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Public Service Commission

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

DATE: June 13, 2002
TO: Division of the Commission Clerk and Administrative Services
FROM: Cochran Keating, Economic Regulation Section-Office of the General Counsel WCK
RE: Docket No. 011605-EI - Review of Investor-Owned Electric Utilities' Risk Management Policies and Procedures

Please file the attached letter dated June 4, 2002, from Susan D. Ritenour, Gulf Power Company and the attachments in the docket file for the above-referenced docket.

Thank you.

WCK/jb

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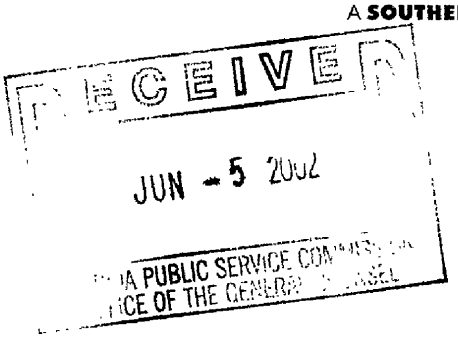
GULF POWER
A SOUTHERN COMPANY

June 4, 2002



Mr. Wm. Cochran Keating
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee FL 32399-0850

Dear Mr. Keating:

RE: Docket No. 011605-EI

Gulf has appreciated the opportunity to participate in the informal meetings with staff and the other parties to discuss the characteristics, advantages, and disadvantages of fuel hedging programs. The discussions have been informative and the catalyst for a healthy exchange of concepts concerning risk management, and we look forward to participating in future discussions.

Enclosed are two documents. The first includes Gulf's comments that have been requested in anticipation of the Commission Workshop scheduled for June 17, 2002. This document includes general principles that Gulf believes should be included in an effective fuel hedging plan. It also includes some specific comments on Staff's Strawman Proposal that was dated May 7, 2002. The second document is a proposal for ongoing filing requirements that would be used to monitor an approved hedging program. This document was crafted from a proposal submitted by staff in December 2001.

Please contact me if you have any questions or need additional information.

Sincerely,

Susan D. Ritenour (lw)

Susan D. Ritenour
Assistant Secretary and Assistant Treasurer

lw

Enclosures

cc: Beggs and Lane
Jeffrey A. Stone, Esquire

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DOCKET 011605-EI

Principles of an Effective Hedging Plan:

- Any hedging program will put the Customer at risk of paying above market prices for fuel; therefore a hedging program must have prescribed *parameters* pre-approved by the Commission to ensure adequate protection for the Customer and to ensure against inappropriate risk to the Company.
- Potential to protect the Customer from adverse price trends, i.e. price spikes.
- Potential to limit the Customers' risk of paying above market.
- Establishes limits (volume and time constraints) to protect against over-hedging and long term, above market exposure.
- Does not create competing interests:
  - Aligns the customers' and the utility's interests by incenting the utility to attempt to save more money for the customer.
  - Maintains the integrity of the principles of economic dispatch by not inserting volume risk into the mix.
  - Does not put the Company at undue risk for hedging on behalf of the Customer. Such risk would encourage the Company to be inactive to avoid risk and would thereby deem the hedging program ineffective.
- Enhances fuel supply reliability by utilizing financial derivatives to manage price risk. Keeping all physical deliveries "at market" mitigates non-performance of suppliers that are committed to a price that has resulted in a below market priced sale.
- Provides for adequate reporting to the Commission to ensure that the Company is hedging within the guidelines approved by the Commission and to monitor the effectiveness of the Company's hedging activities.

Comments on FPSC Staff Strawman Proposal dated 05/07/02:

- A hedging plan, such as the one suggested in the Staff's Strawman Proposal, cannot be tailored to particular hedging needs or address the unique operating environment of each investor owned electric utility (IOU). Gulf is very concerned that a "one size fits all" approach could result in some unintended negative consequences for the IOUs and their customers. Each utility should be allowed to propose a hedging plan tailored to the specific requirements of its operating environment.
- The price risk difference between actual fixed costs and the method for calculating recoverable dollars for (F%) fixed natural gas is borne by the company/stockholder for a small premium that is not commensurate with the risk involved (example: if the fixed price index value for the year ends up being $4.00/MMBtu, then the cap that a utility could break even on would be $4.04/MMBtu
- The (1-F%) does not achieve much for the customer except payment of market price for whatever portion of the utility's actual use is not fixed.
- The (F%) fixed recovery method only hedges two months out for the customer. This short term, mechanical cost averaging hedging plan would not protect the customer from price spikes and would inherently put the customer at risk of paying above market in a declining price trend, thereby not providing two fundamental protections desired of an effective hedging program. Such a program would be no different than buying all purchases at the spot market and paying a two-month lagging price for F%.

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- It is unclear from Staff's Strawman whether or not the utility assumes volume risk. From Gulf's perspective, assumption of the volume risk associated with fuel is unacceptable because the Company incurs/creates significant fuel volume risk as a result of the economic dispatch of its generating units for the customers' benefit.
- The proposal locks the utility in to the Henry Hub spot market for all the remainder (1-F%) of its needs even if there is a market dip that could be taken advantage of for more than a daily volume.
- There is a price (basis) differential between Henry Hub and each utility's respective delivery point into the pipeline which is an additional price risk to the company/stockholder with no provision for recovery of this basis differential for its spot purchases (1-F%).
- Gulf questions the value of establishing a fixed percentage or volume of fuel commodity and the cost recovery associated with that volume at a given point in time. Even if 100% of a projected annual volume is fixed, unless a utility strictly controls the actual burn volume, it is impossible to avoid price risk. Strict control of the burn volume implies an operation that is not dispatched in the most economical manner possible for the customer. Gulf does not operate in such an environment. As part of the Southern electric system, Gulf's generating units are dispatched to run for the customer's greatest economic benefit; thus the volume risk to Gulf in a fixed price scenario is great. In fact, although the coal market is not nearly as dynamic as natural gas or purchased power, because of volume risk, Gulf does not buy all of its coal under fixed price long-term contracts. Gulf has always endeavored to manage the fuel program to achieve the lowest practical cost for its customers. Fixing all or a part of recovered costs in advance may help levelize the customers' costs, but would not necessarily lower them, since they could be fixed at a price above market.

Gulf Power's Proposed Filing Requirements for Approved Risk Management Plans Concerning Fuel Procurement and Wholesale Power Purchases

I. Risk Management Responsibilities

A. Indicate which committees, if any, provide oversight to the utility's risk management of its fuel procurement and purchased power transactions.

B. Indicate what company or division will procure fuel and purchase wholesale power for the utility and what individual should be contacted regarding the risk management plan.

II. Fuel Procurement and purchased power – historical information

A. Coal

1. Procurement Requirements
   a. How much coal did the utility or utility affiliate, on the utility's behalf, procure in total during the previous years? Please provide response in tons and million British thermal units (BTUs).
   b. How much coal did the utility or utility affiliate, on the utility's behalf, procure during the previous year on the spot market? Please provide response in tons and million BTUs.
2. Inventory
   How much coal did the utility have in inventory at year-end? Please provide response in tons, million BTUs, and days supply.

B. Residual Oil

1. Procurement Requirements
   a. How much residual oil did the utility or utility affiliate, on the utility's behalf, procure during the previous year? Please provide response in barrels and million BTUs.
   b. How much residual oil did the utility or utility affiliate, on the utility's behalf, procure during the previous year on the spot market? Please provide response in barrels and million BTUs.
2. