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 Rules

BILL:	SB 1238
INTRODUCER:	Senator Bean
SUBJECT:	Utility Investments in Gas Reserves
DATE:	April 11, 2017
REVISED:	

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Caldwell/Wiehle	Caldwell	CU	**Favorable**
2.	Wiehle	Phelps	RC	**Pre-meeting**

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:

Present Regulation of Electric Industry

Economic regulation is a substitute for market forces in an industry where those forces do not function properly. As such, economic regulation is to some extent a balancing process, assigning both the utility and its customers both benefits and obligations.

The regulated electric utility[1] gets:
- A monopoly service territory with a captive customer base;
- Recovery of all prudent and reasonable costs; and
- A rate of return on capital investments, or a profit.

The regulated utility's customers get:
- The utility's obligation to serve, which consists of an obligation to provide adequate, reliable service, in both production and delivery of electricity, and an obligation to provide that service to all paying customers within its service territory; and
- Fair and reasonable rates.

An inherent element of this arrangement is that the regulated utility is almost always limited to investments within the core of the electric industry, which prevents risks from investments in other types of businesses from having a detrimental impact on reliability and fair rates for the captive customers.

Typically, a regulated utility recovers its capital investments and fixed costs, including a rate of return on capital investments, through base rates, and recovers variable or short-term costs through a cost recovery clause proceeding.

The relevant recovery clause here is the fuel and purchased power recovery clause (fuel clause). The fuel clause was created by commission order, not statute, and the PSC policy and practice on the fuel clause was developed over decades through a series of PSC orders issued in evidentiary proceedings, not set forth in rules established through rulemaking proceedings. Fuel cost recovery is a simple pass-through charge of the costs incurred, and very rarely includes any capital investment or return on that investment. The commission has an annual docket on fuel cost recovery charges, and each public utility projects its fuel costs for the upcoming year and presents documentation on its costs for the past year for a "true-up" of projected compared to actual fuel costs for that year. The fuel charge for the next year is based on the projected costs and any necessary adjustment for overcharges or undercharges from the previous year.

Changes in fuel prices can be volatile, so utilities have fuel price hedging programs, which "promise protection against energy-market price spikes, and they can be important to the

[1] The statutes establish two classes of utilities. The first is a "public utility" which includes Florida Power & Light, Duke Energy Florida, Tampa Electric Company, Gulf Power, and Florida Utilities Company, but does not include either a municipal electric utility or a cooperative. This class of utility is subject to full economic regulation by the PSC. The second class is an "electric utility" which includes public utilities, municipal electric utilities, and rural cooperatives. This class is subject to grid regulation and rate design jurisdiction. This bill applies only to public utilities subject to full economic regulation. See, s. 366.02 and chapter 366, F.S.

regulatory goal of sustainable, lowest long-term service cost."[2] Most hedges are financial and consist of options, swaps, futures, basis swaps, and fixed-price swaps involving natural gas and possibly other commodities whose price movements are known to be related to energy price movements.[3] Storing natural gas provides a physical hedge against price volatility and against shortages and disruptions to pipeline operations.[4]

PSC Order on FPL Hedging Investments

On June 25, 2014, Florida Power and Light Company (FPL) filed a petition seeking PSC approval to recover through the fuel clause its costs of a joint venture with an oil and natural gas company to acquire, explore, drill, and develop natural gas wells in Oklahoma (known as the "Woodford Project"). FPL argued that the investments were permissible as a long-term physical hedge, and that, as they were capital investments, FPL was entitled to earn a rate of return on the investments. FPL also requested that the commission establish guidelines under which FPL could invest in future gas reserve projects without the commission's prior approval and recover the costs through the fuel clause.

On January 12, 2015, in a case of first impression, the commission approved FPL's petition for cost recovery, including a rate of return, through the fuel clause.[5] The PSC established two conditions on the cost recovery. First, FPL had to add the appropriate subaccounts, under the FERC system of accounting, which would correspond on a one-on-one basis with the accounts used by an FPL affiliate that had originally invested in these contracts. Second, FPL had to use an independent auditor in performing audits provided in the agreement.

