Florida Power and Light (FPL)	Florida Power Corporation (FPC)*	Tampa Electric Company (TECO)	Gulf Power Company (GPC)	Florida Public Utilities Company
Rate Base	\$8.4bn	\$3.5bn	\$2.3bn	\$1.1bn	
Number of Employees	9898	4393	2823	1309	350**
Number of customers	3.9m	1.4m	0.6m	0.4m	0.055m
Percentage of customers in Florida	62%	22%	9%	6%	1%

*now Progress Energy Florida (PEF)

Source: FPSC except ** from company website

2.4 Settlements in the electricity sector

The electricity sector in Florida was characterised by modest rate reductions in the 1960s then a series of substantial rate increases in the 1970s and early 1980s. The increases reflected a variety of factors, including inflation, the oil crisis, system expansion and the building of new generation plant including nuclear. In this context the OPC was created in 1974.

Figure 2 shows graphically whether the base rates of the four utilities have been covered by litigated cases (denoted L) or stipulated settlements (denoted S) over the last thirty years. The widths of the four columns correspond broadly to the relative

¹⁰ More precisely, the database is thought to include all FPSC decisions associated with 1) increases or decreases in base rates, 2) changes in authorised return on equity (ROE), and 3) the results of decisions that dealt with earnings or overearnings. I have added two related stipulations that do not appear in this database but nonetheless have implications for base rates, in the first case specifying the costs that should go into base rates and in the second case freezing these base rates.

sizes of the utility companies. The depth of each rectangle indicates the number of years covered by that case or stipulation.

Two features stand out. First, stipulations have gradually taken over from litigated cases. In the first decade 1976-1985 there were a total of 20 base rate cases involving the four major electricity companies; all of them were litigated in the traditional way. In the next decade 1986-1995 there were a further 20 base rate cases, of which 17 were litigated and 3 were stipulated settlements. In the most recent decade 1996-2005 there were only 10 base rate cases, of which all but one were stipulated settlements, and in addition a further two stipulations (denoted S*) covered related base rate matters.

Figure 2 Litigated cases and stipulated settlements in Florida electricity sector

Year	GPC	TECO	FPC	FPL
1976				
1977	L	L	L	L
1978	L			
1979				L
1980	L	L	L	
1981				L
1982	L	L	L	L
1983	L	L		
1984			L	L
1985	L	L		
1986			S	
1987			S	
1988	L	L		L
1989		L(2)		L
1990	L(2)	L		L
1991				L
1992		L	L	
1993	S	L		L
1994		L		
1995		L		
1996		S(2)		
1997			S*(2)	
1998				
1999	S			S
2000		S		
2001				
2002	L		S	S
2003				
2004				
2005			S	S
2006				
2007				
2008				
2009				

Source: FPSC database, plus S*(2) added by author

Second, stipulations typically last longer than litigated cases. The latter determine rates until such time as another case is brought. This could be as soon as the next year. In contrast, the stipulations began to determine rates for three or four years ahead.

A third significant feature of the stipulations is the refunds and rate reductions they brought about. The OPC had begun to achieve rate reductions in the telephone sector, typically by means of stipulations, in the period up to 1986.¹¹ Now it appears there was scope for this in electricity.

Table 2 Electricity sector stipulations

Year	Company Docket	Number of signatories	Base rate change	Other features
1986	FPC 861096	2	\$54m refund	1 year rate freeze
1987	FPC 870220	5	\$121.5m reduction \$18.5m refund	1 year profit sharing
1993	GPC 930139	3	No change	1 year rate freeze
1996a	TECO 950379	3	\$25m refund	3 year rate freeze
1996b	TECO 960409	3	+ \$25m refund	+ 1 year rate freeze
1997a	FPC* 970096	3	No change	Specification of cost treatment to avoid rate increase
1997b	FPC* 970261	8	No change	4 year rate freeze
1999	FPL 990067	4	\$350m reduction	3 year revenue sharing (\$217.8m)
1999	GPC 990947	4	\$10m reduction	3 year revenue sharing
2000	TECO 950379	3	\$13m +\$6.3m refunds	
2002	FPL 001148	8	\$250m reduction	4 year revenue sharing (\$14m)
2002	FPC 000824	6	\$125m reduction	4 year revenue sharing (\$50m)
2005	FPL 050045	9	Rate freeze	4 year revenue sharing
2005	PEF (ex-FPC) 050078	10	Rate freeze	4 year revenue sharing

Total \$856.5m rate reductions + \$141.8m refunds + \$281.8m revenue sharing

Source: Dockets on the website of the Florida Public Service Commission at

<http://www.psc.state.fl.us/dockets/cms/>

¹¹ Over the eight years 1978 to 1986, OPC (together with FPSC staff) had agreed some 19 stipulations with telephone companies. Four of these agreed small rate increases, typically of about \$0.5m in response to company requests of about \$2m. The rest involved more significant rate reductions for over-earnings. Southern Bell, the largest telephone company in Florida, agreed to reduce its rates by \$31m in 1980 and again in 1986, and to make one-time refunds of \$55m, \$12m, \$16m and \$189m on these and other occasions. The stipulations with other telephone companies agreed one-off rate reductions or refunds ranging from \$15,000 up to \$16m, averaging about \$6m each.

The first stipulation between OPC and an electricity utility was in 1986, and secured a \$54m refund from Florida Power Corporation (FPC). Over the next two decades the OPC and the four main electric utilities negotiated and agreed fourteen stipulations related to base rates. Table 2 summarises the headline terms that these stipulations embodied. In total they delivered over \$1 bn of benefits to customers, comprising rate freezes, over \$850m of rate reductions (that is, „permanent“ reductions in annual allowed revenues that will continue annually until otherwise modified), over \$140m of immediate one-time refunds, plus over \$280m from revenue-sharing provisions. None of the stipulations involved base rate increases.¹²

The number of signatories varied from 2 to 10, with the median being 4. This includes OPC and the utility, so there are typically two additional intervenor parties but there have been up to 8 others. The averages over individual companies are GPC 3.5, TECO 3.0, FPC/PEF 5.7 and FPL 7.0 signatories. Thus, not surprisingly, the larger the company, the greater the number of interested parties tend to participate as intervenors. This does not appear to have hindered the ability to reach agreement on stipulations. Discussion with parties involved and transcripts of hearings suggests that OPC made most of the running, with other parties indicating that they supported OPC’s position on many issues.

FPSC approved all the stipulations. Very occasionally it seems that the wording or content of the stipulation was tailored to reflect a potential FPSC concern.¹³

3. Settlements and the costs of regulatory proceedings

Stipulations frequently make reference to avoiding the time, uncertainty and cost of continued litigation.¹⁴ However, in Florida stipulations are typically signed only a few days before the assigned date for the administrative hearing. That hearing might be scheduled to take only a week or two and FPSC would normally issue its decision shortly thereafter. So any time saving is small, and any uncertainty would resolve itself in a matter of weeks.¹⁵

¹² During 2006, stipulations to resolve the treatment of storm damage costs were under active discussion with two utilities. In the event, a stipulation was not agreed with FPL (docket 060038) and FPSC authorised by a monthly surcharge on bills to finance a bond issue. OPC later agreed a stipulation with GPC (docket 060154) that did not involve any increase in the existing surcharge. It is not clear whether there was a difference in the financial position of the two companies that enabled GPC to recover more of its storm costs in its existing base rates than FPL could.

¹³ For example, one element of the GPC 2006 stipulation (previous footnote) was modified after staff expressed concern (later endorsed by FPSC) that it unacceptably delegated (to the utility) FPSC’s statutory authority to authorise a change in rates.

¹⁴ E.g. “This Stipulation and Settlement avoids the time, expense and uncertainty associated with adversarial litigation in keeping with the Florida Public Service Commission’s long-standing policy and practice of encouraging parties in contested proceedings to settle issues whenever possible.” (GPC 1999) “[T]he parties are entering into this Settlement Agreement to avoid the expense and length of further legal proceedings and the uncertainty and risk inherent in any litigation”. (TECO 2000)

¹⁵ Management and investors may nonetheless value the reduction of uncertainty, especially on terms acceptable to the utility. E.g. “Although this outcome is below the original request from FPL, we believe coming to a solution without a long drawn-out potentially litigated process is a more constructive outcome and removes a major overhang for the stock.” UBS Utilities 23 August 2005, commenting on the resolution of FPL 2005.

Although stipulations save some costs, this is only a proportion of the total costs of litigation. For example, the costs of litigation that are normally incurred before a stipulation is considered include the costs of preparing the case, getting the relevant information, completing Minimum Filing Requirements (MFRs) and participating in the discovery process. These costs are considered to account for up to three quarters of the total cost. The additional costs that would be incurred if litigation went ahead and that would be saved if a stipulation were agreed include the costs of the hearing itself, the briefing that precedes it, and the likelihood of an appeal thereafter. These latter costs account for somewhat over a quarter of the total. The parties would need to brief witnesses and prepare testimony in the event that there was no agreement on a stipulation. Such agreement is generally reached only a very short time before the hearing is due to take place, and agreeing the stipulation itself requires intensive participation at senior level. Thus, the costs saved by agreeing a stipulation rather than going to litigation are of the order of a quarter of the total costs of litigating a case, or at most a little more.

3.1 Illustration: the largest electricity utility

To assess and illustrate the potential cost savings from a settlement, consider first the case of Florida Light and Power (FPL), the largest electricity utility in the state, and the **FPL 2002** settlement which involved the largest electricity revenue reduction. I understand that the utility filed projected rate case expenses at about \$5m. Some might say that such expenses do not include all the costs, including those of executive time, and that the full cost might be about double the filed expense. Others might argue that this projection was excessive.¹⁶ In the event, “FPL has stated in its press release that a million dollars in rate case costs will be saved by the Stipulation.”¹⁷

Contrast this figure with the \$250m rate reduction in this stipulation. This reduction applied for four years (and provided for one-time refunds as well), so the total value of the reduction was of the order of \$1 billion.

The announced cost saving was thus of the order of one tenth of one percent of the stipulated rate reduction. In turn, the rate reduction was an order of magnitude less than the total annual revenue covered by the stipulation. The calculations might be slightly different in other FPL cases or for other companies.¹⁸ However, it is implausible that cost savings alone are driving utilities to stipulations that dispose of revenues that are three or four orders of magnitude greater than the regulatory costs saved.

3.2 Illustration: a small intervenor

¹⁶ The figure of \$5m was by some way the highest ever proposed for this category of expense, and since legal fees constituted some \$3m of the \$5m the reasonableness of these could have been challenged.

¹⁷ Case background 10 March 1999 in FPL 1999.

¹⁸ In 1999 the FPL stipulation provided for \$350m reduction for 3 years, total value about \$1bn. In 2005 the FPL stipulation provided for no rate change over 4 years, but the two sides had earlier argued for increases and reductions of the order of \$0.6bn, so an increase or reduction worth over \$2bn was involved. Proportionate cost savings from settlement might be a little higher for the smaller companies in the Florida electricity sector, but probably not much higher.

At the other extreme, consider the situation of an intervenor in the same case (**FPL 2002**). Lee County is a large purchaser of electricity for its local government offices. It was concerned what a rate case might imply after 18 years without review. FPSC staff had asked FPL to calculate and file what rate changes would be needed to bring all rate classes to parity. FPL had not yet filed this calculation but an initial cost study indicated possible rate increases of 10% to 18% for the two largest rate classes. A rough calculation suggested that Lee County might be exposed to an increase somewhere in the range \$200,000 to \$700,000 even if there were no change in FPL's total revenue requirements.

Lee County therefore appointed a representative to monitor the development of the rate case and, if necessary, to organise witnesses and to put forward Lee County's case, and to ensure that transitional rules were applied to limit changes in particular rates. These rules were well established but not always simple.¹⁹

The cost of such representation would depend on the extent of input required. For an intervenor to be represented on all issues in a large case (85 issues in one case) and to hire top quality consultants might cost up to, say, \$300,000 to \$500,000. But it is possible to participate for much less than that. For \$10,000 to \$15,000 it would be possible to hire a representative to take positions on a limited number of issues, and to be represented in the hearing and associated discussions. For an additional \$5,000 to \$10,000 it would be possible to hire an expert witness.

In FPL 2002, OPC and FPL carried out the bulk of the testimony work and negotiations. After most of the testimony was filed, Lee County's representative was contacted to say that a settlement was under consideration, involving an across-the-board decrease in rates. This would mean a reduction of the order of \$200,000 for Lee County, rather than a possible increase of the same or greater amount. Lee County accepted.²⁰

A large electricity user such as Lee County might therefore find it worthwhile to spend a few tens of thousands of dollars in participating actively in a rate case, if this could avoid or mitigate a potential rate increase of the order of a few hundreds of thousands of dollars. The savings from a settlement rather than the full litigated process would therefore be a few thousand dollars, contrasted with the total size of its

¹⁹ They provided, for example, that if the system average was a rate decrease, then no individual class of customer could be given a rate increase. Similarly, if the system average was a rate increase, then no rate class could be given a decrease. There were also more detailed restrictions: if a 5% increase was indicated for one rate class but the system average was a 1% increase, then the maximum increase in that one class was 1 ½% increase.

