

State of Florida



Public Service Commission

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

DATE: December 4, 2014
TO: Carlotta S. Stauffer, Commission Clerk, Office of Commission Clerk
FROM: Traci Matthews, Engineering Specialist, Division of Engineering
RE: DN 140182-EQ - Petition for approval of negotiated power purchase contract with Eight Flags Energy, LLC, by Florida Public Utilities Company

Please file the attached document in the above mentioned docket file.

Thank you.

Summary of Eight Flags Energy, LLC, CHP Ownership and Selection Process

I. Background

As far back as 2010, FPU had dialogue with both Rayonier and RockTenn about optimizing the generation capabilities of the pulp/paper mills located on Amelia Island, which was of critical concern to FPU because optimizing the generation capacity of the mills would make additional, excess QF power available for FPU. This, in turn, would provide an additional, less expensive power supply option for FPU than that which exists under FPU's current contract with its all-requirements supplier, JEA. Initially, these discussions were limited to consideration of placing a gas-fueled boiler at the mill sites, which would produce additional steam and thus enable the mills to produce more excess power.

To better understand the options available, FPU retained Sterling Energy, an energy consulting group, to provide more in-depth analysis of the options for enhanced energy supply arrangements with the mills. In the course of their consultation, Sterling Energy brought to FPU's attention the expanded opportunities that would be available if a Combined Heat and Power unit (CHP) was installed, instead of a gas boiler. The possibility of Rayonier installing and owning such a unit at its mill site was discussed with Rayonier, but Rayonier preferred not to own the unit.

This prompted FPU to consider other options and opportunities for installation of a CHP unit on Amelia Island. FPU retained several additional experts to assist in this further analysis and development of a viable project, including Christensen Associates, Mas Energy, GE Energy, Power Engineers, Power Secure, Haskell Corporation, Crowder Energy Services, Pace Global and Pero Engineering.

II. Option 1 – FPU Ownership

An obvious option considered was for FPU to build and own the unit itself. This option presented, however, some readily apparent challenges that quickly led to review of other options. First and foremost, FPU's current contract with JEA prohibits FPU from self-generating, except in limited emergency situations. Under the contract, FPU may only take power from other

sources when it is otherwise required to do so by law, as in the case of power supplied by a Qualifying Facility (“QF”). Since FPU’s goal was to find an option that would allow FPU to obtain access to a reliable, constant and less expensive power supply – and thus enable FPU to defer the more expensive power from JEA – the limiting provisions in the JEA contract presented a clear obstacle to ownership by FPU.¹

Moreover, the regulatory requirements and steps that FPU would have had to pursue in order to own and operate the CHP as an FPU-owned generation facility presented a significant challenge. The Company anticipated that it would be required to pursue a rate case, or at least a limited proceeding, so that the investment in the CHP could be placed in rate base. Moreover, FPU did not have the in-house expertise necessary to run such a facility; thus, additional employees with such expertise would have to be hired. FPU also considered the fact that there would be a significant risk associated with owning and operating such a facility. In light of these various challenges, FPU, with the help of its consulting team, considered other options.

III. Option 2 – Third Party Ownership or Partial Ownership

Another option considered was third-party ownership. FPU pursued this option, in part, because of its initial understanding that regulatory requirements imposed certain ownership limitations on cogeneration and QF facilities that would have necessitated, at a minimum, that FPU hold only a minority interest in the new generation entity. There were nevertheless certain aspects of third-party ownership, or partnering with a third party, which were attractive. In particular, a potential third-party or partner could have been relied upon as the source of expertise and manpower for running the new facility. In that regard, Mas Energy, which specializes in constructing, owning and operating power generation facilities, was one of the options considered as a possible partner or third-party owner. Discussions were also had with certain private equity firms, which were interested in providing the capital investment for the project. After careful, lengthy analysis, however, these options was also discarded, because FPU

¹ Notably, these same contractual provisions prevented FPU from pursuing, to any significant degree, independent third party power supply arrangements with other Florida utilities for purposes of deferring purchases under the JEA contract. FPU continues, nonetheless, to pursue other options for the period after the JEA contract expires in 2017.

determined that the benefits offered by the involvement of a third party were significantly outmatched by the challenges of such arrangements.