On July 14, 2015, the commission approved 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.[6] One effect of this is that an FPL investment that meets the guidelines is automatically deemed to be prudent and reasonable, and so recoverable from ratepayers.

Florida Supreme Court Order on Appeal of PSC's FPL Order

On January 15, 2015, the Florida Supreme Court (Court) consolidated appeals by the Office of Public Counsel (OPC) and the Florida Industrial Power Users Group's of the commission's orders approving the Woodford Project and approving guidelines.[7] On May 19, 2016, the Court reversed the PSC orders, holding that the commission exceeded its statutory authority when approving recovery of FPL's investment in the Woodford Project.[8]

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[2] Stephen Maloney, When The Price Is Right: How to measure hedging effectiveness and regulatory policy, Fortnightly Magazine - October 2007, https://www.fortnightly.com/fortnightly/2007/10/when-price-right (last accessed April 10, 2017).
[3] *Id*.
[4] *Id*.
[5] *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.*
[6] 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.*
[7] *Id*.
[8] *Citizens of the State of Florida v Art Graham*, 191 So. 3d 897, Fla. (May 19, 2016); Also available at http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf.

The Court explained this holding by addressing two possible bases for cost recovery. First, the Court found that the PSC could not approve cost recovery pursuant to its general authority over matters respecting the rates and service of public utilities. The statutes authorize the commission to set fair, just, and reasonable rates for public utilities, which are defined 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…. In other words, the exploration, drilling, and production of fuel falls outside the purview of an electric utility as defined by the Legislature."[9] This appears to be an application of the limitation inherent in economic regulation that a regulated entity cannot invest in a business not part of its regulated activities in order to prevent risks from investments in outside businesses and the impacts of those risks on reliability and fair rates for the monopoly business' captive customers.

Second, the Court found that the PSC could not approve the investments as a long-term physical hedge. "Specifically, hedging involves locking in a future price to avoid the adverse effects of price fluctuations, and utilities can hedge by entering into financial arrangements to secure natural gas at a future point in time at a fixed price."[10] The Woodford Project does not involve a certain quantity of fuel for a certain price, so it cannot qualify as a hedge.[11] Additionally, the fuel cost recovery process is a cash flow mechanism to allow utilities to recover costs for changes in fuel costs between ratemaking proceedings, and, while it does permit utilities to recover actual costs of financial derivatives and physical hedges that help prevent price shocks from volatile fuel costs, it does not allow a rate of return on money spent to purchase fuel or costs of hedging contracts.[12] The Court closes this discussion by making the following findings.

> Permitting advance recovery of FPL's investment in the Woodford Project's exploration and production of natural gas will not pay for the costs of actual fuel. It will provide recovery, instead, for investment, operation, and maintenance and operation of assets that will provide access to an unknown quantity of fuel in the future. It is impossible to know what the costs of the natural gas will be until it is actually produced. There is more uncertainty from this investment rather than less. Therefore, it cannot be characterized as a physical hedge.
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> Additionally, under FPL's proposal for the Woodford Project, ratepayers (not FPL) bear the risk of natural gas price volatility and all of the production risks. If the production cost of extracting natural gas from the Woodford wells, including profit paid to FPL on its capital investment, is less than the natural gas market price, the ratepayers will benefit. However, if the production costs of extracting natural gas from the Woodford wells is more than the natural gas market, the ratepayers do not benefit but will instead suffer a

[9] *Id.*, http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf, pages 5-8.
[10] *Id.*, http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf, page 9, citing See Stephen Maloney, When the Price is Right, 145 No. 10 Pub. Util. Fort. 24, 25-26 (Oct. 2007).
[11] As is discussed above, typically the fuel cost recovery process is a simple pass-through charge of the costs incurred, with the recovery for any given year based on the projected fuel costs for that year adjusted for overcharges or undercharges from the previous year to true-up recovery to actual costs. One effect of the lack of "a certain quantity of fuel for a certain price" is that there is no basis for a true-up.
[12] *Id.*, http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf, pages 8-10.

