

The Florida Senate
BILL ANALYSIS AND FISCAL IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: The Professional Staff of the Committee on Communications, Energy, and Public Utilities

BILL: SB 1238

INTRODUCER: Senator Bean

SUBJECT: Utility Investments in Gas Reserves

DATE: March 13, 2017

REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Caldwell/Wiehle</u>	<u>Caldwell</u>	<u>CU</u>	Favorable
2.	_____	_____	<u>RC</u>	_____

I. Summary:

SB 1238 authorizes the Public Service Commission (PSC or commission) to approve cost recovery for prudently incurred natural gas reserve investments, including a rate of return and prudently incurred expenses associated with such investments, by a public utility through an adjustment clause. To qualify, the public utility must have at least 65 percent natural gas fueled generation.

By December 31, 2017, the commission must adopt a rule containing the standards by which it will determine the prudence of natural gas reserve investments. The rule must include the following three criteria:

- Each investment is projected to generate savings for customers over the life of the investment.
- Each investment must have at least 50 percent of the wells classified as proven reserves by the Securities and Exchange Commission.
- Total volume of natural gas produced from the utility's reserves must not exceed the following percentages of the utility's average projected natural gas daily burn:
 - 7.5 percent in 2018.
 - 10 percent in 2019.
 - 12.5 percent in 2020.
 - 15 percent thereafter.

The bill would take effect July 1, 2017.

II. Present Situation:

Public Utility Cost Recovery/Fuel Cost Recovery Charge

Each public utility¹ recovers its prudent costs and rate of return through charging base rates and various recovery charges, including the fuel cost recovery charge. Base rates include fixed costs such as capital investments and operating and maintenance costs incurred in predictable amounts. Recovery charges are used to recover unusual or volatile costs.

One recovery charge is the fuel cost recovery charge. The category of recovery charge was created by commission order, not statute. The commission has an annual docket on fuel cost recovery charges, and each public utility participates by petitioning the commission to address the issues particular to that utility. Unlike other types of recovery charges, the fuel cost recovery charges do not include recovery of capital investments or a return on investments; they are pass-through charges, simply passing the projected fuel costs on to customers on a monthly basis. During the annual fuel cost docket, the fuel cost recovery for the previous year is “trued up,” actual costs are compared to costs projected and recovered, and the next year’s charge is adjusted to compensate for any over- or under-charge.

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

Florida Power & Light’s Natural Gas Investment/Public Service Commission

On June 25, 2014, Florida Power and Light Company (FPL) filed a petition requesting a prudence determination on its proposal to acquire an interest in a natural gas reserve project. The determination would allow FPL to recover costs incurred through its joint venture with an oil and natural gas company to engage in the acquisition, exploration, drilling, and development of natural gas wells in Oklahoma (known as the “Woodford Project”) A determination of prudence is the first step in gaining approval for recovery of those costs. FPL also sought approval to recover the revenue requirements associated with investing in and operating the gas reserves through the fuel clause. FPL further requested that the commission establish guidelines under which FPL could participate in future gas reserve projects without the commission’s prior approval and recover the costs through the fuel clause, subject to the commission’s established process for reviewing fuel-related transactions.

On January 12, 2015, in a case of first impression, the commission approved FPL’s petition requesting a prudence determination on FPL’s proposal to acquire an interest in a natural gas

¹ A “public utility” is every person, corporation, partnership, association, or other legal entity and their lessees, trustees, or receivers supplying electricity ... to or for the public within this state.” It does not include either a municipal electric utility or a cooperative. Section 366.02(1), F.S. Basically, it is the four investor-owned utilities: Florida Power & Light, Duke Energy Florida, Tampa Electric Company, and Gulf Power.

reserve project and to allow the revenue requirements associated with investing in an operating the gas reserves be recovered through the fuel clause.² According to the PSC Order:

USG Properties Woodford I, LLC (USG), an FPL affiliate, entered into a series of agreements with PetroQuest Energy, Inc. (Petroquest), under which USG will pay a share of the costs for developing and operating natural gas production wells and will receive a portion of PetroQuest's working interest in those wells in the Woodford Shale Gas Region in Oklahoma. Subject to the terms of the agreements, FPL will be entitled to acquire USG's interest, contingent upon a commission finding that the Project is prudent and may be recovered through the Fuel Clause.³

The PSC approved FPL's petition to recover costs in the Woodford Project with conditions.