²⁰ One other intervenor, South Florida Hospital and Healthcare Association, declined to sign the stipulation. It had argued for an aggregate decrease in rates of \$475m instead of the \$250m agreed in the stipulation. It was rumoured that, if the case had gone to litigation, OPC would have filed for a decrease of a similar order of magnitude. By deferring filing, OPC was not seen to settle for less. South Florida Hospital and Healthcare Association subsequently appealed the FPSC order to the Florida Supreme Court. OPC argued against the appeal, on the grounds that reopening the issue would mean that the generality of customers could lose the benefits of the \$250m decrease already agreed. In the event, the Supreme Court held that the SFHHA did not have sufficient standing since it had not itself applied for a rate case. (SFHHA v Javer, 887 So. 2d 1210, 1214 Fl. 2004) In consequence, some organisations have subsequently applied for rate cases in order to give themselves standing in such matters.

electricity bill likely to be in the millions. Again, there is a difference of some three to four orders of magnitude.

The same argument applies to OPC. Suppose it cost the OPC about \$100,000 to put on a litigated case. A saving of even half of this (\$25,000 to \$50,000) is not what drives the OPC to settlement in cases where the impacts on customers are measured in hundreds of millions of dollars. For all parties, the purpose of settlement is to get something different and better than what litigation would yield, not to get the same outcome at slightly lower cost.

4. Electricity stipulations: the extent of benefits to customers

4.1 Role of OPC

How far are the rate changes, rate freezes and other outcomes in Table 2 due to the actions of the OPC, in particular to the stipulations that it signed? How far would these freezes, reductions and refunds have happened anyway?

A first cut at this is to look at which of the cases were initiated by OPC. In seven of the twelve cases, FPSC was already in process of dealing with the issue. But in the other five cases, the issue was opened or reopened by OPC filing for a review or protesting a previous FPSC decision. These latter five cases²¹ accounted for 37.6% of rate reductions (\$360/956.5m), 68% of refunds (\$98.3/141.8m) and 77.3% of the revenue sharing payments (\$217.8/281.8m).

As a rough approximation, assume that a revenue reduction lasts on average for three years, so give it three times the weight of the one-time refunds and revenue sharing payments. Then the weighted average is $\$1396.1/3293.1\text{m} = 42.4\%$. On this basis, OPC was responsible for opening or reopening cases that accounted for \$1.4 bn of customer benefits measured in terms of electricity rate reductions and refunds, constituting around 40 per cent of the total of such benefits.

However, this calculation does not measure the precise impact of stipulations involving OPC. Regardless of who opened or reopened a case, would FPSC have reached essentially the same outcome in the absence of a stipulation, or did the stipulation make a significant difference? We therefore examine the stipulations in more detail, together with the background to each of them.

4.2 Customer benefits in the largest case

Consider first the stipulation **FPL 1999**, which embodied the largest rate reduction and the most explicit set of calculations about this reduction. The background was that in 1995, 1997 and December 1998 FPSC accepted FPL proposals to use excess earnings to write off deficits and regulatory assets (such as stranded costs). OPC and others objected to the last decision and petitioned for a full rate case. Then FPL agreed with OPC (inter alia) to reduce base rates by \$350m instead. In advising on the stipulation, FPSC staff were split. Primary staff (reflecting the view of the most senior official) recommended that the stipulation be approved. They said “We recognise that,

²¹ These latter five cases were FPC 1986, TECO 1996, FPL 1999, GPC 1999, TECO 2000.

at the conclusion of a full rate case, a greater rate reduction is *possible*.” Alternative staff, opposing the stipulation, said that “Based upon an historic or prospective view of earnings, greater rate reductions would be *likely* if the Commission proceeded to a full rate requirements proceeding”. (Both emphases added.)

It may seem ironic that the stipulation that embodied the largest ever rate reduction to customers led to the most significant questioning and quantification of customer benefits by FPSC staff involved. This may well reflect the fact that the largest reduction was associated with the most significant departure to date from previous regulatory practice. Because of the contrary views and detailed calculations in this case, it is useful to look at the calculations in some detail.

Appendix 1 shows that staff made two calculations. The first, based on a historical view of costs, estimated the scope for rate reductions at \$515m. The second calculation, based on a prospective view of earnings, estimated the scope at \$556m.

The stipulation provided for a rate reduction of \$350m plus refunds when revenues exceeded specified levels. Over the three years 1999 to 2001 these refunds were \$22.8m, \$108.8m and \$86.2m, an average of \$73m per year. So for purposes of comparison the stipulation may be assumed to embody an effective reduction of $\$350m + \$73m = \$423m$ per year (although the size of the ex post refunds could not be known ex ante).

Compare this stipulated and (ex post) achieved rate reduction of about \$423m with the implied staff estimates of \$515m on a historic view and \$556m on a prospective view. Did OPC settle for between \$92m and \$133m less than the Commission would have granted if the case had gone to a full hearing? Put another way, would the Commission have decreed rate reductions and a sharing scheme that yielded in total something in the range \$515m to \$556m, representing some 22% to 31% more than the \$423m outcome of the settlement? Or, if the FPSC had to determine a rate reduction without a revenue-sharing scheme, would it have decreed a rate reduction some 47% to 59% greater than the \$350m provided in the stipulation?

Neither staff estimate was subject to challenge by the utility. Neither estimate makes allowance for uncertainty associated with future costs and other events. Alternative staff’s calculations claiming that a greater reduction was “likely” were of the nature of an initial pre-hearing bargaining position. Primary staff claimed only that a higher rate reduction was “possible”. This view also noted that it would take 8 to 12 months before a full rate case would take effect. The “main reason Primary Staff recommends approval of the stipulation is that it results in immediate and significant savings to all of FPL’s ratepayers.”

What stance would FPSC have taken after a full proceeding? Both staff estimates assume that FPSC would not wish to allow additional amortization. Yet additional amortization was a policy to which FPSC was committed. Ever since 1995 it had consistently written down deficits and regulatory assets instead of reducing rates. I have heard it conjectured that by 1999 FPSC was ready to consider rate reductions, and to that end was about to ask the company to file information on which to base an order. But this was not reflected in the FPSC order of December 1998, only three months earlier, which again decided to write off further assets and not to reduce rates.

A distinctive feature of this stipulation, that must have been a factor in FPL's agreement, was the move from earnings sharing to revenue sharing. This was a revolutionary approach. It was strongly opposed by both sets of staff and seems unlikely to have emerged in the event of a traditional hearings process (as discussed below).

Most telling, and of course most critical, was the stance of FPSC itself in this actual case. If it thought that a full proceeding could have yielded larger benefits to customers, it could have rejected the stipulation. It chose not to. It agonised over none of the points and calculations made by staff. It said simply that the stipulation would resolve all the issues in OPC's petition and provide immediate and substantial benefits for customers, and therefore should be approved.

It is therefore plausible to conclude a) that in the absence of OPC action, there would have been no rate reduction at all, and b) that once OPC had raised the issue, if the case had gone to hearings there would have been much less scope for rate reduction than the stipulation achieved. At least some of the excess earnings would have been applied to additional amortization, and without the inducement of revenue sharing FPL would have argued for lower rate reductions.

4.4 Impact of other stipulations on rate reductions and refunds

Are other stipulations broadly consistent with these conclusions? The first case (**FPC 1986**) is particularly interesting and revealing for the attitude and statement of FPSC. A reduction in federal tax rate was expected. This would not have been passed through to customers because FPC was earning below its authorised ROE, so FPSC had not envisaged taking any action. OPC filed to reduce the ROE and to reduce rates by \$46.3m. OPC and FPC then agreed a refund of \$54m for 1987. The reasons for this are discussed later. FPSC pointed out that this refund was higher than any electricity sector refund to date. (The previous largest was \$14m by FPL, a larger company, in 1979.) FPSC explicitly weighed up the alternatives and concluded that it could not secure a more attractive deal for customers in the time available: "Hence we believe this bird in the hand is worth taking."

Appendix 2 examines the records of the remaining cases to ascertain whether the stipulations embodied lower rates for customers than a traditional litigated proceeding is likely to have achieved. (This also gives a useful overview of the cases.) It attempts a classification of the stipulated outcome into one (or sometimes two) of four categories: would Not otherwise have been secured (N), Greater than otherwise (G), Less than otherwise (L) or Earlier than otherwise (E). No cases suggest that any rate reduction or refund was later than otherwise.

Table 3 summarises the classification of outcomes. On this basis, all the „permanent“ rate reductions, refunds and sharing were greater or earlier than they otherwise would have been, and some of them might not have been achieved at all without stipulations. Note that these summary calculations give zero weight to those stipulations (GPC 1993, FPC 1997a,b, FPL 2005, PEF 2005) that held prices constant when increases might otherwise have been expected, and therefore perhaps understate the value of the stipulations in bringing immediate benefits to customers.

The final column totals these benefits by conservatively weighting each rate reduction by the number of years covered by the stipulation. On this basis, the total revenue reduction during these two decades was over three billion dollars. All of this reduction was greater or earlier than would otherwise have occurred, and it is arguable that up to three quarters of it would never have occurred at all without the OPC stipulation.

Table 3 Nature of benefits from stipulations

Nature of benefit	Reduction \$m	Refund \$m	Sharing \$m	Weighted Total \$m
Not otherwise achieved (N)		50		50
Greater than otherwise (G)		37.8	217.8	255.6
Less than otherwise (L)				
Earlier than otherwise (E)				
N/E	10	54		84
N/G	721.5		29	2200.5
G/E	125		35	535
Total	856.5	141.8	281.8	3125.1

Source: Appendix 2.

These classifications are of course subjective, but they are based on the historical context and the evidence of the FPSC reports and decisions. The evaluation does not extend to possible increases in other rates. (Some of the stipulations allowed utilities to pass new costs through fuel adjustment and other clauses, instead of via base rates.) Nor does it cover the possible longer term impact, nor seek to evaluate whether the outcomes were „better“ than otherwise. What it does suggest is that stipulations involving OPC led unequivocally to avoidance of price increases and greater immediate price reductions, refunds, and sharing benefits for electricity customers than would otherwise have occurred.

5. The nature and distribution of benefits to customers

5.1 The method of rate reduction

Did all classes of customer derive comparable benefits from these rate reductions and refunds? Holburn and Spiller (2002) found evidence that participation of consumer advocates tended to lead to lower allowed rates of return but also to relatively lower industrial rates: in other words, industrial consumers tended to benefit more than residential consumers. Is there evidence of that in the Florida electricity sector?

As it happens, the very first electricity stipulation (**FPC 1986**) touched on this point. OPC and FPC agreed to let FPSC decide how to implement the \$54m credit. Staff proposed to allocate it among rate classes in the same way as the revenue requirement was determined in the last cost of service study, and for ease of administration they proposed to use base revenue instead of rate base. FPSC commented that this slightly

favoured Interruptible users but that this was not unfair since those users had been slightly disadvantaged in the previous decision.²²

5.2 Demand versus energy basis

Later stipulations did not leave it to FPSC staff, but instead specified the method of rate reduction to be used. Staff expressed concern on at least four occasions that the method agreed was more favourable to large industrial users than to smaller users. The first such case explains the concern.

TECO 1996a provided, inter alia, for a one-time refund of \$25m. Staff were split on the proposal. The following was one of the objections of alternative staff:

“Alternative staff has serious concerns about the proposed method of distributing the proposed refunds. The stipulation provides for both the initial \$25 million and subsequent refunds to be refunded on an energy basis, rather than on a demand basis. Applying a refund factor to kWh usage results in large industrial (especially non-firm) customers receiving a greater share of the refund than merited based on the cost allocations underlying the rates which generated the overearnings. ... Allocation of the refund on a demand basis is more consistent with the way costs were allocated in setting base rates.”²³

FPSC nonetheless approved this stipulation, citing the views of primary staff which did not mention this issue.

Appendix 3 summarises the other stipulations that embodied a similar approach and engendered a similar concern by staff. It shows that FPSC’s previous practice was to relate non-energy rates to allocated cost, and to increase and reduce rates on a maximum demand basis. There seems little doubt that, in the absence of the stipulations, FPSC would have continued that practice. It would periodically have reset rates to reflect allocated costs more closely, and would not have introduced rate reductions on an energy basis. The stipulations therefore changed the allocation of rate reductions, in favour of the larger industrial users. This change started with TECO in 1996 and was extended to FPL and GPC in 1999. It was effectively maintained at FPL (and perhaps FPC) in 2002 by across-the-board reductions in lieu of revising the rate structure.

Appendix 3 also shows that staff sometimes sought to quantify the impact of the different method for allocating rate reductions. In the first case their conjectures seem, in retrospect, to have overestimated the extent of the transfer between rate classes. In a later case (FPL 1999) a more considered calculation estimates that a demand-based

²² “Using base revenue, rather than rate base, as the allocator does give the Interruptible class a higher percentage of the refund (2.28% rather than 1.52%). But since their rate of return was left above the system rate of return in the Company’s last rate case this is a reasonable request. The converse is true for the General Service Large Demand class, but again, their rate of return was left below the system average in the Company’s last rate case.”

