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Public Service Commission of Wisconsin
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BEFORE THE

PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of Wisconsin Power and Light Company for a Certificate of Authority to Construct a Wind Electric Generation Facility and Associated Electric Facilities, to be Located in Fond du Lac County, and an Application for Approval of Fixed Financial Parameters and Capital Cost Rate-Making Principles for the Facility, to be Known as the Cedar Ridge Wind Farm	6680-CE-171

FINAL DECISION ON RATEMAKING PRINCIPLES

This is the Final Decision regarding the request by Wisconsin Power and Light Company (WP&L) that the Commission issue an order under Wis. Stat. § 196.371 and Wis. Admin. Code ch. PSC 111, setting fixed financial parameters (FFP). This Final Decision will fix the ratemaking treatment for the capital cost of the Cedar Ridge Wind Farm project in all future rate proceedings before the Commission. The application is APPROVED, subject to conditions and as modified by this Decision. Under Wis. Stat. § 196.371, WP&L has the option to notify the Commission in writing within 60 days of the date this Final Decision takes effect whether it accepts or waives acceptance of the Decision. If WP&L waives acceptance, and if the Commission issues a Certificate of Authority for the project, the costs associated with the Cedar Ridge facility will be subject to recovery under standard ratemaking practices. If WP&L makes no notification, the Commission will consider WP&L to have waived acceptance of this Decision.

Introduction

On September 13, 2006, WP&L filed an application with the Commission for authority under Wis. Stat. § 196.49 and Wis. Admin. Code ch. PSC 112 to construct, own, and operate a wind electric generating facility. The facility, known as the Cedar Ridge Wind Farm, will be located in the area of Eden, Fond du Lac County. The project will include up to 41 wind turbines with a total generating capacity of up to approximately 98 megawatts (MW), depending on the make and model of turbine selected. WP&L anticipates that the project will be constructed in time for a commercial operation date of 2008. In addition to the application for a Certificate of Authority to construct the project, WP&L filed an application in the same docket for authorization of FFP.

The construction and FFP applications were processed by the Commission along parallel but separate timelines, and this Decision addresses only the FFP application. A separate Certificate and Order will be issued by the Commission regarding the construction application.

On January 3, 2007, the Commission held a prehearing conference in this docket. This prehearing conference was limited to the FFP aspects of the docket. The issues for hearing, as determined at the prehearing conference were as follows:

- Is an order authorizing FFP for the Cedar Ridge Wind Project in the public interest?
- What order terms would provide a sufficient degree of certainty to the public utility, investors, and ratepayers with respect to the future recovery of the facility's capital costs?
- What is the appropriate method for determining cost that may be recovered in rates?
- Are any securities to be issued in compliance with Wis. Stat. chs. 196 and 201?

A hearing on the FFP aspects of this docket was held on February 28, 2007, in Madison, Wisconsin. The Commission received expert testimony on the issues from WP&L, the Citizens' Utility Board (CUB), RENEW Wisconsin (RENEW), and Commission staff. The Commission considered this matter at its open meeting on April 24, 2007.

Findings of Fact

1. WP&L is a public utility, as defined in Wis. Stat. § 196.01(5)(a), engaged in rendering electric service in Wisconsin. WP&L filed an application with the Commission under Wis. Stat. § 196.371 and Wis. Admin. Code ch. PSC 111, for authorization of FFP for its proposed Cedar Ridge Wind Farm project, as described in its application and as modified by this Final Decision.

2. This Final Decision authorizing FFP will provide a sufficient degree of certainty to the public utility, investors, and ratepayers with respect to future recovery of the facility's capital costs and is in the public interest.

3. For purposes of FFP, depreciation rates should consider net cost of removal regardless of whether they produce a negative rate base amount.

4. Depreciation rates should be fixed for the life of the project.

5. Any allowance for funds used during construction (AFUDC) shall be based on the weighted cost of capital.

6. As described in this Decision, the financing plan proposed by WP&L to raise capital for the Cedar Ridge Wind Farm under FFP is reasonable.

7. Subject to change based on prevailing market rates when permanent debt and preferred stock are issued, the rates for debt and preferred stock issued to finance the Cedar Ridge Wind Farm proposed by WP&L and as described in the Decision are reasonable.

8. The capital structure in the FFP of 42 percent senior unsecured long-term debt, 5 percent preferred stock, and 53 percent common equity to finance the Cedar Ridge Wind Farm is reasonable.

9. It is reasonable that the amounts approved in the construction certificate of authority in this docket be used for the FFP in rate cases until such time as the final project costs are determined and accepted. It is also reasonable to require WP&L to submit final costs within one year of the commercial operation date to be used for the FFP for the Cedar Ridge Wind Farm beginning in WP&L's next rate case.