We find the Woodford Project, in the manner described in the FPL petition and evidence on the record, is expected to produce customer benefits and is in the public interest. We find its costs are recoverable through the Fuel Clause. In order to provide additional protections for FPL customers, we find it necessary to add two conditions for compliance with the Order. First FPL shall add the appropriate subaccounts, under the FERC system of accounting, which will correspond to a one-on-one basis with the accounts used by the Gas Reserve Company. Second, FPL shall utilize an independent auditor in performing the audits provided in the agreement and shall work with Commission staff to develop the scope of the audits.

On July 14, 2015, the commission approved with modifications FPL's petition requesting guidelines under which FPL could participate in future gas reserve projects without the commission's prior approval and recover the costs through the fuel clause.⁴

Florida Power & Light's Natural Gas Investment/Florida Supreme Court

In January 15, 2015, the Office of Public Counsel (OPC) filed Notices of Appeal with the Florida Supreme Court challenging several PSC orders related to this issue.⁵ The Florida Supreme Court consolidated OPC's three appeals and the Florida Industrial Power Users Group's (FIPUG) appeal of the commission's orders approving the Woodford Project and approving guidelines.

On May 19, 2016, the Supreme Court of Florida reversed the orders stating that the commission exceeded its statutory authority when approving recovery of FPL's costs and investment in the Woodford Project.⁶ The Court held that treating these activities as a hedge would require FPL's ratepayers to guarantee the capital investment and operations of an oil and gas venture without the Florida Legislature's authority:

² See: Order No. PSC-15-0038-FOF-EI, issued January 12, 2015, in Docket No. 150001-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*.

³ *Id.*

⁴ Order No. PSC-15-0284-FOF-EI, issued July 14, 2015, in Docket No. 120005-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*.

⁵ *Id.*

⁶ *Citizens of the State of Florida v Art Graham*, 191 So. 3d 897, Fla. (May 19, 2016).

It is undisputed that FPL is an electric utility. It is also undisputed that the PSC's ratemaking authority encompasses the authority to examine fuel cost expenditures and approve cost recovery to compensate for utilities' fuel expenses through the fuel clause. See *Gulf Power Co. v. Fla. Publ. Serv. Comm'n*, 487 So.2d 1036, 1037 (Fla.1986).

However, the PSC does not have the statutory authority to approve cost recovery for FPL's investment in the Woodford Project. As explained above, Section 366.06(1) provides that the PSC has the authority to determine and fix fair, just, and reasonable rates for public utilities, and Section 366.02(2) defines an electric utility as owning, maintaining, or operating an electric generation, transmission, or distribution system. Therefore, under the plain meaning of these two statutes, cost recovery is permissible only for costs arising from the "generation, transmission, or distribution" of electricity. The Woodford Project's exploration, drilling, and production of natural gas fuel in Oklahoma do not constitute generating, transmitting, or distributing electricity in Florida as the meaning of those terms are plainly understood. *In other words, the exploration, drilling, and production of fuel falls outside the purview of an electric utility as defined by the Legislature.*

Additionally, the PSC does not have the statutory authority necessary to approve cost recovery for the Woodford Project through the characterization of the project as "a long-term physical hedge." While PSC's ratemaking authority includes examining and approving cost recovery for public utilities' hedging of fuel costs, see *In re: Fuel and Purchased Power Cost Recovery Clause with Generating Performance Incentive Factor*, Order No. PSC-08-0667-PAA-EI, 2008 WL 6347188 (Fla.P.S.C. Oct. 8, 2008), the Woodford Project does not involve a certain quantity of fuel for a certain price.⁷

The Court also noted: "... regulated utilities through the fuel clause do not earn a rate of return on money spent to purchase fuel" . . . and "utilities through the fuel clause do not earn a return on the cost of hedging positions purchased."⁸

III. Effect of Proposed Changes:

The bill amends s. 366.04(2), F.S., to authorize the commission to approve cost recovery through an adjustment clause for a utility's prudent investments in natural gas reserves, including rate of return, and for prudently incurred expenses associated with such investments. To qualify to make these investments, a utility must have at least 65 percent natural-gas-fueled generation.