Most critically, this option constrained the Company's ability to ensure (or even gauge) whether the inputs and variables controlled by the third party would ultimately result in the best possible prices for FPU's customers. Based on discussions and review of other projects, FPU determined that it was very likely that a third party owner or partner would endeavor to structure the project and pricing in such a way as to generate a return on investment substantially higher than that typically seen in the regulated utility arena. Consequently, the energy price to be paid by FPU and its customers was projected to be much higher than FPU hoped to achieve. While a third party would have been constrained to the avoided cost standard, FPU concluded that a third party was nonetheless likely (and had every incentive) to design the project in order to obtain the highest price possible under the avoided cost standard. Since FPU already has the highest avoided cost in the state due to the fact that it does not own its own generation, this pricing concern was a significant hurdle.

An equally significant concern was that the introduction of a third party to the project created potential issues with other project partners. As noted at the outset, the Company had determined early on that the success of the project depended upon partnering with an existing industrial on Amelia Island. Rayonier was soon identified as the target, critical partner in this project due to its need for additional steam, as well as its existing power supply arrangement with FPU. Partnering with Rayonier was also attractive, because they own property where the new facility could be located. In discussions with Rayonier regarding partnering on this new project, Rayonier's team expressed hesitation about engaging in a new project with FPU that could potentially involve an entirely new third party with whom they had no previous business dealings. Because Rayonier was viewed as a critical partner, their hesitation on this point was of serious concern.

FPU was further persuaded that involvement of a third party owner significantly limited the Company's ability to ensure that the project was completed as expeditiously as possible. Likewise, construction methods, schedules, technologies and cost would not be within the

control of Chesapeake or FPU, which caused a degree of uncertainty that also weighed against this option.

IV. Option 3 – Affiliate Ownership

The substantial nature of the concerns and challenges associated with third party involvement prompted FPU to give more serious consideration to involving an unregulated affiliate of its parent, Chesapeake Utilities. Early on, this option had been weighed and discarded due to initial concerns regarding regulatory requirements restricting ownership of QFs. However, a more in-depth analysis of both state and federal requirements for QFs revealed that the ownership limitations at issue had been eliminated from the controlling provisions. Consequently, FPU determined that affiliate ownership of the CHP/cogeneration facility was a viable option worthy of further consideration.

Several key benefits associated with this option proved particularly persuasive, as outlined below:

- As an affiliate of Chesapeake, the new entity would share the same overarching corporate goals and ideals as FPU. As such, there would be a greater level of assurance and oversight regarding the pricing and inputs for any power supply arrangement, which would better ensure that FPU was able to obtain the best price possible for its customers. There would also be greater assurance that technology chosen, construction criteria, and project timelines would be consistent with the corporate goals for the project.
- An unregulated affiliate would also be better situated to undertake the significant risk associated with the project, thus protecting FPU's ratepayers.
- Because the new entity would be an affiliate of Chesapeake, FPU's parent, Rayonier indicated it would be comfortable moving forward with the project under this scenario.
- The new affiliate would be able to retain the additional expertise required to own and operate this type of facility.

- FPU determined that the regulatory process for establishing the new entity as a QF was straight-forward and expeditious. FPU further determined that establishing the new entity as a QF negated the previously noted contractual issues arising under FPU's contract with JEA, because FPU would be required to purchase power from the QF by law.
- By using an affiliate company for this project, Chesapeake would have an avenue to assess the viability and potential success of future projects involving construction of similar types of facilities in other areas in the state, or even in the region.
- An additional but no less critical factor considered was the revenue generating opportunity for Chesapeake. To be clear, the project is structured to generate returns akin to those allowed for regulated utilities (unlike the structure FPU expected, as noted above, if an unrelated third party had been involved). Nevertheless, the affiliate will generate a new, regular and reliable revenue stream for Chesapeake, as well as the opportunity, as noted, for future similar ventures should this one prove successful.

V. Conclusion

These three options were the primary options given significant consideration, although certain slight variations thereof were also contemplated. In the final analysis, FPU and Chesapeake determined that the most advantageous and viable approach involved the use of a Chesapeake affiliate. Using a Chesapeake affiliate: (1) gave the critical partner, Rayonier, comfort to move forward with the project; (2) ensured a greater level of control at the corporate parent level to ensure that cost inputs were accurate and reasonable and that project timelines were met; (3) reduced the level of regulatory uncertainty; and (4) avoided potential disputes arising from existing contracts. In addition, this option provided protection to FPU's electric rate payers from the risk associated with owning and operating the facility, as well as significant savings through lower fuel costs with the noted added benefits to Chesapeake. In sum, the Company concluded that the only clearly viable option that would allow this project to

move forward was for the CHP/cogeneration facility to be owned and operated by an unregulated affiliate of Chesapeake.