State of Florida

Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

DATE: January 26, 2006

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Competitive Markets & Enforcement (Bulecza-Banks, Beard, Broussard)
Division of Economic Regulation (Slemkewicz)
Office of the General Counsel (Gervasi)

Docket No. 050835-GU – Petition for approval of Amendment No. 2 to gas transportation agreement (special contract), master gas transportation service termination agreement, delivery point lease agreement and letter agreement: CFG Transportation Aggregation Service between Florida Division of Chesapeake Utilities Corporation and Polk Power Partners, L.P.

AGENDA: 02/07/06 – Regular Agenda – Proposed Agency Action on Issue 1 – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Arriaga

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\CMP\WP\050835.RCM.DOC

Case Background

In 1992, Florida Division of Chesapeake Utilities Corporation (Chesapeake) and Polk Power Partners, L.P., (Polk Power) formerly Mulberry Energy Company, Inc., petitioned the Florida Public Service Commission (the Commission) for approval of a Large Volume Transportation Service Rate Schedule and Gas Transportation Agreement. The Agreement was approved by Order No. PSC-92-0201-FOF-GU, issued April 14, 1992, in Docket No. 920156-

GU, In re: Petition for Approval of Large Volume Contract Transportation Service Rate Schedule and Gas Transportation Agreement with Mulberry Energy Company, Inc. by Florida Division of Chesapeake Utilities Corporation.

In 1993, Chesapeake and Polk Power petitioned the Commission to approve a second gas transportation agreement for additional transportation service. This agreement was approved by Order No. PSC-93-1178-FOF-GU, issued August 11, 1993, in Docket No. 930453-GU, In re: Emergency Petition for approval of interconnection agreement with Polk Power Partners, L.P., by Florida Division of Chesapeake Utilities Corporation.

In 1994, the Commission approved a transportation agreement between Chesapeake and Polk Power that terminated and superseded the two existing agreements. Amendment No. 1 was added to the Transportation Agreement filed in 1992, and was approved by Order No. PSC-94-0541-FOF-GU, issued May 10, 1994, in Docket No. 940320-GU, In re: Petition for approval of a gas transportation agreement with Polk Power Partners, L.P. by Florida Division of Chesapeake Utilities Corporation.

On October 24, 2005, Chesapeake petitioned the Commission for approval of three new agreements with Polk Power along with Amendment No. 2 to the existing Special Contract. Amendment No. 2 and the three agreements have an effective date of January 1, 2005, and are as follows:

- Amendment No. 2 to Gas Transportation Agreement (Special Contract) - discontinues a rate escalator clause and replaces it with a fixed fee per month (Transportation Service Reservation Charge) over the remaining term of the Agreement (December 31, 2015). A contract provision has been added that requires Polk Power to provide an 18-month prior notification to terminate this Agreement with Chesapeake.

- The Master Gas Transportation Service Termination Agreement - provides the rights and conditions of termination of any or all agreements by Chesapeake, Polk Power, or a regulatory authority. This agreement also states that all agreements are interconnected.

- Delivery Point Lease Agreement - designates Chesapeake as the Delivery Point Operator (DPO) for the Delivery Point that interconnects the Polk Power facility to Florida Gas Transmission (FGT). The DPO is responsible for balancing the amount of gas ordered versus the amount used. Chesapeake is already the DPO for another facility owned by the partners of Polk Power, also located in Polk County, called Orange Cogeneration Facility (Orange Cogen).

- Letter Agreement: CFG Transportation Aggregation Service between Chesapeake and Polk Power – The Letter Agreement clarifies that sections of Chesapeake's standard Transportation Aggregation Service Agreement related to capacity relinquishment do not apply to the agreement between Polk Power and Chesapeake.

The Commission has jurisdiction pursuant to Sections 366.04, 366.05, and 366.06, Florida Statutes.

Discussion of Issues

Issue 1: Should Amendment No. 2 to the Gas Transportation Agreement (Special Contract), Master Gas Transportation Service Termination Agreement, Delivery Point Lease Agreement, and Letter Agreement: CFG Transportation Aggregation Service between Chesapeake and Polk Power be approved?