²³ Alternative staff continued “If it is appropriate to allocate the earnings on an energy basis, it could be argued that it is appropriate to allocate the cost of Polk [a new generating unit] on energy as well. / In addition, there is an inherent unfairness in giving a smaller share of the refund resulting from over-recovery of base rate costs to the customers who will likely be asked to shoulder the bulk of any stranded generation costs in a competitive environment. Large customers are likely to have the most opportunities to utilise alternative electric suppliers, and, as a result, “strand” utility plant. Since the bulk of stranded costs will be production related, any refund of base rates should be made on a demand basis to mitigate the impact of stranded costs.” Alternate Staff Analysis, pp. 9-10, Memorandum: Case Background, 18 April 1996, TECO 1996a.

reduction would imply a 10% greater reduction for residential customers than an energy-based reduction.

Table 4 shows the refunds and rate reductions in cases where the energy basis was involved. It calculates the residential share by reference to the residential share of total energy consumed, which varies from 45% to 56% depending on the utility.

Table 4 Refunds to residential customers on energy rather than demand basis

Company	Year	Total Refunds \$m	Residential refunds \$m	Total Reductions \$m	Residential reductions \$m
TECO	1996a	25			
“	1996b	25			
“	2000 ²⁴	13 + 6.3			
	Total	69.3	x 48% = 33		
GPC	1999			10	x 45% = 4.5
FPL	1999	217.8	x 56% = 122	350	x 56% = 196
	2002			250	x 56% = 140
Total			\$155m		\$340.5m
Possible redistribution (= Total x 10%)			\$15.5m		\$34.1m

Source: Table 2 above

In total, residential customers received one-time refunds of about \$155m and „permanent“ rate reductions of \$340m. On the basis of the 10% calculation, which is the latest available, residential customers in Florida would have received additional refunds of about \$15.5m and additional rate reductions of about \$34m if the conventional demand basis had been used instead. If rate reductions are assumed to last three years, the total value of the redistribution in question is about \$118m.

An obvious question is whether residential customers were better or worse off as a result of the stipulations entered into by the OPC. The above calculation suggests that answer depends on whether the refunds and rate reductions were more or less than 10 per cent higher than they would otherwise have been. The analysis in the previous section suggests that they were much more than 10 per cent higher, not least because an estimated three quarters of the refunds and reductions might otherwise not have occurred at all. On this basis, commercial industrial customers gained particularly from stipulations involving the OPC, but residential customers too were better off despite the change in method.

These calculations do not attempt to estimate whether earlier rate reductions might necessitate rate increases later. On the other hand, neither do they estimate the longer term benefits of any efficiency incentives associated with (e.g.) the fixed prices and use of revenue sharing. Efficiency benefits are seldom mentioned by staff or in FPSC

²⁴ TECO 2000 implemented the two earlier stipulations TECO 1996a,b. It confirmed further refunds for 1997 and 1998 at \$13m and a refund for 1999 that was later agreed at \$6.3m.

orders, although some FPSC decisions include a couple of brief references to acknowledge this aspect.²⁵ Such incentives to greater efficiency could be quite substantial, and imply additional benefits to both investors and customers.

5.3 Method of cost allocation

A case that was eventually litigated (GPC 2002 docket 010949) sheds further light on the distribution of benefits because it involved a partial stipulation that impacted on this issue. The utility had requested a rate increase. Two representatives of large users - (Federal Executive Agencies (FEA) and Florida Industrial Power Users Group (FIPUG) - agreed a partial stipulation with GPC on certain cost of service and rate design issues (on which OPC took no position). As part of that stipulation, the two consumer parties agreed to withdraw from involvement in the non-stipulated issues concerning the level of rates. GPC argued that this would streamline remaining proceedings.

FPSC chairman noted a concern that “The proposed settlement has the potential of creating an allocation methodology that puts a burden on, that could put a burden on, the residential consumer versus the large industrial consumer.”²⁶ Staff argued that the proposed methodology would be inappropriate and inconsistent with FPSC practice, as well as an additional burden on residential consumers. The parties removed the controversial elements from the partial stipulation. FPSC accepted the stipulation, and separately found against these elements.

In this particular case, there was a potential for a stipulation to act against the interests of residential customers. The stipulation was agreed by larger users and OPC took no position. In the event, there was no such detriment because FPSC rejected that aspect.. The prospect of FPSC rejection seems to have led the parties to withdraw that element of the stipulation.

It is worth remarking that, looking at the picture as a whole, the rate reductions and refunds negotiated by the OPC considerably outweigh the costs of running that organisation. A rough calculation suggests these benefits are about two orders of magnitude greater than the costs.²⁷ In addition, OPC’s arguments presumably have an impact in litigated cases where it does not sign a stipulation.

²⁵ In the telephone case Southern Bell 1988 (docket 871401), FPSC set rates to produce a 13.2% ROE. Instead of the traditionally allowed range of ROE plus or minus one percent, it set a floor at 11.5%, and the sharing threshold at 14% “to encourage Southern Bell to become more efficient”. In TECO 1996, following primary staff recommendation, FPSC said “This settlement provides an incentive for TECO to be more cost efficient since it can retain a significant portion of any increased earnings. In recent years the Commission has promoted various forms of incentive regulation.” Order p. 5.

²⁶ GPC 2002, Prehearing conference 15 February 2002, p. 14. The stipulation calculates that 79.2% of the revenue increase would be allocated to residential service compared to 73.5% in the revenue increase approved in 1990.

²⁷ Looking only at the electricity sector, assume that the rate reductions of \$1 bn over the last 20 years (see Table 2) last on average for 3 years and that about half of that reduction accrues to the residential sector. This makes an average reduction of about $(\$1bn \times 3 \times \frac{1}{2})/20 = \$75m$ per year. (The actual proportion of residential benefits may be slightly lower than one half but against this are one-off refunds of \$140m not included here.) The annual budget of OPC is about \$2.5m. Assume about two-thirds of this budget pertains to the electricity sector, that is about \$1.5m. (This is roughly the proportion of total stipulated rate reductions accruing from the electricity sector.) OPC’s electricity budget is thus of the order of 2 per cent $(=1.5m/75m)$ of the electricity rate reductions it has negotiated

6. Benefits to utilities, and how rate reductions are achieved

6.1 Gains from trade

The utilities, OPC and other parties all agree to stipulations for essentially the same reason: they believe they can negotiate more from the stipulation than the full FPSC hearing process would deliver. We have seen that the OPC and electricity consumers typically get bigger and earlier rate reductions and refunds than the FPSC would otherwise be able or prepared to concede. Many might not have happened at all. But why do utilities agree to such large rate reductions and refunds when apparently the FPSC would not be prepared to order them? What benefit do utilities derive from stipulations?²⁸

There seem to be two main avenues for creating benefits to utilities. One possibility is that the OPC and other parties can offer concessions to the utility that are within their own control but beyond the remit of the FPSC. The other possibility is that the OPC and other parties are willing to make concessions that FPSC is able but unwilling or unlikely to make. In both cases, however, there is a regulatory constraint. OPC, the utility and the other parties can only propose a stipulation to the FPSC, they cannot commit the commission. The overall stipulation package therefore has to be acceptable to the commission as well as to the parties.

6.2 Concessions outside the remit of the FPSC

Just as the parties cannot commit FPSC, so too FPSC decisions cannot commit or bind the parties. It is therefore open to the non-utility parties either to support or to oppose the utility in subsequent actions, either before the FPSC or in other fora. This can be important to both parties. Commitments by the parties to act or not to act in a specified way are something that the parties can deliver that the FPSC cannot.

Thus, the parties typically commit not to undermine the agreement by later action.²⁹ This is particularly important if the agreement covers a substantial period of time, as in the case of price freezes and incentive agreements. It is normally beyond the power of a regulatory commission to preclude a utility from making a request to increase rates, or a consumer group from requesting a rate review or decrease. An example is

for residential customers. It was argued above that OPC stipulations have led to rate reductions much more than 10 per cent higher than they otherwise would have been (probably an order of magnitude higher).

²⁸ Larry Kaufmann remarks that “discussions vary on a case by case basis depending on what is most important to the companies and what are they willing to fight for – it’s not always the amount of the initial rate change, it could be a reasonable policy for stranded cost recovery, future treatment of pollution control obligations, getting a multi-year stay-out period etc. Everything is often on the table and the process is by nature not mechanical, so it’s difficult to generalize about what drives it.” (personal communication 29 December 2006)

²⁹ E.g. in the FPC 1986 stipulation, which agreed a \$54m refund for 1987, OPC undertook not to initiate or support any action to reduce FPC’s 1987 revenues, and FPC undertook not to initiate or support any action to increase its 1987 revenues.

the commitment in the pioneering three year incentive agreement in **FPL 1999**.³⁰ Later examples (**FPL 2005** and **PEF 2005**) are the commitments not to appeal (and/or the withdrawal of existing appeals) against separate FPSC decisions on the utilities' recovery of storm damage costs.

Parties sometimes agree to withdraw opposition in another forum. For example, in **FPC 1997b** an intervening Senator agreed to withdraw his complaints in the Supreme Court.³¹ In **FPL 1999** the utility agreed to cap accruals for nuclear decommissioning and fossil dismantlement at previously authorised levels, and FIPUG and CER agreed to withdraw their protests on this issue. In **TECO 2000** the settlement agreed to a refund of \$13m "as soon as practicable after [the relevant FPSC orders] are made final and non-appealable", and also provided that "FIPUG and OPC will file a joint Dismissal of the Appeal in FIPUG v FPSC" at the Florida Supreme Court which had previously challenged these orders.

6.3 An example from the telephone sector

An earlier example from the telephone rather than electricity sector further illustrates this point. In June 1992 Centel filed to request a permanent rate increase of \$17.9m with an interim increase of \$9.1m. In September 1992 FPSC approved an interim increase of \$4.6m, effective immediately. Meanwhile, Centel had announced a merger with Sprint (the owner of United Telephone Company of Florida). OPC filed motions to dismiss or delay the rate hearing. During the final hearing on the docket in December 1992, the parties reached a stipulated settlement. Centel agreed to reduce its rates and make a refund for the forthcoming 18 months for its earnings in excess of 12.0% ROE, maintaining its recently-authorised ROE for other purposes at 12.5%. This stipulation corresponded to a permanent rate increase of \$3.5m rather than the interim \$4.6m. Since the agreed rate increase was \$1.1m less than the approved interim rate increase, OPC and the parties could (and did) announce it as a rate reduction.

This was obviously attractive to OPC, but why would Centel agree to accept \$1.1m less revenue than the Commission had already approved? Part of the explanation is that the revenue reduction would have less adverse impact on the merged company than on Centel alone. But additional features of the stipulation were that it was contingent on the approval of the merger by Centel shareowners, that the Commission's approval of the stipulation eliminated the need for the Commission to resolve any issues raised in the docket except those in the stipulation, and that the parties undertook to support the acceptance of the stipulation by the Commission. The net effect of these conditions was presumably to withdraw any substantive or procedural objection to the merger by OPC and, if accepted, by FPSC as well. The company evidently judged that this was worth \$1.1m.

³⁰ "OPC, FIPUG and the Coalition [for Equitable Rates, or CER] will neither seek nor support any additional reduction in FPL's base rates and charges ... for three years. ... FPL will not petition for an increase in its base rates and charges ... [for] three years." Similar provisions apply in FPL 2005 and PEF 2005.

³¹ "Dismissal of impending litigation. This section provides that upon approval of the Stipulation, Senator Charlie Crist shall promptly take all appropriate steps and file all appropriate pleadings to effectuate a dismissal of his complaints pending before the Sixth Judicial Circuit and the Supreme Court of Florida." FPC 1997, p. 7.

7. Accounting policy

Independently of the stipulations, FPSC's thinking and practice on accounting policy was evolving, including in the direction of greater flexibility. During the 1990s, particularly from about 1993, FPSC policy was to apply excess earnings to faster depreciation of regulatory assets in order to avoid potentially stranded costs in the event of deregulation and competition. This was attractive to the utilities too: it reduced the risk of stranding, and put them in a stronger financial position if deregulation did not occur. FPSC recognised that the discretion to apply excess earnings in this way, rather than in the form of refunds or rate reductions, could therefore be an incentive to efficiency on the part of the utility.

Not surprisingly, perhaps, this was not OPC's preferred use of excess earnings. But it had to offer at least comparable flexibility and incentives to the utilities in order to secure their agreement. Over the years, stipulations have often prescribed accounting policy for the utilities, notably with respect to depreciation and reserves, which in many cases have been less onerous, or allowed greater flexibility to the utility, than FPSC's rather conservative policy. This has often facilitated refunds, rate freezes or reductions that would otherwise not have been possible.

Appendix 4 sets out the provisions of the stipulations with respect to these accounting policy issues. This section summarises the main features and notes the views expressed by staff and others, which are often a useful guide to where the stipulations departed from established policy.