10. It is reasonable to include new purchases of land by a utility in its FFP. It is also reasonable to include in the FFP the capital cost of land that was previously owned and held for future use by the utility when the land will now be used for the project for which FFP is approved.

11. Until construction work in progress (CWIP) expenditures may be included in net investment rate base in a rate case proceeding, it is reasonable for WP&L to accrue AFUDC. At such time that CWIP expenditures may be included in net investment rate base in a rate case proceeding, it is reasonable for WP&L to earn a current return on 100 percent of CWIP.

12. It is reasonable that any changes in income tax rates during the project's life span be included in the determination of any future year net investment rate base related to FFP costs. If such tax changes result in any regulatory assets or liabilities, it is also reasonable that such

amounts would be included in the computation of FFP net investment rate base for the time periods impacted by the changes.

13. If the entire cost for the project is removed from the utility's books before the end of the 20-year life expectancy, then it is reasonable that the FFP should stop for the project.

14. Use of a projected 20-year life for the Cedar Ridge Wind Farm for the purposes of the FFP is reasonable.

15. It is reasonable that the authorized return on equity be set at 10.5 percent for the 20-year life span.

16. WP&L should be required to submit final cost rates for the debt and preferred equity securities, once those securities are issued.

Conclusions of Law

The Commission has jurisdiction under Wis. Stat. §§ 196.371 and 196.395, and Wis. Admin. Code ch. PSC 111, to issue an order authorizing WP&L, as an electric public utility, to specify in advance the ratemaking principles, or FFPs, that the Commission shall apply to the public utility's recovery of the capital costs of the Cedar Ridge Wind Farm in future ratemaking proceedings and to impose the conditions specified in this Final Decision.

Opinion

Under Wis. Stat. § 196.371, a utility that applies for a certificate for the construction of an electric generation facility may apply to the Commission for an order[1] specifying in advance the FFP that the Commission shall apply to the public utility's recovery of the capital costs of the

[1] Wis. Stat. § 196.371 uses the term "order." In this proceeding, a "Final Decision" is an "order."

facility in future ratemaking proceedings. Pursuant to Wis. Stat. § 196.371, the Commission must make its decision regarding the FFP application no later than the date that the Commission takes final action regarding the construction application if a construction application is filed for the project. The Commission may issue an order regarding the FFPs if it determines that the order will provide a sufficient degree of certainty to the public utility, investors, and ratepayers with respect to future recovery of the facility's capital cost, and that the order is otherwise in the public interest.

Under Wis. Stat. § 196.371, the Commission shall specify a deadline of at least 60 days after the date the order takes effect for the public utility to notify the Commission in writing regarding whether the public utility accepts or waives acceptance of the order. If the utility does not make the notification by the deadline specified in the order, the public utility is considered to have waived acceptance of the order. If the utility accepts the order, then the order shall be binding in all future ratemaking proceedings. The FFPs authorized by the order are applied only to the costs of the electric generating facility associated with the request. If the public utility waives or is considered to have waived acceptance of the order, the Commission shall withdraw the order and consider the capital costs of the facility in all future ratemaking proceedings in the same manner as the Commission considers capital costs for which no order has been issued under Wis. Stat. § 196.371.

Cedar Ridge Project Costs

In its construction application, WP&L requests that the Commission authorize the project cost assuming that CWIP is included in WP&L's net investment rate base beginning January 1, 2008. To enable flexibility in turbine selection, and because no turbine supply agreement has yet

been executed by WP&L with a turbine manufacturer, WP&L requests that the approved amount set by the Commission be $179 million, with CWIP in rate base, and with the usual condition in the Certificate of Authority order that the approved amount not exceed more than 10 percent without prior Commission approval. On this basis, the estimated cost of the project by major plant account is as follows:

Plant Account	Description	
344	Wind Turbine Generators, Engineering, Procurement, Construction Management, Erection	$160,081,508
341	Surfaced Areas, Operations Building	7,975,784
345	Met Towers, Electrical Collection, SCADA	7,471,104
345	Substation	3,257,752
340	Land	80,000
	Total Capital	**$178,866,148**

Proposed FFP Financing Plan

If WP&L accepts this Decision, WP&L will implement the FFP approach as follows. It recommends a capital structure consisting of:

• Debt	42%
• Preferred stock	5%
• Common stock	53%
TOTAL	100%

WP&L suggests that the Commission apply the following returns, or costs of capital, on the respective capital types:

