

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/HB 1043 Prudent Utility Investments in Natural Gas Reserves
SPONSOR(S): Energy & Utilities Subcommittee; Brodeur and others
TIED BILLS: None. **IDEN./SIM. BILLS:** SB 1238

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Energy & Utilities Subcommittee	9 Y, 6 N, As CS	Keating	Keating
2) Government Operations & Technology Appropriations Subcommittee			
3) Commerce Committee			

SUMMARY ANALYSIS

The Public Service Commission (PSC) has broad jurisdiction over the rates and service of public (investor-owned) electric utilities in Florida. Under this authority, the PSC has established a mechanism by which these utilities may recover certain fuel and purchased power costs through customer charges that are separate from the utilities' base rates.

In 2015, the PSC used this mechanism to approve a utility's request to recover, through customer charges, the utility's investment and other costs, including a rate of return, associated with its participation in a joint venture with an oil and natural gas exploration, development, and production company. Under this arrangement, the utility would invest directly in its partner's shale gas reserves in a specific region in Oklahoma and receive the rights to a share of the physical gas produced. The PSC separately approved guidelines under which the utility could participate in similar projects in the future without the need for PSC approval of individual projects. In 2016, the Florida Supreme Court reversed both PSC decisions, finding that the PSC's authority to set rates extends only to costs arising from the generation, transmission, or distribution of electricity in the state, which does not include exploration, drilling, and production of natural gas fuel in Oklahoma.

The bill provides explicit authority for the PSC to approve cost recovery through an "adjustment clause" for a utility's prudent investments in natural gas reserves, including a rate of return, and for prudently incurred expenses associated with such investments. To qualify for cost recovery, the utility must generate at least 65 percent of its electricity using natural gas.

The bill requires the PSC to adopt rules by December 31, 2017, by which it will determine the prudence of a utility's gas reserve investments. The rules must require that:

- Each natural gas reserve investment is projected to generate savings for customers over the life of the investment.
- The total volume of natural gas produced from all of the utility's natural gas reserve investments must not exceed the following percentages of the utility's average projected daily burn of natural gas:
 - 7.5 percent in 2018;
 - 10 percent in 2019;
 - 12.5 percent in 2020; and
 - 15 percent in 2021 and thereafter.
- Each investment must be made in gas reserve projects where at least 50 percent of the wells within the projects are classified as proved oil and gas reserves by the Securities and Exchange Commission.

The bill does not appear to have an impact on state or local government revenues or expenses.

The bill provides an effective date of July 1, 2017.

This document does not reflect the intent or official position of the bill sponsor or House of Representatives.

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DATE: 3/29/2017

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Present Situation

The PSC has broad jurisdiction over the rates and service of public (investor-owned) electric utilities in Florida.¹ Under this broad grant of authority, and through more specific grants of authority in Chapter 366, F.S., the PSC sets rates for such utilities through five primary components, each of which is established in a separate administrative proceeding:

- Base rates
 - Adjusted as needed in a general rate case, conducted through a formal evidentiary hearing.²
 - Designed to recover most operations and maintenance expenses, depreciation expense (recovery of capital investment over time), and a return on capital investment.
- Fuel and purchased power cost recovery charges
 - Adjusted annually through a formal evidentiary hearing.
 - Designed to recover the costs of fuel and the energy component of wholesale power purchases.
 - By PSC order, may include recovery of certain capital investments, including a return on investment.
- Capacity cost recovery charges
 - Adjusted annually through a formal evidentiary hearing.
 - Designed to recover costs of the capacity component of wholesale power purchases.
 - By statute, may include recovery of certain costs related to development of new nuclear power plants, including a return.³
- Environmental cost recovery charges
 - Adjusted annually through a formal evidentiary hearing.
 - Designed to recover costs to comply with government-mandated environmental standards.
 - By statute, may include recovery of certain capital investments, including a return on investment.⁴
- Energy conservation and efficiency cost recovery charges
 - Adjusted annually through a formal evidentiary hearing.
 - Designed to recover costs of implementing PSC-approved energy conservation and efficiency programs.

