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June 27, 2002

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Blanca S. Bayó
Director, Commission Clerk and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

011605-EI

Re: Review of Internal Controls of Florida's Investor-Owned Utilities for Fuel and Wholesale Energy Transactions

Dear Ms. Bayó:

I am enclosing for filing the original and seven (7) copies of Florida Power & Light Company's ("FPL") Request for Confidential Classification of Portions of Commission Audit Report and Associated Audit Notes for Review of Internal Controls of Florida's Investor-Owned Utilities for Fuel and Wholesale Energy Transactions (Control No. RR-01-08-004), together with a diskette containing the electronic version of same. The enclosed diskette is HD density, the operating system is Windows 2000, and the word processing software in which the documents appear is Word 2000.

If there are any questions regarding this transmittal, please contact me at 305-577-2939.

Very truly yours,

Karl M. Dubin for JTB

John T. Butler, P. A.

Enclosure

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Review of Internal Controls of Florida's Investor-Owned Utilities for Fuel and Wholesale Energy Transactions	)))	**Dated: June 28, 2002**

FLORIDA POWER AND LIGHT COMPANY'S REQUEST FOR CONFIDENTIAL CLASSIFICATION OF PORTIONS OF COMMISSION AUDIT REPORT AND ASSOCIATED AUDIT NOTES FOR REVIEW OF INTERNAL CONTROLS OF FLORIDA'S INVESTOR-OWNED UTILITIES FOR FUEL AND WHOLESALE ENERGY TRANSACTIONS (CONTROL NO. RR-01-08-004)

Florida Power & Light Company ("FPL"), pursuant to Rule 25-22.006, F.A.C., and Section 366.093, Florida Statutes, requests confidential classification of certain portions of the Commission Staff's report entitled "Review of Internal Controls of Florida's Investor Owned Utilities for Fuel and Wholesale Energy Transactions," dated June 2002, Control No. RR-01-08-004 (the "Audit Report") and of the Staff's notes taken in connection with preparation of the Audit Report (the "Audit Notes"). In support of its Request, FPL states as follows:

1. The Staff transmitted the Audit Report to FPL by letter dated May 30, 2002, from Lisa Harvey to Kory Dubin. The letter advised FPL that it had 21 days after completion of the exit conference on the Audit Report to request confidential classification of any portions of the Audit Report that FPL considers confidential. The Staff conducted its exit conference with FPL on June 7, 2002. On June 17, 2002, FPL was given access to the Audit Notes and was asked to request confidential classification for any portions of the Audit Notes that FPL considers confidential at the same time that it seeks such classification for the Audit Report. FPL hereby makes its request for confidential classification of portions of the Audit Report and Audit Notes.

2. The following exhibits are included with this Request:

a. Composite Exhibit A consists of a copy of the Audit Report (less the sections that relate exclusively to utilities other than FPL) and a copy of the Audit Notes, in

which all information that FPL asserts is entitled to confidential treatment has been highlighted. Composite Exhibit A is submitted separately in a sealed folder marked "CONFIDENTIAL."

b. Composite Exhibit B consists of two copies of the Audit Report and Audit Notes in which all information that FPL asserts is entitled to confidential treatment has been redacted.

c. Exhibit C is a table containing a line-by-line and page-by-page identification of the information in the Audit Report and Audit Notes for which confidential treatment is sought, together with references to the specific statutory basis for the claim of confidentiality and to the affidavits in support of the requested classification. Exhibit C is sometimes referred to hereinafter as the "Justification Table."

d. Exhibit D consists of the affidavit of Joseph Stepenovitch, Director of FPL's Energy Marketing & Trading Division, attesting to the asserted basis for confidential classification.

4. FPL seeks confidential protection for the information highlighted in Exhibit A. As shown on the Justification Table, a portion of the highlighted information comprises excerpts from documents that the Commission has already classified as confidential, in Order No. PSC-01-2530-CFO-EI. The excerpted information must be likewise classified as confidential in order to continue protecting that information in the manner that the Commission has previously approved. The remainder of the highlighted information is confidential because it comprises trade secrets of FPL, which allow FPL to conduct its fuel procurement on favorable terms for FPL and its customers. The disclosure of that trade-secret information would provide other participants in the fuel markets insight into FPL's fuel-procurement practices that would allow

them to anticipate FPL's procurement decisions and/or impair FPL's ability to negotiate, to the detriment of FPL and its customers. *See* § 366.093(3)(a), Fla. Stat (2000).

5. FPL submits that the highlighted information is proprietary confidential business information within the meaning of section 366.093(3). Pursuant to section 366.093, such information is entitled to confidential treatment and is exempt from the disclosure provisions of the public records law.

6. The material in Exhibit A for which FPL seeks confidential classification is intended to be and is treated by FPL as private and its confidentiality has been maintained.

7. Upon a finding by the Commission that the material in Exhibit A for which FPL seeks confidential treatment is proprietary confidential business information within the meaning of section 366.093(3), pursuant to section 366.093(4) such materials should not be declassified for at least eighteen (18) months and should be returned to FPL as soon as the information is no longer necessary for the Commission to conduct its business.

WHEREFORE, FPL respectfully requests that its Request for Confidential Classification be granted.

Respectfully submitted,

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By: Karel M. Dubin for JTB
John T. Butler, P.A.
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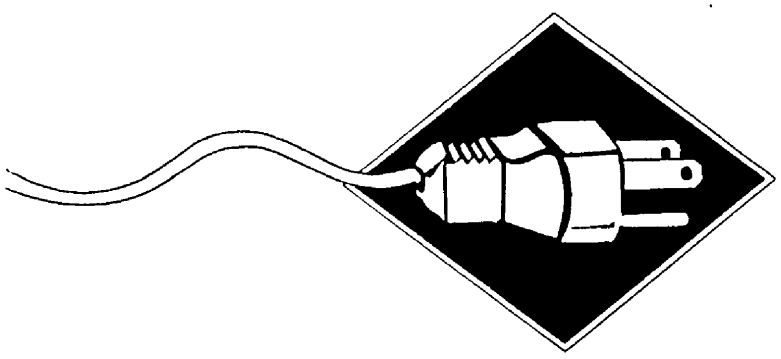
EXHIBIT A

CONFIDENTIAL MATERIALS ATTACHED ONLY TO ORIGINAL

EXHIBIT B

REDACTED COPIES OF AUDIT REPORT AND AUDIT NOTES

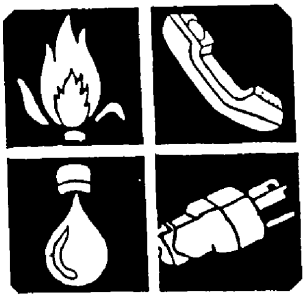


Review of

Internal Controls of Florida's Investor Owned Utilities for Fuel and Wholesale Energy Transactions

June 2002

By Authority of
The State of Florida for
The Public Service Commission
Division of Competitive Markets and Enforcement
Bureau of Regulatory Review



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Review of

Internal Controls of Florida's Investor Owned Utilities for Fuel and Wholesale Energy Transactions

Louis J. Yambor
Operations Review Specialist
and
Rodney P. Wallace
Government Analyst I

June 2002

By Authority of
The State of Florida for
The Public Service Commission
Division of Competitive Markets and Enforcement
Bureau of Regulatory Review

RR-01-08-004

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Table of Contents

Chapter		Page
1.0	**EXECUTIVE SUMMARY**	
1.1	Objectives	3
1.2	Scope	3
1.3	Methodology	4
1.4	Overall Opinion	4
2.0	**BACKGROUND AND PERSPECTIVE**	
2.1	Gas Industry Development	9
2.2	Fuel Cost Recovery	11
2.3	Current Trends in Utility Purchasing of Fossil Fuel	11
2.4	Industry and Commission Actions Regarding Hedging	12
2.5	National Regulatory Research Institute Report	14
2.6	Internal Controls for Physical and Financial Hedging	15
3.0	**FPL'S FUEL PURCHASING PRACTICES**	
3.1	FPL Company Profile	19
3.2	FPL's Fossil Fuel Purchasing Policies and Controls	25
3.3	FPL's Wholesale Energy Purchasing and Sales Policies and Controls	32
3.4	FPL's Risk Management Plan	34
3.5	Risk Plan Analysis	38
4.0	**FPC'S FUEL PURCHASING PRACTICES**	
4.1	FPC Company Profile	43
4.2	FPC's Fossil Fuel Purchasing Policies and Controls	48
4.3	FPC's Wholesale Energy Purchasing and Sales Policies and Controls	53
4.4	FPC's Risk Management Plan	54
4.5	Risk Plan Analysis	62
5.0	**TEC'S FUEL PURCHASING PRACTICES**	
5.1	TEC Company Profile	67
5.2	TEC's Fossil Fuel Purchasing Policies and Controls	71
5.3	TEC's Wholesale Energy Purchasing and Sales Policies and Controls	73
5.4	TEC's Risk Management Plan	74
5.5	Risk Plan Analysis	79

6.0 GULF'S FUEL PURCHASING PRACTICES

6.1 Gulf Company Profile 83
6.2 Gulf's Fossil Fuel Purchasing Policies and Controls 87
6.3 Gulf's Wholesale Energy Purchasing and Sales Policies and Controls 89
6.4 Gulf's Risk Management Plan 90
6.5 Risk Plan Analysis 100

7.0 COMPANY COMMENTS

7.1 Florida Power & Light Company Comments 103
7.2 Florida Power Corporation Comments 103
7.3 Tampa Electric Company 103
7.4 Gulf Power Company 103

Table of Exhibits

No.	Exhibit Name	Page
1.	U. S. Natural Gas Electric Utility Prices 1974-2000	10
2.	FPL Group 2001 Organizational Structure	20
3.	Energy Marketing and Trading Division for 2001	22
4.	Risk Management Organizational Chart	23
5.	Finance and Accounting Organizational Chart	24
6.	[redacted]	27
7.	[redacted]	28
8.	FPL's Fossil Fuel Purchases	30
9.	FPL's Wholesale Megawatt Hour Purchases, Sales, and Options	34
10.	Progress Energy 2002 Organizational Structure	44
11.	CP&L Gas & Oil Trading	45
12.	Progress Ventures-Progress Fuels	46
13.	CP&L Power Trading	47
14.	CP&L's Fossil Fuel Purchases	51
15.	FPC's Wholesale Megawatt Hour Purchases, Sales, and Options	54
16.	TECO Energy 2002 Organizational Chart	68
17.	Tampa Electric Fuels Department	69
18.	Tampa Electric Wholesale Power Trading	70
19.	TEC's Fossil Fuel Purchases	72
20.	TEC's Wholesale Megawatt Hour Purchases, Sales, and Options	74

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21. Southern Company Fuel Organizational Chart 84

22. Southern Company Services Fuel Services Department 2002 85

23. Southern Company Services Risk Management Fuel Services Separation of Duties . . . 86

24. Gulf's Fossil Fuel Purchases 88

25. Gulf's Wholesale Megawatt Hour Purchases, Sales, and Options 90

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1.0 EXECUTIVE SUMMARY

1.0 Executive Summary

1.1 Objectives

On November 26, 2001, as a spin off of Docket 010001-EI, Docket 011605-EI was created to fully address the issue of risk management and the hedging theory. Consequently, the Florida Public Service Commission's (FPSC) Division of Economic Regulation requested that the Bureau of Regulatory Review (BRR) examine and evaluate risk management policies and procedures associated with the procurement of fossil fuel and wholesale energy for the four largest investor-owned electric utilities: Florida Power and Light (FPL), Florida Power Corporation (FPC), Gulf Power (Gulf), and Tampa Electric Company (TEC).

BRR's primary objectives were as follows:

- To protect the interests of ratepayers and evaluate the processes by which each company obtains fuel and manages its fuel procurement, to determine how effectively these practices are used, and to ensure that adequate and effective policies and procedures are in place
- To provide a basis for enhancing the Commission staff's understanding and knowledge of each company's risk management policies and procedures associated with the procurement of fuel and wholesale energy
- To provide an overview and comparison of hedging current and best practices within the electric utility industry
- Identify those areas where the greatest opportunities exist to improve both managerial and operational practices and where cost-effective benefits may be realized

1.2 Scope

Using the content from these objectives, this study looked at the four largest IOU's overall practices, controls, and policies when purchasing fossil fuel and wholesale energy. The review looked at the years from 1998 through 2001. Additionally, staff considered what other state commissions have recommended to curtail fuel prices and what the electric utility industry has considered when hedging techniques and financial options are sanctioned policies. This review is not intended to give an opinion on the use of financial hedging by a regulated utility. Instead, its focus is on controls that should be used if such a strategy were to be pursued.

1.3 Methodology

This review was based upon information gathered through document requests, interrogatories, interviews with fossil fuel department personnel, examination of company policies and procedures, and analysis of all company trading. These trading transactions include all hedging, contracts, contract swaps, options, and the spot market. Particular attention was given to current practices and to comparing them to industry recommendations.

In examining these practices and philosophies, staff focused on the following information sources:

- Transcripts of the FPSC undocketed Hedging and Portfolio Management Workshop held on May 14, 2001
- FPSC's Digest of Commission Regulatory Practices, Section XIII, Fuel and Purchased Power, Revised 4/98
- *Regulatory Perspective on Hedging and Speculating in the Electricity Futures Market*, FPSC Bureau of Research, July 1997
- *Review of Purchasing and Selling Practices for Natural Gas*, FPSC Bureau of Auditing, Audit Control No. 00-353-4-1, April 2001
- *A Practical Guide to Hedging: Operational and Accounting Controls, Financial Reporting, and Federal Income Tax*, NYMEX/Pricewaterhousecoopers, Chapter 4, pp 40-47, June 2001
- *Use of Hedging by Local Gas Distribution Companies: Basic Considerations and Regulatory Issues*, National Regulatory Research Institute, May 2001
- *Investment Management Theory and Application*, Sarkis J. Khoury, 1983
- Company responses to FPSC interrogatories and document requests
- Other documented Commission activities related to fuel cost recovery

1.4 Overall Opinion

There is considerable risk for utilities opting not to engage in financial hedging and there is considerable risk inherent in financial hedging. More risk is encountered if such an activity is not

adequately controlled[1]. Given that, the summary below describes each company's approach to hedging techniques in fuel procurement and related controls.

1.4.1 Florida Power & Light Company

FPL is a large electric utility that purchases and consumes mass amounts of oil and natural gas. The Energy Marketing and Trading Division's fossil fuel purchasing department has a staff that appears to have the skills and abilities necessary to buy, contract, and hedge fuel purchases. The company currently engages primarily in physical fuel purchases, physical hedging, and minor derivative hedging. FPL has implemented all the general internal controls described in Section 2.6 that are necessary safeguards for a hedging program. The scope of hedging operations is described in Chapter 3.

Potential areas of improvement were identified within FPL's fuel procurement process. The first area of improvement relates to the separation of operations between the regulated Energy Marketing & Trading division and its unregulated affiliate, Power Marketing. When the audit commenced, they did not have separate policy and procedure manuals, which are considered important to ensure a constant arms-length relationship is maintained. As discussed further in Section 3.2.1, Energy Marketing & Trading and Power Marketing have recently adopted separate policy and procedure manuals.

Secondly, the Exposure Management Committee, which oversees Energy Marketing & Trading operations, used to meet only every quarter. Fuel costs are a large portion of the company's expense, thus indicating that top management should give fuel procurement a good deal of attention. Staff notes that since the beginning of the audit, the Exposure Management Committee has begun to meet monthly. Staff believes that this is appropriate and also suggests that Energy Marketing & Trading provide the Exposure Management Committee with biweekly trend reports. More detail on this committee's function is available in Section 3.2.1.

As demonstrated by FPL, Physical hedging appears to be the most useful position in saving the ratepayer money. FPL has time-tested the process and has the management, and controls that are mandatory for a hedging program. The company asserts that the fuel savings each year, such as the $43.9 million in 2000, is an example of hedging and good procurement management.

1.4.2 Florida Power Corporation

[1]According to Sarkis J. Khoury, author of *Investment Management Theory and Application*, "No matter how well conceived a hedging strategy is, it is not always superior to a no-hedge position. . . . hedging depend[s] on expectations. . . the ability to predict the behavior of the basis should dictate the hedge ratio (*where the hedge ratio is*). . . determined by the yield volatility of the asset to be hedged relative to that of the futures contract."

Progress Energy has established the basic requirements that FPC needs for a working risk management program. However, there is one area of improvement that should be addressed before CP&L and Progress Fuels (the companies procuring for FPC) begin futures trading.

Fuel related and wholesale energy policies, procedures, and guidelines need to be updated. If adopted by the FPC, these changes should improve its overall risk management program. More detail on these improvement areas is discussed in Section 4.2.4.

