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## WISCONSIN LEGISLATIVE COUNCIL INFORMATION MEMORANDUM

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### **“Power the Future-2 (PTF-2)” and the New Law Regarding Leased Generation Contracts for the Construction or Improvement of Electric Power Plants**

#### **INTRODUCTION**

In recent years, there has been considerable concern about the adequacy of the electric power supply, in Wisconsin and across the county. The Legislature, the Public Service Commission (PSC) and the electric power industry have all taken steps to address these concerns and short-term power shortages so far have been avoided. However, no new base load power plants (large power plants that are designed to run full-time) have been built in Wisconsin since 1985, in spite of significant growth in demand for power since then. There is a general consensus that a substantial amount of new electric generation capacity, including base load facilities, must be built in the next 10 years to meet the projected demand for power.

An ambitious construction program announced by Wisconsin Energy Corporation (Wisconsin Energy), the parent company of Wisconsin Electric Power Company (Wisconsin Electric), has dominated recent discussion of construction in Wisconsin. Wisconsin Energy proposes to build as many as three 600 megawatt (MW) coal-fired power plants at Oak Creek and two 500 MW gas-fired combined cycle power plants at Port Washington. Regulatory innovations that Wisconsin Energy proposed along with its construction program have similarly dominated recent discussions of electric utility regulation.

This Information Memorandum describes the regulatory aspects of Wisconsin Energy’s proposal and recent legislation enacted to allow implementation of those regulatory innovations.

#### **POWER THE FUTURE-2**

In the fall of 2000, Wisconsin Energy Corporation announced a proposed new approach to the organization and regulation of electric power generation, which it called, “Power the Future.” In November 2000, Wisconsin Energy submitted a petition to the PSC requesting a declaratory ruling on various aspects of its proposal. The proposal was opposed at that time by the Customers First! Coalition (CFC). However, in February 2001, Wisconsin Energy and CFC announced an agreed-upon modified proposal, which was dubbed “Power the Future-2” (PTF-2). That same month, Wisconsin Electric filed a revised petition with the PSC requesting a declaratory ruling on various aspects of the modified proposal.

PTF-2 proposes to allow Wisconsin Energy to form a nonutility affiliate to build and own electric power generating facilities. This company would lease the generating facilities to Wisconsin Electric, which would operate the new facilities to produce electric power for its customers, much as it operates its current stock

of generating facilities. This ownership and lease arrangement is intended to allow Wisconsin Energy to build generation facilities outside of its public utility affiliate, taking advantage of various financing and contracting options this allows. At the same time, it keeps the generation function inside the public utility affiliate, ensuring the availability of the power to the utility's retail customers, providing the generated power at rates based on the cost of production and retaining regulatory jurisdiction at the state level.

A key element of the proposal is the lease, referred to as a "leased generation contract." The lease would specify a number of important terms, including the recovery by the nonutility affiliate of the construction cost of the facility and other costs, including capital improvements to the facility during the term of the lease.

Among other specifics, the proposal calls for the affiliate to be allowed to receive a greater rate of return on its investment in new generating plants than the PSC currently allows for similar investments by public utilities and to amortize the investments over a shorter time. It also would allow Wisconsin Energy's shareholders to receive 25% of the profit from opportunity sales (sales of excess capacity to entities outside the utility's service territory), something not currently allowed. The proposal also calls for measures to mitigate the potential market power of Wisconsin Energy and commits Wisconsin Energy to increase its investments in energy conservation and the development of renewable energy sources.

Finally, under the proposal, Wisconsin Energy would retain ownership of its current stock of electric generating plants, except for some old plants that are due for retirement. The proposal limits the ability of a utility to transfer real property to its affiliates under a leased generation contract.

Implementation of PTF-2 will require a number of PSC approvals. These approvals will come in steps as Wisconsin Electric and the PSC follow the existing process for the approval of new power plant proposals. In particular, each leased generation contract will require PSC approval under the affiliated interest statutes and construction approval will be required for each power plant to be built or modified. In a petition currently under consideration by the PSC, Wisconsin Electric is requesting assurances that it will be allowed to recover expenses it incurs before final construction approval is given. This docket is particularly significant because in it Wisconsin Electric is asking the PSC to declare that it is "prudent," as that term is used in its regulatory sense, for Wisconsin Electric to pursue implementation of the PTF-2 proposal. A ruling on this petition is expected soon.

In addition, certain statutory changes were required to allow certain aspects of the proposal. The legislation making these changes, which was enacted as part of 2001 Wisconsin Act 16, the 2001-03 Biennial Budget Act, is the subject of the remainder of this Information Memorandum.

While PTF-2 was designed to apply specifically to Wisconsin Energy's plans for the development of new electric power generating facilities, the concepts of the proposal could be applied to other utility holding companies, as well as to public utilities that are not in holding companies. What is more, the legislation described in the next section is written in general terms that apply to any electric utility.