7.1 The main cases

FPC 1986 specified that the \$54m refund was dependent, inter alia, on deferring the FPSC's prescription of FPC's depreciation rates that might otherwise have necessitated a rate increase. This does not seem to have caused a problem with staff, perhaps since FPSC had not yet taken a final view on the nature of the prescription.

GPC 1993 provided that the utility would use an alternative straight-line method instead of FPSC's recently determined dismantlement policy. This would defer the amount of the dismantlement accrual. Primary staff recommended against this because of inter-generational inequities and because it precluded proper debate of a generic issue. Alternative staff noted the benefits of avoiding the present rate increase and of lower future rates. Picking up the Commission's phrase in an earlier stipulation, they advised "Although adoption of the stipulation will defer implementation of the dismantlement accrual increase found appropriate by the Commission in Order No. 24741, we believe that a bird in the hand is worth two in the bush."

FPSC had approved TECO's proposals to use a reduction in its authorised ROE to build up its storm damage accrual. In contrast, **TECO 1996a** applied the overearnings to a refund. Alternative staff was concerned that "other opportunities to reduce regulatory assets, mitigate potential 'stranded costs', or handle other regulatory balance sheet concerns will be foregone".

FPC 1997b facilitated a four year rate freeze by suspending accruals to the fossil dismantlement reserve for four years. It also provided discretion to amortize regulatory assets.

During the mid-1990s FPSC had approved FPL plans for writing off nearly \$1 bn of regulatory assets, and in 1998 approved a continuation of this. OPC objected that “the time has now come for the customers to share in the benefits.” As a means of facilitating a \$350m reduction in base rates, **FPL 1999** capped accruals for nuclear decommissioning and fossil dismantlement at previous authorised levels. It also authorized FPL to record amortization up to \$100m per year to reduce nuclear and/or fossil plant in service, in addition to normal depreciation. This latter discretion was presumably attractive to the utility, but anathema to staff. Accelerated depreciation was “not the writing off of a perceived historical deficit”, which would have been acceptable. Instead, it would mean that depreciation, and the resultant rate base, would reflect the variability of the company’s revenues. This was a violation of the “matching principle”, of matching capital recovery with consumption over an asset’s service life.

In response to concerns about earnings and ROE, GPC proposed an earnings sharing incentive plan that, inter alia, devoted 20% of excess earnings to writing off certain regulatory assets and increasing a reserve. FPSC approved an alternative plan proposed by staff, which involved a higher proportion to writing off assets. **GPC 1999** provided for an immediate rate reduction for customers. GPC was given discretion, rather than a requirement, to write off the regulatory assets and increase the reserve. This did not attract adverse comment from staff.

Two contemporaneous stipulations, **FPL 2002** and **FPC 2002** embodied significant rate reductions of \$250m and \$125m, respectively. In both cases, half of this was effectively funded by annual reductions in depreciation of \$125m and \$62.5m, respectively.³² FPL had discretion to reduce depreciation up to that amount; FPC had discretion to reverse all or part of the \$62.5m reduction, and discretion to accelerate amortization of certain regulatory assets, and accruals for nuclear decommissioning and fossil dismantlement were suspended. Instead of increasing the annual accrual for storm damage reserve, FPL agreed to petition for recovery of storm costs in the event there were insufficient funds in the reserve. Perhaps in view of FPSC’s approval of the previous stipulation (**FPL 1999**), staff this time expressed no concern about the discretionary element of depreciation.

Three years later, the new challenge was to address requested rate increases of \$430m and \$206m respectively, particularly given that the Attorney General’s Office had indicated a strong preference for no rate increases. The stipulations achieved this by suspending storm damage accruals and meeting future storm costs by surcharge or securitisation; suspending nuclear decommissioning and fossil dismantlement accruals; continuing the ability to reduce depreciation and to accelerate amortization; and providing for certain future costs to be recovered as prudently incurred instead of by base rate increases. There was no adverse comment from staff.

³² In the accounts, this was achieved by recording the normal approved level of depreciation, then recording a negative depreciation expense that effectively reduced the normal level of depreciation, though not to the point of effectively writing up rather than writing down the value of assets.

7.2 Conclusions on accounting policy

Over time, stipulations seem to have terminated then reversed the conservative accounting policy that FPSC had adopted in the early 1990s. FPSC encouraged the utilities to use excess earnings to write off regulatory assets and to increase reserves. It gave the utilities discretion in doing so as an incentive to efficiency. In contrast, OPC and other signatories took the view that adequate provision had now been made for writing off regulatory assets and increasing reserves: consumers preferred jam today in the form of refunds and rate reductions, rather than lower prices tomorrow. And if additional costs needed to be incurred in future (e.g. for storm damage) they could be funded at the time or thereafter.

The stipulations further moved away from FPSC's conservative policy by capping accruals and reducing depreciation. They still gave companies the incentive of flexibility, indeed they extended that flexibility to include reduced or accelerated depreciation of economic assets. Staff at first objected to those stipulations that went beyond conventional treatment of economic assets, but later accepted this. It had become apparent that FPSC was willing to accept a more flexible policy if that secured the significant refunds and rate reductions that customers appeared to want: the FPSC, too, came to prefer the bird in hand.

8. From rate of return regulation to revenue sharing incentive plans

Under traditional rate of return regulation, the regulatory commission determines fair and reasonable rates based on an examination of operating costs and capital investments. A central role is played by the determination of an appropriate rate of return on the approved rate base. This rate of return comprises an allowed return on equity (ROE) plus an assumed equity ratio (the ratio of common equity to total borrowings including debt plus equity). Traditionally, commissions would call utilities for review, or utilities would petition for a rate increase, as and when their achieved returns exceeded or fell below a range around the last allowed ROE (or seemed likely to do so). The range was typically plus or minus 1 %. In this „building block“ model, the determination of allowed rate base and allowed ROE are necessary inputs for determining allowed rates for the utility.

In principle this approach still applies in Florida, although FPSC has modified it to include incentive elements based on discretionary write-downs of regulatory assets and earnings sharing. For example, it was last applied in the electricity sector in GPC 2002 (docket 010949), where the utility requested a rate increase.³³

In practice the traditional approach has largely been superceded in the Florida electricity sector by the different approach embodied in stipulated agreements between the utilities and interested parties including OPC. In addition to the more extensive use of discretionary writedowns, as noted in the previous section, there seem to be two main aspects to the change of approach. First, there is a downplaying of ROE and other inputs to the regulatory decision and a correspondingly increased focus on rates and other outputs of the regulatory decision. This leads on to the use of

³³ A part of this Order, FPSC rejected the incentive plan proposed by GPC and invited the utility to propose another earnings sharing plan. GPC attempted to negotiate a settlement along these lines but was unable to reach agreement, and declined the invitation.

refunds and multi-period rate freezes. The change in focus from inputs to outputs is also noticeable with respect to the determination of the rate base, as exemplified by the treatment of new investment. Second, there has been a development of revenue-sharing instead of earnings-sharing incentive plans.

8.1 Downplaying ROE

FPC 1986 was agreed in a context of expected reductions in federal income tax and ROE. However, contrary to normal regulatory practice it did not agree revised levels of these inputs and calculate whether a refund was appropriate, nor did it defer the issue in order to calculate an appropriate rate for the longer term. Instead, it noted that the relevant magnitudes were uncertain and nonetheless proceeded to specify a one-time refund to customers.

In determining a permanent rate for the next year onwards, **FPC 1987** first declare the agreed annual rate reduction of \$121.5m in 1988. It then commented that “The data used during the negotiating process would indicate that an equity return of 12.6% would be produced.” To the extent that FPC’s earned ROE did not exceed 13.6% FPC was entitled to a corresponding increase in its base rates in 1989. And for the purpose of determining whether to institute proceedings for interim rate increases or decreases, “the parties and FPC agree that the Commission shall utilize” an ROE of 12.6% and 13.6% respectively. Perhaps the form of wording is chosen to avoid either party having to commit to a particular value that it might wish to argue against if litigation proved necessary. But in appearance, at least, ROE has already become an output or decision variable rather than an input. ROE figures now have a functional role as contract reopeners, rather than as the basis of the price determination.

FPSC made some approving remarks about stipulations (see earlier). “In addition” to this, it was worth noting that the revenue reduction was the highest in the history of the state and within 4% of Staff’s initial position. FPSC did not seek to assess or demonstrate further – for example, by carrying out its own calculations – whether the stipulated values were reasonable.

GPC had requested a rate increase associated with FPSC’s new dismantlement accruals policy. **GPC 1993** provided that GPC would use an alternative straight-line method of calculation, and “that in exchange for the foregoing relief the Company agrees to accept 12.00% as the midpoint of a range of 11.0% - 13.0% for its authorized rate of return on common equity”. Together, these provisions would avoid the need for an increase in rates. Allowed ROE is thus chosen to avoid a price increase, rather than estimated as the basis for deciding whether a price increase is justified or not.

8.2 Refunds and rate freezes

Over the period 1993 to 1995 FPSC reviewed and promulgated a series of proposals for revising TECO’s ROE and deferring a proportion of earnings from one year to the next. In contrast, **TECO 1996a** provided for an immediate refund plus a three year rate freeze for 1996 to 1998. It also agreed to defer proportions of net revenues outside specified ROE bands. Alternative staff objected that many of the ROE and

other provisions were not justified.³⁴ FPSC accepted the stipulation, essentially repeating the benefits of the stipulation noted by primary staff³⁵ with no further reference to the concerns of alternative staff.

Staff evidently responded to this decision. **TECO 1996b** made an additional refund and extended the existing rate freeze and other provisions for a further year (1999). Staff raised no significant objection.³⁶

While the parties may well have made assumptions about ROE in negotiating these agreements, there is no claim in the stipulations themselves that they embody accurate forecasts of cost of capital or that the prescribed rates follow from ROE assumptions. Rather, the rate refunds and freezes are paramount, while the ROE figures are a convenient basis for sharing earnings over a multi-year period.

8.3 Prudent investment: two TECO cases

Allowed ROE is traditionally applied to an authorised rate base. The Commission satisfies itself that a new utility investment is prudent, and that it is used and useful. Two pairs of stipulations in particular effectively took over this role from the Commission.

A new IGCC unit was being added at TECO's Polk Power station, the background to which was somewhat unusual.³⁷ **TECO 1996a** provided for this investment to be considered separately, with the parties to negotiate a joint recommendation thereto for Commission approval. Primary staff listed a series of benefits of the stipulation that led them to recommend acceptance, but nonetheless had a "major concern" about the ratemaking treatment of Polk.³⁸ Alternative staff shared the concern, arguing that "at a

³⁴ It also agreed to defer 60% of 1996 net revenues contributing to ROE over 11.75% and 60% of 1997 and 1998 net revenues over 11.75% and all 1997 net revenues over 12.75%, and to refund to customers all 1998 net revenues over 12.75%. Alternative staff objected that: based on current market conditions the ROE midpoint should be reduced from 11.75% to the range 9.75% to 11.25%; there was no mechanism to ensure that future sharing points are reasonable (they should be indexed to movements in a readily available, widely traded interest rate); there was no ROE cap for 1996, which would set a precedent; and there was doubt about the accuracy of TECO's projected returns.

³⁵ Primary staff argued as follows: that ratepayers were protected for the most part by the rate freeze; that although the capped 1997 and 1998 returns were high it was unlikely that TECO would reach them; that the refund and deferral of revenues would reduce the possibility of over-earnings in 1996; and that the settlement would provide an incentive for TECO to be more cost efficient since it could retain a significant portion of any increased earnings.

³⁶ The stipulation gave TECO permission to defer 1998 revenues into 1999, and required a refund in 2000 of 60% of 1999 earnings on ROE in the range 12% to 12.75% and of all 1999 earnings beyond that. Staff commented only that the proposed starting point for 1999 sharing was now 12% instead of 11.75%, so that TECO could retain more earnings before it started to share.

³⁷ In 1992 the Commission had approved TECO's petition to build a 220MW Integrated Gasified Combined Cycle (IGCC) unit, fueled by gasified coal, in Polk County, Florida. A docket was opened to review the prudence of this unit, and the appropriate regulatory treatment. Approval was contingent on TECO securing a \$120m grant from the US Department of Energy to defray construction and operating costs, which it did. The Commission order said that the unit was projected to have an installed cost of \$389m including DOE funding. In 1996, TECO projected the cost of the plant, scheduled to be placed in service in October 1996, to be approximately \$506m net of the DOE grant.

³⁸ If the Commission disallowed some of the related costs as imprudent, the settlement might prevent an otherwise justified rate reduction and/or refund. "It would be preferable for the parties to agree that the settlement could be modified to the limited extent action is taken for the Polk Power Plant. ...Primary Staff recommends isolating the 1997 and 1998 ROE impacts of any disallowance of Polk

minimum, the Commission should defer voting on the stipulation until the regulatory treatment of the Polk Power Station is determined”. They noted that the regulatory treatment of Polk was a major controversial issue yet outstanding, and could necessitate a decrease in base rates. FPSC nonetheless approved the stipulation with no reference to the concerns about Polk.