• Debt	6.58%
• Preferred stock	6.77%
• Common stock	12.90%

Under WP&L's proposal, before considering tax effects, the weighted average cost of capital would be:

Capital Type	Percent of Capitalization	Cost Rate	Weighted Average Cost Rate
Debt	42%	6.58%	2.76%
Preferred equity	5%	6.77%	0.34%
Common equity	53%	12.90%	6.84%
Total	**100%**		**9.94%**

WP&L's proposed weighted cost of capital does not reflect income tax effects, which are significant. While interest paid on debt instruments is tax deductible, returns on preferred equity and common equity are subject to state and federal income taxes. Assuming a 40 percent joint state/federal tax rate, under WP&L's proposal, the true economic cost of equity capital to the ratepayers would be 21.55 percent, of which 12.90 percent would flow to WP&L, with the remaining 8.65 percent going to the state and federal taxing authorities. The return on preferred equity is adjusted similarly. Including tax effects, the project's weighted average cost of capital would be:

Capital Type	Percent of Capitalization	Adjusted Cost Rate	Weighted Average Cost Rate
Debt	42%	6.58%	2.76%
Preferred equity	5%	11.31%	0.57%
Common equity	53%	21.55%	11.42%
Total	**100%**		**14.75%**

Adjusting for taxes therefore increases the weighted average cost of capital from about 10 percent to almost 15 percent.

The financing mechanism proposed by WP&L for the Cedar Ridge Wind Farm under FFP is reasonable.

Negative Net Salvage

WP&L maintains that any depreciation rate approved in an FFP proceeding should only consider a reasonable useful life and not consider any net cost of removal. However, for purposes of FFP, depreciation rates should consider net cost of removal regardless of whether

they produce a negative rate base amount. The accounting for plant and associated depreciation under FFP should be consistent with normal regulatory accounting. In setting depreciation rates, therefore, the Commission will take into consideration a reasonable useful life and net cost of removal. Whatever depreciation rate results from considering both of these factors will be used, regardless of whether it produces a negative rate base amount.

Depreciation Rates

Regarding whether depreciation rates should be fixed for the entire life of a project, the Commission considered two options. Either the depreciation rate could change based on changes in depreciable book lives, or the depreciation rate could remain fixed for the life of the project.

WP&L maintains that for purposes of FFP, the depreciation rate should remain fixed for the life of the project. WP&L's position is based on its interpretation of 2005 Wisconsin Act 7 (Act 7). WP&L's interpretation is that an order under Act 7 would set the depreciation life and rate for the applicable project.

The Commission finds that depreciation rates should be fixed for the life of the project and not be included in the future determination of revenue requirements. This treatment is consistent with Act 7 and will provide WP&L with a sufficient degree of certainty with respect to future recovery of capital costs.

AFUDC Rate

Regarding the rate to use for computing AFUDC, the Commission considered two options. Either AFUDC could be calculated using the adjusted weighted cost of capital, or using the pre-tax weighted cost of capital. In this proceeding, WP&L argues for an AFUDC rate based on the pre-tax weighted cost of capital.

This Commission's past practice has been to calculate AFUDC based on the adjusted weighted cost of capital. In addition, WP&L was ordered to use this rate in several recent rate cases including the Final Decision in its most recent case, docket 6680-UR-115, dated January 19, 2007.

Consistent with the Commission's Final Decision in docket 6680-UR-115 and current Commission practice, the Commission determines that AFUDC in this proceeding should be based on the adjusted weighted cost of capital. WP&L has not made an adequate showing that a project under FFP is somehow different than a similar project under regular rate-of-return ratemaking.

Cost of Debt

WP&L estimates that the cost of debt that it will issue to finance the Cedar Ridge Wind Farm is 6.58 percent. This is a reasonable estimate based on current market conditions. The actual fixed rate will be set at the actual effective interest rate, when the debt securities are issued. This assumes that rate at which the debt is issued is consistent with the then-current market conditions. Within ten business days of issuance, WP&L shall file a letter with the Commission documenting the actual issuance cost rate.

Cost of Preferred Equity

WP&L estimates that the cost of preferred equity that it will issue to finance the Cedar Ridge facility is 6.77 percent. This is a reasonable estimate based on current market conditions. The actual fixed rate will be set at the actual effective interest rate, when the preferred equity securities are issued. This assumes that rate at which the preferred equity is issued is consistent

with the then-current market conditions. Within ten business days of issuance, WP&L shall file with the Commission a letter documenting the actual issuance cost rate.

Return on Common Equity

Unlike the cost of debt and preferred equity securities, the cost of common equity is not directly observable. Rather, it must be estimated. There is considerable disagreement among the witnesses in this proceeding as to the appropriate return on equity for the Cedar Ridge Wind Farm. The recommended equity returns range from 9.75 to 12.90 percent.