As required by law, the PSC sets base rates to allow utilities to recover their legitimate costs of providing service (not otherwise recovered through another cost recovery mechanism), including a return on the utility's prudent capital investments ("rate base").⁵ In each rate case, the PSC sets a "reasonable" rate of return on equity for each utility to apply to its rate base. This rate is typically applied to the utility's investments that the PSC allows to be recovered through cost recovery mechanisms other than base rates.

¹See, e.g., ss. 366.01, 366.04(1), 366.041, 366.05(1), and 366.06, F.S. There are five public electric utilities in Florida: Florida Power & Light Company, Duke Energy Florida, Tampa Electric Company, Gulf Power Company, and Florida Public Utilities Company.

² A public electric utility whose annual sales to end-use customers amount to less than 500 gigawatt hours may request that the PSC process the utility's petition for rate relief using an informal "proposed agency action" procedure. s. 366.06(4), F.S. Currently, no public electric utility qualifies for this treatment.

³ s. 366.93, F.S.

⁴ s. 366.8255, F.S.

⁵ ss. 366.041(1) and 366.06(1), F.S.

The fuel cost recovery mechanism is not specifically authorized by statute but has been used by utilities in some form for several decades and has been established by the PSC under its broad authority to set rates. PSC policy and practice related to this mechanism has developed through a series of orders issued in evidentiary proceedings.⁶ Because fuel costs have historically been more volatile than many other utility costs and can constitute a significant portion of overall utility costs, the fuel cost recovery mechanism allows utilities to pass through these costs to customers via an annually adjusted charge, reducing the need to conduct frequent and costly rate cases.⁷

Fuel price hedging is a tool that utilities may use to reduce their exposure to volatile and potentially rising fuel costs. A fuel price hedging contract is a futures contract that allows an IOU that uses fuel as a means of generation to establish a fixed or capped cost, via a commodity swap or option. Florida utilities can seek to recover their prudent financial hedging costs through the fuel cost recovery mechanism.⁸

Since 1985, the PSC has maintained a policy under which, on a case-by-case basis, it may allow a utility to recover, through fuel cost recovery charges, “[f]ossil fuel-related costs normally recovered through base rates but which were not recognized or anticipated in the cost levels used to determine current base rates and which, if expended, will result in fuel savings to customers.”⁹ Under this policy, the PSC has approved cost recovery, including a return on investment, for various utility capital projects through fuel cost recovery charges.

In 2014, Florida Power & Light Company (FPL) petitioned the PSC to approve of FPL’s participation in a joint venture with PetroQuest, an oil and natural gas exploration, development, and production company, by which FPL would invest directly in PetroQuest’s shale gas reserves in the Woodford Shale region in Oklahoma and receive the rights to a share of the physical gas produced (the “Project”).¹⁰ In its petition, FPL asserted that the Project was estimated to save its customers approximately \$107 million on a net present value basis by allowing FPL to obtain a portion of its natural gas needs at production costs rather than market price over the “30 plus” year life of the Project. FPL characterized its investment in the Project as a long term physical hedge, though it noted that there would be “a measure of variation and uncertainty in the overall level of incurred costs that can be expected for gas reserve projects over time.” On this basis, FPL sought approval to recover the costs of its investment in and operation of the Project through the fuel cost recovery mechanism. FPL further requested that the PSC establish guidelines under which FPL could participate in future gas reserve projects without the PSC’s prior approval and recover the costs through the fuel cost recovery mechanism.

In January 2015, the PSC approved FPL’s participation in the Project and approved FPL’s request to recover its investment, including a return, and other Project costs through the fuel cost recovery mechanism on the grounds that FPL’s participation in the Project is a long-term physical hedge on natural gas prices and that net savings over the life of the Project were estimated by the PSC at \$51.9 million, with the magnitude of potential savings projected to exceed the magnitude of potential losses.¹¹

In July 2015, the PSC approved guidelines under which FPL could participate in similar projects in the future without the need for PSC approval of individual projects. These guidelines included limits on the maximum volume of FPL’s average daily natural gas usage that could be obtained through such projects (20%); limits on the maximum annual investment allowed (\$500 million); limits on the types of

⁶ The PSC is exempt from rulemaking for its policies and practices related to “cost-recovery clauses, factors, or mechanisms implemented pursuant to chapter 366, relating to public utilities.”