The commission must adopt by rule no later than December 31, 2017, standards by which it will determine the prudence of such gas reserve investments. The standards must require, at minimum, all of the following:

- Each natural gas reserve investment is projected to generate savings for customers over the life of the investment.

⁷ *Id.*, at 901, (Emphasis added).

⁸ *Id.*

- 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 natural gas projects that have at least 50 percent of the wells within the project classified as proved gas reserves by the Securities and Exchange Commission.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

According to the commission Order approving the Woodford project, “the base case indicates savings [to the customers] of \$51.9 million over the life of the project.”⁹ It is important to note that these savings are calculated by taking the forecasted price for natural gas and calculating to its present value. Thus, the savings can fluctuate based upon the price of natural gas.¹⁰

A public utility will be able to recover its incremental operating and maintenance costs as well as recovery of a rate of return on its capital investments in a natural gas reserve project through the fuel clause associated with long-term capital investments (30 years or more).

⁹ Order No. PSC-15-0038-FOF-EI, page 5.

¹⁰ According to the Order No. PSC-15-0038-FOF-EI, at page 5: “the sensitivities show that the magnitude of potential positive savings (\$170.2 million assuming high fuel price and high productivity) exceeds the magnitude of potential losses (-\$50.7 million assuming low fuel price and low productivity).

C. Government Sector Impact:

According to the commission, “rulemaking associated with the implementation of SB 1238 is not expected to require additional staff. The bill also authorizes recurring responsibilities associated with oversight of a qualifying electric [public utility’s] investments in natural gas reserves, and allowing recovery of prudently incurred investments including a rate of return. Recurring administrative expenses can be moderated by using an existing adjustment clause and associated resources.

VI. Technical Deficiencies:

None.

VII. Related Issues:

As the Florida Supreme Court noted, allowing a regulated public utility to recover costs and a rate of return on an investment in the exploration and production of natural gas is different from traditional hedging activities and traditional use of the fuel cost recovery charge process.

- Investing in natural gas exploration, drilling, and production falls outside the core function of an electric utility.¹¹
- The investment does not involve a certain quantity of fuel for a certain price, and thus not only fails to help prevent price shocks from volatile fuel prices but creates more uncertainty in prices rather than less.¹²
- Contrary to traditional uses of the fuel cost recovery clause where the utility neither incurs capital costs nor earns a rate of return¹³, here, at least as authorized by the commission, the utility does both.
- Instead of hedging taxpayer risk, the investment, as approved by the commission, shifts both the risk of price volatility and the risks of exploration and production to ratepayers¹⁴.

The Court stated: “[t]his may be a good idea, but whether advance 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.”¹⁵

The criteria in the bill for the standards by which the commission will determine the prudence of gas reserve investments are similar to some of the guidelines adopted by the commission in its July 14, 2015, Order.¹⁶ The guidelines approved by the commission included criteria for the scope of gas reserve project participation for the estimated aggregate output limits; customer savings, supply diversity, and characteristics of gas reserves.

The percentages of the utility’s average projected daily burn of natural gas to the total volume of natural gas produced from all of the utility’s natural gas reserve investments in the bill are less

¹¹ *Citizens of the State of Florida v Art Graham*, 191 So.3d 897, 901 Fla. (May 19, 2016)

¹² *Id.*, at 902

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See Appendix A, Order No. PSC-15-0284-FOF-EI, issued July 14, 2015, in Docket No. 120005-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*.

than those approved by the commission. The commission approved for years 2015 through 2018: 5 percent, 10 percent, 15 percent, and 20 percent respectively and capped the maximum at 20 percent.