Recommendation: Yes. Staff recommends that Amendment No. 2 to the Gas Transportation Agreement (Special Contract), Master Gas Transportation Service Termination Agreement, Delivery Point Lease Agreement, and Letter Agreement: CFG Transportation Aggregation Service between Chesapeake and Polk Power should be approved effective January 1, 2005. (Beard, Broussard)

Staff Analysis: The original agreement between Chesapeake and Polk Power approved by Order No. PSC-02-92-0201-FOF-GU, established the Large Volume Transportation Service Rate Schedule within Chesapeake's tariff. By Order No. PSC-93-1178-FOF-GU, the Commission approved Chesapeake's request for a second transportation agreement, allowing Chesapeake to provide Polk Power an increased volume of transportation service. By Order No. PSC-94-0541-FOF-GU, the Commission approved Chesapeake's and Polk Power's Gas Transportation Agreement that consolidated the terms and conditions of the 1992 and 1993 agreements.

Prior to 1993, Chesapeake was the only source of transportation service from FGT to Polk Power's generation facilities. In 1993, Polk Power obtained a direct connection to FGT. This connection allowed Polk Power to receive gas transported from FGT directly into Polk Power's gas lines connected to the plant. As a result, the amount of transportation service required to be provided by Chesapeake was greatly reduced in the 1994 Agreement. While in 1992 and 1993 Chesapeake was providing 100 percent of Polk Power's transportation service, in 1994, Chesapeake's obligation fell to 38-45 percent with the remainder being transported by FGT. The 1994 Agreement established an escalation rate that increased the amount per dekatherm (Dth) that Polk Power would be required to pay Chesapeake for transportation service. The escalation factor was set at 7.5 percent per year beginning in 1994 and extending through December 2015.

In 2004, there was a change in ownership of Polk Power Partners. Polk Power contacted Chesapeake about renegotiating the agreements given the favorable economics of receiving its entire transportation service from FGT.[1] To avoid losing the entire revenues generated from Polk Power, Chesapeake began negotiations with Polk Power. Since 2004, Chesapeake and Polk Power have worked together to develop new terms and conditions under

[1] FGT's current recourse reservation rate authorized by FERC for FTS-1 capacity is $0.3855 per Dekatherm (Dth). The addition of Chesapeake's 2005 transportation rate of $0.465 per Dth results in a total transportation rate to Polk Power of $0.8315 per Dth. As approved by the Commission in the 1994 Gas Transportation Agreement with Polk Power, for the first 5,640 Dth of gas transported each day, Chesapeake's rate is billed based on a calendar year rate schedule that was established in the agreement. Any Dth transported above the 5,640 Dths are billed at $0.025 per Dth. Polk Power could acquire its 5,640 Dth through FGT FTS-2 lines for $.07690 per Dth. This FTS-2 rate is less than the current combined rate for FGT FTS-1 and the rate of $0.8315 per Dth.

which Chesapeake would provide some of the transportation service necessary to fuel Polk Power's generation facilities. The negotiations resulted in the need to amend the existing Special Contract, as well as the execution of three (3) new agreements. The Amendment No. 2 and the three new operating agreements were signed by the parties on August 24, 2005[2]. According to the agreements, the new rates would be retroactively applied to January 1, 2005, and remain in effect on an interim basis, pending Commission approval.

Chesapeake has petitioned the Commission for approval of three new agreements with Polk Power along with Amendment No. 2 to the existing Special Contract. The agreements include: Master Gas Transportation Service Termination Agreement; Delivery Point Lease Agreement; and Letter Agreement: CFG Transportation Aggregation Service.

Amendment No. 2 to the existing Special Contract discontinues a rate escalator clause and replaces it with a fixed fee per month (Transportation Service Reservation Charge) over the remaining term of the Agreement, which expires on December 31, 2015. A contract provision has been added that requires Polk Power to provide an 18-month prior notification to terminate this Agreement with Chesapeake.