Six months later, **TECO 1996b** provided a further refund and extension of the rate freeze. It included a finding of prudence on the commencement and continued construction of the Polk IGCC unit, and provided for inclusion of the actual final capital cost in the rate base and of its full operating expense in net operating income.

This time, staff views were consolidated into a single recommendation in favour of the stipulation “overall”. However, there was an extensive discussion of advantages and disadvantages. The main advantages to customers were the additional one-year extension of the rate freeze, which was important in the context of Polk,³⁹ and the guaranteed additional \$25m refund. The disadvantages included the conferral of a determination of prudence and hence authorised full cost recovery for the continued construction of the Polk Unit. Staff questioned the prudence of this investment in lieu of a natural gas fired combined cycle alternative.⁴⁰

Whether and to what extent this investment could or would have been proved imprudent in a full hearing was and is uncertain. Staff were evidently concerned at not being able to assess the prudence of the investment in the traditional way. It was presumably advantageous to both TECO and OPC to reserve the initial treatment of Polk station to themselves, especially given the strong and unanimous staff concern about this issue, rather than to incur the uncertainty and other costs of a hearing. TECO was presumably relieved to get its investment into the rate base, while OPC took the view that the additional year of rate freeze provided better practical protection for customers than the conventional regulatory approach.

8.4 Prudent investment: two FPC cases

Another pair of stipulations involved FPC. The utility had requested approval to buy-out Tiger Bay cogeneration plant and associated fuel contracts, an expensive legacy of the Qualifying Facility era. The rationality of this does not seem to have been questioned, but OPC was concerned that it could lead to rate increases before the cost reductions took effect. **FPC 1997a** gave additional certainty to customers by varying

Power Plant costs and deferring it until 1999 when the disposition of the potential increased earnings can be determined.” Alternative cost recovery mechanisms “may be appropriate in light of the Polk units” apparent high overall cost of generating electricity and increasing electric utility competition”.³⁹ Additional rate stability was particularly important during the initial years of operation of the Polk IGCC unit, which involved the testing of experimental technology on a variety of different coal-based feedstocks. Also, TECO was experiencing increasing pressure from large-use customers that were threatening to find other power supply alternatives. The stipulation provided that, if TECO were to respond by seeking authority to negotiate discount rates with these customers, rates to the remaining customers would not increase during the period of the stipulation.

⁴⁰ There was also concern about another provision. The stipulation recognised that the Port Manatee site was not currently used nor planned to be used, so it placed the current book cost of the site below the line for regulatory purposes. The stipulation also provided that the company would get 100% of any subsequent gain or loss on the sale of the site, although ratepayers would be no worse off if the site were subsequently required by TECO for utility purposes. Staff supported the exclusion of the investment in the Port Manatee site, but not its subsequent ratemaking treatment

the conventional regulatory accounting treatment so that the additional costs should not flow through to customers faster than the benefits.

At the same time, FPC was also applying to recover replacement fuel costs associated with an outage at its Crystal River 3 nuclear plant. OPC challenged the amounts claimed, arguing inter alia that FPC bore some responsibility for the outage. **FPC 1997b** confirmed that FPC's costs would be recovered, but on a deferred basis and with an immediate refund of the additional charges levied to date. There was a four year freeze on base rates, and a four-year suspension of accruals to reserve. Again, the conventional accounting and regulatory provisions (such as whether expenses would go into base rates or fuel adjustment and other clauses) were varied to enable the desired outcome.

These four stipulations do not start from, or explicitly describe, an analysis of the justification for the investments involved, and proceed to calculate the implications for rates. This does not necessarily mean that OPC and FPSC did not carry out such analyses. However, having presumably satisfied themselves as to how much of the investment it is reasonable to recover, the direction of causation is the opposite: the aim is the freezing of rates over a foreseeable period ahead, and the accounting and regulatory treatments are adjusted to secure that end.

8.4 Revenue sharing incentive plans

Reference has been made to earnings sharing arrangements introduced by FPSC and OPC. Monitoring and enforcement of these schemes was not without difficulty. In the telephone sector there had been problems in agreeing the levels of earnings each year under the Southern Bell 1994 sharing scheme. In electricity, the calculation of TECO's earnings led to a series of potentially debatable determinations.⁴¹ FIPUG and OPC protested FPSC decisions on TECO's 1997 and 1998 earnings, before agreeing refunds in the **TECO 2000** stipulation. FPSC's decision on 1999 earnings was also protested.

The concern was that companies were reducing their earnings by artificially increasing their costs, particularly by additional or inappropriate expenditure. OPC wanted a more objective scheme, less subject to manipulation of costs, one that was quicker and easier to implement. It saw revenue-sharing rather than earnings-sharing as the answer.

FPL 1999 provided for sharing of revenues within specified ranges. The range was \$3.4bn to \$3.556bn in the first year rising to \$3.56bn to \$3.656bn in the third year. Within this range, one third of revenues would go to FPL and two thirds to customers; revenues above the tops of those ranges would be refunded wholly to customers. The

⁴¹ E.g. "TECO's 1997 Earnings Surveillance Report was the subject of an audit by Commission staff. The audit report discusses certain transactions and practices which could potentially change the amount of TECO's 1997 earnings. Specifically, the issues in this Order discuss asset transfers between affiliates, the Company's equity ratio, TECO's investment in a 25% interest in a transmission line, industry association dues, advertising, allocation to subsidiaries and the Energy Technology Resource Center. Each of these issues not only affects earnings for 1997, but also has an impact for 1998 and beyond." In re: Determination of regulated earnings of Tampa Electric Company pursuant to stipulations for calendar years 1995 through 1999. Docket No. 950379-EI Order No. PSC-99-1940-PAA-EI Issued: October 1, 1999.

stipulation specified FPL's authorised ROE range as 10% to 12% with an 11% midpoint "for all regulatory purposes". However, the stipulation was quite explicit that rate of return regulation was to be superseded by the revenue sharing mechanism.

"... it being understood that during the term of this Stipulation and Settlement the achieved return on equity may, from time to time, be outside the authorized range and the sharing mechanism herein described is intended to be the appropriate and exclusive mechanism to address that circumstance. ...[and] it being expressly understood and agreed that the mechanism for earnings sharing established herein is not intended to be a vehicle for "rate case" type enquiry concerning expenses, investment and financial results of operations."

There is no indication that FPSC staff shared OPC's concern about using earnings as the basis of an incentive scheme. Rather, staff were worried about the radical implications for regulation. Primary staff expressed concern about the achieved ROE being outside the authorised range, about the sharing mechanism being the exclusive mechanism to address that circumstance, about the mechanism for earnings sharing not intended to be a vehicle for "rate case" type enquiry, and indeed about the whole concept of revenue sharing.⁴² To ameliorate this last concern, there is a repeated affirmation that the Stipulation should not and cannot fetter the discretion of the Commission.⁴³ Alternative staff estimated that FPL would earn over the top of the ROE range and that earnings would continue to grow, and noted with concern the absence of a cap on earnings: "This provision of the Stipulation makes ROE basically meaningless for surveillance purposes."

FPSC showed no concern on these regulatory issues. It noted the benefits of the stipulation and approved FPL 1999 without qualification.⁴⁴

Meanwhile GPC had proposed a regulatory incentive plan on 2 March 1999. On 20 April 1999 FPSC rejected this proposal and approved a similar plan designed by staff.

⁴² "This Stipulation will cause the Commission to alter its traditional viewpoint concerning ROE and excess earnings.... FPL could earn above the top of its authorised range for ROE, 12% if its revenues are below \$3.4 billion. Therefore, this Stipulation requires the Commission to make a fundamental change in its traditional rate base and rate of return regulation. The Stipulation is essentially based on revenues, not earnings. / The Commission has approved sharing plans before. In Docket No. 880069-TL, the Commission approved a rate stabilisation plan for Southern Bell. This plan had a sharing mechanism in which revenues were shared between customers and shareholders from the point at which earnings exceeded the top of the range for ROE. The proposed Stipulation presented by FPL, OPC et al *could* allow earnings to exceed the authorized ROE and be retained entirely by shareholders."

⁴³ The wording of a previous order is recalled. "The Commission, even if it so desired, cannot be bound to a specific course of action through the approval of a stipulation. ... we may not bind the Commission to take or forego action in derogation of our statutory obligations." This leads on to a conclusion that may be somewhat more reassuring to staff and FPSC than to the utility. "The Stipulation binds the parties, and not the Commission. The Commission remains able to utilise during the term of the agreement, all powers explicitly and impliedly granted by Chapter 366, Florida Statutes. This includes the ability to determine that the rates charged by FPL are no longer fair, just and reasonable, and to change those rates. This also includes the ability to order an interim change in rates. Given that this stipulation does not limit the Commission's ability to exercise its jurisdiction to the fullest extent, and does not violate any specific provision of Chapter 366, it is consistent with the requirements of Chapter 366."

⁴⁴ "Among other things, this Stipulation provides for a \$350m annual rate reduction. It provides immediate and substantial benefits for customer of FPL. Therefore we find that the Stipulation should be approved."

Both plans prescribed earnings levels and sharing of earnings.⁴⁵ In contrast, **GPC 1999** filed on October 1 1999 embodied an immediate rate reduction and a three year revenue-sharing plan along the lines of FPL 1999. Staff noted that “this Stipulation requires a fundamental change in its traditional rate base and rate of return regulation”, but that the stipulation binds the parties not the Commission. Staff recommended approval and FPSC agreed.

FPL 2002 that succeeded FPL 1999 was more explicitly aimed at incentives to efficiency.⁴⁶ What is now called a Revenue Sharing Incentive Plan to the end of 2005 involves base revenue thresholds and caps rising from (\$3580m - \$3740m) in 2002 to (\$3880m - \$4040m) in 2005. As before, revenues within these ranges go 1/3 to shareholders and 2/3 to customers, with all revenue over the cap going to customers. There is a similar affirmation of the non-role of ROE regulation. In fact, “FPL will no longer have an authorized ROE range for the purpose of addressing earnings levels”, although if FPL’s earnings fall below 10% ROE it may petition FPSC to amend its base rates. FPSC found that the stipulation “appears to be a reasonable resolution of the issues”.⁴⁷ **FPC 2002** embodied the same provisions for a Revenue Sharing Incentive Plan.⁴⁸

FPL 2005 and **PEF 2005** succeeding the 2002 stipulations define new four-year Revenue Sharing Incentive Plans, refined in the light of experience to reduce forecasting risk. This time the thresholds and caps are defined in terms of the previous year’s outturn values increased by the average annual growth rate in kWh sales for the previous ten year period. As before, the companies would operate without authorized ROE levels for the purpose of addressing earnings levels, with the revenue sharing mechanism the appropriate and exclusive mechanism to address earnings levels, but an ROE of 11.75% would be used for all other regulatory purposes. The option to petition FPSC if ROE fell below 10% remained.

PEF 2005 gave the company the option of continuing the plan for another six months into 2010. **FLE 2005** introduced an „evergreen“ clause.⁴⁹ FPSC seems to have accepted these and the other regulatory changes with equanimity.⁵⁰

⁴⁵ The main differences between the two proposals were the ROE at which earnings are targeted, the ROE at which sharing would begin, the sharing percentages, a productivity factor for 2000 and the treatment of non utility investments. Order May 24 1999.

⁴⁶ The preamble to FPL 1999 had remarked that “a rate base proceeding can be costly, time consuming, lengthy and disruptive to efficient and appropriate management and regulatory effort.” The preamble to FPL 2002 observes that the parties have aimed “to provide incentives to FPL to continue to promote efficiency through the term of this Stipulation”.

⁴⁷ It clarified that “FPL will still have a currently authorized ROE range of 10.00% to 12.00%, with an 11.00% midpoint, for all other purposes, such as cost recovery clauses and Allowance for Funds Used during Construction.”

⁴⁸ In FPC’s case the currently authorized FOE range was 11 – 13% with 12% midpoint.

⁴⁹ It would continue for its Minimum Term until 31 December 2009, “and thereafter shall remain in effect until terminated on the date that new base rates become effective pursuant to order of the FPSC following a formal administrative hearing held either on the FPSC’s own motion or on request made by any of the Parties”.

⁵⁰ In approving both stipulations, FPSC commented “As with any settlement we approve, nothing in our approval of this Stipulation and Settlement diminishes this Commission’s ongoing authority and obligation to ensure fair, just, and reasonable rates. Nonetheless, this Commission has a long history of encouraging settlements, giving great weight and deference to settlements, and enforcing them in the spirit in which they were reached by the parties.”

9. Rate structure and quality of service

9.1 Further effects of stipulations on rate structure

As the representative of citizens in utility matters, OPC has been primarily interested in refunds, rate freezes and rate reductions wherever possible. It typically takes no position on the distributional aspects.⁵¹ Other intervenors have a particular concern for the type of customer they represent, hence have an interest in rate structure as well as the general rate level.