⁷ See, *In re: Petition by Fla. Power & Light Co. to Recover Scherer Unit 4 Turbine Upgrade Costs through Envtl. Cost Recovery Clause or Fuel Cost Recovery Clause*, Order No. PSC-11-0080-PAA-EI, pp. 6-7 (Jan. 31, 2011).

⁸ Florida Public Service Commission, Agency Analysis of 2017 House Bill 1043, p. 1 (Mar. 21, 2017).

⁹ *In re: Cost Recovery Methods for Fuel-Related Expenses*, PSC Order No. 14546, p. 5 (July 8, 1985).

¹⁰ *Petition by Florida Power & Light Company*, PSC Docket No. 140001-EI (Jun. 25, 2014).

¹¹ *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*, Order No. PSC-15-0038-FOF-EI (Jan. 12, 2015).

projects allowed (onshore projects in areas with “proved” or “probable” reserves); and reporting and auditing requirements.¹²

In May 2016, on appeal of the Citizens of the State of Florida, through the Office of Public Counsel, and the Florida Industrial Power Users Group, the Florida Supreme Court reversed both PSC orders, finding that the PSC exceeded its statutory authority by approving cost recovery for the Project.¹³ The Court determined that the PSC’s authority to set rates extends only to costs arising from the generation, transmission, or distribution of electricity in the state. The Court found that the “exploration, drilling, and production of natural gas fuel in Oklahoma do not constitute generating, transmitting, or distributing electricity in Florida” and that such activities are therefore outside the purview of an electric utility as defined by the Legislature.¹⁴ Further, the Court determined that the Project could not be characterized as a physical hedge because it “does not involve a certain quantity of fuel for a certain price.” In closing, the Court stated that whether “cost recovery of speculative capital investments in gas exploration and production by an electric utility is in the public interest is a policy determination that must be made by the Legislature.”

Effect of Proposed Changes

The bill provides explicit authority for the PSC to approve cost recovery through an “adjustment clause” (i.e., through customer charges) for a utility’s prudent investments in natural gas reserves, including a rate of return, and for prudently incurred expenses associated with such investments. To qualify for cost recovery, the utility must generate at least 65 percent of its electricity using natural gas. The bill does not specify if the utility must sustain this level of usage to ensure cost recovery through the term of an investment project.

Based on forecasts through 2025, multiple utilities could qualify for cost recovery in each year. FPL projects sustained generation from natural gas in excess of at least 65 percent. Duke Energy Florida, Inc., projects sustained usage in excess of 65 percent after 2016. Gulf Power Company projects a declining reliance on natural gas from a peak in 2017 due to an anticipated increase in coal-fired resources, though its usage during the period 2016 through 2019 may qualify it for cost recovery. Various factors influence a utility’s annual usage of natural gas in the production of electricity. The percentage of natural gas used can be expected to continue to change annually based on market forces.¹⁵

The bill requires the PSC to adopt rules by December 31, 2017, by which it will determine the prudence of a utility’s gas reserve investments. The rules must require that:

- Each natural gas reserve investment is projected to generate savings for customers over the life of the investment.
- The total volume of natural gas produced from all of the utility’s natural gas reserve investments must not exceed the following percentages of the utility’s average projected daily burn of natural gas:
 - 7.5 percent in 2018;
 - 10 percent in 2019;
 - 12.5 percent in 2020; and
 - 15 percent in 2021 and thereafter.

¹² *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*, Order No. PSC-15-0284-FOF-EI (Jul. 14, 2015).

¹³ *Citizens of the State of Florida v Art Graham*, 191 So. 3d 897, (Fla. 2016).

¹⁴ The Court relied on s. 366.02, F.S., which defines an “electric utility” as an entity, including an investor-owned electric utility, that owns, maintains, or operates an electric generation, transmission, or distribution system within the state.

¹⁵ Florida Public Service Commission, Agency Analysis of 2017 House Bill 1043, p. 2 (Mar. 21, 2017).

- Each investment must be made in gas reserve projects where at least 50 percent of the wells within the projects are classified as proved oil and gas reserves by the Securities and Exchange Commission.¹⁶

The bill prohibits the PSC from approving an electric utility's natural gas reserve investment for cost recovery if it determines the investment is not prudent. The bill also prohibits the PSC from approving recovery of costs to operate and maintain the investment if those costs are not reasonable. These provisions appear to restate and reinforce current law related to PSC review of utility projects, including cost recovery.