For a fuller description of PTF-2, see the materials referenced at the end of this Information Memorandum.

## **NEW LAW REGARDING LEASED GENERATION CONTRACTS (ACT 16)**

As noted above, Act 16 makes certain statutory changes that are necessary to allow implementation of PTF-2. Specifically, the Act authorizes leased generation contracts between public utilities and their affiliates and authorizes the transfer of land or facilities from a public utility to a nonutility affiliate of the public utility for the purpose of implementing a leased generation contract. In addition, it implements a number of points in PTF-2 by specifying conditions under which the PSC may approve leased generation contracts.

### **LEASED GENERATION CONTRACTS UNDER THE AFFILIATED INTEREST LAW**

Under the affiliated interest law, any contract or arrangement between a public utility and an affiliated interest of the public utility must be approved by the PSC. [s. 196.52, Stats.] (An “affiliated interest” is any entity that has control or influence over a public utility, as determined by controlling at least 5% of the public utility’s stock or as determined by the PSC, or any entity over which the public utility has such control. Note that the entities do not have to be in a holding company system to be affiliated interests.) This statute establishes procedural requirements for obtaining this approval, and standards the PSC must consider in determining whether to grant the approval. A leased generation contract would be subject to this statute.

The Act establishes additional limitations on the approval of leased generation contracts, exceptions to existing limitations, and other requirements regarding such contracts.

### **Definitions and Terminology**

The Act defines “*leased generation contract*” as “a contract or arrangement or set of contracts or arrangements under which an affiliated interest

of a public utility agrees with the public utility to construct or improve an electric generating facility and to lease to the public utility land and the facility for operation by the public utility.”

The Act defines “*electric generating facility*” to mean, in effect, an entire power plant. It defines “*electric generating equipment*” very precisely to include only the equipment that actually converts a fuel or source of energy into electricity. For example, in a coal-fired plant, this would include the boiler, turbine and generator, but would not include other facilities, such as the building shell, rail spurs and other coal handling facilities, or water intake structures and other cooling facilities. It also includes fuel cells and photovoltaic cells.

The definition of “*leased generation contract*” refers to both the **construction** and the **improvement** of a power plant. This allows application of the leased generation contract mechanism to the construction of an entire new power plant or to the replacement of an existing component or the construction of a new component of an existing power plant. For example, an affiliated interest may install a new turbine or electric generator or build a new air pollution control system on an existing plant owned by a utility; the affiliated interest would then own that component of the power plant and lease it to the utility.

The Act amends the definition of “*public utility*” to specify that a person who owns a facility that is subject to a leased generation contract is not a public utility unless the person otherwise qualifies as such. This appears to have the same effect as prior law. The Act also amends the definition of “*wholesale merchant plant*” to specify that a facility that is subject to a leased generation contract is not a wholesale merchant plant. This also appears to have the same effect as prior law.

### General Provisions

The Act establishes a number of general requirements and limitations regarding leased generation contracts. It limits the application of leased generation contracts to projects for which, as of January 1, 2002, the PSC has not approved the construction or improvement that will be conducted under the contract and, as of January 1, 2002, the construction or improvement has not started. It also limits application of these contracts to projects for which the estimated gross cost of the construction or improvement is at least \$10 million. Projects smaller than this could not be financed under a leased generation contract. It also prohibits the application of a leased generation contract to the construction or improvement of nuclear powered plants.

The Act specifies that the term of a leased generation contract for construction of a gas-fired facility be at least 20 years and, for construction of a coal-fired facility, at least 25 years. The Act does not specify the term of contracts for improvements to existing facilities, leaving this determination to the PSC. Presumably, the PSC would base the term of such a contract on the projected useful life of the improvement.

At the end of a contract, the public utility has the option to renew the contract or to purchase the power plant or equipment that is subject to the contract. The new lease or the sale would be based on the fair market value of the plant or equipment, as determined by a valuation process specified in the contract and conducted by a third party. If the utility chooses to exercise this option, the affiliated interest may require that the utility extend the contract, rather than purchase the property, if extension of the contract will avoid material adverse tax consequences and if the extension of the contract provides terms and conditions that are economically equivalent to a purchase. If the utility does *not* exercise this option, the power

plant or equipment remains the property of the affiliated interest, with no further obligation to the utility.

The Act specifies that a leased generation contract does not take effect until the date on which the affiliated interest starts construction or improvement of the power plant. If a contract applies to more than one construction project, the contract does not take effect with respect to an individual project until the date on which the affiliated interest starts that project. It also directs the PSC to maintain jurisdiction to ensure that the power plant or equipment is constructed and placed in service as provided in the contract.