The components of the return on equity at issue in this proceeding are: (1) the reasonable return for WP&L as an integrated regulated utility; (2) the appropriate adjustment, if any, for generation risk; (3) the appropriate adjustment, if any, for wind technology risk; (4) the appropriate adjustment, if any, for fixing the return on equity over the life of the facility; (5) the appropriate adjustment, if any, for the risk of rising interest rates; (6) the appropriate adjustment, if any, to provide incentives for utilities to construct renewable generation facilities; and (7) the appropriate adjustment, if any, to reflect broader public policy concerns, such as the need to maintain financial stability.

The Commission recently established the return on equity for WP&L as a regulated utility at 10.8 percent.[2] While useful, this number is not controlling for this financial parameters analysis. To establish a return on equity, we consider the most recent financial information presented in the record, including market model results, macroeconomic conditions and company-specific information. Here, as in each case, we establish a return on equity by balancing the needs of investors and consumers.

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[2] *See* Final Decision, docket 6680-UR-115, January 19, 2007.

Holding all else equal, fixing the return on equity over the life of a facility, as is done under the FFP approach, should increase investor certainty and decrease risk, namely, that risk associated with traditional ratemaking practices. Under standard ratemaking, future authorized returns, especially those 10 to 20 years in the future, are difficult to predict with reasonable accuracy, thereby creating a risk that is not present under the FFP approach. Finance principles make it clear that lower risk results in lower investor required returns. Thus, absent some major difference in the risk associated with the Cedar Ridge Wind Farm as compared to traditional utility assets, the return on equity in this FFP proceeding should be lower than the return on equity set in a contemporaneous rate proceeding for WP&L.

The differences in the risk associated with the Cedar Ridge Wind Farm relative to traditional utility assets are minor, and to a large extent, offsetting. For example, while the risk associated with generating assets built either in deregulated markets or in other regulatory jurisdictions may be noticeable, generation risk in Wisconsin is largely a non-issue. Evidence presented in this proceeding shows that the average generation risk adjustment associated with investing in generators operating in deregulated markets is about 300 basis points. For regulated utility generators operating in jurisdictions outside Wisconsin, it has been about 150 basis points. Yet, in Wisconsin it has been about 10 basis points, on average. Therefore, the evidence on this record makes it clear that the generation risk that WP&L faces in constructing the Cedar Ridge Wind Farm is relatively small.

In addition, this small upward adjustment in return for Wisconsin-specific generation risk is offset by the fact that renewable generating facilities constructed under this Commission's jurisdiction are afforded special cost recovery protection under Wis. Stat. § 196.378(2)(d). This

suggests that a wind generator is less risky, not more risky, than a conventional generating facility.

In contrast, WP&L sees this issue differently. It asserts that, after adjusting for all other risk factors, the greater certainty associated with the Commission fixing the return on equity should increase that return by as much as 192 basis points. However, that argument runs counter to the principle that suggests increasing certainty lowers the investors' required return. In this proceeding, the Commission will not adjust upward the return on equity when investor certainty is increased.

WP&L also requested that the Commission consider the risk that WP&L faces under a fixed return on equity should interest rates rise in the future. The Commission finds that this is not a compensable risk factor. If WP&L accepts the FFP Decision, then it avoids not only bad outcomes, but some good outcomes as well. If WP&L is to be compensated for the fact that interest rates might rise in the future, then its return should also be reduced to reflect the fact that interest rates might decline. Again, the upward and downward adjustments offset each other.

The record shows that authorized returns under traditional ratemaking move to some extent in tandem with changes in interest rates. If WP&L believes that there is a stronger likelihood that interest rates will rise than there is that they will decline, then it can reject the FFP Decision and rely on the traditional ratemaking approach.

WP&L suggests that it should receive an incentive return to promote the construction of renewable generation facilities. The Commission strongly supports renewable generating technologies, but that does not necessitate an addition to the return on equity. WP&L is required by statute to develop a renewable generating portfolio. See Wis. Stat. § 196.378(2). A return on

equity that is over 500 basis points in excess of the long-term Treasury bond yield, which is the nature of the return approved in this Decision, for an asset with highly certain cost recovery prospects provides substantial financial incentive for WP&L to construct the Cedar Ridge Wind Farm.

In determining the appropriate return on equity, the Commission looks beyond the financial model results, the various risk factors, and the likelihood of future interest rate changes. The return on equity is a policy decision as much as a financial one. Such policy considerations include the need to maintain stable rates and to apply a sense of gradualism to rate changes. Considering the broad public policy issues, as well as the technical finance issues discussed above, the Commission finds that a return on equity of 10.5 percent is reasonable in this proceeding.

