State of Florida

Public Service Commission

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

DATE: February 22, 2016

TO: Carlotta Stauffer, Commission Clerk, Office of Commission Clerk

FROM: Martha Barrera, Senior Attorney, Office of the General Counsel

RE: Docket Number 160001-EI - Fuel and purchased power cost recovery clause with generating performance incentive factor.

Please place the attached correspondence from John Truitt of Office of Public Counsel in the above-referenced docket file.

MFB/as
Attachment

ANDY GARDINER
President of the Senate

J.R. Kelly
Public Counsel

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STEVE CRISAFULLI
Speaker of the House of Representatives

February 19, 2016

Braulio Baez, Executive Director
via email
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Docket 160001 – Fuel and Purchased Power Cost Recovery Clause

Dear Mr. Baez:

After the February 9, 2016, meeting concerning the scope of the first Woodford Project audit, the Office of Public Counsel (OPC) has several concerns that we urge Commission staff to include in the scope of the first Woodford Project audit to ensure ratepayers are protected and the Woodford Project is operating as represented to the Commission during hearing. Given the unique nature of the Woodford Project as well as oversight concerns expressed by the Commission, OPC believes this first audit is critical in understanding both how the Woodford Project operates and how costs and production are allocated.

During the 2015 Fuel Clause hearing, we learned the Woodford Project lost $5.5 million through September of 2015 and was projected to be a loss for ratepayers again in 2016. Obviously, many different factors can contribute to this loss; however, this audit by the Commission is the only line of defense for ratepayers with respect to the operations of the driller/operator PetroQuest. The Commission has no jurisdiction over PetroQuest or its activities; therefore, Commission staff has no stand-alone legal right to access PetroQuest's records. The only opportunity for the Commission to look behind the curtain at the operational side of the Woodford Project is through this audit; thus, the independent auditors, as required by Commission Order No. PSC-15-0038-FOF-EI, must conduct a sufficiently comprehensive and thorough audit to protect FPL's ratepayers.

First and foremost, OPC strongly urges the audit to cover at least 19 wells. The Woodford Project, as approved, will encompass 38 wells. Under the Woodford Project, FPL's ratepayers are the first customers of an electric IOU in the United States to pay for investments in natural gas reserves. The accounting methods created for the Woodford Project are unique. At both hearing and agenda, the Commission and intervenors expressed concerns regarding the scope of oversight available since PetroQuest is not under the jurisdiction of the Commission and the possible reserves are located in Oklahoma. OPC recognizes that audit costs can increase with an increase in the number of wells audited; however, given the uniqueness of the Woodford Project, OPC strongly suggests auditing the operation of at least half of the wells in the Woodford Project is justifiable and warranted.

An audit of at least half of the wells will provide critically important information in several areas. The larger audit scope provides greater assurance that expenses billed to and production provided to FPL's subsidiary are in accordance with the contracts approved by the Commission. Given the uniqueness of the Woodford Project, a larger audit scope will provide a greater level of operational knowledge and experience with gas reserve investment projects, which were concerns raised by the Commission and intervenors. Furthermore, given the fact that the Commission lacks jurisdiction to directly demand records from PetroQuest, any and all information regarding PetroQuest's operations and the corresponding expenses and production is only available through the upcoming audit process.

Second, OPC recommends the Woodford Project audit examine the Project all the way down to the detailed transactional level, which FPL testified was possible at hearing. At a minimum, the audit should cover every detail of FPL's working interest in the joint venture, including whether any assets of the joint venture have been sold, transferred or otherwise encumbered. The audit should also examine well lease term compliance, including items such as royalty payments, shut-in fees, and lease extension costs due to drilling delays, to ensure potential liability issues are mitigated. The audit should also contain an analytical review for each "well proposal" and the corresponding "consent" and "non-consent" decisions as those terms are used in the Woodford Project Drilling and Development Agreement (DDA) since FPL acknowledged that it will rely on a non-FPL employee to make the consent/non-consent assessment, and FPL represented to the Commission that the Commission would have full access to all information used during the consent/non-consent decision making process.

Third, OPC recommends the audit examine and obtain verification that PetroQuest, including its contractors and subcontractors, are in compliance with regulatory operational and reporting requirements. Given the increased level of scrutiny on hydraulic fracturing, Oklahoma's recent increase in earthquakes potentially linked to injection of fracking waste product (according to current United States Geological Survey (USGS) studies), and the strict liability provisions found in most federal environmental laws, it is incumbent that PetroQuest remain in regulatory compliance to avoid creating additional liability for FPL and its ratepayers.

Finally, OPC recommends the audit incorporate an analytical review of PetroQuest's ability to complete the joint venture. According to a press release from Moody's dated January 19, 2016 (enclosed), PetroQuest has been downgraded to Caa3 from B3, downgraded to the lowest speculative grade liquidity rating of SGL-4, and had an event of default according to Moody's definition of default. To ensure PetroQuest's poor financial outlook is not affecting the Woodford Project and that FPL's ratepayers will not be financially harmed due to future defaults by PetroQuest, the audit should review the financial viability of PetroQuest and whether that impacts Woodford Project expenses.

As stated from the bench during the Commission's vote, the Woodford Project can be "used as a test product" to "give us an opportunity to get some live experience with it." There is no historical experience to fall back on when examining the Woodford Project as this is the first investment in gas reserves by an electric IOU in the United States. This audit is that chance to gain knowledge and experience. Therefore, OPC urges that the scope of the Woodford Project audit covers at least half of the wells and encompasses the topics described herein to ensure FPL ratepayers are protected.