> loss. The monies spent on the Woodford Project are not a mere pass-through, like other fuel expenses, because FPL will earn a return on its capital expenditures. Accordingly, the Woodford Project is a guaranteed capital investment for FPL; it is not a hedge to stabilize fuel costs.
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> This 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.[13]

Subsequent Supreme Court Decision on the Fuel Clause

The Court further addressed the PSC's use of the fuel clause in a subsequent case involving Florida Public Utilities Company (FPUC), an investor-owned electric utility located in Fernandina Beach that does not generate its own electricity, but instead relies solely on wholesale purchase power agreements with other electric utilities.[14] On August 29, 2014, FPUC entered into a settlement agreement with OPC to resolve FPUC's then-pending petition for an increase in base rates. The settlement agreement, approved by the PSC on September 29, 2014, prohibited FPUC from increasing its base rates until at least December 31, 2016, but did allow FPUC to seek PSC approval for recovery of costs "of a type which traditionally and historically would be, have been, or are presently recovered through cost recovery clauses."

On September 1, 2015, FPUC petitioned the commission for approval to recover through the fuel clause its costs of constructing a new interconnection with FPL, including a return on investment. In support of its petition, FPUC argued that it was purchasing power from Jacksonville Electric Authority pursuant to a contract that would expire on December 31, 2017, and that the interconnection with FPL would give FPUC access to electricity from two sources and a better bargaining position, with any savings to be passed on to customers in the form of lower rates. OPC objected that the costs were barred by the settlement agreement. Commission staff agreed, and recommended that the petition be denied. Nonetheless, the commission voted to reject the staff recommendation and approve the recovery.

On appeal, the Court found that the PSC failed to consider and apply the settlement agreement and turned to the issue of whether the petition could be granted. The Court began by noting that the term "fuel clause" is a misnomer as the fuel clause is not a particular provision, but rather "a regulatory tool designed to pass through to utility customers the costs associated with fuel purchases."[15] Its purpose is to prevent "regulatory lag" a time lag between ratemaking proceedings in which volatile prices result in under-recovery of costs. However, as the commission has recognized, regulatory lag is not as much of a problem when expenses such as capital improvements can be planned for and included in base rate calculations. The PSC has approved recovery of some capital costs through the fuel clause. For example, in 1995, it approved FPL's purchase of 462 high capacity rail cars which allowed FPL to obtain favorable transportation rate savings that exceeded the recoverable cost of the purchase, saving an estimated $24 million in fuel costs. Turning to the issues at hand, the court stated:

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[13] *Id*., http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf, pages 9-10.
[14] *Citizens of the State of Florida v Art Graham,* March 16, 2017, http://www.floridasupremecourt.org/decisions/2017/sc16-141.pdf.
[15] *Id.*, at 19.

With the purpose of the fuel clause in mind, we conclude that the Commission erred as a matter of law in determining that the construction type costs associated with the actual construction of the physical structure for the transmission interconnection are recoverable through the fuel clause pursuant to Order No. 14546. Unlike the dissent, if we were to allow recovery of these capital construction costs through the fuel clause simply because they may result in savings and are loosely linked to fuel and purchased power through transmission lines, the fuel clause exception would finally totally swallow whole the rule that capital costs should be recovered through base rates because they can be subject to adequate planning.

Indeed, in this very case the testimony of FPUC witnesses suggested that FPUC simply chose to pursue recovery through the fuel clause as a matter of convenience, rather than any necessity borne of unforeseen volatility. Moreover, tellingly, FPUC had always recovered costs for transmission assets through base rates on prior occasions. Only after a settlement agreement freezing base rates was in place did FPUC for the first time seek to recover transmission asset capital construction costs through the fuel clause.