1.4.3 Tampa Electric Company

According to TEC's management plan, TEC has not engaged in fuel hedging practices due to its historical fuel mix being primarily coal, a relatively stable priced fuel. TEC recognizes that as the amount of natural gas increases in its overall fuel mix, the price volatility of the resulting mix may increase. Therefore, as TEC gains experience operating natural gas-fired generating units and developing natural gas marketing expertise, the company will evaluate potential hedging strategies.

Because TEC does not have controls in place to maintain a trading and risk management program, the company will need to establish a portfolio concept capable of supporting procurement, trading, and strategy for all fossil fuels and wholesale energy. TEC has some of the basics of a risk management program, but lacks the following:

- Updated procedures for all fuel departments and wholesale energy procedures
- Designated front, middle, and back offices
- Certain industry-experienced personnel

More data and analysis on TEC's fuel and wholesale energy operations are in Sections 5.2 and 5.3.

1.4.4 Gulf Power Company

Gulf also lacks some of the controls necessary to operate a risk management program. Gulf has multiple companies and departments contributing to the trading portfolio. Southern Company should consider central consolidation under the Risk Management Department. Secondly, the risk management policy needs more detail regarding office designation, credit monetary limits, and other department procedures that support the entire procurement operation. Currently, Southern has not engaged in any hedging transactions for Gulf, but is financially trading on behalf of Savannah Electric, Alabama Power, and Mississippi Power.

Policies and procedures that support the company risk management concept need much more detail and revision. For example, the contract procedures for fuel procurement are only six pages long and lack any policy on procuring gas and oil. They address coal only. The company is currently revising them. More detail is provided in Sections 6.2 and 6.3.

2.0 BACKGROUND AND PERSPECTIVE

2.0 Background and Perspective

2.1 Gas Industry Development

The nationwide natural gas prices during 2000/2001 resulted in a burden on many utility customers and prompted regulators to look for ways to protect consumers from fuel price spikes. One option is to do nothing, assume these spikes are rare, isolated occurrences. However, public response demanded price protection. There appear to be two alternatives state utility commissions have used to mitigate utility fuel cost recovery: mandating some form of hedging or locking in prices through price moratoriums. Both alternatives can shift part of the price risk from rate payers to the companies.

Both of these options would require a company to create a risk management plan and a department to execute the plan. A company that has heavily depended upon spot purchases and contracts as its purchasing norm may have to redefine its mission and acquire personnel who have commodity trading, forecasting, and financial skills. Further a utility company that fails to mitigate fuel prices through some form of hedging or alternate purchasing plan runs the risk that a regulator could deny full cost recovery.

According to *Webster's Third New International Dictionary,* "a commodity is something of value especially when regarded as an article of commerce." Fossil fuels (natural gas, coal, crude oil) and wholesale energy are classified as commodities. Commodities are nonfinancial by nature but are sold through futures contracts and most are commonly traded on recognized exchanges. Futures trading has long existed for commodities such as orange juice, metals, livestock, and currency. However, according to TEC, futures trading for coal is very infrequent and is in jeopardy of being suspended by the exchange. The most prominent futures exchange for gas is the New York Mercantile Exchange (NYMEX), although there are currently sixteen exchanges across the United States that trade commodities.

Natural gas price volatility began with the Natural Gas Policy Act of 1978 and the passage of the Wellhead Price Decontrol Act of 1989 (1989 Act). The 1989 Act transformed natural gas from a regulated supply into a speculative commodity that began trading in 1992. Today, all utility commissions must cope with a market that can be changed by rumors and by speculators who are betting on rising and falling prices.

Exhibit 1 depicts the price trend for utility natural gas in the United States from 1974 through 2000. More important are the future prices of gas. The Energy Information Administration predicts that natural gas prices will rise at a faster pace than oil. The Energy Information Administration expects wellhead natural gas to increase 2.8 percent per year reaching $3.05 per MMBTU by 2020. Rising prices are reflected by projected rising demand. However, supply is expected to meet demand, which will assure price stability.

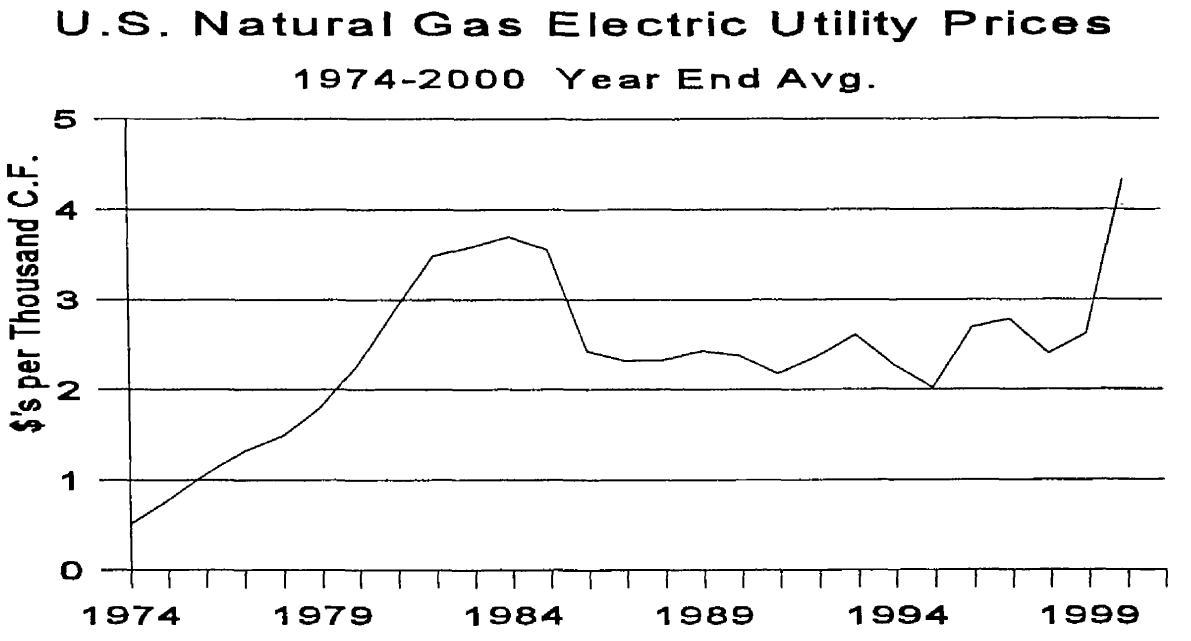


EXHIBIT 1 *Source: Energy Information Administration, Table 4*

Supply will be a cause for concern for utilities. The trend of electric utilities either converting plants to natural gas or building gas-fired plants greatly impacted demand. Increased demand creates concerns about gas production. The Energy Information Administration predicts that short-term (through 2004) and mid-term (2010) supply appears adequate, but long-term (2020) domestic production is not expected to keep up with demand.

The Energy Information Administration asserts that natural gas demands have risen 57 percent due to increased demand in electricity generation since 1999. By 2020, demand by utilities is expected to rise to 11.3 trillion cubic feet when based upon usage for the year 1999. That would be a rise of 336 percent. The Energy Information Administration cautions consumers that the ever-increasing demand raises the following questions:

- Is there enough to gas to meet demand?
- Can it be produced fast enough?
- Can we build pipelines fast enough?
- How high will prices go?

Questions such as these can and have affected market prices. A shortage assures higher prices, and increased availability can reduce prices. This is further solidified by looking at natural

gas futures on the NYMEX Henry Hub Index for one-thousand cubic feet. In December 2001, the price was set at $2.55. In December 2002 it is $3.44, and for December 2003, it is $3.80.

A key event affecting the wholesale energy markets took place in 1996 when the Federal Energy Regulatory Commission (FERC) laid the foundation for competitive wholesale power markets by opening access to transmission lines. The wholesale energy bulk trading market started with the establishment of the Independent System Operators. In 1999, FERC mandated grid management through Regional Transmission Organizations. This rule affected all public held electric companies.

At present, bulk power is traded at NYMEX and other markets in various hubs throughout the United States. The hubs are regional since interconnections are the limitations. For example, no transmission connection exists between Florida and California. Clusters among neighboring utilities are the norms. Peninsular Florida belongs to the Florida Regional Reliability Council region. However, bulk power in peninsular Florida is not currently, nor has ever been, traded on the NYMEX or any other market.

Wholesale power is traded and sold in megawatt hours. Like any other commodity, both futures and options are available. According to NYMEX data accumulated in Energy Information Administration, a large amount of electricity is traded in wholesale purchases and resale contracts. IOUs are responsible for over half of all those sales. In the last quarter of 2001, the NYMEX average megawatt hour sold for $35. However, in that same year, which was subject to heat waves and other factors such as the time of day and weather, a megawatt hour has sold for more than $1000.

2.2 Fuel Cost Recovery

From 1974 and forward, oil volatility has keenly affected utilities and the ratepayers they serve. It led to the mechanism used to recuperate the cost of fuel that cannot be anticipated in base rates costs: fuel and purchase recovery clause. Florida's history on this clause goes back to the 1950's, but it was effectively established in 1974 by Florida Public Service Commission Order No. 6357. It has been modified by eight Commission orders since that date.

The fuel cost recovery is designed and allowed by the FPSC as a means for the IOUs to recover for cost-effective fuel, purchased power, and other related expenditures on a dollar-for-dollar basis. Upon Commission approval, it passes on costs to customers when there is a fuel price increase. It also passes on any savings realized to the customers when there are price reductions. Recovery of costs applies to coal, nuclear, oil, gas, and purchased power expenses.

2.3 Current Trends in Utility Purchasing of Fossil Fuel

The largest criticisms of fossil fuel cost-recovery involve purchasing practices and ratepayer price protection. One way for an electric utility to purchase fuel is to buy it on the spot market. The spot market is the current daily price. Simply put, the company buys the fuel at the current price, applies to the Commission for a fuel-price adjustment, and passes it onto the rate-paying customers. This practice provides very little incentive for the utility to look for ways to save the consumer from added fuel adjustment charges.

In lieu of spot market purchases, there are transactions that may mitigate the risk associated with spot oil and gas markets. The first is financial or derivative hedging. Derivatives include futures contracts and options such as puts, calls, and contract swaps. Another way to hedge is physical hedging through contract purchase with actual physical possession. These can also include contracts, puts, calls, and contract swaps.

2.4 Industry and Commission Actions Regarding Hedging

The use of fossil fuel hedging options and derivatives by electric utilities is a relatively new practice. Most state commission activity has centered on local distribution gas companies with two time-tested exceptions.

In November 1999, the Minnesota Public Utilities Commission granted an electric utility a one-year pilot program to purchase future contracts, puts, calls, and linked transactions in the purchase of wholesale energy. Also in 1999, the Minnesota Commission granted permission for the company to hedge natural gas. In 2001, the Georgia Public Service Commission ordered Savannah Electric and Power to engage in hedging transactions.

2.4.1 Northern States Power Company-Minnesota

The original Minnesota Commission order included three safeguards and limitations: purchases are limited to the electricity commodity, no speculating, and all activity is subject to prudence reviews. The commission imposed no specific internal risk management controls on the company. All effects would flow back through the fuel clause. In the first year, the net impact was a $6.9 million loss and an extra burden to ratepayers. The commission extended the program another 15 months. Total gas and wholesale power losses for the second year were $5.1 million. The commission extended the program for a third year, but the results are not available at this time. This is an example of how substantial losses may occur over the short term when forecasted pricing goes the other way, particularly in derivative trading.

2.4.2 Savannah Electric and Power-Georgia

The other company that was recently ordered to hedge was the Savannah Electric and Power (which is part of the Southern Company). The Georgia Public Service Commission was concerned because Savannah Electric had experienced high gas price volatility and believed the rate payers were entitled to price protection. The commission held hearings and ordered on May 24, 2001, that

Savannah Electric must hedge part of the oil and gas purchases with financial instruments. The order imposed the following time and percentage limitations on the company:

- Hedging program begins June 1, 2001
- Maximum time is 42 months into the future
- Annual above market cap equal to 10 percent of gas/oil budget
- Prospective above market cap equal to 5 percent of the 42 month forward oil/gas budget
- All losses and gains will flow back to the fuel clause
- The company must procure all physical gas/oil at market

The commission imposed no specific risk management rules. However, commission staff will monitor the program and evaluate its success. Additionally, Savannah will retain 25 percent of the gains, and the company must keep records of all transactions. In the ensuing seven months, the company recorded hedging losses as actual fuel prices varied from what was predicted.

2.4.3 NARUC/NRRI Survey

The National Association of Regulatory Utility Commissions (NARUC) conducted a state commission survey on the hedging mechanism. The twenty-eight state responses were compiled by the National Regulatory Research Institute (NRRI). One of the questions asked was: Has your state utility commission addressed hedging as a risk management technique? Twenty-six answered affirmatively. The survey further verifies that at least six states have ordered or permitted hedging as a tool to mitigate prices on natural gas. The survey further shows that 14 states allow some tool for hedging cost recovery subject to provisos such as prudence review, reasonableness, or prior commission approval.

2.4.4 Regulatory Actions on Local Gas Distribution Companies

The West Virginia Public Service Commission also issued a specific order on hedging. In early 1995, a local distribution gas company filed a rate case along with a separate cost-recovery proceeding. Staff at the West Virginia Commission looked at futures gas prices on the NYMEX and proposed a settlement. The proposal was a three-year lock-in on rates.

After considerable discussion, the West Virginia Commission and the company agreed to a total rate moratorium for years 1996 through 1998. The agreement was a locked-in price of $2.00 per thousand cubic feet. Action by the West Virginia Commission essentially hedged for the customer by specifying a three-year tariff.

The gas company was free to rely on spot markets, but it recognized that there was too much assumed risk to its stockholders. Therefore, the company did not hesitate in making a management decision to lock-in a rate for 36 months. Since the burden of gas prices had switched from ratepayers to stockholders, hedging became a company strategy.

Further, the company agreed to the same conditions for the years 1999 through 2001. Commission staff calculated that action by the West Virginia Commission saved customers $30 million for the first three years and forecasted savings of $81 million for 1999 through 2001.

Arkansas also has taken recent action on natural gas price control during 2001. The Arkansas Commission realized that natural gas prices were being determined by traders and financial instruments. After hearings and workshops, it ordered all gas companies under its jurisdiction to adopt the principles for gas procurement:

- Develop a diversified gas supply portfolio which should include hedging, contracts, and financial instruments
- Submit portfolio for Commission review
- Costs associated can be recovered through the Cost Recovery Clause
- Maintain records
- Educate customers and levelize billing

The Arkansas Commission will closely monitor each company plan for proper price strategy and execution of the plan.

Lastly, the state utility commissions in Indiana, Nevada, and New Mexico either have publicly admonished or penalized local gas companies for failure to protect their customers from unreasonable gas prices. These commissions informed the companies that spot-market buying is insufficient, and that it is their duty to mitigate large price increases. Failure to do so will result in a denial for partial cost recovery.

2.5 National Regulatory Research Institute (NRRI) Report

In a May 2001 report by NRRI, entitled *Use of Hedging by Local Gas Distribution Companies: Basic Considerations and Regulatory Issues*, hedging natural gas was given close scrutiny. The NRRI offers the following caveats when hedging price control is endorsed by a commission:

- Risk management has costs; establish a need for the program
- Keep the hedging program simple
- Specify and articulate all objectives
- Identify the hedging costs
- Make sure the company has the qualified personnel to sufficiently run a program

- Utilities may want to avoid shifting risk, "play it safe," and avoid financial hedging altogether

- Rapid falls in price may rule out hedging

The NRRI identified the winter of 2000-2001 market shortfalls as illustrative of how volatile natural gas prices can be. They caution commissions that hedging in its purest form is only an insurance policy and, over time, should not be expected to reduce the average price. Hedging only stabilizes prices if they continue to rise.

2.6 Internal Controls for Physical and Financial Hedging

A company that plans to hedge commodities must have internal controls in place before the program is instituted. A guide for operation, internal controls, and accounting entitled *A Practical Guide to Hedging* is referenced by NYMEX on its internet website. Below is a summation of the general elements of the guide as well as other pertinent risk management controls:

- Inform the board of directors and seek board approval for a hedge program

- Establish a risk management executive committee composed of company top executives; establish dotted line reporting to the front office.