The Master Gas Transportation Service Termination Agreement provides the rights and conditions of termination of any or all agreements by Chesapeake, Polk Power, or a regulatory authority. This agreement also states that all agreements are interconnected.

The Letter Agreement: CFG Transportation Aggregation Service clarifies that sections of Chesapeake's standard Transportation Aggregation Service Agreement related to capacity relinquishment do not apply to the agreement between Polk Power and Chesapeake. Because Chesapeake did not release capacity it holds on FGT to Polk Power, the capacity relinquishment provisions are not applicable.

The Delivery Point Lease Agreement allows Polk Power to designate Chesapeake as the Delivery Point Operator (DPO) at the point Polk Power's gas lines connect to FGT. As DPO, Chesapeake is responsible for managing deliveries with actual usage. The designation permits Chesapeake to combine the volumes delivered to Polk Power's generation facilities for purposes of managing gas deliveries. The Polk Power Partnership operates two cogeneration facilities in Polk County, Orange Cogeneration and Polk Power. The Polk Power facility receives gas in two ways: 1) through a direct interconnect with FGT and, 2) through Chesapeake's delivery system. In contrast, all the gas delivered to the Orange Cogeneration facility is provided via Chesapeake's system. By designating Chesapeake as the DPO for Polk Power's direct connect delivery points at the cogeneration facilities, Chesapeake will be able to pool Polk Power's deliveries with Chesapeake's other gas deliveries. By pooling the deliveries, gas over burns and under burns can be offset which could serve to reduce or eliminate potential penalties imposed by the pipelines. Chesapeake believes that by aggregating the gas deliveries, Polk Power could experience significant economic and operational benefits. According to Chesapeake, the potential to extract such benefits is a substantial reason Polk Power is interested in continuing its transportation relationship with the utility. For providing DPO services to Polk Power,

[2] In response to Staff's Data Request, Chesapeake advised that notwithstanding the August 24, 2005, date on the agreements, the agreements were actually executed by all parties in mid-October 2005.

Chesapeake will receive an initial payment of $20,000 and an Operation and Maintenance fee of $2,500 per month.

Chesapeake has petitioned to retroactively apply the rates charged to Polk Power for transportation service to January 1, 2005, and to issue a refund to Polk Power for the difference between the current and proposed rates. As stated in its petition, Chesapeake implemented the rates in August 2005, on an interim basis retroactive to January 1, 2005. In October 2005, Chesapeake issued Polk Power a credit of approximately $8,400 and an additional charge of $22,500 was assessed for Chesapeake's service as DPO. The appropriateness of implementing rates prior to Commission approval is addressed in Issue 2.

In reviewing Chesapeake's June 2005 Rate of Return Report, the retroactive application of rates and associated refund will not cause Chesapeake's earnings to fall outside its authorized range. Chesapeake has an authorized return on equity of 11.50%, and is currently earning a return on equity of 11.11% based on its June 2005 Earnings Surveillance Report. Application of the proposed rates and associated refund should increase Chesapeake's return on equity by 7 basis points on an annual basis.

Staff also analyzed Chesapeake's cost of service calculations to ensure that the proposed rates will recover Chesapeake's cost to service Polk Power. As designed, the earnings from this contract on a stand-alone basis will provide the company an 11.50% return on equity, which is Chesapeake's authorized midpoint.

The intent of Chesapeake is to retain one of its largest customers, while ensuring that the rates charged are competitive with the customer's other gas delivery options. In 2004, Chesapeake received $571,848 in margin revenue from Polk Power. It is Chesapeake's opinion that due to the rate escalator clause in the 1994 Agreement, Polk Power has an incentive to bypass Chesapeake's distribution system and receive all of the gas necessary to operate the Polk Power facility directly from FGT. Since Polk Power has a direct connection with FGT, and since FGT is providing the majority of Polk Power's transportation service, there are economic incentives for Polk Power to bypass Chesapeake's system entirely.