The main intervenor and co-signer of electricity stipulations has been the Florida Industrial Power Users Group (FIPUG). Its interest is in keeping electricity prices to large users as low as possible, consistent with maintaining quality and continuity of supply. The use of energy-based reductions in certain stipulations favoured large industrial users. This presumably reflects the influence of FIPUG, as discussed above.

A number of other intervenors have signed stipulations. Presumably they would not continue to do so unless they generally secured a more favourable outcome than would otherwise eventuate. What sorts of aims do these other intervenor groups have, and what kinds of detail do they seek to embody in the stipulations?

Exhibit A in **FPC 2002** dealt specifically with some rate structure issues. Some provisions maintain existing rate structures that would otherwise disappear, others introduce new rate structures. It is possible that the latter would not have been introduced otherwise, but it is also possible that the parties are content to use the stipulations to implement provisions that would otherwise have been introduced via the normal hearings process.

9.2 Maintaining existing rate schedules

FPC was proposing to close certain uneconomic rate schedules.⁵² FPSC would normally transition off uneconomic schedules, and indeed these might have disappeared earlier had previous stipulations not precluded rate reviews. The stipulation provided that the schedules should remain in effect for existing users.⁵³ This ensured the continuation of these schedules for at least the term of the settlement, over three and a half years. The beneficiaries of this would have been existing large users, no doubt members of FIPUG.

⁵¹ In FPC 2002 discussed below, OPC and the Florida Retail Association explicitly noted that they had taken no position on these particular issues, and “neither support nor oppose the cost of service and rate design provisions set forth in this exhibit”.

⁵² “In its MFR filing FPC had proposed to close the rates and require the existing customers to transfer to the IS-2, IST-2, CS-2 and CST-2 non-firm rates because the company did not believe that the current IS-1, IST-1, CS-1 and CST-1 credits were cost effective.” Order on the Stipulation.

⁵³ “The billing demand credits for Interruptible and Curtailable customers currently receiving service under FPC’s IS-1, IST-1, CS-1 and CST-1 rate schedules shall remain in effect for the term of this Stipulation and Settlement, and thereafter until these rates schedules are reviewed in a general rate case, provided however, that these rate schedules shall continue to be closed to new customers....” Stipulation para 15.

Another example (Exhibit A, para 3) provides that “customers will be billed for a minimum of 500 kw of demand, even if their actual measured demand falls below that level for the month”. However, this will not apply to existing customers if they give 36 months notice. FPC indicated that there are three existing customers who will be affected by the new requirement. Presumably these are FIPUG members, who gain three years grace.

9.3 Introducing new rate schedules

Sometimes stipulations are used to achieve the same ends as the litigated approach. For example, the Stipulation provides (Para 16 and Exhibit A para 1) that the current flat-rate energy charge shall be redesigned using an inverted rate design. The first 1000Wh per month is to be billed at a lower rate than the next 1000 kWh. My understanding is that such a rate had earlier been adopted by FPL, and had been proposed by FPC. Staff had no objection, and it had some basis in energy conservation as well as assisting lower income customers.⁵⁴ It is not clear whether any signatories of the stipulation would themselves benefit from this provision. (The average consumption of members of the Sugarmill Woods Civic Association might be under the breakeven level.)

Another example (Exhibit A, para 2) provides for an increase in the billing demand credits for certain interruptible rates, to compensate non-firm customers for interruptions. According to Staff, “The revised credits represent the cost-effective level proposed by FPC in its MFR filing.” The purpose of the clause is presumably to secure the level of credit that would have resulted from the litigated process rather than to lose this as a result of the stipulation replacing that process. The beneficiaries of higher credits for non-firm customers would be FIPUG members.

Other paragraphs of Exhibit A propose to adopt increases in certain other service charges and lighting charges as earlier proposed by FPC, to the extent of \$11m and \$3m respectively. This is presumably a cost-reflective move that is in the interests of FPC and customers generally. There is a provision that maintenance charges (typically for existing lighting fixtures) will remain unchanged, which might benefit such signatory customers as Publix supermarket. Yet other provisions may be a convenient means of recording items that the company and FPSC have agreed upon. They are not always a means of giving preferential treatment that would not otherwise be allowed.⁵⁵

9.4 Quality of supply

FPC 2002 included a specific and novel quality of service provision that provided for compensation payments (a refund of \$3m a year in 2004 and 2005) to customers served by the worst performing lines if FPC did not achieve a 20% improvement in a standard interruptions index.

⁵⁴ The Order points out that “Under the inverted rate, customers who use less than 1500 kwh per month will see a reduction in their bill relative to the levelized rate, while those who use above that level will see an increase.” (p. 7)

⁵⁵ E.g. “Employee dental expenses are considered to be a prudently incurred expense and will be treated as such, including for surveillance reporting, as of the Implementation Date.” FPL 1999

FPC will continue the implementation of its four-year Commitment to Excellence Reliability Plan, including its objective of a 20% improvement in FPC's System Average Interruption Duration Index (SAIDI), measured on a calendar-year basis, by no later than 2004. FPC will provide a \$3million refund to customers in the event that this SAIDI improvement is not achieved for calendar years 2004 and 2005. Any such refunds will be paid in equal amounts to the 10% of FPC's total retail customers served by FPC's worst performing distribution feeder lines based on each feeder line's SAIDI performance. SAIDI levels will be calculated consistent with the Commission's reliability reporting procedures, but SAIDI performance levels during 2004 and 2005 will be adjusted for extraordinary weather conditions that may occur during those years. Any disputes concerning the existence or extent of extraordinary weather conditions will be resolved by the Commission.

Given the concern at the time about FPC's service, it seems likely that some measures would have been taken even in the absence of the stipulation. Whether the same measures would have been taken is debateable. The approach adopted here, involving payments, mirrors that adopted earlier in a 1994 stipulation between OPC and Southern Bell. **FPC 2002** seems to be the first use of this approach in the Florida electricity sector. A customer refund was then a novel approach, and had obvious advantages over a penalty payment. Focusing it on the worst-served areas had intuitive appeal. Capping the level would give assurance to the company that the adverse consequence of failing to meet the target would be manageable. Allowing the company to adjust for extraordinary weather conditions (subject to appeal to the Commission) gave additional assurance and workability.

It is not clear that the Commission would have the power to order any or most of these provisions, either ex ante or ex post. FPSC cited the possible refund as one of the benefits that led it to approve stipulation **FPC 2002**.⁵⁶

10. Conclusions

10.1 Summary of findings

The main findings of this paper are as follows.

- Stipulated settlements in the electricity sector (and other sectors) in Florida have primarily been driven by the Office of Public Counsel (the consumer advocate), but supported by other intervenor groups.
- The complexity of issues and the varying number of intervenors did not make it difficult to reach agreements to sign stipulations. Smaller intervenors were frequently content to let OPC make the running on their behalf.
- The use of stipulations increased dramatically over time. In the first decade from 1976 there were 20 electricity base rate cases and no stipulations; in the second decade there were another 20 base rate cases and three stipulations; in the last decade there have been only 10 base rate cases, all but one of which have been resolved by stipulation (plus another 2 stipulations bearing on base rate issues).

⁵⁶ The successor stipulation involving this utility (PEF 2005) did not repeat this refund provision. PEF maintained that it had fulfilled its commitment to improve performance, and would continue to focus on its customer service and reliability consistent with Commission standards. This suggests a greater element of flexibility, tackling specific problems as and when needed, than a commission might be minded to implement.

- All these stipulations have been associated with rate freezes, refunds and rate reductions, none explicitly with rate increases.
- Although stipulations regularly cite savings in time and cost of regulatory proceedings, this cannot explain their extent and nature. The cost savings involved are several orders of magnitude less than the revenues at issue. Rather, the signatory parties secure greater and different gains from a stipulation than they would if the case went to a litigated hearing.
- Benefits to consumers in terms of rate reductions and refunds associated with electricity stipulations totalled over \$3 billions over the period 1986 to 2006. All these benefits were greater or earlier than would otherwise have occurred. About three quarters of the rate reductions (by value) would not have occurred at all in the absence of the stipulations.
- In some cases stipulations changed the basis of rate reductions and refunds, to adopt energy-based instead of demand-based rate reductions. This was to the benefit of larger users. Whether smaller users were on balance better off depends on whether the overall reductions were more than 10 per cent greater than they would have been in the absence of the stipulations. It is likely that this was the case.
- Why do utilities sign stipulations that involve rate freezes instead of increases, or greater rate reductions and refunds than they would otherwise be forced to make? In some cases the parties offer commitments that FPSC cannot do (such as agreeing not to request rate reductions, or withdrawing opposition in other fora). In other cases the stipulations embody changes in regulatory policy compared to what FPSC would otherwise adopt.
- Many of the stipulations reflected a less conservative policy on depreciation, amortization, accruals and reserves than FPSC had adopted. For example, possible storm damage costs are recovered ex post rather than by building up reserves. Some stipulations involved discretion for the utility to accelerate its depreciation and/or to reduce it.
- Stipulations have abandoned the rate of return „building block“ approach using allowed return on equity (ROE) applied to an agreed rate base in order to determine rate levels. Instead, they have introduced fixed prices for specified periods of time (rate freezes often following refunds or rate reductions) with little or no explicit reference to ROE and rate base.
- Some stipulations have approved new investments entering the rate base, and modified conventional regulatory treatment of fuel costs and base rates, as part of an agreement to freeze base rates.
- Whereas FPSC had approved proposals for earnings caps and earnings sharing incentive schemes, stipulations have replaced these by revenue-sharing arrangements (without earnings caps) in order to enhance incentives and facilitate enforcement. The stipulations provide that such mechanisms are the only basis for dealing with excess revenues, with no effective regulatory role for ROE.
- Stipulations have embodied some changes, or prevention of changes, in rate structure. Examples include the introduction of targeted refunds for failure to meet specified quality of service standards, and the temporary preservation of uneconomic rate schedules.

10.2 Further reflections

Stipulations have thus changed significantly certain aspects of regulatory decision-making in the Florida electricity sector. The result has been a greater emphasis on refunds, earlier and more certain rate reductions, and greater use of price freezes to protect against rate increases. To achieve this, the stipulations reflect a less conservative and more flexible approach to accounting and regulatory conventions, little role for ROE, and the kind of price cap incentive regulation that has been used elsewhere (for example, in the UK).

Could it be argued that the outcome is less satisfactory than would otherwise have occurred? Utilities negotiated and chose to sign stipulations in preference to FPSC decisions, as did a wide variety of intervenor consumer groups. It is difficult to argue that electricity customers did not prefer earlier and more tangible price. OPC is surely no less attuned than FPSC to the interests of consumers since it is statutorily charged with representing those interests whereas FPSC has a more neutral duty to fix fair, just and reasonable rates having regard to actual legitimate costs. Public Counsel himself was reappointed repeatedly for the twenty five years until his retirement. Other intervenor consumer groups repeatedly looked to OPC to represent their interests. The outcomes of stipulations were repeatedly acclaimed in the media. FPSC staff may have challenged some of the elements of the stipulations, but FPSC commissioners never challenged the substance in their judgements.

The changes are unlikely to have emerged from the traditional formal hearing process, and some could not have done so. Frequently, stipulations followed protests against FPSC's previous decisions. Some of the stipulation provisions aroused the concerns of FPSC staff, or at least staff wished to ensure that FPSC fully appreciated the extent to which the stipulation modified FPSC policy. In the event FPSC accepted all the stipulations put to it. It consistently encouraged stipulated settlements as a more effective method of regulation. It also caught the mood of the stipulations in remarking early on that the Commission could not secure a more attractive deal for customers in the time available: "Hence we believe this bird in the hand is worth taking." All the stipulations seem to have reflected a preference for the bird in hand.

Experience in Florida shows that, within a regulatory framework, interested parties can indeed negotiate and come to agreement with utilities, at least where rate reductions and rate freezes are attainable. Whether similar agreements will be reached in future, when rate increases may be the order of the day, remains to be seen. But experience in Florida (as in Canada and elsewhere) does offer the prospect of an evolution in ratemaking procedure. The regulatory Commission can have a less prominent role: as a facilitator of contractual agreements between producers and consumers that reflect their knowledge and interests, rather than as a substitute for their judgements.

Appendix 1 Staff calculations of customer benefits in FPL 1999

Alternative staff made two calculations. The first, based on a historic view of earnings, was as follows.

In 1998, FPL's achieved earnings were 12.6% even with FPL recording \$372m of additional expenses under the Commission Plan. The rate reduction is less than the amount of additional expenses recorded in 1998. In a rate case, rates would be set at the midpoint. Under the stipulation the midpoint is 11.0%.

This is saying, in effect, that if the additional expenses would not be required in future and other costs remained the same, then rates could be reduced by \$372m on a permanent basis and still yield 12.6% ROE; in addition the rates could be further reduced by the difference between 12.6% and 11.0% ROE. The revenue impact of 1% change in ROE was \$89.5m for FPL in 2001.⁵⁷ So the scope for rate reduction based on this historical view would have been about $\$372\text{m} + (1.6 \times \$89.5\text{m}) = \$515\text{m}$.