- Create an organization of personnel and facilities capable of commodity trading, portfolio management, procurement, financial planning, and an understanding of financial and inherent risk; within the organization it must have:
  - Continuing education for all front office personnel
  - Established clear communications
  - Organize the supporting departments which may include legal, data information, and contract administration

- Create and segregate duties in the front, middle, and back offices
  - Front office would be trading and procurement
  - Middle office would be risk management
  - Back office would be accounting and finance

- Draft a risk management plan
  - Goals and objectives
  - List strengths, weaknesses, opportunities, and threats

- Write policies and procedures that comply with all regulating authority, other laws and practices, and reflect the risk plan objectives; establish the following as a minimum:
  - Purpose of hedging and trading

- Responsibilities of each supporting department and establish independence between each department
- Stop loss and position limits
- Types of options tools to be used
- Value at Risk (VaR) and other analytical tools
- Credit risk management with exposure standards and limits
- Accounting
- Authorization; state who has authority to do what
- Employee duties and limitations
- Timely reports to monitor positions, trades, and markets

♦ Institute annual internal auditing as part of the check process

(GA)

3.0 FPL's FUEL PURCHASING PRACTICES

3.0 FPL's Fuel Purchasing Practices

3.1 FPL Company Profile

As Florida's largest electric utility, FPL serves about half the state's population. The operating utility is by far the largest subsidiary of the parent corporation, FPL Group. As shown in **Exhibit 2**, the organization has three major companies with FPL being the sole regulated entity. One branch of FPL is a division called Energy Marketing and Trading. It is the division that acquires all fuel for FPL. In 2001, this division had 63 employees. Its internal operations will be discussed and analyzed throughout this chapter. The sister division to Energy Marketing and Trading is the unregulated company, Energy Power Marketing. Energy Power Marketing exists to facilitate all out-of-state buying and selling transactions.

For year end 2001, operating revenues for FPL totaled slightly more than $7.4 billion and it employed a total workforce of 9,757 full-time employees. FPL's service territory covers an area of 27,650 square miles and customer accounts totaled an average of 3.935 million. At the end of 2001, FPL's generating capacity stood at 16,619 megawatts and was generated by 57 percent fossil-fuel burning, of which 7 percent was coal. Of the remainder, 17 percent was purchased and interchanged and 26 percent was nuclear-powered. FPL is the largest IOU oil buyer in the United States.

FPL's 34 base-load generating units include 28 steam turbines and six combined-cycle units. To operate those generators in 2001, total fuel consumption was 41,376,251 of barrels oil and 222, 327,090 MMBTUs of gas. The cost of the oil was $1.08 billion, and natural gas costs were $1.02 billion. Considering the price paid for gas and the amount used in 2001, FPL paid an average of $4.58 per MMBTU. In total, the fossil fuel (excluding coal) bill to fire FPL's generators was $2.10 billion. It is approximately $.35 cents per kilowatt hour cheaper to burn natural gas when priced against heavy oil.

For the current status of fuel cost-recovery, FPL has Commission approval for a $76,378,071 mid-course correction underrecovery for the period of January through December 2000. FPL asserted the correction was due to cold weather, higher demand on natural gas, and the sharp rise in natural gas prices. In addition, FPL is including an underrecovery of $259,002,688 for January through December 2002. That amount represents the remaining portion of 2000's estimated and actual true-up underrecovery of $518,005,376 that is being recovered over 24 months.

Order No. PSC-01-0963-PCO-EI approved FPL's mid-course correction. In that order, the Commission Chairman dissented stating that "IOU's have an obligation to take reasonable measures to ameliorate the negative effects that can be caused by highly volatile fuel markets." The Chairman also expressed the idea that FPL had the remainder of the year to explore other options to mitigate fuel costs. Hedging is one alternative to mitigate price volatility.

FPL GROUP
2001 ORGANIZATIONAL STRUCTURE

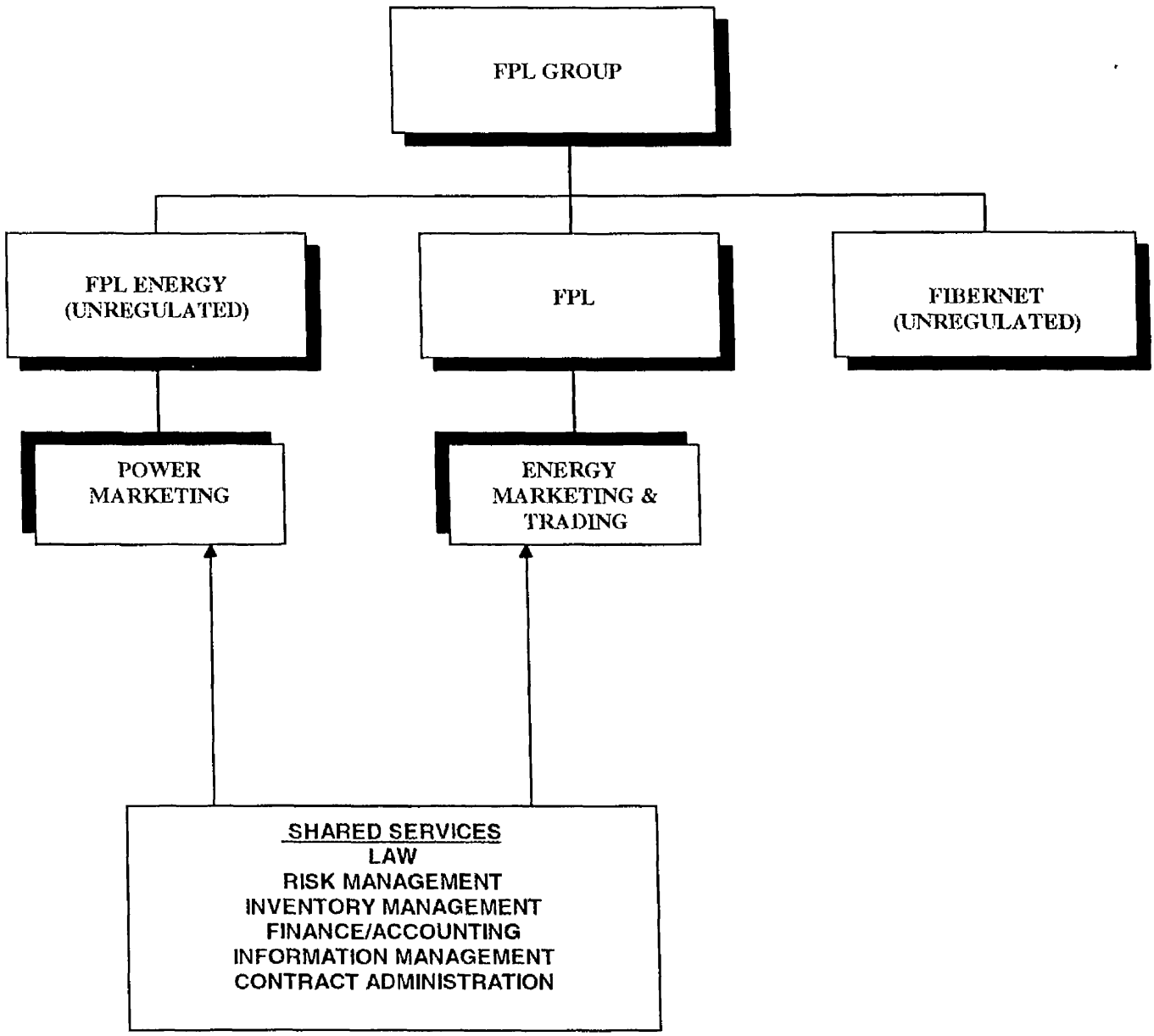


EXHIBIT 2

Source: DR-1

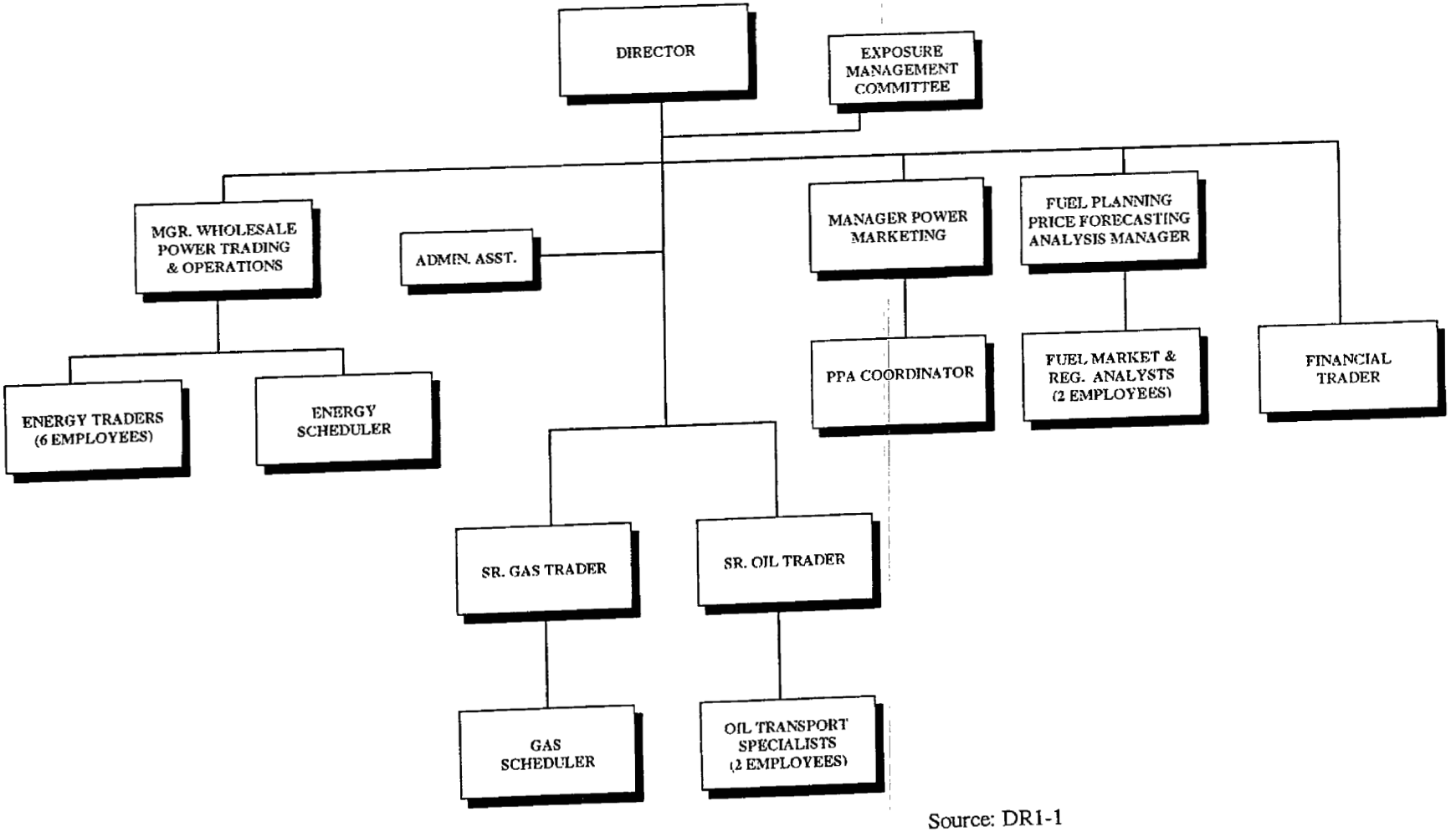
3.1.1 Fuel and Wholesale Power Purchasing Organization

As reflected in **Exhibit 3**, Energy Marketing and Trading is a separate division of FPL and Energy Marketing and Trading's sole mission is the acquisition of all fossil fuel and the operation of wholesale power trading for FPL. Energy Marketing and Trading is considered to be FPL's trading front office. Energy Marketing & Trading procures all fossil fuel required to run FPL's generation units as needed to meet customer load. If marketing conditions warrant, Energy Marketing & Trading may engage in selling any fuel in excess of these requirements to FPL Energy Services (an unregulated affiliate) or to third parties. As Exhibit 3 reflects, the Energy Marketing and Trading division is divided into the following six functions:

- Wholesale power trading
- Gas trading
- Oil trading
- Power Marketing
- Fuel planning and price forecasting
- Financial trading

Working in conjunction with, but independent of Energy Marketing and Trading, is the Risk Management Group (mid office), Finance/Accounting Group (back office), and the Exposure Management Committee. These three organizations will be discussed further in Section 3.2.1. **Exhibits 4 and 5** show the organization for both the Risk Management and the Finance and Accounting groups. Additionally, Energy Marketing and Trading shares employees with the legal, information management, inventory management, and contract administration departments.