We do not believe that the fuel clause is an end-all-be-all of cost recovery, but rather its history suggests its use should be limited to facilitating recovery of costs related to fuel and power purchases that are volatile, rendering them less than ideal for a base rates case. Today's case is certainly not the first example of utilities seeking to recover for items that are more properly base rate costs through the fuel clause in a practice that has become alarmingly frequent. Just recently we reexamined the contours of the fuel clause in reversing a commission order approving cost recovery of " 'exploration expense, depletion expense, operating expenses, G & A, taxes, transportation costs and a return on the unrecovered investment, including working capital' for investments in the exploration, drilling, and production of natural gas in the Woodford Shale Gas Region in Oklahoma." Citizens of State v. Graham, 191 So. 3d 897, 899 (Fla. 2016). The project was characterized as "a long-term physical hedge." Id. at 901. In that case we reaffirmed the purpose of the fuel clause as a mechanism for addressing the volatility of fuel prices between ratemaking proceedings.

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.[16]

[16] The phrase "has at least 65 percent natural-gas-fueled generation" can refer either to installed power plant capacity or actual electricity generation, stated in kilowatt-hours (kWh). According to the PSC bill analysis, if the phrase refers to capacity, as of December 31, 2015, 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. If the phrase refers to actual kWh generated, this can vary from year to year based on a variety of factors. 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 could potentially qualify during the period 2016 through 2019.

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.
- 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.

The bill takes effect July 1, 2017.

The Court noted in both cases discussed above that capital investments and the related return on investments are not usually included in an adjustment clause (recovery clause). There is, however, an argument that recovering these costs in a recovery clause is more appropriate. The Court found that:

- The costs of these investments are not related to the utility's core functions of generating and delivering electricity.
- These are not long-term physical hedging contracts as they do not involve a set amount of natural gas for a set price.
- Under the terms of the PSC order (and of this bill) "ratepayers (not FPL) bear the risk of natural gas price volatility and all of the production risks."
- "Accordingly, the Woodford Project is a guaranteed capital investment for FPL; it is not a hedge to stabilize fuel costs."

As these investments can be considered to be outside a regulated utility's regulated business practices, these costs arguably are not appropriate for inclusion in base rates and could more appropriately be included in a pass-through recovery clause.

Similar to the PSC order, the bill establishes standards which if met, constitute a binding determination of prudent and reasonable costs, with no subsequent review and no opportunity for a true-up of projected costs as compared to actual costs.

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.

The Securities and Exchange Commission has three classes of natural gas reserves based on the probability that the predicted quantity of gas can be commercially recovered under current technical, contractual, economic, and regulatory conditions:

- Proved reserves have reasonable certainty (90 percent probability);
- Probable reserves have some uncertainty (50 percent probability), and
- Possible reserves have high uncertainty (10 percent probability).[17]

Because one of the primary purposes of gas reserve projects is a physical source of supply to serve its natural gas needs, the PSC required that at least 50 percent of the wells in each gas reserve project must be classified as proved reserves, and it prohibited FPL from entering into transactions for gas reserve projects that involve wells classified as possible reserves. The bill, on the other hand, would allow up to 50 percent in possible reserves.

The bill also does not have the PSC's requirement that FPL add the appropriate subaccounts to correspond on a one-on-one basis with the accounts used by the affiliated Gas Reserve Company.

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:

Qualifying utilities will receive a rate of return on all investments. Customers should benefit if natural gas prices increase sufficiently, but could bear additional costs if natural gas prices decrease. Additionally, customers would not benefit if there is no natural gas in a well (and up to 50 percent of all projects can be possible resources with a 10 percent possibility of the projected success), if less natural gas is produced than projected, or if production costs increase.

[17] 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.*

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Statutes Affected:

The 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.