Alternative staff's second calculation, based on a prospective view of earnings, was as follows.

Under the Stipulation, staff estimates of the achieved return on equity indicate that FPL will earn over 12.0% ... in 1999 and that the achieved earnings will continue to grow over the three year period.

In other words, having made the \$350m rate reduction, and assuming no additional expenses of \$372m, the expected ROE would exceed the 11% midpoint by over 1% in 1999, and would thereafter increase. The expected scope for reduction based on this prospective view of earnings would therefore be over $\$350\text{m} + \$89.5 = \$439.5\text{m}$ and increasing over time.

How much over 12% would FPL be expected to earn? Primary staff gives a specific number. "We calculate that the Stipulation will result in an achieved ROE of 13.3% assuming FPL does not opt to record any „amortization amount“." If a full hearing process would not allow any such „amortization amount“, the scope for rate reduction in 1999 would be $\$350\text{m} + (13.3 - 11.0) \times \$89.5\text{m} = \$556\text{m}$.⁵⁸

Appendix 2 Impact of other stipulations on rate reductions and refunds

This Appendix reviews the evidence in each of the cases as to the impact of the stipulation on rate reductions and refunds. FPSC staff views, as reported in the decision dockets, are of assistance here. In some cases staff explicitly accepted that the benefits to customers were greater than could have been achieved if the case were litigated. In other cases staff questioned this. In three cases views differed within the staff, so that two views (primary and alternative staff views) were presented.⁵⁹ In most cases, however, staff did not challenge the benefits involved, and any staff reservations about the stipulations generally concerned other aspects of the stipulation, as discussed later.

The fourteen cases are as follows.

⁵⁷ Source: Analysis of Florida Electric Utilities, December 2001 (FPSC factsheet). This is consistent with alternative staff comment that "A million dollars is a little over a basis point for FPL". (A basis point is 1/100 of 1%, so corresponds to \$895,000.)

⁵⁸ As to the increase in earnings over time, primary staff says that historically FPL's revenue has grown at about 3% a year, so earnings could be expected to grow by at least that rate.

⁵⁹ These three cases were GPC 1993, TECO 1996 and FPL 1999.

FPC 1986: This is discussed in the main text. (Classified N/E)

FPC 1987: A large user (Occidental Chemical Corporation) claimed that FPC rates should be reduced by \$362.6m on an ongoing basis to reflect (inter alia) a lower ROE and the lower federal tax rate. FPSC opened a docket and FPC proposed a reduction of \$61.7m. FPC, OPC and Occidental subsequently agreed a reduction of \$140m (\$121.5m permanent based on lower ROE and \$18.5m tax credit). FPSC noted that the \$140m revenue reduction was “the largest in the history of this State”, and that the \$121.5m was “within 4 % of our Staff’s position for the Prehearing Conference”. The latter is typically a bargaining position that FPSC would not normally expect to secure. (Classified G)

GPC 1993: GPC filed for a rate increase citing FPRC’s recent dismantlement policy as implying \$10.8m increase. OPC and GPC agreed a lower ROE, deferred dismantlement, and withdrawal of the filed application. Staff were split on the merits of the stipulation but agreed that it avoided a present rate increase and (via the lower ROE) would reduce future rates. (Classified N)

TECO 1996a: In face of continued excess earnings, FPSC accepted TECO proposals in 1993 and 1994 to apply overearnings to a storm damage renewal account, and accepted further TECO proposals in May 1995 and January 1996 to defer excess revenues to future years. OPC objected and in March 1996 agreed with TECO to allow some deferrals but also to refund \$25m and to freeze rates until end-1998. Staff were again split on the merits, but there was no suggestion that there would otherwise be any refund. (Classified N)

TECO 1996b: This provided for the regulatory treatment of new investment at TECO’s Polk power station and also included another \$25m refund. Staff were concerned about a number of issues including the treatment of Polk, but did not suggest that there would otherwise have been a refund. (Classified N)

FPC 1997a, b: These two cases involved actions to avoid possible rate increases, and in the second case explicitly to freeze base rates, rather than to secure refunds or rate reductions. They are not included in Table 3.

FPL 1999: This case is discussed in the main text. (Classified N/G)

GPC 1999: In response to concerns about earnings and ROE, GPC proposed an earnings sharing incentive plan. FPSC rejected this and approved an alternative plan proposed by staff. OPC objected and filed for a rate case. OPC and GPC then agreed a reduction of \$10m with 3 year revenue sharing. Staff analysis mirrored the points made in FPL 1999, noting that “at the conclusion of a full rate case a greater reduction is possible. However, that would be after eight to twelve months.” Staff recommended approval of the stipulation since the \$10m rate reduction resulted in immediate and significant savings to all ratepayers, and in addition there was the potential for revenue sharing. (Classified N/E)

TECO 2000: FPSC initially calculated that the previous stipulations (TECO 1996a,b) implied a refund to customers for overearnings of \$11.2m in 1997 and 1998, later

revised to \$12.3m. OPC and TECO agreed a slightly higher refund of \$13m. In January 2001 FPSC approved a further refund of \$6.1m for 1999 sharing, revised after protest to \$6.3m. (Classified G)

FPL 2002: FPSC opened a rate review as FPL's 1999 stipulation came to its expiry date. OPC and FPL agreed a further rate reduction of \$250m and a continuation of the revenue cap and sharing scheme for nearly 4 years. There was no suggestion that in the absence of the stipulation there would be a rate reduction greater than \$250m, or indeed any rate reduction at all. The stipulated rate reduction depended on departures from certain FPSC accounting policies. FPSC approved, noting the immediate benefits to customers and the additional refunds that the previous scheme had brought (then totalling \$128m to date plus \$84m projected for final year). (Classified N/G)

FPC 2002: In 2000 FPSC opened a docket to review FPC's earnings. In 2001 it ordered \$113.9m held subject to refund, later reduced to \$98m. Testimony was filed and discovery ended March 2002, at about the same time as FPL agreed its stipulation. Shortly afterwards, FPC, OPC and others agreed a stipulation in similar form to FPL 2002 including a rate reduction of \$125m and a refund of \$35m. FPSC approved, noting that the reduction and refund afforded ratepayers immediate relief, and the revenue sharing plan could result in future refunds. (Classified G/E)

FPL 2005: In March 2005 FPL requested a rate increase of \$430m for 2006 plus a further \$123m increase when its new plant came into service in June 2007. In contrast, OPC indicated that FPL's rates should reduce by \$679m. Other intervenors, this time including the Florida Attorney General's office, filed to support OPC's case. The parties agreed a last-minute stipulation involving no change in rates for four years. The strong view of the Attorney General's Office was that there should be no rate increase. It is perceived that this facilitated a settlement.⁶⁰ Various modifications of FPSC accounting policy were implied by the stipulation. The FPSC approved the settlement, endorsing the previous and prospective benefits to customers listed by the stipulation. (Classified G)

PEF (formerly FPC) 2005: In April 2005 PEF requested a \$206m rate increase for 2006 onwards. OPC argued that PEF's rates should be reduced by \$630m. Substantial agreement was reached before settlement of FPL 2000, and finalised shortly afterwards. The main provisions, not dissimilar to those of FPL 2005, included no change in existing base rates for four years (except for miscellaneous increases of about \$15m). FPSC approved the stipulation in similar terms as for FPL 2005. (Classified G)

⁶⁰ A formal administrative hearing was set to begin on Monday 22 August 2005. The parties considered that the gap between them was so great that there was no point in talking. Then, on Friday 19 August, the Attorney General's office telephoned the parties and suggested a meeting. The Attorney General Mr Charles J Christ Jr had consistently taken a strong pro-consumer stand and was perceived as a candidate for Governor in due course. (And the former Public Counsel, Mr Jack Shreve, was now an adviser in his Office.) After meeting all weekend, the parties reached agreement late on Sunday night, and signed and filed the stipulation on Monday morning. The hearing was recessed to allow staff to review the settlement, and advise the commission when it reconvened on Wednesday 24 August.

Appendix 3 The method of rate reduction

The main text describes the issue in **TECO 1996a**. Five other cases discuss the method of the rate refund or reduction.

TECO 1996b: This provided for a further \$25m refund on the same energy basis as in **TECO 1996a**. On this second occasion, the staff recommendation was unanimously in favour of the stipulation (no doubt bearing in mind the FPSC decision on the previous stipulation). Nonetheless, staff pointed out that there were advantages and disadvantages with the stipulation. Prominent among the disadvantages was the proposed method of distributing the rate reduction. The staff analysis reprinted almost verbatim the concern previously voiced by alternative staff.⁶¹

FPL 1999: This stipulation proposed once again to reduce rates by reference to the energy charge. This time the proposed reduction was \$350m permanent (rather than just a one-time refund) plus revenue-sharing. Staff opinion was split on the stipulation as a whole, but unanimous in its concern about the method of rate reduction.⁶²

GPC 1999: This stipulation proposed the same method, again for a \$10m permanent rate reduction. Staff recommended that the stipulation as a whole be approved, and again noted its concern about the method. However, Staff seems by now to have accepted that FPSC was willing to accept reductions on an energy basis rather than demand basis, and even found a justification for this approach.⁶³

FPL 2002 and FPC 2002: These stipulations again made substantial reductions in rates, but this time they were across-the-board rather than on energy costs alone. Staff expressed a degree of satisfaction, even of relief, using essentially the same words in both cases.⁶⁴

It seems unlikely that it was pressure from the Commission or staff that led the stipulating parties to discontinue the energy-based rate reductions. Such pressure had

⁶¹ Staff had an additional concern about the treatment of off-system sales that might subsidise wholesale sales at the expense of retail ratepayers. The parties slightly modified the stipulation on 27 September to address this point.

⁶² Primary Staff repeated much of the previous argument. “By reducing rates on a kWh basis, high load factor classes ... such as large commercial and industrial classes, receive a proportionately larger share of the reduction than they would had the reduction been allocated in a manner similar to that used in a rate case. Conversely, lower load factor classes, such as residential and small commercial classes, receive a smaller share of the reduction.”

⁶³ “Although staff continues to believe allocating the reduction on a demand and energy component better matches the way dollars are collected through base rates, we recognise that the reduction in the base rate energy charge for all customers is administratively quicker to implement and more easily explained to customers. Similarly, since any shared revenue credits are to be shown as a separate line item on the bill, allocating these dollars on an energy basis makes the credit easier for the customers to relate to the other charges on their bill.”

⁶⁴ “This allocation methodology differs from FPL’s previous rate stipulations that allocated the reduction on a kWh basis. The percentage reduction in base rates is a better method of allocating a decrease because all classes receive the same percentage reduction in base rates. Under an energy allocation, a larger percentage of total reduction goes to larger commercial and industrial customers relative to residential and small commercial customers.” Docket No. 001148, Order No. PSC-02-0501-AS-EI, issued April 11, 2002, p. 3. See also Docket No. 000824, Order No. PSC-02-0655-AS-EI, issued May 14, 2002, p. 4.

clearly not been effective in the past, and staff had become resigned to the Commission's acceptance of energy-based reductions.

A more plausible explanation for the changed approach is that, for FPL at least, the rates in effect as of 2002 already reflected the energy-based reductions effected earlier. The stipulation in 2002, which provided for an across-the-board rate reduction, protected these gains by avoiding the rebasing based on relative costs that would have accompanied a traditional rate hearing. The stipulation essentially prolonged the energy-based reductions and the associated benefits already established by the large users. The wording of the staff analysis is consistent with this conjecture.

FPL's rate structure has not been formally reviewed since its last rate case in 1983. Since then, new classes have been added and customers have shifted among rate classes seeking more advantageous rates. Based on FPL's cost of service study, there are disparities among the rates of return by class. In a rate case, one of the goals of rate design is to set rates that reflect the costs to serve that class or, stated differently, to set the rate of return for each class equal to the system rate of return. We recognise, however, that a Stipulation is a negotiated document with all participants making some concessions. While the proposed across-the-board percentage reduction does not move FPL's rate structure towards parity, it does not worsen it. Accordingly, we find that the across-the-board reduction is reasonable.

It is not clear whether FPC's rates were as favourable to large users as FPL's: the utility had not had a previous stipulation that reduced rates on an energy basis, and the staff analysis does not explicitly claim that there are disparities by class at FPC. However, there are similar indications of concern about changes that have taken place over time.⁶⁵ These are followed by the same remarks about the Stipulation being a negotiated document and not making the rate structure worse.

As regards calculations of the extent of the distortion, in the first case (**TECO 1996a**), staff conjectured as follows. "If the \$25m is allocated on energy, the residential customers could realize up to \$4.25 million less in total refund dollars than if the refund were allocated on demand (\$10.75 million versus \$15 million)." This calculation assumed that residential customers accounted for 60% of peak demand but only 43% of energy demand (in MWh). The refund to residential customers on a peak demand basis would have been $60/43 = 1.395$ or 39.5% higher than it was on an energy basis.