ENERGY MARKETING AND TRADING DIVISION
2001



Source: DR1-1

EXHIBIT 3

RISK MANAGEMENT GROUP

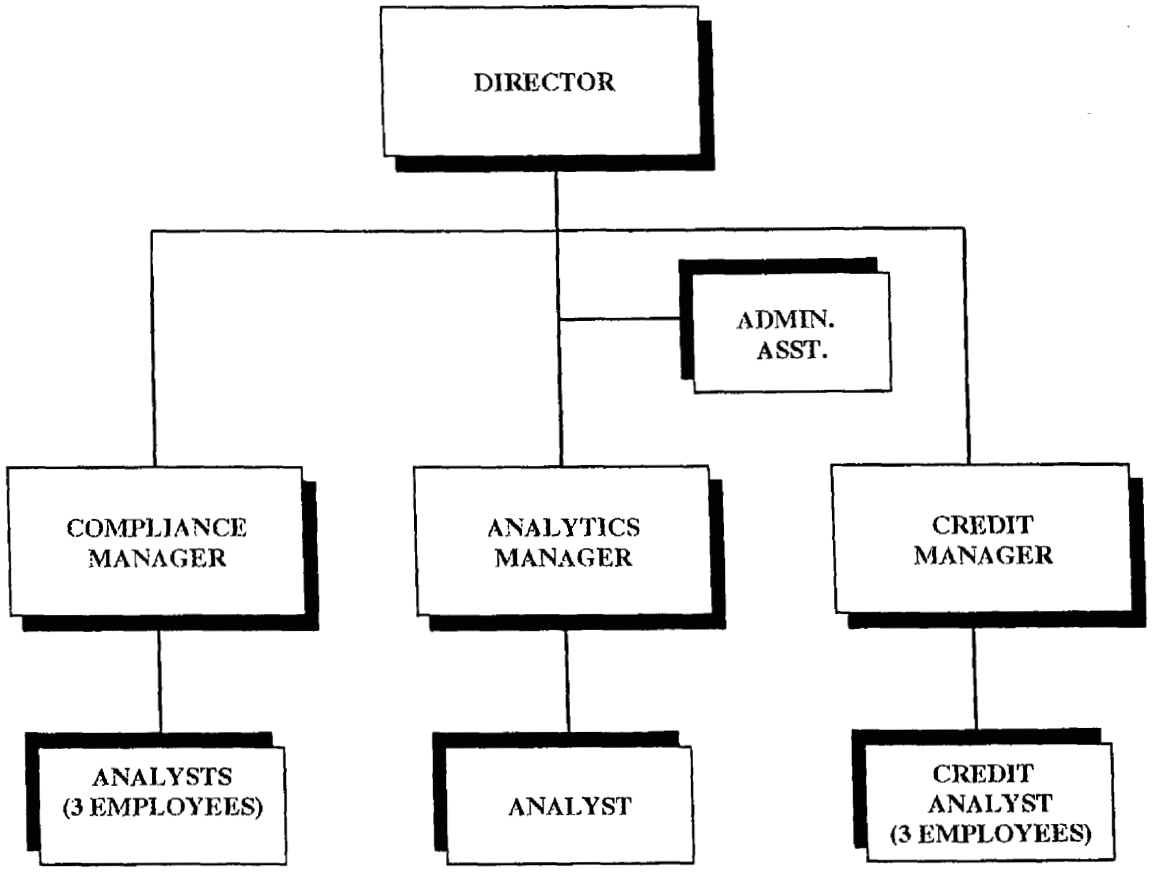


EXHIBIT 4

Source: DR-1

FINANCE AND ACCOUNTING GROUP

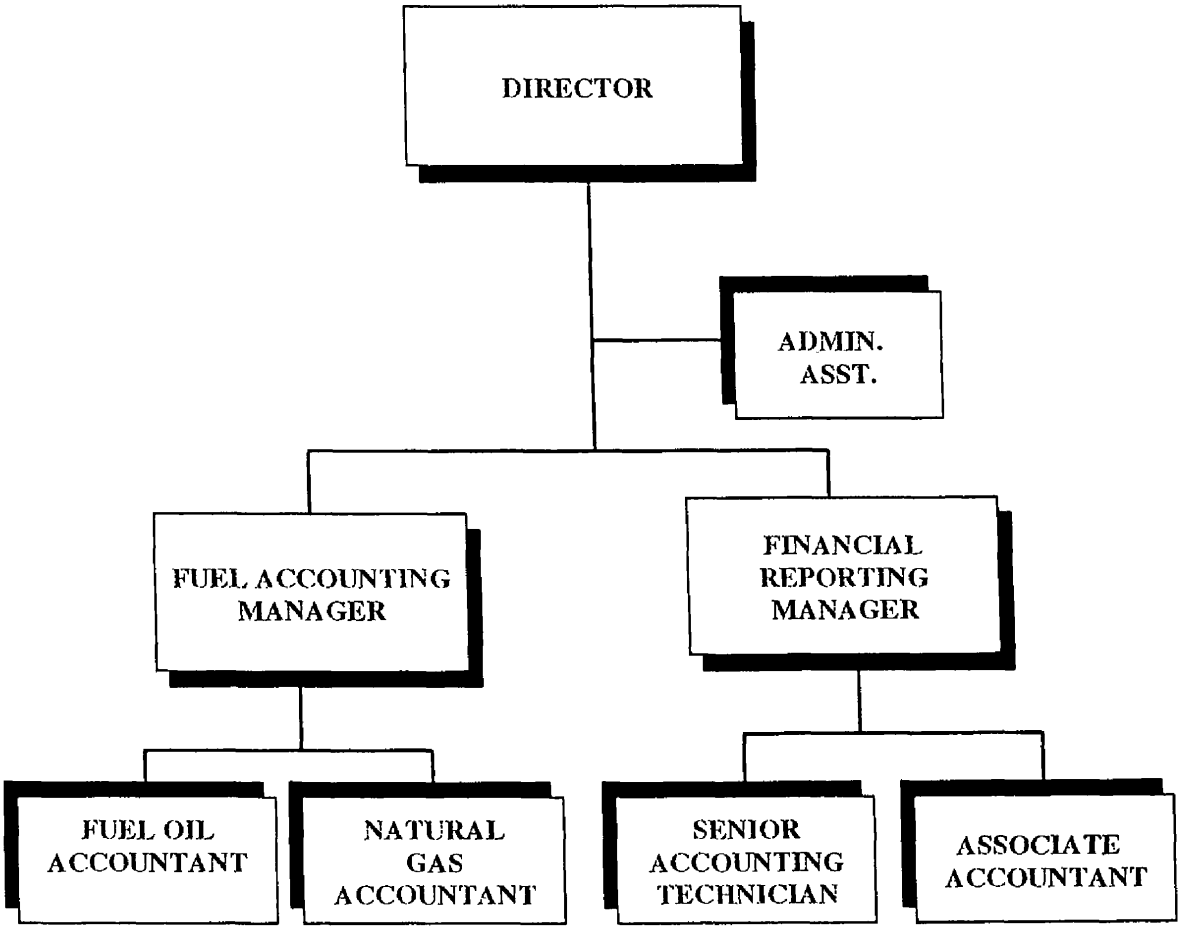


EXHIBIT 5 *Source: DR-1*

3.2 FPL's Fossil Fuel Purchasing Policies and Controls

The goals and objectives of the entire Energy Marketing and Trading Division are to procure fuel below market index pricing and procure purchased power at a savings. The resulting savings are to be passed on to FPL's customers. In 2000, Energy Marketing and Trading asserts that it saved FPL customers $43.9 million in gas purchases when compared to market indexes. Additionally, this savings was augmented by FPL's power plant capability to mix and switch natural gas and oil.

FPL's fuel consumption has one advantage and one disadvantage. The disadvantage is that FPL power plants are not coal-fired units (FPL does partially own both in- and out-of-state coal-fired plants). Although coal has historically stable pricing, pollution is always a concern to environmentalists. In contrast, FPL has 28 generation units that can burn either natural gas or oil. The ability to switch and mix in real time gives an option in the type of fuel to use. Obviously it depends on market prices, maintenance schedules, and availability when deciding with which fuel source to fire the units. Precise planning is crucial for optimum economic dispatch on all fossil units.

In a fuel strategy used prior to 2000, FPL considered the reservoir storing of natural gas. The decision at that time was that it was not economically feasible since no Florida storage facilities were in operation. However, at the end of 2000, storage was reconsidered. Since gas had escalated so much in price, FPL decided that it was now economically wise to store natural gas. Beginning in 2001, FPL obtained capacity to inject a maximum of 300,875 MMBTU at any time. The strategy was successful as FPL was able to reduce spot-market buying of high-priced gas during peak times and draw on the underground reserve.

3.2.1 Company Trading and Risk Management Controls

At the present time, Energy Marketing and Trading's policy and procedures on fuel trading and procurement are written in two separate manuals. The first is entitled ***FPL Group Risk Management and Trading Manual.*** The second is combined for FPL/Energy Marketing and Trading/Energy Power Marketing and is entitled ***Risk Management and Trading Procedures Manual.*** Both manuals seem comprehensive.

At the time that this audit began, the second manual was shared with the unregulated affiliate, Power Marketing. As a result, there was no clear demarcation between the policies and procedures for Energy Marketing & Trading and Power Marketing, with an appearance of intermingling employee duties, particularly for the "deal makers" (traders). During the audit, FPL asserted that it was in the process of creating two separate manuals for each company. FPL has advised that the separate manuals were completed during the first quarter of 2002.

[redacted]

[redacted]

[redacted]

The Exposure Management Committee meets at least every quarter (and more recently on a monthly basis) to monitor Energy Marketing and Trading's performance.

Staff suggests that meeting every quarter may not be adequate. Our dynamic economy, especially in the area of commodity trading and futures, can rapidly change with immediate trends of economic up and downturns. Although Energy Marketing and Trading management appears to have adequate staff for daily operations and decisions, the current situation of economic movement and fuel price sensitivity are indications that the committee should meet more often. Fuel costs are a large portion of the company's budget thus indicating that top management should give fuel a good deal of attention.

In staff's opinion, the Exposure Management Committee provides executive management guidance using collective minds who are aware and attuned to the economic trends and market risk. This guidance should be tapped more often to mitigate risk. Therefore, timely committee input is crucial to Energy Marketing and Trading's operation and readiness to initiate rapid change. Staff notes that in the [redacted] It is proposed that Exposure Management Committee meet every month at a minimum. It is also suggested that Energy Marketing and Trading provide the committee with trend reports at a minimum on a biweekly basis. FPL has confirmed that it is now the policy of the Exposure Management Committee to meet on a monthly basis and that it has been doing so since January 2002.

[redacted] The risk group ensures that all fuel transactions have been properly recorded. It also verifies trading data and confirms those transactions. In other responsibilities, it ensures all models are accurate and tracks all company credit risk with counterparties. Finally, it issues daily hedging reports and other periodic material related to trading activities.

3.2.2 Fuel Portfolio Policy

Energy Marketing and Trading's fuel planning policy can be described as a team effort developed and implemented using long-term strategy sessions, monthly planning meetings, and daily

and hourly operational updates. The division has a POWRSYM computer model that requires input such as generation parameters, load, fuel price forecasts, and projected power sales and purchases. The system output augments a starting point for long-term planning. The output determines how much fuel will be needed, and the decision will be made as to how it should be procured.

FPL amasses all acquisitions of its fuels and physical and financial options into what is referred to as a fuel and asset portfolio. The portfolio is the total fuel holdings that FPL anticipates using from all sources, both physical and financial. Inherent to any portfolio is risk, and FPL's focuses on price risk. Some of the risk exists in natural gas trading since FPL started contract hedging gas in September of 1999 using exchange-traded futures and options. Currently, it financially or physically hedges very little oil. Most of the oil is purchased through contract and spot markets.

As stated by management and in operating procedures, Energy Marketing and Trading will not physically purchase or sell more fuel than needed to meet customer demand. It may purchase a volume of natural gas at a fixed price for a long position so it may be used to meet short-term customer demand, but the company asserts that it never takes a position in the market without an offsetting position. Management asserts this would be classified as speculating.

Further, FPL procedures describe [redacted]

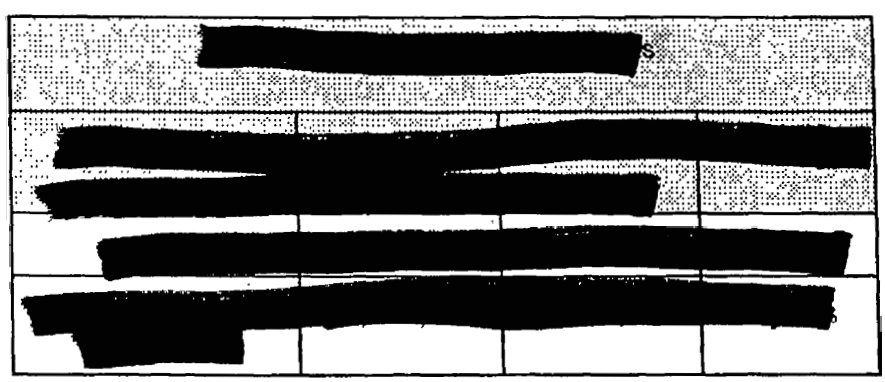


EXHIBIT 6 *Source: Docket 010001, Staff Interrogatories #1.*

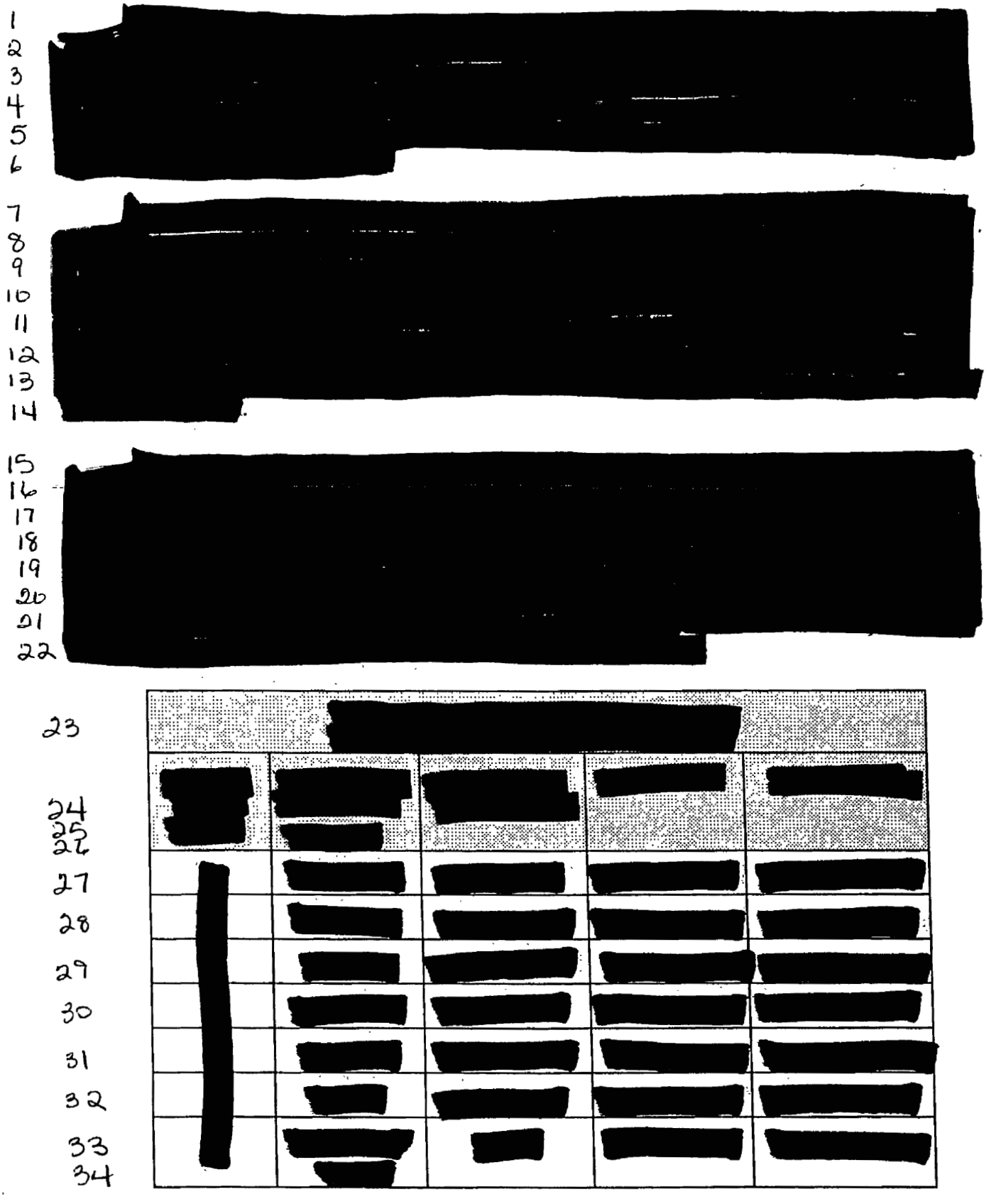
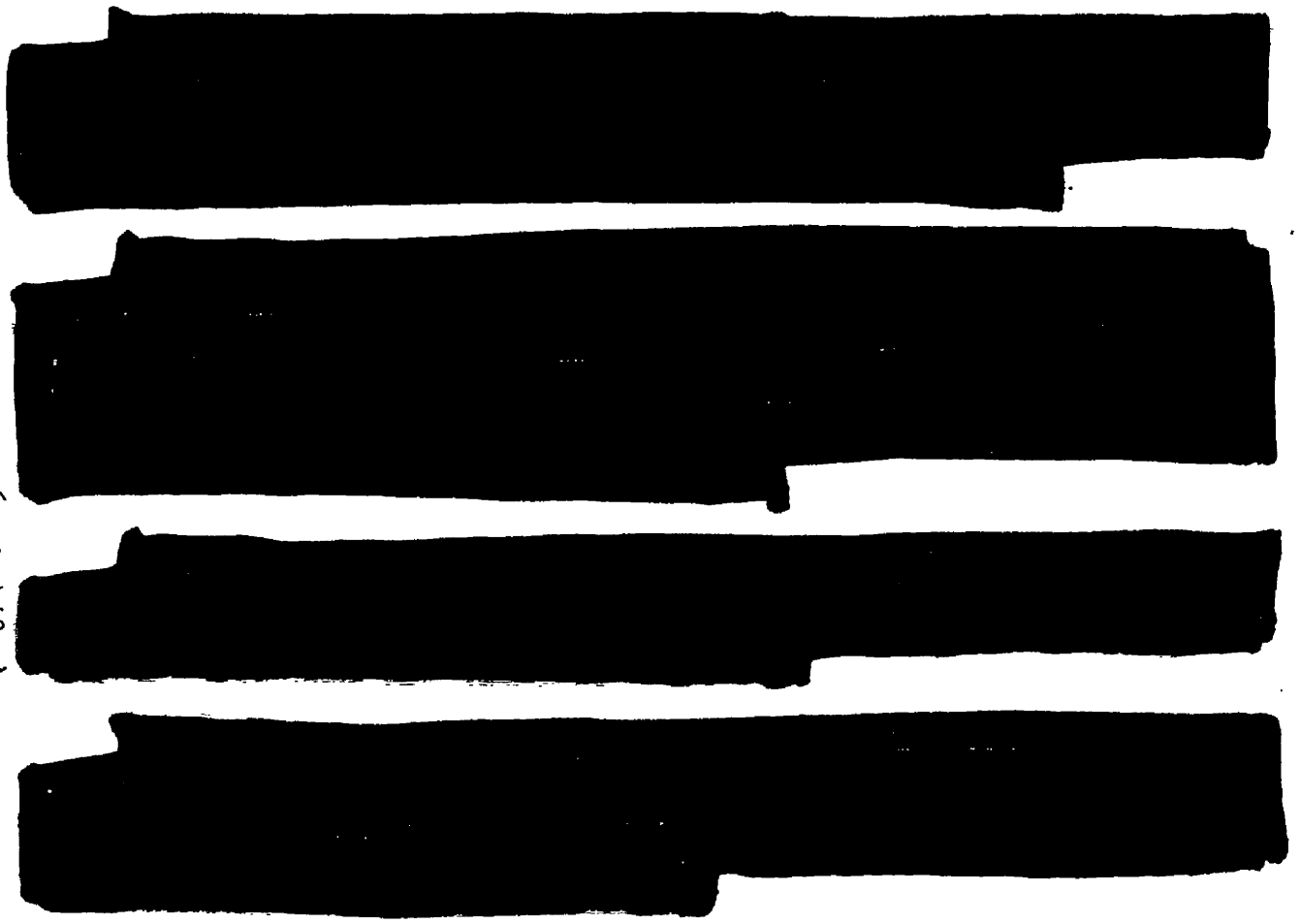


EXHIBIT 7 *Source: Docket 010001, Staff's first set of Interrogatories*



3.2.3 Contracts Policy

FPL writes short, medium, and long-term contracts for both oil and gas. These contracts are also known as bilateral agreements. For gas contracts, short-term is defined from one month to two years, medium as two to five years, and long-term as greater than five years. Oil agreements are time defined differently: short is greater than one month but less than six months, medium is six months to a year, and long is one year or longer. The company heavily depends on these contracts for price stability and minimizing volatility.