The Act specifies that the new statute regarding leased generation contracts does not prohibit electric cooperatives and municipal electric utilities from acquiring an interest in a power plant that is constructed under a leased generation contract or the land on which the plant is located.

### Utility Rates

The Act provides that, in setting rates of a public utility, the PSC may not consider any income, expenses, gains, or losses that are received or incurred by an affiliated interest as a result of its ownership of a power plant under a leased generation contract. This is essentially a restatement of the general policy that underlies the affiliated interest law, which is that the finances of a public utility and its affiliates should be strictly separated and the financial condition of the affiliate should not affect the utility or its rates.

The Act requires the PSC to allow a utility to fully recover, in its retail rates, the portion of payments it makes under a leased generation contract and of prudent costs related to the operation and maintenance of a power plant or equipment under the contract that relate to the provision of retail utility service. This, too, is a

restatement of a general policy of utility regulation, which is that a utility is entitled to recover through its rates the prudently incurred costs of providing the service to which the rates apply. It does not state, but implies that the costs incurred under a contract that are allocable to wholesale power sales must be recovered through those sales.

### **Transfer of Real Property**

The Act prohibits the transfer from a public utility to its affiliated interest of any “electric generating facility, electric generating equipment, or associated facilities, held or used by the public utility for the provision of electric service” under a leased generation contract. It provides an exception for the transfer of specified facilities between a public utility affiliate and nonutility affiliate within a holding company system, as described below. However, that exception does not apply to affiliated interests that are not subject to the holding company law. As a consequence, a utility that is not subject to the holding company law is not allowed to transfer any of the described facilities to its affiliated interest under a leased generation contract.

The Act requires that any transfer of real property from a utility to its affiliate under a leased generation contract must be made at the book value of the property at the time of the transfer. (Book value is the original cost of the real property, minus accumulated depreciation.) It also requires that any property that is transferred be transferred back to the utility, on the same terms and conditions as the original transfer, if the construction or improvement is not completed as provided in the contract.

### **Modification of Contracts**

Under the affiliated interest law, when approving any contract or arrangement between a public utility and its affiliated interest, the PSC is required to “reserve the power of the

commission to revise the terms and conditions of the contract or arrangement to protect and promote the public interest.” [s. 196.52 (5) (a), Stats.] The Act states that, notwithstanding this provision, the PSC may not modify a leased generation contract that it has approved, except as specified in the contract or in the PSC order approving the contract.

### **TRANSFER OF REAL PROPERTY UNDER THE HOLDING COMPANY LAW**

Under the holding company law, in general, a public utility may not transfer, sell or lease real property to its nonutility affiliate except by public sale or by offering to the highest qualified bidder. [s. 196.795 (5) (k), Stats.] (A “nonutility affiliate” is a company in a public utility holding company system that is not a public utility.)

The Act provides that a public utility may transfer certain real property to its nonutility affiliate at book value for the purpose of implementing a leased generation contract. The utility may transfer land that is held and used for the provision of utility service.

In addition, it may transfer electric generating equipment or associated facilities if all of the following apply: (a) the equipment or facilities are located on the land on which an electric generating facility subject to a leased generation contract is to be constructed; and (b) the equipment or facilities are part of an electric generating facility on that land that is no longer used and useful for the provision of utility service and that has been retired from the provision of utility service. In other words, only land or parts of a retired power plant on the site where a new power plant will be built may be transferred. An entire power plant may not be transferred; neither may equipment that is used or held by a utility for future use nor equipment that is not on the site of the proposed new construction.

**INITIAL APPLICATION**

The provisions of the Act first apply to a leased generation contract that is entered into, modified, renewed or extended on September 1, 2001.

**ADDITIONAL RESOURCES**

For a fuller description of PTF-2, see Wisconsin Electric's formal filings with the PSC, in particular its Petition, dated February 23, 2001, and its Reply to Comments, dated March 30, 2001.

For discussion and analysis of PTF-2 by PSC staff, including a summary of testimony presented to the PSC in formal hearings, see two memoranda from Robert Norcross, Electric Division Administrator, and others to the PSC, both titled, *In the Matter of Wisconsin Electric Power Company's Request for Declaratory Ruling Approving a Plan to Increase Generation In Wisconsin*, dated April 26 and August 21, 2001.

Copies of these documents can be obtained from the PSC or from the author of this Information Memorandum.

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This memorandum, prepared on October 15, 2001, by **David L. Lovell, Senior Analyst**.

This information memorandum is not a policy statement of the Joint Legislative Council or its staff.

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**WISCONSIN LEGISLATIVE COUNCIL**

One East Main Street, Suite 401 • P.O. Box 2536 • Madison, WI 53701-2536

Telephone: (608) 266-1304 • Fax: (608) 266-3830

Email: [leg.council@legis.state.wi.us](mailto:leg.council@legis.state.wi.us)

<http://www.legis.state.wi.us/lc>