Based upon the above analysis, staff recommends that Amendment No. 2 along with the three new agreements should be approved, effective January 1, 2005. The contract will provide benefits to Chesapeake and to Polk Power, and will assure a revenue stream from Polk Power will not be lost.

Issue 2: Should Chesapeake be required to show cause, in writing within 21 days, why it should not be fined for its apparent violation of Section 366.06(1), Florida Statutes, and Rule 25-9.034(1), Florida Administrative Code, for its failure to obtain Commission approval prior to the execution of Amendment No. 2 to Gas Transportation Agreement (Special Contract) with Polk Power Partners, L.P.?

Recommendation: No, Chesapeake should not be required to show cause why it should not be fined for its apparent violation of Section 366.06(1), Florida Statutes, and Rule 25-9.034(1), Florida Administrative Code, for its failure to obtain Commission approval prior to the execution of Amendment No. 2 to Gas Transportation Agreement (Special Contract) with Polk Power Partners, L.P. However, Chesapeake should be put on notice that future implementation of any rates and/or charges prior to Commission approval, in apparent violation of Section 366.06(1) Florida Statutes and/or Rule 25-9.034(1), Florida Administrative Code, could result in the initiation of show cause proceedings. (Gervasi)

Staff Analysis: By its terms, Amendment No. 2 to the Gas Transportation Agreement (Special Contract) was made and entered into between the parties on August 24, 2005, to be effective January 1, 2005. Among other things, this special contract discontinues the Commission-approved rate escalator clause contained in Chesapeake's 1994 gas transportation agreement with Polk Power and replaces it with a fixed fee transportation service reservation charge. Paragraph 9 of the Special Contract provides for the proposed new rate to be placed into effect on January 1, 2005, on an interim basis pending Commission approval, and for the difference between the existing and proposed rate to be collected or refunded in the event the Commission declines or fails to issue a final order approving the amended rates, terms and conditions within 12 months after its execution.

Chesapeake's failure to obtain Commission approval prior to the execution of the Special Contract with Polk Power is in apparent violation of Section 366.06(1), Florida Statutes, and Rule 25-9.034(1), Florida Administrative Code. Section 366.06(1), Florida Statutes, provides that:

> [a] public utility shall not, directly or indirectly, charge or receive any rate not on file with the [C]ommission for the particular class of service involved, and no changes shall be made in any schedule. All applications for changes in rates shall be made to the [C]ommission in writing under rules and regulations prescribed.

Rule 25-9.034(1), Florida Administrative Code, provides that:

> [w]herever a special contract is entered into by a utility for the sale of its product or services in a manner or subject to the provisions not specifically covered by its filed regulations and standard approved rate schedules, such contract must be approved by the Commission prior to its execution. Accompanying each contract shall be complete and detailed justification for the deviation from the utility's filed regulations and standard approved rate schedules. If such special contracts are approved by the Commission, a conformed copy of the contract shall be placed on file with the Commission before its effective date.

Section 366.095, Florida Statutes, authorizes the Commission to assess a penalty of not more than $5,000 for each offense, if a utility is found to have refused to comply with or to have willfully violated any lawful rule or order of the Commission or any provision of Chapter 366, Florida Statutes. Each day that such refusal or violation continues shall constitute a separate offense. In Order No. 24306, issued April 1, 1991, in Docket No. 890216-TL, titled In Re: Investigation Into The Proper Application of Rule 25-14.003, F.A.C., Relating To Tax Savings Refund For 1988 and 1989 For GTE Florida, Inc., the Commission, having found that the company had not intended to violate the rule, nevertheless found it appropriate to order it to show cause why it should not be fined, stating that "in our view, 'willful' implies an intent to do an act, and this is distinct from an intent to violate a statute or rule." Id. at 6.