Further, FPL writes contracts in two ways: fixed-price and market-indexed. A fixed-price contract is an agreement between two parties to buy at a predetermined and agreed upon price. The disadvantage of fixed prices is that the price of oil or gas may drop below the contractual price. A market-indexed contract is a contract between two counter parties in which the selling price is tied to a certain index of a selected market. Market-indexed contracts are more flexible because they take advantage of market trends particularly if the price drops. **Exhibit 8** reflects a four-year purchasing plan and the variances by fuel and year. In 2000, FPL purchased 90 percent of its residual oiland65percent natural gas on indexed contracts. For 2001, results show a shift away from spot market to indexed-pricing for gas procurement.

FPL'S Fossil Fuel Purchases

	Residual Oil Percent				Distillate Oil Percent				Natural Gas Percent			
Purchased as	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Fixed Long Term												
Indexed Long Term									31%	37%	48%	55%
Fixed Medium Term												
Indexed Medium Term	32%	30%	35%	21%					4%			10%
Fixed Short Term	20%	14%	0%	0%					0%			26%
Indexed Short Term	0%	4%	55%	71%					1%	57%	17%	9
Spot Market	48%	52%	10%	8%	100%	100%	100%	100%	64%	6%	35%	0%

EXHIBIT 8

Source: Interrogatory Response 33 from Docket 010001-EI & DR 1-18.

Note: Coal was omitted because of limited usage and FPL is only partial owner of the plants.

It appears that in 2000, FPL may have experienced contractual gas procurement pricing problems. That year, 65 percent of purchased gas was indexed and 35 percent was spot market as shown in Exhibit 8. As the price escalated in the winter of 2000 and 2001, so did FPL's fuel costs. FPL was obligated to pay spot and near-spot price for the entire time period.

Over the last four years, it is apparent that Energy Marketing and Trading has changed its purchasing philosophy in both residual oil and gas. In 1998 and 1999, it relied heavily on the spot market, but the shift went primarily to indexed short and long-term contracts at the end of 1999. FPL has also recently reviewed its oil supplier process and has revised it to solicit other suppliers to offer oil while meeting supply terms. According to the company, the goal is to encourage liquidity and give FPL more asset management options.

FPL has multiple contractual clauses to protect itself from the price spikes. For example, FPL may strike a contract for long-term, but it is only executable month-to-month. Second, FPL has resale options such as selling it back to the original provider for a trade in future months. Third, other imbedded options include language intended to reduce risk such as legalities, quantity, price, and enforcement.

3.2.4 Physical & Option Hedging Policy

Energy Marketing and Trading began physical and option hedging of natural gas in 1998. The company defines hedging as a contract between two counter parties, thus making them bilateral contracts. Energy Marketing and Trading's mainstay is hedging in the physical buying of gas and oil by using contracts, as described in Section 3.2.3 above, and buying on the spot market. It then manipulates the physical supply to accommodate needs and uses limited financial trading to augment the physical hedging.

Energy Marketing and Trading uses option contracts to purchase natural gas as insurance against adverse price movements. This will reduce price volatility for any upward or downward movement and provide a form of hedging on price adversity. In 1999, Energy Marketing and Trading increased transactions, and to offset prices in 2000, the company physically and option-hedged 108,730,000 MMBTU of natural gas through long and short futures. Using options of puts and calls in 2000, the company traded 47,690,000 MMBTU and swapped 157,358,300 MMBTU.

Energy Marketing and Trading staff also write puts and calls. The strategy that Energy Marketing and Trading applies has several aspects. First, it takes advantage of either upward or declining prices because it may acquire natural gas at below-market price. Second, the company would get a premium from the counter party whether the fuel is delivered or not. Third, even though the option may never be executed, the premium can be applied to other purchases, which reduces overall fuel costs.

Energy Marketing and Trading asserts it will continue various forms of hedging when purchasing natural gas and fine-tune the program to become still more cost effective. In the past, it has not hedged residual oil; however, it is now looking for ways to lower oil prices.

3.2.5 Spot Market

Spot market is defined as the price of a commodity at today's prices and up to 30 days in advance. Purchasing on the spot market is extremely advantageous when commodity prices drop. The reverse becomes the managerial nightmare. Uncontrolled price jumps in 2000 and 2001 are the most recent example of the consequences when high demand and speculators have control. Indexing data from the Energy Information Administration in January of 2000, a thousand cubic feet of natural gas provided to utilities was $2.74. In December 2000, it was $8.23. The all time high was $9.47 in January of 2001, which equates to a 346 percent increase within a one-year period.

In essence, spot market purchasing may be sufficient when prices are in decline or relatively stable; however, spot market purchasing has been the mainstay approach for most fuel-fired utilities to purchase fossil fuel. During the past decade, natural gas prices have lost stability and the trend, as noted in Exhibit 1, is escalating prices. It is, therefore, obvious that spot market purchases are only useful when prices are stable or are dropping. When utilities use fossil fuels to generate, they must have an alternative plan to mitigate price increases.

FPL is not as dependent on the spot market as it has been in the past. Its residual oil spot purchase was at 52 percent in 1999 and has dropped to 8 percent in 2001. The same holds true for natural gas. FPL purchased 64 percent spot gas in 1998 and dropped to zero percent in 2001.

An event impacting FPL and other IOUs is the completion of the Gulfstream 36-inch natural gas pipeline. The pipeline has been constructed from Mobile Bay, Alabama, to Port Manatee, Florida. It has the capability to transport 1.1 billion cubic feet of gas per day. The new line will impact the cost of gas transportation because it will be in direct competition with the Florida Gas Transmission pipeline. The new pipeline should reduce firm transportation cost of natural gas to FPL customers.

3.3 FPL's Wholesale Energy Purchasing and Sales Policies and Controls

Energy Marketing and Trading has a separate department that trades wholesale energy. The department states that wholesale energy needs are executed largely on a short-term basis. Short-term is defined as a month or less. The department uses the following five parameters in determining whether it will sell or purchase energy:

- Market conditions
- Generation outage schedules
- Load forecasts
- Fuel price forecasts
- Reserve margins

Once all factors are determined, the planners apply the same strategy used in fuel procurement.

The typical strategy meeting involves arriving at a decision to either physically buy or sell. An example of a decision is arriving at a conclusion that selling call options is indicated. The company would then write call options for a set megawatt amount and have them recallable in case that load is needed. The strategy behind option selling is capturing the premium on the call and providing economic benefit to FPL's customers. At the same time, the company has hedged. The call may increase in price during the time frame of the call but, if it does not, the customer still has gained from the premium. However, if the call does increase in price, FPL will capture gains by selling excess energy on a real-time basis.

Energy Marketing and Trading has found that greatest economic benefit to its customers is dealing in the short-term and real-time market. For example, if the wholesale market looks favorable for the next day, company generation is high, and hourly megawatt prices are high, Energy Marketing and Trading may choose to sell up to 70 percent of its excess on the next day market. Each daily or hourly decision is determined by existing conditions and all transactions are executed to optimize monetary benefit.

When FPL trades in wholesale energy, it deals directly with the counter parties in physical movement. FPL states it does not trade on the NYMEX for several reasons. First, it is a core function to optimize generation resources as strategy has found real-time to be the best optimization. Secondly, NYMEX is normally a financial futures market. This will limit real-time opportunities as previously discussed.

3.3.1 Contract Buying, Selling, and Hedging

FPL's basis for hedging is contracting to purchase future wholesale energy when prices look favorable compared to the cost of generation. The company does not financially purchase or hedge on the NYMEX, but it uses the same concept in real-time. **Exhibit 9** presents a three-year summation of all buying, selling, and two-year option activity FPL has engaged in. Overall, it appears FPL has increased sales and purchases of wholesale electricity. The largest noted change is the number of call options executed for year 2000.

Energy Marketing and Trading has determined that real-time and short-term transactions are the most advantageous way to operate within the wholesale energy market. FPL asserts 2000 revenues from sales was $144 million compared to $121 million in 1999.

It appears that FPL has become increasingly proactive in wholesale energy transactions. Staff believes the company should continue taking advantage of real-time and short-term transactions especially if megawatt hours continue to rise in price.

3.3.2 Staff Analysis

As illustrated in Section 3.2.1, FPL has instituted general risk management internal controls recommended in *A Practical Guide to Hedging* by Pricewaterhousecoopers. These general control elements are described in Section 2.6.

FPL's Wholesale Megawatt Hour Purchases, Sales, and Options (000)			
	1999	2000	2001
Purchased*	17,024	19,376	19,603
Sales	2,680	2,863	2,007
Call Options	63,600	493,260	N/A

EXHIBIT 9 *Source: Staff's First Set of Interrogatories in Docket No. 01001EI & DR-2-2.*

**Includes all Qualifying facilities.*

Energy Marketing and Trading has become more proactive in achieving price stability by using hedging tools, most particularly in natural gas purchases. It is Energy Marketing and Trading's responsibility to its customers to procure fuel at the lowest prices available and utilize plants with the optimum fuel mix. Staff concurs that it is a complex, sometimes unpredictable, and a monumental task to physically deliver fuel to the power plants. Procurement requires an effective strategic plan, valid economic predictions, inter-company coordination, and a proactive stance in all spheres of influence. All plans must come together and the end result must be delivered fuel to the plant at the most economical prices.

[redacted]

3.4 FPL's Risk Management Plan

As a culmination of risk planning for fuel purchases and hedging, FPL was asked to submit a risk management plan that would summarize its strategy for year 2002 and beyond. Included is an

excerpt of FPL's risk management strategy from section four of the plan. The company responses are verbatim and identified in *italics*.

IV. RISK MANAGEMENT STRATEGY

S. Risk Identification

1. Identify each type of risk that the utility encounters when procuring:

a. Coal

FPL encounters three (3) risks when procuring Coal: 1. supply (either related to the commodity or transportation), 2. price, or 3. quality.

b. Residual Oil

The potential risks FPL encounters when procuring residual fuel oil include supplier credit, fuel supply and transportation availability, product quality, demurrage from arriving to early, weather, environmental risk from potential spills, and emissions risk from burning the fuel.

c. Distillate Oil

The potential risks FPL encounters when procuring distillate fuel oil include supplier credit, fuel supply and transportation availability, product quality, demurrage from arriving too early, weather, environmental risk from potential spills, and emissions risk from burning the fuel.

d. Natural Gas

The potential risks FPL encounters when procuring natural gas include supplier credit, fuel supply and transportation availability risk, product quality, and weather.

e. Purchased Power

The potential risks FPL encounters when purchasing power include supplier credit, transmission availability risk, supplier failure to deliver and weather or generation variances that change the economics of the purchased power.
Separately identify the utility's goal(s) in managing the recognized risks associated with each fuel or power purchases.

FPL's goals are always to minimize or mitigate the risks associated with each fuel and power purchases.

Describe how the utility decides what an acceptable level of risk is when associated with fuel procurement and purchased power transactions.

The utility determines acceptable levels of risk for fuel procurement and purchased power transactions by performing various analyses that include forecasted/expected levels of activity, forecasted price levels and price changes, price volatilities, and Value-at-Risk (VaR) calculations. The analyses are then presented to the Exposure Management Committee for review and approval. Approval is given to remain within specified VaR limits.

B. Describe your fossil fuel procurement and wholesale purchased power plans separately for 2002. Please include:

General

1. Types of fuel used and power purchased or sold
2. Quantities and mix and by percent
3. How purchased and by percent
4. Justify all purchasing strategies in items 1-3.

Specific

1. What derivatives will be used and how
2. What will be hedged and how
3. Savings (net of expenses) anticipated and why

SWOT

1. Describe the strengths of the plan
2. Describe the weaknesses of the plan
3. Describe the opportunities within the plan
4. Describe the threats and possible countermeasures

The objectives of FPL's fossil fuel procurement and wholesale purchase power plans for 2002 are cost and volatility minimization for FPL's customers through asset optimization of the FPL generation and fuel handling facilities. FPL projects that in 2002 it will generate 20,996,554 MWH from heavy oil (25.69% of the mix), 239,476 MWH from light oil (0.29% of the mix), 6,558,665 MWH from coal (8.03% of the mix), 29,639,042 MWH from gas (36.27% of the mix), and 24,283,718 MWH from nuclear (29.72% of the mix) as filed by FPL on November 5, 2001. In addition, FPL plans to purchase 20,398,312 MWH of power and plans to sell 2,333,502 MWH of power. The projected generation mix, as well as, the level of power purchases and sales are based on an economic dispatch from FPL's POWRSYM model, and FPL's

projection of fuel costs, load requirements, generation availability and the market price of power.

The primary strengths of the plan are a diversified fuel mix, balanced procurement portfolio, optimization of FPL's fuel switching assets, and dynamic management of market opportunities. The weaknesses are only if anticipated market opportunities do not arise allowing FPL to obtain the savings projected above. The greatest opportunities arise from FPL's ability to fuel switch and optimize a balanced portfolio, through FPL's integrated trading operations where fuel and power, physical and financial, traders, as well as, market experts plan, develop strategies, and implement a balanced and optimal program, on a daily basis, for FPL's customers.

C. Audits

1. Internal Auditor – describe the level of audit oversight that the utility's internal auditor provides to the utility's risk management efforts.

   The following answer assumes that the utility's risk management efforts you are referring to is the middle office within the trading floor, commonly referred to in our company as risk management.

   Risk Management efforts within the trading floor receive the same level of audit oversight as all other areas in the company. That is, a risk assessment process is performed with all potential areas of audits considered (including the middle office of the trading floor). Based on a series of factors, for example, materiality, prior findings, management requests, control environment, level of change, etc., the risk for the area is determined, and based on the level of risk, our audit plan is developed. The audit plan includes areas of audits deemed as having the highest level of risk for the company.

The risk management function has been reviewed and will continue to be reviewed through this process.

2. Outside Auditors

a. Indicate which outside auditors, if any, provide oversight to the utility's risk management efforts.

Outside auditors do not provide specific audit oversight of the utility's risk management efforts.

b. Describe the level of audit oversight that these outside auditors provide to the utility's risk management efforts.

Deloitte & Touche has indicated that in planning and performing their audit of the financial statements of FPL Group, Inc. and Florida Power & Light Company, they consider its overall internal control in order to determine their auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the Company's internal control. They have indicated that their consideration of the Company's internal control would not necessarily disclose all matters in the Company's internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. They do not provide any specific audit oversight of the utility's risk management efforts.

3.5 Risk Plan Analysis

FPL's primary objectives for its 2002 fossil fuel procurement includes a well-balanced asset optimization plan that considers cost and volatility. It will use computer models for projections in fuel costs, load requirements, generation availability, and market price of power. [redacted] All fuel procurement and hedging will have benefit of oversight by the Exposure Management Committee.

The company lists the strengths of the plan as fuel mix, fuel switching, a balanced procurement portfolio, and dynamic management of market opportunities. The fundamental weakness is when the market opportunities do not occur.

[redacted]

The company identifies the following generic risks inherent with fossil fuel and purchased power procurement:

- Supply
- Price
- Quality of product
- Supplier credit
- Weather
- Environmental

FPL asserts that its plan has methods and operations that can mitigate the acceptable risk by forecasting and using various analytical tools such as VaR. The overall objective of the plan will minimize fuel cost and volatility by hedging [redacted]

INTERVIEW SUMMARY

Company: FPL Area: Fuel and Wholesale Energy Transactions Auditor(s): Yambor, Wallace (also present: supervisor Vinson and ECR analyst Brinkley)	Interview Number: 1 File Name: G:\INT FPL 10 17-18 01.wpd
Name: Stepenovitch, Canino, Ungar, Yupp, Dubin Title: Dir. Energy Marketing and Trading, Dir. Risk Management, Mgr. Fuel Planning and Price Forecasting & Analysis, Mgr. Wholesale Power Trading and Operations, Mgr. Regulatory Issues Job Experience: 22 yrs, 12 yrs, 16 yrs, 11 yrs, 20 yrs	Date of Interview: 10/17 & 10/18/01 Location: FPL, North Palm Beach, FL Telephone Number: 561-625-7510 (Stepenovitch)

(1) Purpose of Interview: Fuel and wholesale energy transaction risks management and practices review.

(2) Interview Summary: Auditors asked prepared questions of responsible supervisory personnel to ascertain and review FPL's management practices and controls as relate to fuel purchases and energy trading.