According to the commission, the phrase “has at least 65 percent natural-gas-fueled generation” can refer either to installed power plant capacity or actual electricity generation, or kilowatt-hours (kWh). If it refers to capacity, as of December 31, 2015, public utility generation capable of using natural gas as the primary fuel ranged from 67 percent to 24 percent based on net summer capacity megawatt (MW) ratings. Existing natural gas generation for FPL was 67 percent, Duke Energy Florida, LLC, (DEF) was 62 percent, Tampa Electric Company (TECO) was 58 percent, and Gulf Power Company (GPC) was 24 percent. This data set suggests only one electric generating public utility would qualify at this time.¹⁷

The commission continued, “if the standard refers to actual generation or kWh, actual natural gas usage varies from year to year based primarily on:

- the dynamics of price differentials between fuels;
- the ability of a given power plant to switch to lower priced fuels;
- the public utility’s generation technology diversity;
- the price of available wholesale transactions; and
- the public utility’s real-time system requirements.”¹⁸

Based on forecasts through 2025, multiple utilities could qualify in every year. FPL projected sustained generation from natural gas in excess of at least 65 percent. DEF projected sustained usage in excess of 65 percent after 2016. GPC projected a declining reliance on natural gas from a peak in 2017 due to an anticipated increase in coal-fired resources. However, GPC could potentially qualify during the period 2016 through 2019. Various factors influence an public utility’s annual usage of natural gas in the production of energy. The percentage of natural gas used on an energy basis can be expected to continue to change annually based on market forces.¹⁹

Natural Gas Usage – Percent of Net Energy for Load²⁰

Utility	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
FPL	69.9	67.8	70.6	70.7	69.9	71.2	70.2	69.6	69.9	69.9	69.9
DEF	59.7	64.8	70.7	76.1	79.0	69.2	66.9	79.1	78.4	81.1	81.4
GPC	64.9	73.8	80.8	77.2	68.3	36.9	34.0	34.7	18.7	12.6	14.5
TECO	49.3	44.3	50.1	52.3	52.8	50.9	52.3	51.3	50.7	51.7	51.9

Based upon this uncertainty, the phrase “at least 65 percent natural-gas-fueled generation” should be clarified.

The June 4, 2015, recommendation from PSC staff discussed the categories for classifying gas reserves for public company reporting. Proved reserves are those reserves with reasonable certainty (90 percent probability), probable reserves are those reserves with some uncertainty

¹⁷ PSC Bill Analysis of SB 1238, Mar. 10, 2017.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ PSC Bill Analysis of SB 1238, Mar. 10, 2017, page 3, citing: 2016 Ten-Year Site Plans, Schedule 6.2.

(50 percent probability), and possible reserves are those reserves with high uncertainty (10 percent probability) that the predicted quantity of gas can be commercially recovered under current technical, contractual, economic, and regulatory conditions.²¹

In its Order, the commission amended the guidelines to state:

In addition, FPL will only enter into transactions for gas reserve projects that involve wells classified as “Proved Reserves” or “Probable Reserve” as defined by the Securities and Exchange Commission for public company reporting. Because one of the primary purposes of gas reserve projects is a physical source of supply to serve its natural gas needs, at least 50 percent of the wells in each gas reserve project must be classified as “Proved Reserves.” FPL will not enter into transactions for gas reserve projects that involve wells classified as “Possible Reserves.”

The bill does not restrict transactions for gas reserve projects that involve wells classified as “possible reserves.”

The commission in both its order authorizing the recovery of the Woodford project and in the Guidelines required FPL to “add the appropriate subaccounts, under the FERC system of accounting, which will correspond to a one-on-one basis with the accounts used by the Gas Reserve Company.” And that FPL must “utilize an independent auditor in performing the audits provided in the agreement and shall work with Commission staff to develop the scope of the audits.” If it is intended that the Guidelines be consistent with those contemplated in the commission order, more specific rulemaking authority may be required.

The bill requires the commission to adopt by rule no later than December 31, 2017, standards by which it will determine the prudence of gas reserve investments. The commission points out in its review of the bill, that while a rule may be proposed before or by that date, the date of adoption will depend in part upon what further legal process stakeholders avail themselves of pursuant to s. 120.54, F.S.

VIII. Statutes Affected:

This bill substantially amends section 366.04 of the Florida Statutes.

IX. Additional Information:

A. Committee Substitute – Statement of Changes:

(Summarizing differences between the Committee Substitute and the prior version of the bill.)

None.

B. Amendments:

None.

²¹ Order No. PSC-15-0284-FOF-EI, issued July 14, 2015, in Docket No. 120005-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor*.

This Senate Bill Analysis does not reflect the intent or official position of the bill's introducer or the Florida Senate.