John J Truitt
Associate Public Counsel

CC: Office of Commission Clerk (Stauffer via email)
Division of Audit Performance Analysis (Maurey via email)
Office of General Counsel (Helton, Barrera via email)
Florida Power & Light (Butler via email)
FIPUG (Moyle via email)

Enclosure: Moody's Rating Action Jan. 19, 2016

MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Petroquest to Caa3; negative outlook

Global Credit Research - 19 Jan 2016

New York, January 19, 2016 -- Moody's Investors Service downgraded Petroquest Energy, Inc.'s (Petroquest) Corporate Family Rating (CFR) to Caa3 from B3, the Probability of Default Rating (PDR) to Caa3-PD from B3-PD, and the company's senior unsecured notes ratings to Ca from Caa1. The Speculative Grade Liquidity (SGL) Rating was lowered to SGL-4 from SGL-3 and the rating outlook was changed to negative.

Petroquest announced a private exchange offer to exchange up to $300 million of its existing 10% senior unsecured notes due 2017 ($350 million outstanding) for up to $75 million of cash, $202.5 million of new 10% second lien senior secured notes due 2021, and six million shares of its common stock. Moody's views this exchange offer as a distressed exchange, an event of default under Moody's definition of default. Upon closing of the second lien financing, Moody's will append Petroquest's PDR with an "/LD" designation indicating limited default, which will be removed after three business days. Our ratings are subject to review of all final documentation related to this transaction.

"The ratings downgrade and the negative outlook reflect the pressure on Petroquest's internal cash flow generation and credit metrics due to the weak commodity price outlook," commented Arvinder Saluja, Moody's Vice President. "While the proposed second lien secured notes issuance temporarily eases the stress of addressing a material debt maturity in 2017 and provides up to approximately $10 million per year in fixed charge savings, weak cash flow generation will cause the liquidity profile to deteriorate and the risk of additional distressed exchanges remains."

Downgrades:

..Issuer: PetroQuest Energy, Inc

.... Probability of Default Rating, to Caa3-PD from B3-PD

.... Corporate Family Rating, to Caa3 from B3

....Senior Unsecured Regular Bond/Debenture, to Ca, LGD6 from Caa1, LGD4

Lowered:

.... Speculative Grade Liquidity Rating, to SGL-4 from SGL-3

....Outlook, Changed To Negative From Stable

RATINGS RATIONALE

The downgrade of Petroquest's CFR to Caa3 reflects the anticipated worsening of liquidity and credit metrics in 2016 due to the weak commodity price environment. The rating is also constrained by the company's modest scale and geographic concentration risks, with one well in the Gulf Coast Basin expected to contribute disproportionately to production and cash flows in 2016. Reserves and production growth are likely to remain muted (although capex requirements to maintain production in 2016 are very low), and with no meaningful hedges in 2016, we do not expect the company to generate meaningful positive operating cash flow. Subject to the participation levels in the exchange offer, the proposed second lien secured notes issuance could leave the company with approximately $202.5 million of second lien notes due 2021, $50 million of existing unsecured notes due September 2017 and approximately $70 million of cash. While this exchange offer could significantly reduce the 2017 maturity burden to $50 million from $350 million, the glum industry environment could lead to severe liquidity stress with cash balances and revolver availability not sufficient to address the maturity.

The existing unsecured notes have been downgraded to Ca, one notch below the CFR, reflecting the subordination of the unsecured notes to the secured borrowing base revolving credit facility and the proposed second lien secured notes. The proposed second lien secured notes are subordinated to the first lien secured borrowing base revolving credit facility under Moody's Loss Given Default (LGD) methodology.

The SGL-4 rating reflects weak liquidity through 2016. The company is estimated to have approximately $70 million of cash on the balance sheet, pro forma for the proposed issuance and continues to maintain an undrawn revolver. Moody's expects cash balances to diminish as EBITDA generation will not to be sufficient to support cash interest needs of $25 million - $30 million, a reduced capital spending program of $13 million - $15 million and working capital swings. Pro forma for the exchange offer, the maturity of over $50 million of the existing senior unsecured notes will need to be addressed by September 2017. The company has a borrowing base revolving credit facility that expires on the earlier of June 4, 2020 or February 19, 2017, if any portion of the senior unsecured notes remain outstanding as of that date. The borrowing base is $55 million and the company had no borrowings outstanding under the revolver as of December 31, 2015. Financial covenants under the facility are debt / EBITDAX of 4.0x through December 31, 2016, reducing to 3.5x thereafter, as well as a minimum current assets / current liabilities ratio of 1.0x. There is a high likelihood of a covenant violation in 2016 unless the company achieves a covenant waiver or amendment, which Petroquest has been successful in obtaining through recent redeterminations.

The negative outlook reflects the anticipated elevation of liquidity stress on the company due to the commodity price outlook and potential covenant breach. The outlook also reflects the risk of purchasing any remaining unsecured notes at steep discounts to face value, post-closing of the current exchange offer.

The ratings could be downgraded if Petroquest does not maintain sufficient cash balances to cover the 2017 maturity of the unsecured notes that remains in place after the completion of the proposed exchange offer.

A ratings upgrade is less likely through September 2017 given the debt maturity and the weak commodity price outlook. However, ratings could be upgraded if Petroquest maintains adequate liquidity, including sustained positive cash flow after funding maintenance capital expenditure and dividends.

The principal methodology used in these ratings was Global Independent Exploration and Production Industry published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Petroquest is an exploration and production company based in Lafayette, Louisiana.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this rating action, and whose ratings may change as a result of this rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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MOODY'S
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