This is the Commission's first docket involving the fixed financial parameters statute. Its administration of this novel financing mechanism is a work in progress. Accordingly, the Commission's administration of Wis. Stat. § 196.371 may evolve over time as more experience is gained with the FFP mechanism.

Order

1. WP&L shall, within 60 days of the date this Final Decision takes effect, notify the Commission in writing whether it accepts or waives acceptance of this Decision. If WP&L makes no notification to the Commission within 60 days, the acceptance of the Decision shall be deemed to have been waived.

2. The revenue requirement determination under the FFP for Cedar Ridge shall be based on a 20-year life span.

3. Depreciation rates shall be fixed for the life of the project.

4. WP&L shall calculate any AFUDC based on the weighted cost of capital.

5. WP&L shall submit final project costs to the Commission within one year of the commercial operation date to be used for the FFP for Cedar Ridge beginning in WP&L's next rate case.

6. WP&L shall accrue AFUDC until CWIP expenditures may be included in net investment rate base in a rate case proceeding. At such time that CWIP expenditures may be included in net investment rate base in a rate case proceeding, WP&L shall earn a current return on 100 percent of CWIP.

7. WP&L shall include any changes in income tax rates during the project's life span in the determination of any future year net investment rate base related to FFP costs. If such tax changes result in any regulatory assets or liabilities, WP&L shall include such amounts in the computation of FFP net investment rate base for the time periods impacted by the changes.

8. If the entire cost for a project is removed from the utility's books before the end of the 20-year life expectancy, WP&L shall cease using the FFP for that project.

9. Within ten business days of any issuance of the debt and preferred equity securities associated with the Cedar Ridge Wind Farm, WP&L shall file a letter reflecting the effective interest rates or returns on those instruments.

10. Once all the final capital cost rates are determined and deemed reasonable, the Commission will issue an amendment to this Final Decision that fixes the final returns. The return on equity is not subject to future review and is established irrevocably at 10.5 percent by this Decision.

11. This Final Decision takes effect on the day after the date of mailing.

12. Jurisdiction is retained.

Dated at Madison, Wisconsin, May 9, 2007

By the Commission:

Sandra J. Paske

Sandra J. Paske
Secretary to the Commission

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See attached Notice of Appeal Rights

Notice of Appeal Rights

Wisconsin Power & Light Company (WP&L) has 60 days from the date of this Final Decision to act under Wis. Stats. § 196.371(3)(am) to accept or waive acceptance of this Final Decision. Beginning the date WP&L informs the Commission it accepts or waives acceptance of this Final Decision, or the date acceptance is deemed waived, the following paragraphs of this notice apply.

Notice is hereby given that a person aggrieved by the foregoing decision has the right to file a petition for judicial review as provided in Wis. Stat. § 227.53. The petition must be filed within 30 days after the date of mailing of this decision. That date is shown on the first page. If there is no date on the first page, the date of mailing is shown immediately above the signature line. The Public Service Commission of Wisconsin must be named as respondent in the petition for judicial review.

Notice is further given that, if the foregoing decision is an order following a proceeding which is a contested case as defined in Wis. Stat. § 227.01(3), a person aggrieved by the order has the further right to file one petition for rehearing as provided in Wis. Stat. § 227.49. The petition must be filed within 20 days of the date of mailing of this decision.

If this decision is an order after rehearing, a person aggrieved who wishes to appeal must seek judicial review rather than rehearing. A second petition for rehearing is not an option.

This general notice is for the purpose of ensuring compliance with Wis. Stat. § 227.48(2), and does not constitute a conclusion or admission that any particular party or person is necessarily aggrieved or that any particular decision or order is final or judicially reviewable.

Revised 9/28/98

APPENDIX A
(CONTESTED)

In order to comply with Wis. Stat. § 227.47, the following parties who appeared before the agency are considered parties for purposes of review under Wis. Stat. § 227.53.

Public Service Commission of Wisconsin
(Not a party but must be served)
610 N. Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

WISCONSIN POWER AND LIGHT COMPANY
Tom Pyper
Whyte Hirschboeck Dudek, S.C.
One East Main Street, Suite 300
Madison, WI 53701

CITIZENS UTILITY BOARD
Curt F. Pawlisch
Kira E. Loehr
Cullen Weston Pines & Bach LLP
122 West Washington Avenue, Suite 900
Madison, WI 53703

RENEW WISCONSIN
Michael Vickerman
222 South Hamilton Street
Madison, WI 53703