Although regulated utilities are charged with knowledge of Chapter 366, Florida Statutes, and of Commission rules, staff does not believe that the apparent violation of Section 366.06(1), Florida Statutes, and Rule 25-9.034(1), Florida Administrative Code, rises in these circumstances to the level of warranting the initiation of a show cause proceeding. In response to a Staff Data Request on the matter, Chesapeake advised that it understands that it did not have Commission approval prior to implementing the proposed rates; however, as stated in Paragraph 9 of the special contract:

> The Parties agree that the rates, terms and conditions established in this Amendment shall be placed into effect on the Effective Date on an interim basis until such time as the FPSC has issued a final order approving the amended rates, terms and conditions. The Parties agree that, in the event the FPSC (a) expressly declines to issue such a final order….. the rates, terms and conditions shall revert to the original Agreement.

According to Chesapeake, Polk Power expressly requested a January 1, 2005 effective date. Chesapeake was concerned that the lost revenues from Polk Power would ultimately have a detrimental effect on the rates of Chesapeake's other customers. Chesapeake's rationale for agreeing to this provision was based solely on the fact that Polk Power has a direct connect with Florida Gas Transmission (FGT) and was threatening immediate bypass unless the rates became effective January 1, 2005. If Chesapeake had not entered into amended agreements with Polk Power ending the rate escalation and bypass occurred, Chesapeake would have had its transportation revenues reduced by approximately $700,000 per year. A revenue loss of this magnitude would require Chesapeake to seriously consider filing for a general rate increase from the remaining customers.

Moreover, upon inquiry as to why Chesapeake failed to seek Commission approval of its proposed Special Contract with Polk Power prior to implementing the rates, charges, and contract provisions detailed in its Petition, Chesapeake responded that it began negotiations with Polk Power about 20 months ago regarding the issues contained in the Petition. During the interim period, the two main partners of Polk Power sold their interests in the project. The new partners suspended negotiations until early 2005. Negotiations were concluded in August 2005, and, according to Chesapeake, the August 24, 2005 date of the agreements notwithstanding, the agreements were actually executed by all parties in mid-October 2005. Chesapeake promptly filed its Petition on October 24, 2005.

Chesapeake must be mindful of its legal responsibilities under Chapter 366, Florida Statutes, and of the rules of this Commission. Section 366.06(1), Florida Statutes, prohibits a public utility from charging or receiving any rate not on file with the Commission, and Rule 25-9.034(1), Florida Administrative Code, expressly required Chesapeake to obtain Commission approval prior to the execution of the special contract, not promptly thereafter. Chesapeake reasonably could have apprised the Commission of the need for the contract by filing an emergency petition at the time it began negotiating with Polk Power. Nevertheless, the unique circumstances surrounding the execution of the Special Contract mitigate the utility's apparent violation in this instance. It appears likely that Chesapeake would indeed have suffered a revenue loss to the detriment of its general body of ratepayers had a bypass to FGT occurred. Moreover, Chesapeake arranged to have the rates, terms, and conditions of the Special Contract revert to the original agreement in the event the Commission declined or failed to approve it, including a provision for the difference between the existing and proposed rate to be collected or refunded. Therefore, staff does not recommend that the Commission initiate a show cause proceeding against Chesapeake for failure to obtain approval prior to execution of Amendment No. 2 to the Gas Transportation Agreement (Special Contract). However, Chesapeake should be put on notice that future implementation of any rates and/or charges prior to Commission approval, in apparent violation of Section 366.06(1) Florida Statutes and/or Rule 25-9.034(1), Florida Administrative Code, could result in the initiation of show cause proceedings.

Issue 3: Should this docket be closed?

Recommendation: Yes, if no timely protest is filed by a person whose substantial interests are affected within 21 days of the Commission Order approving the Agreement, this docket should be closed upon the issuance of a Consummating Order. If a protest is timely filed by a substantially interested person, the Agreement should remain in effect pending resolution of the protest and the docket should remain open. (Gervasi)

Staff Analysis: If no timely protest is filed by a person whose substantial interests are affected within 21 days of the Commission Order approving the Agreement, this docket should be closed upon the issuance of a Consummating Order. If a protest is timely filed by a substantially interested person, the Agreement should remain in effect pending resolution of the protest and the docket should remain open.