(3) Conclusions: Obtained overview and detailed explanations of FPL's perspectives and practices. Some additional information was indicated by FPL as could be expected to be submitted to auditors subsequent to the interview - including more detailed breakdown in response to interview's Trading question 1.

(4) Date Request(s) Generated:
No. _____
No. _____
No. _____

(5) Follow-up Required: Review interview notes for possible follow up clarifications or document requests - in addition to further detailed response(s) FPL indicated during interview would be forthcoming,

Louis J. Yambor
Project Manager

Fuel Audit
Interview at FPL
October 17 & 18, 2001

Present at interview:

PSC - Lou Yambor, Rod Wallace, Carl Vinson, Matt Brinkley
FPL - Joe Stepenovitch, Michele Canino, Gene Ungar, Gerry Yupp, Kory Dubin, Tom Sikes

Management

1. For our clarification, are EMT and FPL Energy, regulated companies and PMI a non regulated company? Further clarify that EMT does all trading for FPL?

STEPENOVITCH: Yes to both. On FPL Group's organizational chart there is a functional (code-of-conduct-based non communication) "steel wall" between the unregulated FPLE/PMI and the regulated FPL/EMT groups - with support areas such as Risk Management allocating its shared services between the two.

2. Please explain FPL's management philosophy in regards to all fuel purchases and wholesale energy purchase and sales.

YUPP: Simple objective is cost minimization of fuel and energy to pass to customers. To do so must be diversified - from generation to fuel procurement - in portfolio (maintaining mix of long, mid, and short term contracts).
Historically, saw little volatility. So, hedging was day to day - looking at the next month, projecting spot markets, and arriving at optimal mix economically for fuel. Looked at where the spot would be going next month and adjusted between longer and shorter term contracts and the spot market. Same idea applied relative to fuel switching in response to gas and oil price fluctuations. [redacted] **cautiously, to avoid tops and bottoms of market and give flexibility both ways. Now and forward, may change, due to increased volatility, in order to work toward mitigating price volatility to customers (protecting up side, realizing may not avoid bottom or get total minimization due to trying to avoid volatility).**
YUPP: In response to BRINKLEY's query if they've explored more aggressive hedging, said yes, FPL is presently studying that with a consultant, but also asserted that last year was an anomaly.
[redacted]
STEPENOVITCH: With 97% not delivered per YAMBOR, financial NYMEX-traded hedging is "a" concept, but EMT engages more in physical/operational hedging in its

portfolio. A study of what hedging is the right thing to do is going on. No final answer yet, but do think maybe could've hedged more. This is a historical study - looking back.

[redacted]

3. With this philosophy in practice, can you give us an idea how much savings is realized every year and how this is calculated?

YUPP: Referred to its DR1-21 response, which was reviewed briefly. Monthly procured molecules compared versus Inside-FERC Index showed $18.2 million gas savings in 2000. Said FPL would do nothing differently, even if no Fuel Recovery Clause (FRC) available.
DUBIN: Off-system sales are taken into consideration versus offsetting cost of generation.

[redacted]

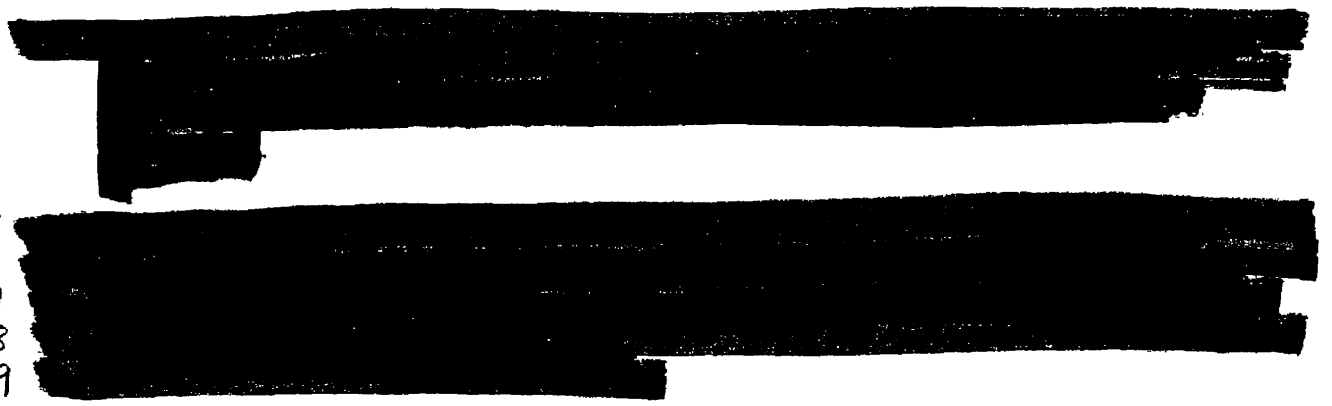
YUPP: But FPL hasn't instituted this practice yet (and, again, previously went out on a month by month basis). As pointed out before, a study of what hedging is the right thing to do is going on with no final answer yet, but do think maybe could hedge more. It might consider financial derivatives in oil, under certain terms, but less likely to do so in gas.

4. Since regulated and non-regulated use the same policies and procedures, is there any interface at all between FPL's fuel purchases and PMI's?

STEPENOVITCH: No - as addressed earlier in response to Management question 1.
CANINO: Additionally, those policies and procedures will be separated for the non regulated and regulated entities in the near future, anticipated by end of November.

5. FPL's hedging strategy effectiveness is assessed by using correlation of rolling quarter price changes. Can you explain this and present the documents that support overall assessment?

STEPENOVITCH: Referred back to response to Management question 3 as to what FPL actually does.
UNGAR et al: No one could come up with any understanding of or respond to YAMBOR's "rolling quarters" reference.
DUBIN: In response to BRINKLEY query as to whether FPL relies - as part of its strategy and effectiveness assessments - on availability of FRC, said have worked with FPSC on FRC, but going to it annually affects it. FPL tries to work it to help minimize impact to customer via FRC. Also, offer budget billing and try to give price signals to customers.



7. In DR 1-5, FPL states there were no policy changes that affect fuel purchasing. Please refer to Interrogatory response 23, page 5-17. It appears procurement strategy was changed in 2001. Please explain.

UNGAR/YUPP/DUBIN: Referring to POD no. 23, actually, the strategy was the same; it was just outcomes that were different.
STEPENOVITCH: Of FPL's POD's submitted, the slide they point to as the most informative is the one called Basic Tactics for FPL Fuel Portfolio for 2001, which they reviewed and reported that it was at that time, 12/6/00, 1 to 3 months. Promised a better copy of it to be forthcoming.

8. Referring to the same interrogatory response, page 3 future issues, the memo has asked for the EMC to clarify accepted practices for hedging. Has the EMC done that? Please explain what was recommended?

YUPP: Referencing the same POD as in Management question 7, EMC's "clarify" of practices for hedging really is more like making them aware of what is being done and is documented in their minutes.
CANINO: As there has been no real change, no response or recommendation was needed.
STEPENOVITCH: Said should always look at portfolio components per production units' capabilities and needs. The mix is still under the study previously referred to.
DUBIN: At the fuel hearings (see in transcripts) also the Commissioners sounded like they would encourage more hedging.
YUPP: In response to queries from BRINKLEY relative (a) to general benefits in other industries of hedging and (b) to use of calls and puts, said (a) the benefits are the same in any industry, which is to remove cost volatility - and budget uncertainties, and (b) there may some periods when calls and puts could be a good strategy - portion of year unknown.
STEPENOVITCH: FPL does asset optimization, not speculation. We don't buy more than we need or sell more than we have.

9. Referring to the #33 and #34, reflecting natural gas spot market, why is the acquired percentage going from 35% in 2000 to 0% expected in 2001.

DUBIN: The 0% was forecast for 2001 at time of midterm correction filing, reflecting not

an economic choice strategy change but pricing impacts, and 2001 spot could end up more.

10. Referring to the #33 and #34, why is all distillate oil purchased at spot market?

[redacted]

11. In general it appears natural gas is being hedged and traded but in oil, it is not. Is this a fair statement?

[redacted]

STEPENOVITCH: We are working on a parallel strategy on oil side; don't know %'s yet.

Trading

1. Please specified the aggregate amounts of gas, oil, coal and energy purchased at spot market price for 1998, 1999 and 2000. Please specify the amounts purchased by hedging, trading, or other means of purchase.

YUPP: Will provide more of a breakdown.

2. It appears that FPL risk management endorses swaps and options. Please explain how they are used and applied to FPL's fuel purchases. If there is a large loss, wouldn't FPL rate-base payers share in it?

YUPP: Volume is small percentage and is means to cap/floor range.
STEPENOVITCH: In FPL's opinion, we don't consider swaps as losses since we don't buy more than we need.

A. Specifically regarding FPL provided documentation of an 8/8/01 trade date natural gas commodity swap transaction entered into with Enron for October did (or, if not effected as yet, will) fixed price payor (FPL) or floating price payor (Enron) pay the difference to the other party? Does FPL pass the disbursement or receipt of that difference payment through the Fuel Recovery Clause (FRC)? Does this type of trading constitute speculation?

UNGAR/YUPP: Yes; yes; and, no - because it helps volatility and mitigates pricing.
STEPENOVITCH: If it achieves goals overall and helps stabilize prices, is it truly a loss? In physical it is not speculation like it might be in financial markets, by definition; it is asset optimization. In FPL's case, only what is to be used is bought. It is like insurance.
CANINO: If did nothing that would be speculating. FPL does not do such trades usually.
STEPENOVITCH: FPL has separate strategies, by plan, for long term and short term, and management approval is required beyond a certain point.

CANINO: Reports look at how it's going day to day.
UNGAR/YUPP: There are team meetings month to month plus daily conference calls, all relative to FPL asset optimization.
DUBIN: In response to query from BRINKLEY as re: what incentives FPL had aside from FRC, said they go to great lengths to demonstrate prudence - plus annual audits review it.
YUPP: His incentive is that it is his job to minimize costs and mitigate volatility.
STEPENOVITCH: FPL, corporately, has same incentive, and history shows they do good.
STEPENOVITCH: FPL would get more into hedging regardless of FRC.
YUPP: With FRC, the measure may be how often FPL must go back for under/over recovery.

3. In options there is a large risk exposure due to oil price volatility. Please explain why the EMC has decided to authorize this risk?

STEPENOVITCH: EMT recently (within last year or so) took over the oil group, reviewed what they're doing, and auditing revealed a process they've put in place: RFP out to more than usual few suppliers (29 different) and giving them open end to make offers of how to supply and under what terms. They are responsive because FPL is largest IOU oil buyer in the U.S. We're trying to encourage liquidity, forward market to develop, and more people to be trading.
UNGAR: Within RFP process, a goal is to achieve a more diversified portfolio, in order to give FPL more asset management options.
STEPENOVITCH: And to hopefully lower prices over time.
UNGAR: As this evolves, to get those results, will do more hedging in oil.
STEPENOVITCH: That is physical hedging; in the short term may need to do more financial hedges - not many, but we will be more proactive.

4. What is FPL's definition of hedging? How do bilateral contracts fit the definition as stated in DR 1-9?

Already addressed within answers to previous questions, especially management ones.

5. In the Planned Position Strategy (PPS) of 5/10/01, for effective period June through September 2001, your EMT suggests that hedges be placed with multiple counter parties and not with Enron alone. How effectively has that trading partner diversity been achieved?

YUPP: It serves the purpose. A review would show good results over prior years. We try to do that in all areas - even power purchases.

6. How does FPL's price paid, in general, compare to the spot market exchange close of day price? How does it compare, in general, to that obtained by other IOU's?

YUPP: FPL uses on-line price discovery tools to look at market and, then, to negotiate. As addressed earlier, relative to IOU's, FPL beats them all, and beats the market as well.

FPL's size even allows some price influence power; we are major enough to bring/push a market to where we want it to be.
UNGAR: The previously discussed proof is the savings achieved versus various indices.

7. Does FPL take delivery of all bilateral fuel contracts? Can it sell them to another party?

[redacted]

UNGAR: As to storage for FPL, due to nature of FPG's pipeline (and non storage capability), they contract for someone to store in salt/sandstone caverns out of state. There is no gas storage in Florida, but option of storage in Everglades may be worth considering; it may become economical if gas volatility continues.

[redacted]

YUPP: FPL cashes out under burns at the end of each month, also.
UNGAR: Other parts of country must store and true-up daily.

[redacted]

UNGAR: Besides the only pipeline in Florida, FPG, the cross-Gulf Gulfstream pipeline is underway with the first phase availability anticipated June 2002.

8. If a bilateral contract is considered a hedge, what if the price drops during the contract maturity? What offsets it?

Already addressed within answers to previous questions.
UNGAR: There are (within physical deals) imbedded options (selling put - get premiums) and many types of hedging under broader definition of hedging (operational/contract).

General

1. If FPL is primarily successful at option trading, why the large FRC in the past and anticipated in the future?

UNGAR: In response to elaboration on question by YAMBOR if the FRC is what gets price per bill higher and why, said actual price per KWH is low versus TECO and FPC. It's coal plants that help others. In response to YAMBOR's query as to what besides that, other factors are more efficient generating, burning from gas. In response to BRINKLEY's question that costs may be more, said but it allows FPL to generate more without investing in capital.
DUBIN: Our fuel mix is low coal - therefore, higher cost, and FPL has asked for coal plants before and been denied.
UNGAR: Still, bottom line, customer pays less.
In response to query by BRINKLEY as to pros and cons by type plant, said looks at total costs over life: combined cycle is efficient, lower capital cost, and modular (units can be added incrementally); coal is environmental, permitting lead time longer, fuel cheaper.

2. Would FPL object if staff recommended that all fossil fuel prices be fixed for up to a three year period?

[redacted]

UNGAR: In response to BRINKLEY query if derivatives were viewed by some as the magic bullet what would FPL have paid, said have to be realistic; no one would have known to lock in 100%.

[redacted]

ADDENDUM:

3. Recap overall strategic plan for future fossil fuel purchases (e.g., next one to five years).

[redacted]

DUBIN: Weather conditions and temperatures also impact volatility but hard to capture.

[redacted]

UNGAR: See more opportunistic physical aspects (such as the new pipeline, for example).

[redacted]

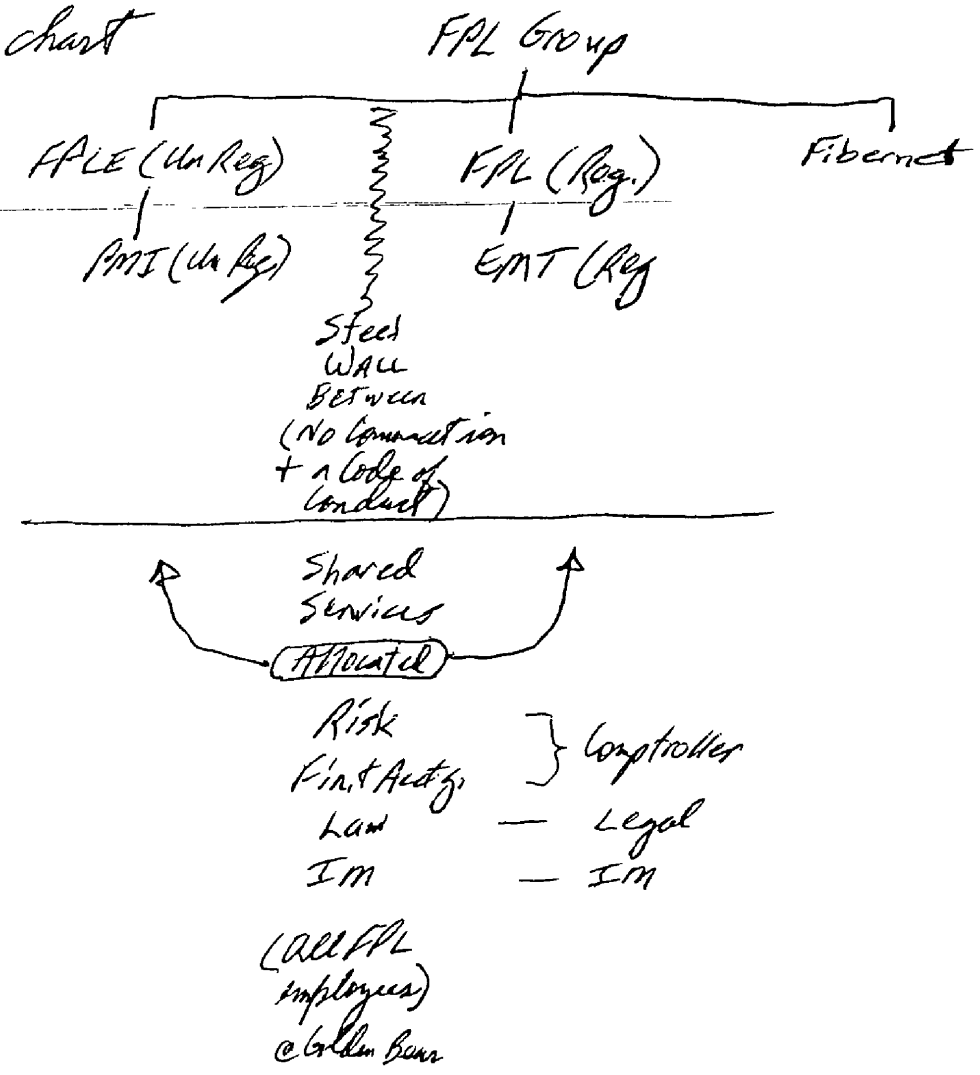
YUPP: FPL deals with counter parties directly on wholesale energy.
STEPENOVITCH: In response to Yambor query as to who would do puts and calls, said FPL has procedures for long and short term strategies and, if an out of the ordinary proposal by a trader, it goes through several layers of management.
CANINO: Reporting is on daily exposure reports.
UNGAR: It is a team atmosphere.
YUPP: We involve all asset option people, dispatch control people, environmental people, and plant operational people in a recap of last month and plans for next month. In response to YAMBOR query if physical and financial, said yes.