A second calculation in the same staff analysis suggested that the peak demand basis might have justified only 55% of the reduction. On this basis the refund to residential customers would have been $55/43 = 1.279$ or 27.9% higher than on the energy basis.

A later calculation by staff (**FPL 1999**) suggests that both the above estimates may have overestimated the transfer from residential to industrial customers.

⁶⁵ "Order No. PSC-01-1348-PCO-EI, requiring FPC to file MFRs, states that one of the reasons for requiring MFRs was to ensure proper ratemaking and cost allocations among the rate classes to reflect changes that have occurred since the company's last rate case. FPC's most recent fully allocated cost of service study was filed in 1991, and utilised a prospective 1993 test year. Since that time, significant changes have taken place in the company's operations, and cost shifting among the rate classes has occurred. / This Commission has historically sought to establish rates that recover the cost to serve each rate class. Stated differently, this Commission has attempted to set the rate of return for each rate class as close as practicable to the system-wide rate of return."

For illustrative purposes, staff has estimated the impact on residential customers of allocating the entire \$350 million reduction on a 12 CP and 1/13 AD basis⁶⁶, in lieu of the proposed energy basis. ... Based on this data, the residential customers would receive a .463 cent per kWh reduction in their non-fuel energy charge, as compared to the .420 reduction proposed. The demand allocation would result in a reduction of \$4.68 on the monthly 1,000 kWh bill, a \$.43 larger reduction than under the energy allocation. / Staff believes that the use of a demand allocator more closely reflects how the reduction would be distributed in a full requirements rate case.⁶⁷

This calculation is that a demand-based reduction would imply a reduction for residential customers that was $0.463/0.420 = 1.10$ or 10% higher than on an energy basis.

Appendix 4 Accounting policy

The following summaries highlight those aspects of the stipulations that refer to accounting policy.

FPC 1986: This noted the problem posed for the company by the Commission's recent ruling on depreciation.⁶⁸ It specified that the \$54m refund was contingent on the Commission's acceptance that it was in lieu of (inter alia) any re-prescription of FPC's depreciation rates before 1988.

GPC 1993: The utility filed for a rate increase citing FPSC's recent dismantlement policy.⁶⁹ The stipulation provided that GPC would use an alternative straight-line method of calculation that deferred the amount of the dismantlement accrual, agreed a lower ROE and provided that the rate would remain unchanged. Primary staff recommendation was not to approve the stipulation because of inter-generational inequities and because all electricity companies should have a proper chance to debate what was a generic issue.⁷⁰ Alternative staff noted the benefits of avoiding the present rate increase and of lower future rates.

⁶⁶ "The bulk of FPL's fixed production and transmission plant costs were allocated based on each class's estimated contribution to the 12 monthly maximum system peaks. This method, known as the 12 Coincident Peak and 1/13 Average Demand (12 CP and 1/13 AD) method, was used to allocate most fixed production and transmission costs for each of the four major investor-owned utilities in their last full requirements rate cases." (p. 5)

⁶⁷ Memorandum: Case background, Docket No. 990067-EI, March 15, 1999, Primary Staff analysis pp. 5-6. Also endorsement by Alternative Staff at p. 12.

⁶⁸ "Public Counsel and FPC further recognise that FPC's costs are subject to increase in a substantial but uncertain amount from a pending re-prescription of its depreciation rates in Docket No. 851097-EI, and that a deferral of such re-prescription is essential to FPC's ability to provide a benefit from the aforementioned cost reductions to its customers. OPC and FPC wished to provide an immediate benefit to customers in a manner that satisfactorily balanced the interests of the company and its customers."

⁶⁹ In 1989 an FPSC order had established a new method for calculating the amount of the accrual for the dismantlement of fossil fuel plant. FPSC had agreed to GPC's request that new depreciation rates and dismantlement accruals be effective in its next rate case. Now, GPC mentioned a \$10.8m revenue impact of its depreciation study, and said that the method prescribed in the FPSC order "places significant upward pressure on the Company's retail rates and charges to the general body of customers, and places the Company in the position of having to seek retail rate relief in order to cover such expenses".

⁷⁰ "deferring implementation results in inter-generational inequities in that a delay in implementation would only move those dollars of expense into the future – with a shorter period of recovery". "Now, at this point GPC wishes to re-argue the Commission's prescribed policy without the involvement of the other electric companies. ... if GPC wishes the Commission to readdress the methodology for

TECO 1996a: In 1993 FPSC approved TECO's proposal to use a reduction in its authorised ROE to begin a \$4m annual storm damage accrual, and not to make a rate reduction as OPC urged. In 1994 FPSC applied any overearnings to increase this storm damage accrual. In contrast, TECO March 1996 applied the overearnings to a refund. One of the concerns of alternative staff about the TECO March 1996 stipulation was that a refund might not be the best way of using excess revenues, since "other opportunities to reduce regulatory assets, mitigate potential „stranded costs“, or handle other regulatory balance sheet concerns will be foregone”.

FPC 1997b: see text.

FPL 1999: FPSC's conservative policy applied not least to FPL, where there was a plan for writing off assets.⁷¹ In December 1998 the Commission approved a further proposal to extend the plan through 2000. Various parties now filed protests.⁷² In January 1999 OPC filed a petition to have FPSC conduct a full revenue requirements rate case, alleging that "while long-term benefits for both FPL and its customers may have been achieved by the „Plans“ approved by the FPSC [over the five years 1995-1999], the time has now come for the customers to share in the benefits.”

FPL 1999 authorized FPL to record amortization up to \$100m per year to reduce nuclear and/or fossil plant in service, in addition to normal depreciation. It also provided that accruals for nuclear decommissioning and fossil dismantlement would be capped at previously authorised levels. Making these charges discretionary or capping them facilitated the \$350m reduction in base rates. Because of this benefit, primary staff recommendation was to approve the stipulation, but the analysis was so heavily qualified that it could have been the basis for a rejection. The discretionary amortization was a serious concern because it would mean that depreciation would reflect the variability of the company's revenues rather than be matched to asset service life.⁷³ FPSC accepted the stipulation without commenting on this modification of its accounting policy.

calculating the dismantlement accruals, another generic docket should be opened where all companies can participate. It should not be buried as an issue in the Company's next rate case.”

⁷¹ In 1995 FPSC accepted FPL's proposal for writing off various deficits and regulatory assets totalling \$485m during 1995, 1996 and 1997. In 1997 FPSC extended the plan so as to write off a further \$401m in 1998 and 1999. Dockets 950359-EI and 970410-EI refer.

⁷² The parties were FIPUG, Tropicana Products Inc, the Coalition for Equitable Rates (CER), the Florida Alliance for Lower Electric Rates Today (ALERT) and Georgia Pacific Corporation.

⁷³ “In a word, this is accelerated depreciation. The potential end-point is that the design of depreciation rates, and the resultant rate base, will no longer reflect the matching principle, but rather, the degree of variability in the company's revenues. ... / One of the basic axioms of depreciation is to match capital recovery with consumption. Staff is concerned with the concept of using economic conditions to adjust depreciation expenses which should properly be matched to service life. Previously, the Commission has approved faster write-offs of perceived reserve deficits, and of unrecovered net plant that are not life related; such actions were considered not to conflict with the matching principle. / The Stipulation essentially allows FPL the flexibility to shorten the recovery period of the fossil/nuclear plants. This is not the writing off of a perceived historical deficit, but simply accelerated depreciation, in conflict with the matching principle. Staff's concern is that each step made in this direction makes the next step easier. Further, the amortization will reduce the company's achieved earnings over the life of the Stipulation.”

GPC 1999: In response to concerns about earnings and ROE, GPC proposed an earnings sharing incentive plan that reduced its authorised ROE from 12% to 11.6% and shared any earnings in excess of 12.6% in the following ratios: 40% to the company shareholders, 20% to write off certain regulatory assets and to increase the Property Insurance Reserve, and 40% refunded to customers. FPSC was attracted by the earnings incentive concept and by the notion of writing off assets.⁷⁴ But FPSC was not satisfied with the parameters, so it rejected this plan and approved an alternative plan proposed by staff, which involved lower proportions to the shareholders and customers and a higher proportion to writing off assets.⁷⁵ This plan was in turn challenged by OPC and superseded by the stipulation GPC 1999 that provided for an immediate \$10m rate reduction for customers; for revenues (rather than earnings) between certain levels to be shared in the ratio 1/3 to shareholders and 2/3 to customers; and for all revenues in excess of the upper level to be refunded entirely to customers. GPC was given discretion up to specified annual amounts to write off the regulatory assets and increase the Property Insurance Reserve. Again, the FPSC accepted the stipulation without commenting on this aspect.

FPL 2002: As FPL 1999 came towards termination, the parties considered a further agreement. The challenge was to enable a further significant rate reduction, this time of \$250m. FPL 2002 authorised the company to reduce depreciation by up to \$125m per year, which would effectively fund half the rate reduction. FPL agreed to withdraw its request for an increase in the annual accrual to the storm damage reserve, and instead would petition FPSC for recovery of prudently incurred costs in the event that there were insufficient funds in the reserve. This would avoid whatever rate increase that cost represented.

FPC 2002: This stipulation, contemporaneous with FPL 2002, took a similar approach. FPSC had already placed \$98m subject to refund but OPC evidently envisaged more. To help fund the \$125m rate reduction, there was an annual reduction in depreciation of \$62.5m, with the company given discretion to reverse all or part of this, and discretion to accelerate amortization of certain regulatory assets. Accruals for nuclear decommissioning and fossil dismantlement were suspended, worth another \$16m.⁷⁶ It was agreed that, when the new plant Hines Unit 2 came on stream, its costs would be recovered through the Fuel and Purchase Cost Recovery Clause until 2005 (the end of the stipulation): this kept that additional item out of the cost base.

⁷⁴ “Gulf is expected to bring additional generating capacity on line in 2002, which could increase revenue requirements. A plan which reduces future revenue requirements by writing off past costs before 2002 and encourages it to become more efficient ... will mitigate the impact of this additional investment.” (Docket 990244-EI, Order PSC-99-1047-PAA-EI, May 24, 1999, p. 7.

⁷⁵ This plan provided for writing off certain regulatory assets and increasing the Property Insurance Reserve by specified amounts; reduced the authorised ROE from 12% to 11.2%; shared earnings between 12.2% and 14.2% in the following ratios: 2/3 to further write off certain regulatory assets and increase the Property Insurance Reserve and 1/3 to company shareholders; and refunded to customers any earnings over 14.2%.

⁷⁶ It has been suggested that this may have followed a decision to extend the life of nuclear and other stations. However, it has also been suggested that FPSC had approved FPC’s dismantlement and decommissioning studies less than a year earlier, and that these studies had indicated that continued accrual was necessary.

FPL 2005: Three years later, the new challenge was to avoid a rate increase for FPL when the company had requested a rate increase of \$430m, particularly given that the Attorney General's Office had indicated a strong preference for no rate increase. The requested increase comprised \$100m for GridFlorida expenses, \$100m for an increase to storm damage accrual, and \$225m for two recently-introduced generation plants. The stipulation FPL 2005 dealt with these three items by, respectively 1) affirming FPL's right to recovery of prudent incremental costs associated with establishing a Regional Transmission Organization, thereby obviating the need for an immediate base rate increase⁷⁷; 2) allowing FPL to levy a surcharge and/or to securitize any under-recovery or replenishment of the storm damage fund; and 3) suspending future storm damage accrual (\$20.3m annually), suspending FPL's nuclear decommissioning accrual (\$78.5m annually) and giving FPL the option to amortize up to \$125m annually as a credit to depreciation and a debit to depreciation reserve (that is, to reduce depreciation). The first two steps avoided the need for any immediate rate increase, the remaining measures provided earnings cover for the new plants. The parties explained that „in a period of unprecedented world energy prices“ their aim was „to maintain a degree of stability to FPL's base rates and charges“.

PEF 2005: A similarly imaginative approach was taken to PEF's requested \$206m rate increase, which comprised \$50m for an increase to storm damage accrual, \$70m for an increase in depreciation and dismantlement expenses and \$86m for the new Hines Units 2 and 3 that had been brought into service in December 2003 and 2005. Stipulation PEF 2005 provided for 1) no increase in storm damage accrual, since in future storm costs would be recovered through surcharge and/or securitization; 2) no increase in depreciation and dismantlement expenses by virtue of a continued suspension of nuclear decommissioning accrual (\$7.7m annually) and fossil fuel dismantlement accrual (\$9.9m annually); 3) continued recovery of all Hines Unit 2 costs from the fuel recovery clause until December 2007 when Unit 4 comes on stream and base rates will increase for both Unit 2 (about \$38m) and Unit 4 (\$49.4m); and 4) lower depreciation rates (\$30m) with discretion for accelerated amortization, an increase in miscellaneous revenues (\$15m) and an adjustment to PEF's deemed equity ratio (worth \$5m) to provide earnings coverage for the new Hines 3 unit.

⁷⁷ Parties could participate in subsequent proceedings for the purpose of challenging the reasonableness and prudence of such costs but not for challenging FPL's right to clause recovery.

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