B. SECTION DIRECTORY:

Section 1. Amends s. 366.04, F.S., relating to jurisdiction of the Public Service Commission.

Section 2. Provides an effective date of July 1, 2017.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

A utility that is eligible to use this cost recovery mechanism will have the opportunity to expand the base upon which it earns a return on investment at the PSC-approved rate.

Customers may or may not experience savings as the result of a PSC-approved investment. The bill requires that each investment must be *projected* to generate savings over its life. These savings are

¹⁶ The Securities and Exchange Commission (SEC) defines “proved oil and gas reserves” as “those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible, from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations, prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain regardless of whether deterministic or probabilistic methods are used for the estimation.”

The SEC establishes additional categories of reserves. “Probable reserves” are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered, i.e., at least a 50% probability of commercial extraction. “Possible reserves” are those additional reserves that are less certain to be recovered than probable reserves, generally at least a 10% probability of commercial extraction. *SEC Modernization of Oil and Gas Reporting Release Nos. 33-8995; 34-59192; FR-78; File No. S7-15-08, available at <https://www.sec.gov/rules/final/2008/33-8995.pdf> (last visited Mar. 24, 2017).*

calculated based on projections of natural gas market prices, production costs, and volumes of natural gas produced over the life of the investment. *Actual* savings will be dependent upon the market prices, production costs, and volumes produced over the life of the investment. For example, since the time that FPL filed its petition for approval of its Woodford Shale Project, the Project's production costs have fallen below the levels originally projected and it has produced higher volumes than originally projected. Both of these factors have a positive impact on savings. Market prices, however, have fallen far enough below the projected levels to offset these factors, turning the projected savings negative.¹⁷ These factors will continue to change over the life of the Project and drive the actual savings realized.

D. FISCAL COMMENTS:

None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable. The bill does not appear to affect county or municipal government.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

The bill requires the PSC to adopt rules by December 31, 2017, for determining the prudence of natural gas reserve investments and specifies what the rules must require. While a rule may be proposed before or by that date, the date of adoption will depend in part upon what further legal processes stakeholders avail themselves of during the rule adoption process under Section 120.54, F.S.¹⁸

C. DRAFTING ISSUES OR OTHER COMMENTS:

The bill allows for recovery of certain costs through an "adjustment clause." This term is not defined in the bill or in chapter 366, F.S. In PSC practice, this term is understood to refer generically to a mechanism by which a utility may recover certain costs through a charge established separately from its base rates in a proceeding other than a full rate case.

The bill amends s. 366.04, F.S., to authorize the PSC to approve certain investments by "electric utilities" for cost recovery. As defined in s. 366.02, F.S., "electric utilities" include investor-owned utilities, municipal electric utilities, and rural electric cooperatives. Section 366.11, F.S., exempts municipal electric utilities and rural electric cooperatives from PSC jurisdiction *except as specified in certain provisions, including s. 366.04, F.S.* Thus, the bill appears to subject certain potential investments by municipal electric utilities and rural electric cooperatives to PSC oversight. The PSC does not otherwise have jurisdiction over the rates and service of these types of utilities.

IV. AMENDMENTS / COMMITTEE SUBSTITUTE CHANGES

On March 28, 2017, the Energy & Utilities Subcommittee adopted one amendment to the bill and reported the bill favorably as a committee substitute. The amendment:

¹⁷ August 2015 through December 2015 Hedging Activity True-Up Report, Testimony & Exhibits of Gerard J. Yupp, Florida Power & Light Company, PSC Docket No. 160001-EI (April 6, 2016).

¹⁸ Florida Public Service Commission, Agency Analysis of 2017 House Bill 1043, p. 4 (Mar. 21, 2017).

- Prohibits the PSC from approving an electric utility's natural gas reserve investment, including a rate of return, for cost recovery over the life of the investment if it determines the investment is not prudent.
- Prohibits the PSC from approving recovery of costs to operate and maintain the investment if those costs are not reasonable.