(Y) = Terry Yupp
(S) = Joe Stepenovitch
(C) = Michele Canino
(U) = Gene Ungar
(T) = Tom Sikes

10/17/01

Keyed to:
Management question #'s

1. (S) Yes. Drew chart



2. Lon: Overall overview

(T) - Single objective is cost minimization of fuel and energy to pass to customers. To do so must be diversified — from generation to fuel procurement - in portfolio (consist mix of long, mid, & short term contracts).

10/15/01

(mgt. 2. cont'd)

From Carl to ? re: history,

(T) Historically saw little volatility. So hedging was day to day and looking at the next month, arriving at optimal mix economically for fuel. Looked at where spot would be going next month and adjusted between longer and shorter term contracts and spot market. Ditto that idea relative to fuel switching.

Now and forward may change due to increased volatility in order to work toward mitigating price volatility to customer (protecting up side, realizing may not avoid bottom end getting total minimization due to trying to avoid volatility).

Matt said they're starting to look at testing scenarios

(S) asked what is hedging definition.

Matt spoke to it generally, as did Lou text book-wise.

[redacted]

Lou: What about financial, NYMEX-traded hedging with 97% not delivered?

(S) said that is "a" concept but that ENT engages more in physical/operational hedging in its portfolio.

(S) Study of what hedging is right thing to do is going on — no final answer yet, but do think maybe could've hedged more. This is a historical study, looking back.

[redacted]

10/11/01

(Mgt. 2. cont'd)

Matt asked for chart of data showing what they say is historical

Ⓤ may be providing that for him.

Ⓢ says they measure comparing to Henry Hub index, NYMEX #'s.

[redacted]

3. Ⓣ calculate gas: referred to DR 1-21 response and reviewed briefly

Ⓣ said would do nothing different even if no FRC available

Ⓓ system sales taken into consideration too, vs. cost of generation-

[redacted]

but they haven't instituted this practice yet - and, again, before went out month to month.

4. Per Ⓢ's org chart in response to 1: No.

In future Ⓣ said, confirmed by Ⓒ they will have separate ones

5. Ⓢ Refer back to discussion in 3.

Ⓤ Gastel: no one knew what Lou's rolling quarters assessment referred to

Matt questioned if FPL relied on FRC to minimize costs.

Ⓓ said have worked with FPSC on FRC, but going to it annually affects it. FPL tries to work it to help minimize impact to customer, via FRC. Also, they have offered budget (levelized) bills

6. [redacted]

(Mtg. cont'd)

7. Ref'g POD No. 23 –

(U) (Y) + (D): same strategy, different outcomes.

(S): Most important and informative slide in those POD's submitted: Basic Tactics for FPL Fuel Portfolio for 2001 (Better copy to be provided) (and it's presently 1-3 months at that point in time, 12/6/00)

8. Same POD –

(Y) EMC clarifying practices for hedging really is more like to make them aware of what they're doing

(C) No real change and, thus, no response needed.

(S) Should always look at portfolio components per production units' capabilities / needs. The mix is still under the study.

9. Re: Int. rog's #33 + 34

(D) The 0% was forecast at time of mid-term correction filing, reflecting not a strategy change but pricing impacts, and may be same in 2001 to date now.

10. [redacted]

11. (Y) Yes, because gas is liquid and residual fuel oil is not.

General

2. [redacted]

10/18/01

Keyed to Trading question #'s

1. (Y) to give more of a breakdown to come, per Lou's request + Matt's ?'s

Carl: We'll put this in a document request.

2. (Y): Volume is overall % + is a means to cap / floor range – options

A. (U) + (Y): Specifics to FRC: Yes.. As to speculation: No. To help volatility + mitigate pricing.

(S): If it achieves goals overall and helps stabilize prices, is it truly a loss?

(margin: a asset system) → As physical it is not speculation + like it is in financial market, by definition. In FPL's case, they buy only what they need, etc. It is like insurance.

(C): If you did nothing that would be speculation ... NOT ... [illegible]

12

10/10/01

5 of 6

Trading: 2 cont'd)

(S) FPL has separate strategies, by plans for long term & short and mgt approval beyond a certain point.
(E) Reports back at how it is going day to day (R)+(T) There are team meetings month to month & daily conference calls, all relative to asset optimization.

(short & long term, physical & financial)

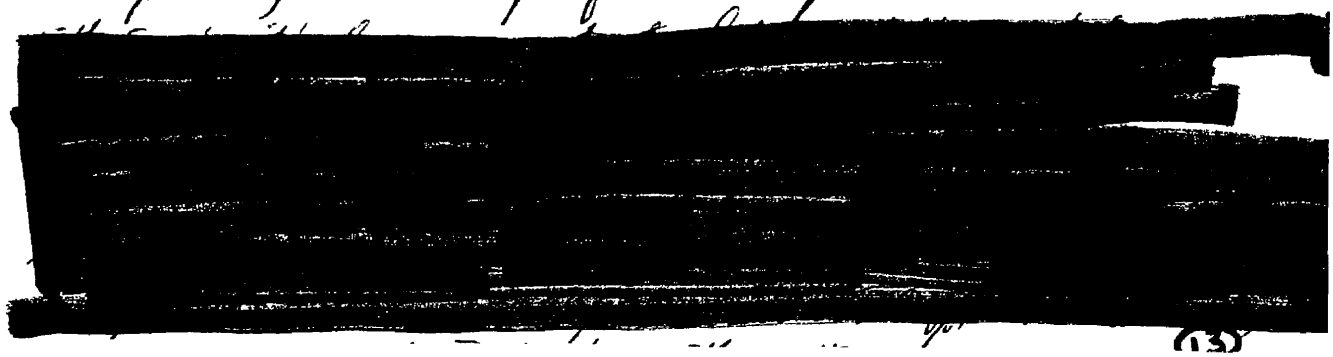
Watts: What incentive, aside from FPC?

(D) Go to great lengths to demonstrate prudence; plus annual audits review it.
(Y) His incentive is it is his job to minimize costs and mitigate volatility; within a band.
(R)+(S): Would get more into hedging, regardless of FPC.
(T): With FPC, the measure may be how often they must go for order/more recovery
(U)+(S): Corporately, like (T) said as his incentive, is same & history shows they do good

3. (S) EMT recently (yrs or so) took over the oil group, reviewed what they're doing, and audit revealed a process they've put in place: RFP to more than usual few suppliers (and giving them open end to make offers of how to supply under what terms). FPL is largest FOW oil buyer in U.S.
(W) Within RFP, their goal is to achieve a more diversified portfolio, to give FPL more asset management options (S) to hopefully lower prices over time.
(U) As this evolves, to get these results, will do more hedging in it. - (S) physical hedging; long in short term may need to do some financial, but not many

4. Dealt with in previous questions, especially mgt. questions.
5. (Y)+(S) a review will show good results, even prior years, on that.
6. (Y) They do on-line price discovery tools to look at market & then negotiate How does that compare results-wise? Would take various considerations to see vs. market.

Re FOW's, they addressed earlier that they've beat them all. (S)
(Y): Beat market and IOU's. FPL's size even allows some price influence
(W): The primarily discussed proof is savings achieved vs. various indexes
7. (W):



(13)

10/18/01

(Trading 7 cont'd)

(U) Storage for FPL due to nature of FPG pipeline (and non-storage ability) storage, they contract for someone to store in salt/sandstone caverns out of state. [redacted]

(Y) Cash out under burns at end of month, also (U) Other parts of country must store if ... [redacted]

(W) besides only pipeline FPG, the cross-Gulf pipeline is underway. (GULFSTREAM)

8. Addressed prior - many options to hedge.

General

1. Lou: As large FRC what gets price per bill higher? & why?
(D) - actual price per KwH is low (vs. TECO, FPC, etc).
(Y)(D)(C)(W): it's coal plants that help others

Lou What besides 4

(W): Other factors - more efficient generating, burn from gas.

Matt But costs may be more.

(C): But allows us (FPL) to generate more without investing in capital.

(D): And FPL has asked for coal plants before & been denied-

2. Answered on page 4

Addendum General (#3?)

Lou: Recap overall strategic plan for fossil fuel purchases (like next 5 yrs)

(Y) Operational hedging being reviewed as to sufficiency

With study, looking at what is right mix of hedging - (mainly physical)

[redacted]

(D) Weather conditions and temperatures have impact (hard to capture) on volatility.

Lou: Don't see much financial derivatives hedging - future?

[redacted]

(U) See more opportunistic physical aspects and such as new pipeline [Lou ...

Joe Michele
Jean
Mary (1)

Fuel Audit
Interview Questions for FPL
October 17 & 18, 2001

Management questions

1. For our clarification, are EMT and FPL Energy, regulated companies and PMI a non-regulated company? Further clarify that EMT does all trading for FPL?

FPL Energy is Un Reg (See Back)

2. Please explain FPL's management philosophy in regards to all fuel purchases and wholesale energy purchase and sales.

Objective - cost minimization - Divers. Factor - in Portfolio - Fuel switching

Physical Hedging

[redacted]

3. With this philosophy in practice, can you give us an idea how much savings is realized every year and how this is calculated?

NG - Monthly - All monthly procurement - Compare with daily analysis - may not always work

Used monthly as basis for savings

Will consider Financial Hedging

4. Since regulated and non-regulated use the same policies and procedures, is there any interface at all between FPL's fuel purchases and PMIs?

Will Be Separated (P & P)

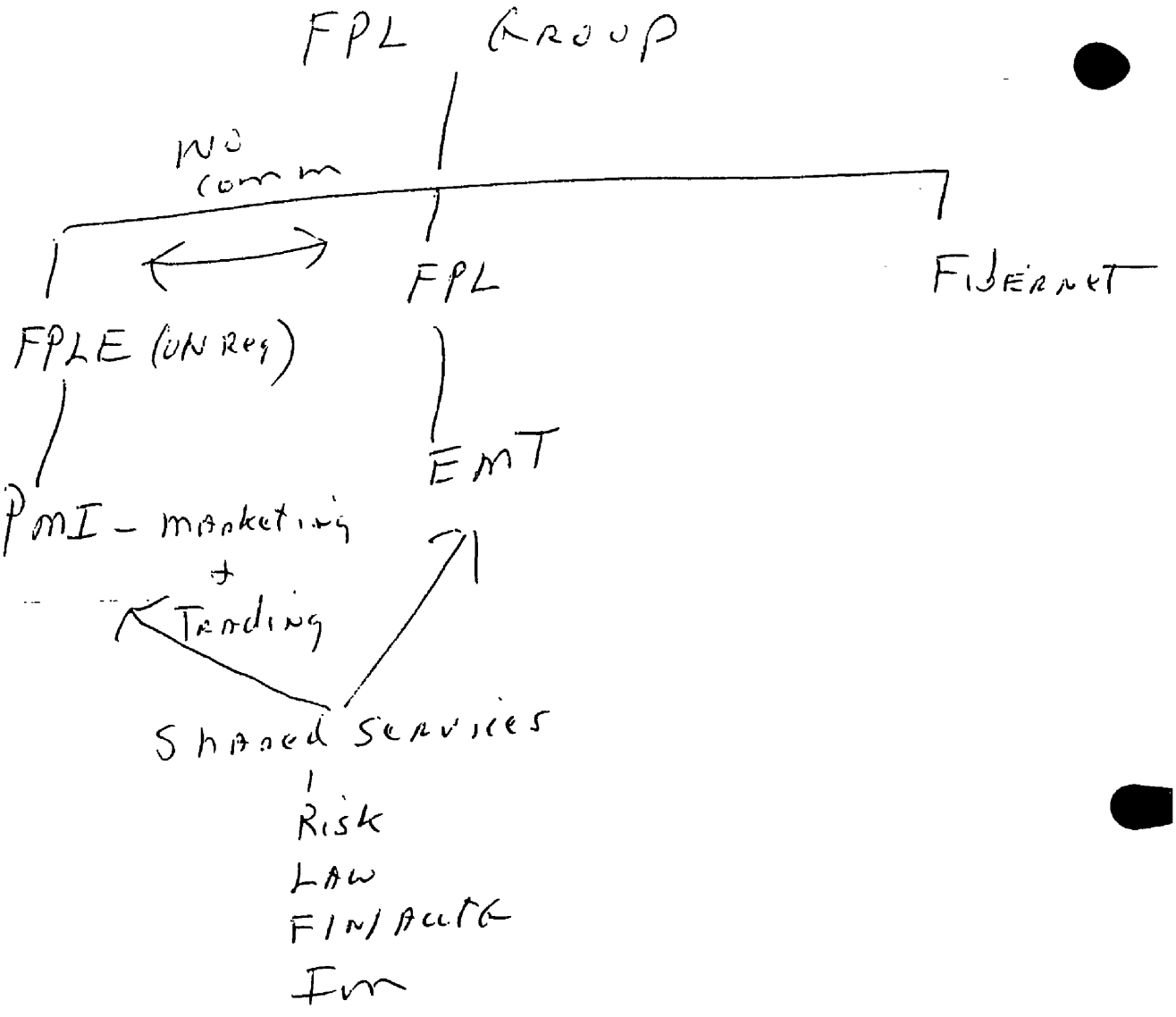
By end of November

5. FPL's hedging strategy effectiveness is assessed by using correlation of rolling quarter price changes. Can you explain this and present the documents that support overall assessment?

Will

(See Back)

(15)


FPL GROUP
NO comm
FPL
FIBERNET
FPLE (UN Reg)
EMT
PMI - marketing
+
Trading
Shared Services
Risk
LAW
FIN/Acctg
Im

(3)

[redacted]

7. In DR 1-5, FPL states there were no policy changes that affect fuel purchasing. Please refer to Interrogatory response 23, page 5-17. It appears procurement strategy was changed in 2001. Please explain.

No change - as of Dec 2000

8. Referring to the same interrogatory response, page 3 future issues, the memo has asked for the EMC to clarify accepted practices for hedging. Has the EMC done that? Please explain what was recommended?

Not sure, if we asked for approval

Much discussion

Cost stability - Hedging (FPL)'s opinion

9. Referring to the #33 and #34, reflecting natural gas spot market, why is the acquired percentage going from 35% in 2000 to 0% expected in 2001.

#33 is Actual -

#34 is Projection - spot will be up in 2001

10. Referring to the #33 and #34, why is all distillate oil purchased at spot market?

[redacted]

11. In general it appears natural gas is being hedged and traded but in oil, it is not. Is this a fair statement?

yes

[redacted]

Speculating - short the market - going down

(17)

Put it's
Renewal

Give us an overall strategic plan for Future fossil fuel purchases.

— We learned about hedging (operational) is not Enough.
— what is the right amount – [redacted]
— Use + capitalize on down price markets.
— Fuel Switching by spot market advantage.
— more sophistication
2 — Protect Customer
[redacted]
3 —
4 —
5
6

Pipeline across Gulf will Lower NG price

FPL ~~costs~~ deals with counter parties Directly on wholesale energy.

(18)

(5)

Trading

1. Please specified the aggregate amounts of gas, oil, coal and energy purchased at spot market price for 1998, 1999 and 2000. Please specify the amounts purchased by hedging, trading, or other means of purchase.

OK - will provide

2. It appears that FPL risk management endorses swaps and options. Please explain how they are used and applied to FPL's fuel purchases. If there is a large loss, wouldn't FPL rate-base payers share in it?

Volume is low on this Time - we use our opinion - we don't consider swaps as Losses since we don't buy more than we need

A. Specifically regarding FPL provided documentation of an 8/8/01 trade date natural gas commodity swap transaction entered into with Enron for October did (or, if not effected as yet, will) fixed price payor (FPL) or floating price payor (Enron) pay the difference to the other party? Does FPL pass the disbursement or receipt of that difference payment through the Fuel Recovery Clause (FRC)? YES Does this type of trading constitute speculation? —

USE ASSET OPTIMIZATION

3. In options there is a large risk exposure due to oil price volatility. Please explain why the EMC has decided to authorize this risk? — Emt Johnson OIC - Audited the process. Using RFP - 29 Different Suppliers - made an offer - mostly Physical

4. What is FPL's definition of hedging? How do bilateral contracts fit the definition as stated in DR 1-9? Answered

Wholesale energy - Certain Amount goes out at Lower price (Flat Tariff)

We use PPS to go day today & use Term effort to make procurement Purchase

(19)

5. In the Planned Position Strategy (PPS) of 5/10/01, for effective period June through September 2001, your EMT suggests that hedges be placed with multiple counter parties and not with Enron alone. How effectively has that trading partner diversity been achieved? Serves the purpose. Need to compare to prior years.

6. How does FPL's price paid, in general, compare to the spot market exchange close of day price? How does it compare, in general, to that obtained by other IOU's?
Better job than Co. We are Large purchasers & therefore have price power.

7. Does FPL take delivery of all bilateral fuel contracts? Can it sell them to another party?
[redacted]

8. If a bilateral contract is considered a hedge, what if the price drops during the contract maturity? What offsets it?
Embedded option - selling put - get premium

Gas Storage - None in Florida -

General

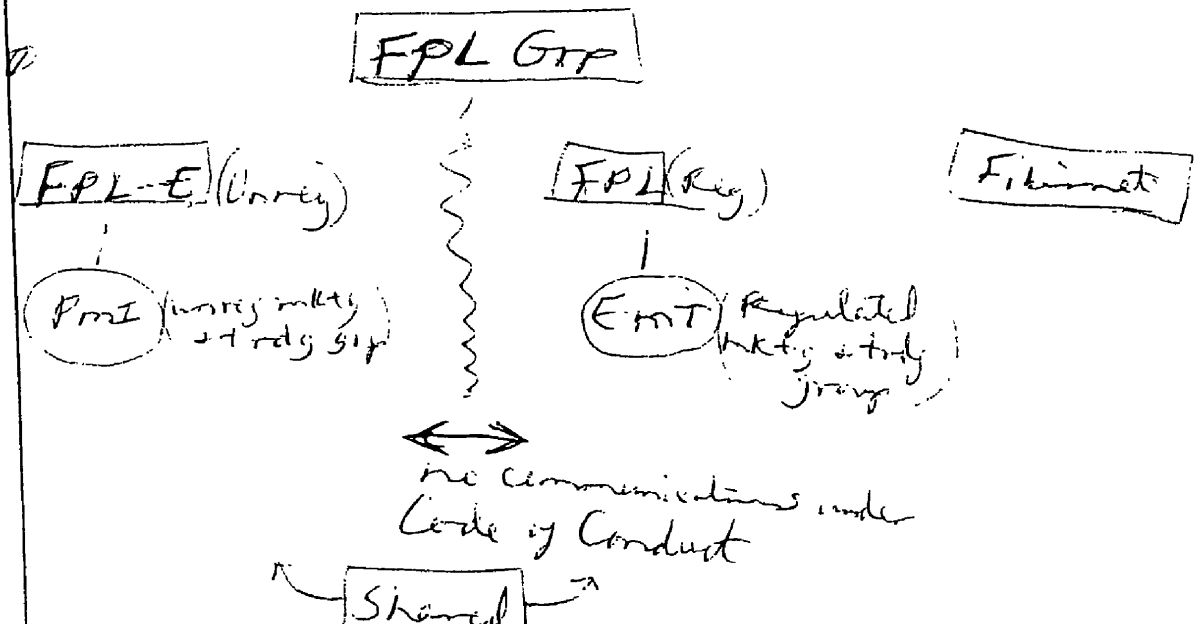
1. If FPL is primarily successful at option trading, why the large FRC in the past and anticipated in the future? No coal plants / 3.1 Mon Line Customers paying less. We do have a structural disadvantage.

2. Would FPL object if staff recommended that all fossil fuel prices be fixed for up to a three year period?
[redacted]

Fuel Hedging Trip

Tom Sykes – works for Kerry
Kerry Dubin
Gene Unger Mgr
Jerry Kopf Mgr
Michelle ~~Karina~~ Dir

Joe Step. – Dir VP Trading + Ops
– EMT '94 start
Michelle – Risk mgt Dir 4½ mos
Kerry Dubin – risk assessment discussion



Time Allocated by these employees

(2) Objective/goal = cost min.

diversification - by fuel type

- by agreement/purch arrangement

eg. long term % of Gas

mid term

spot mkt

History of

Hedging - volatility is new + / deny of gas

- fuel plan monthly - forecast as input

run program to detm optim. mix of gas

project spot mkt - [redacted]

daily practices

- Fuel Switching in resp to gas/oil price fluctuations

transportation, storage arrangements

[redacted]

to avoid top + bottom of mkt

give flexibility both ways

matter Q: Do you study effects of more aggressive hedging? Yes we are working w/a consultant but last yr is an anomaly

Hedging [redacted] has long range benefits

Operational hedging - ~~fuel mkt~~

for ~~i~~ locked in on gas + oil both

w/ fuel switching as option, you can take more advantage of hedging

Most of our hedging is ~~phys~~ financial

Joe: Study on Benefits of Hedging - last 4 yrs of data. Would have been better to have hedged more than we did

[redacted]

Lou's EIA Database projecting out 20 yrs

$4.00

(Gene reconciled Him

(3) Savings realized monthly ~~realized~~ # of molecules (compared) vs Inside-FERC index

$18.2 mill yrs savings (2006)

oil

off system sales also affect fuel costs

[redacted]

Would you consider this derivatives as part of future strategy? (11) Yes will have to look in finance. Gas/Physical

(5) Rolling Qtr price changes - what he already told us in 3 response (how to locate returns) — is what they do.

Matt's Q on Fuel Clause

Kory around about shift from 6 mos FAC to 12 mos + bill levelling

Gene - w/the consultant were looking at proposing larger band. —

[Trying to give customers price signals]

(8) Reg + Non-reg. Pol + Pipe are the same?
Yes, but we're separating - draft in Progress
Due date = Nov, then draft examined by Mgt

(6) [redacted]

(2)

[redacted]

michelle

In process of reviewing all procedures now
To be segregated
Trading floor - started to swap F&L
- used more on non-reg side
Now need to separate.

(7) "No changes" ~~Est~~ Need new copy

(8) making them aware - documented in minutes of EOC
Kory - at the Fuel hrg, (see Xscripts)
Also Commissioners sounded like they would encourage more use of hedging

Matt Q: General benefits of hedging (even in other industries)
Jerry: Its same in any industry to remove cost volatility, certainty in budgeting costs

Matt Q: Calls - puts
Jerry - may be some periods of yr it will be a good strategy
- portion of yr unknown

~~Lee~~ -

Joe - we don't buy more than we need or sell more than we have
- we do "exact optimization" not "speculation"

(9) Gov Wise not pro, in 2001, to ever be elon choice

(12) [redacted]

(11) ~~Lee~~ Q: What about a parallel strategy on the oil side?

Joe. We are working on it, don't know % yet

36 mill barrels

(G-2) would FPL object if staff rec. . . 3 yr period?

[redacted]

[redacted]

Joe. Proposal that if we could pass this ... what will comm. think?

Day 2 10/18/01 Jupiter FPL Offices

Jerry [redacted]

[redacted]

Matt Q: Commie think of deriv.s as magic bullet —.

what would you have pd. - do you know?

Jerry - have to be realistic - no one did have known to lock in 100%

Matt - I think only a few % (FPL cost) [redacted]

Lou: Who would do cost + call?

Joe: We have procedures for long + short term strategies

If out outs the ordinary

Proposal Done by trader, goes thru several layers of mgt

Michelle: Reporting on Daily Exposure Reports

Gene: It's a team atmosphere

Jerry - get all 'asset optim' people, disgruntled control people, environmental people, plant operational people

recap last month + plans for next

Lou: Physical + financial? All: Yes

Matt: Ever had something dissallowed? Kory: Turkey Pt $40 requal exam cos about '88-'89

What's your incentive

(8)

Matts Q: Possibility of check box to participate optionally - customer by customer

Michelle - hard to educate customers + this wld be tough project

Zoli (3) oil volatility - price up in long run audit Joe mentioned

- sending RFP to multiple suppliers they can propose several diff options

Deal w/ Cape Cod

(See RFP given out tomorrow

Joe - we're trying to encourage liquidity, fwd mkt to develop, more people to be trading. ∴ will be more proactive, hedging more

What's the timeframe on this RFP

H.H.

(5) Jerry: We try to do that in all areas even power purch. It serves the purpose

(6) Jerry: Very comfortable on hrly, day ahead + longer term We are major enough to bring/push mkt to where we want it to be.

Matt Q. Embedded option - option w/in phys deal

Gene -

many types of hedging under a broader definition of hedging (operational / contract hedging)

Gulf Stream pipeline 1st phase avail 6/02

Option of Storage in Everglades - may be worth considering / may become economical if gas volatility continues
- old oil & gas mining / drilling operations not connected to pipeline now

G-1

Lou Q: FPL w/ lighter fuel cost adjustment
Why?
Tony: Our fuel mix is low coal ∴ higher cost
Gene - still bottom line customers pays less

Matt Q: By type plant, pros & cons of cost
Combined cycle vs coal
look at total costs over life cycle (unit can be added incrementally)
CC - efficient, lower cap costs, modular
Coal - environmental, permitting, lead time longer
but fuel is cheaper

Low Summation: (1-5 yrs) Gerry: What will Δ operational + (K) hedging are not enough in a volatile ~~market~~, will seek to deter right and buy hedging in future.

[redacted]

Operational, fuel hedging still.
Getting more sophisticated to prevent Jan 01 volatility.

Michelle - we will use financ. instruments as appropriate. Do not finalized, will vary time to time

EXHIBIT C

COMPANY: Florida Power & Light Company
TITLE: List of Confidential Workpapers
AUDIT: Review of Internal Controls of Florida's Investor-Owned Utilities for Fuel and Wholesale Energy Transactions
AUDIT CONTROL NO. RR-01-08-004

Page No.	Description	Confidential Yes/No	Line No.	Justification	Affiant
1A		N			
1B		N			
1C		N			
1D		N			
1E	Excepts from Policy and Procedures Manuals	Y	7, 8	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
1F		N			
1G		N			
3		N			
4		N			
5		N			
6		N			
6A		N			
9		N			
10		N			
11		N			
12		N			
13		N			
14		N			
15		N			
16A		N			
16B		N			
19		N			
20		N			
21		N			
22		N			
23		N			
24		N			
25	Excepts from Policy and Procedures Manuals	Y	34, 35, 36, 37	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
26	Excepts from Policy and Procedures Manuals, Board Meeting Minutes	Y	1-11, 25, 26, 31, 32	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
27	Excepts from Policy and Procedures Manuals	Y	17-32	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
28	Excepts from Policy and Procedures Manuals	Y	1-34	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
29	Excepts from Policy and Procedures	Y	1-21	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch

Page No.	Description	Confidential Yes/No	Line No.	Justification	Affiant
	Manuals, Board Meeting Minutes				
30		N			
31		N			
32		N			
33		N			
34	Excerpts from Dean Study	Y	18-31	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
35		N			
36		N			
37	Fuel Procurement Strategy	Y	3-14	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
38	Fuel Procurement Strategy	Y	23, 24, 25, 30, 31, 32, 33	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
39	Fuel Procurement Strategy	Y	11	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
1	Staff Audit Notes	N			
2	Staff Audit Notes	Y	22, 30, 31, 32	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
3	Staff Audit Notes	Y	3-9, 16, 17, 18	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
4	Staff Audit Notes	Y	1-9	Order No. PSC-01-2530-CFO-EI	Joe Stepenovitch
5	Staff Audit Notes	Y	3, 4, 7, 8	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
6	Staff Audit Notes	N			
7	Staff Audit Notes	Y	5-8, 13, 16	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
8	Staff Audit Notes	Y	3-8, 12, 13, 14, 17-24, 26, 27, 29, 30	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
9	Staff Audit Notes	N			
10	Staff Audit Notes	Y	18-21, 29, 30, 31	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
11	Staff Audit Notes	Y	6-10, 14, 15, 16, 27-31	Order No. PSC-01-2530-CFO-EI, Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
12	Staff Audit Notes	Y	17, 18, 19, 21	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
13	Staff Audit Notes	Y	33-37	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
14	Staff Audit Notes	Y	5, 7, 24-27, 31	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch

Page No.	Description	Confidential Yes/No	Line No.	Justification	Affiant
15	Staff Audit Notes	Y	15, 16, 17	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
16	Staff Audit Notes	N			
17	Staff Audit Notes	Y	1-5, 21, 25,-27	Order No. PSC-01-2530-CFO-EI, Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
18	Staff Audit Notes	Y	7, 8, 13-16	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
19	Staff Audit Notes	N			
20	Staff Audit Notes	Y	12-14, 26-30	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
21	Staff Audit Notes	N			
22	Staff Audit Notes	Y	13-15, 18	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
23	Staff Audit Notes	Y	10, 11	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
24	Staff Audit Notes	Y	1-3, 18-21	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
25	Staff Audit Notes	Y	1	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
26	Staff Audit Notes	Y	5-7, 14-19	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
27	Staff Audit Notes	Y	3, 4, 11, 12	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch
28	Staff Audit Notes	N			
29	Staff Audit Notes	N			
30	Staff Audit Notes	Y	4-8	Florida Statute 366.093(3) Subsection (a)	Joe Stepenovitch

EXHIBIT D

BEFORE THE FLORIDA
PUBLIC SERVICE COMMISSION

In re: Florida Power & Light Company's)
Request for Confidential Classification)
Of Material Provided pursuant to)
Audit Control No. RR-01-08-004)

STATE OF FLORIDA)
)
PALM BEACH COUNTY)

AFFIDAVIT OF JOSEPH P. STEPENOVITCH

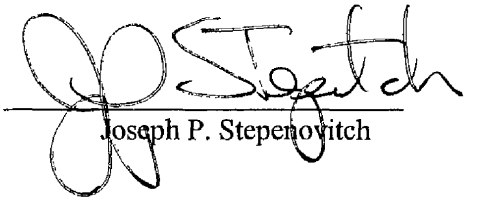
BEFORE ME, the undersigned authority, personally appeared Joseph P. Stepenovitch, who, being first duly sworn, deposes and says:

1. My name is Joseph P. Stepenovitch. I am currently employed by Florida Power & Light Company (FPL) as Director of the Energy Marketing and Trading Division. I have personal knowledge of the matters stated in this affidavit.

2. With respect to Exhibit C, I have reviewed the documents and information for which I am listed as Affiant and which are included in Exhibit A to FPL's Request for Confidential Classification. Documents or materials that I have reviewed and which are asserted by FPL to be proprietary confidential business information contain or constitute excerpts from documents that the Commission has already classified as confidential, in Order No. PSC-01-2530-CFO-EI. The excerpted information must be likewise classified as confidential in order to continue protecting that information in the manner that the Commission has previously approved. The remainder of the information is confidential because it comprises trade secrets of FPL, which allow FPL to conduct its fuel procurement on favorable terms for FPL and its customers. Disclosure of that trade-secret information would provide other participants in the fuel markets insight into FPL's fuel-procurement practices that would allow them to anticipate FPL's procurement decisions and/or impair FPL's ability to negotiate, to the detriment of FPL and its customers.

3. Consistent with the provisions of the Florida Administrative Code, such materials should remain confidential for a period of not less than 18 months. In addition, they should be returned to FPL as soon as the information is no longer necessary for the Commission to conduct its business so that FPL can maintain the confidentiality of these documents.

4. Affiant says nothing further.



Joseph P. Stepenovitch

SWORN TO AND SUBSCRIBED before me this 21st day of June, 2002, by Joseph P. Stepenovitch, who is personally known to me or who has produced _____ (type of identification) as identification and who did take an oath.

Judith N. Steffen
Notary Public, State of Florida

My Commission Expires: 2/21/04

JUDITH N. STEFFEN
Notary Public - State of Florida
My Commission Expires Feb 21, 2004
Commission # CC912663