

**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.)

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Prepared By: The Professional Staff of the Committee on Rules

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BILL: CS/SB 1238

INTRODUCER: Rules Committee and Senator Bean

SUBJECT: Utility Investments in Gas Reserves

DATE: April 25, 2017

REVISED: \_\_\_\_\_

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Caldwell/Wiehle</u>	<u>Caldwell</u>	<u>CU</u>	<b>Favorable</b>
2.	<u>Wiehle</u>	<u>Phelps</u>	<u>RC</u>	<b>Fav/CS</b>

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**Please see Section IX. for Additional Information:**

COMMITTEE SUBSTITUTE - Substantial Changes

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**I. Summary:**

CS/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.

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 include, at minimum, all of the following:

- A requirement that each natural gas reserve investment be projected to generate savings for customers over the life of the investment.
- A requirement that the total volume of natural gas produced from all of a utility's natural gas reserve investments not exceed specified caps.
- A requirement that each investment have at least 50 percent of the wells within the project classified as proved gas reserves and the remaining wells classified as probable.
- A prohibition against recovery of the costs of fracking natural gas within the state.
- A prohibition against the recovery of the costs of extracting natural gas from state, U.S., or international waters.

Each public utility engaging in natural gas reserve investments must file annually with the commission a detailed comparison of all gas reserve projects entered into on behalf of the utility and any affiliate or subsidiary of the utility's parent company. The filing must show all material

assumptions relied upon to support each gas reserve project; calculate the associated revenue requirement for each gas reserve project; and provide the net present value savings for each gas reserve project entered into by any affiliate or subsidiary of a parent company. For any gas reserve project, the utility must use an independent third-party auditor in performing audits of the associated transactions. Subaccounts that correspond on a one-on-one basis with the oil and gas system of accounts must be established and used by the utility for each investment in a gas reserve project.

A public utility may enter into a gas reserves project only if there is a transportation path available to deliver the gas produced from that project to the public utility's service territory. The costs of any new transportation needed to deliver gas from a gas reserve project must be taken into consideration when analyzing the economics of that project.

The bill takes 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<sup>1</sup> 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.

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<sup>1</sup> 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.

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 regulatory goal of sustainable, lowest long-term service cost.”<sup>2</sup> 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.<sup>3</sup> Storing natural gas provides a physical hedge against price volatility and against shortages and disruptions to pipeline operations.<sup>4</sup>

### **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.<sup>5</sup> 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.

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<sup>2</sup> 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).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *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*.

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.<sup>6</sup> 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 of the commission's orders approving the Woodford Project and approving guidelines.<sup>7</sup> 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.<sup>8</sup>

The Court explained this holding by addressing two possible bases for cost recovery: through base rates as part of the public utility's regulated business activities, or through the fuel cost recovery clause as a long-term physical hedge. The Court found the following:

- The exploration, drilling, and production of fuel is outside the utility's regulated business activities as defined by the Legislature, and so the costs of these investments cannot be recovered through base rates.<sup>9</sup>
- The costs cannot be recovered through the fuel clause as the investments are not a long-term physical hedge because:
  - the contracts are not long-term physical hedging contracts as they do not involve a certain amount of natural gas for a certain price;<sup>10</sup> and
  - the fuel clause is a mechanism by which costs are passed-through, without any rate of return on money spent to purchase fuel or on the cost of hedging positions purchased.<sup>11</sup>
- Additionally, under the terms of the PSC order "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."<sup>12</sup>

### **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

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<sup>6</sup> 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*.

<sup>7</sup> *Id.*

<sup>8</sup> *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>.

<sup>9</sup> *Id.*, <http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf>, pages 5-8.

<sup>10</sup> *Id.*, <http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf>, page 8.

<sup>11</sup> *Id.* 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.

<sup>12</sup> *Id.*, <http://www.floridasupremecourt.org/decisions/2016/sc15-95.pdf>, pages 8-10.

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.<sup>13</sup>

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 include, at minimum, all of the following:

- A requirement that each natural gas reserve investment be projected to generate savings for customers over the life of the investment.
- A requirement that the total volume of natural gas produced from all of a utility's natural gas reserve investments not exceed the following percentages of the utility's average 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.
- A requirement that each investment be made in natural gas projects that have at least 50 percent of the wells within the project classified as proved gas reserves and the remaining wells within the project classified as probable gas reserves by the Securities and Exchange Commission.
- A prohibition against the recovery by a utility of the costs of natural gas extracted from the state by means of any well-stimulation treatment, including hydraulic fracturing, acid fracturing, and matrix acidizing.
- A prohibition against the recovery by a utility of the costs of natural gas extracted from the waters of the state, from the waters of the United States, or from international waters.

Annually, each public utility must file with the commission a detailed comparison of all gas reserve projects entered into on behalf of the utility and any affiliate or subsidiary of the utility's parent company as part of its Risk Management Plan. The information must be the same for each gas reserve project entered into by any affiliate or subsidiary which was used to support or justify the appropriateness of each gas reserve project entered into during the reporting period. The filing must:

- Show all material assumptions relied upon to support each gas reserve project, including the capital investment amount;
- Calculate the associated revenue requirement for each gas reserve project; and
- Provide the net present value savings for each gas reserve project entered into by any affiliate or subsidiary of a parent company.

For any gas reserve project, the utility must use an independent third-party auditor in performing audits of the associated transactions. Subaccounts that correspond on a one-on-one basis with the

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<sup>13</sup> 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.

oil and gas system of accounts must be established and used by the utility for each investment in a gas reserve project.

A public utility may enter into a gas reserves project only if there is a transportation path available to deliver the gas produced from that project to the public utility's service territory. The costs of any new transportation needed to deliver gas from a gas reserve project must be taken into consideration when analyzing the economics of that project.

The bill takes effect July 1, 2017.

**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, if less natural gas is produced than projected, or if production costs increase.

C. Government Sector Impact:

None.

**VI. Technical Deficiencies:**

None.

## VII. Related Issues:

The bill provides:

A public utility may enter into a gas reserves project only if there is a transportation path available to deliver the gas produced from that project to the public utility's service territory. The costs of any new transportation needed to deliver gas from a gas reserve project must be taken into consideration when analyzing the economics of that project.

These provisions are ambiguous. They could simply acknowledge: that the natural gas to be produced in these projects has to be transported to the utility's service territory to be used; that this will require the utility to use means of transportation that it has not used before and that are, therefore, "new" to that utility; and that the transportation costs are integral to the project and must be considered by the PSC in determining whether a natural gas reserve investment is projected to generate savings for customers over the life of the investment.

On the other hand, the word "new" *could* impliedly authorize a utility to construct, own, and operate a new natural gas pipeline and to recover all the costs from its ratepayers. The idea that a regulated electric utility would get into the business of constructing and operating a natural gas pipeline may not be what is contemplated, but the bill authorizes a regulated electric utility to get into the business of exploration and production of natural gas, and the gas must be transported to the utility's Florida service territory, so utility ownership and operation of a pipeline could be considered a natural extension.

FPL entered into natural gas production projects by buying project contracts from an affiliate, NextEra's US Gas Assets. Research indicates US Gas now is a partner in the proposed Sooner Trails natural gas pipeline, which will serve the Woodford Shale region in Oklahoma where FPL is drilling. These circumstances can lead to an interpretation that the language would authorize FPL to purchase US Gas' share of this proposed pipeline and recover the costs from its ratepayers.

## VIII. Statutes Affected:

The bill substantially amends section 366.04 of the Florida Statutes.

## IX. Additional Information:

### A. Committee Substitute – Statement of Substantial Changes:

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

#### CS by Rules on April 25, 2017:

- Adds to the bill's requirement that at least 50 percent of wells in an investment be in the proved gas reserves classification a requirement that the remainder be classified as probable gas reserves;
- Prohibits recovery of the costs of fracking natural gas within the state or from state, U.S., or international waters;
- Requires an annual detailed account comparison of all gas reserve projects entered into by a public utility and by any affiliate;

- Prohibits a public utility from entering into a gas reserves project unless there is a transportation path available to deliver the gas produced to the utility's service territory; and
- Requires the PSC to consider the cost of any new transportation needed to deliver the gas when analyzing the economics of that project.

**B. Amendments:**

None.

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

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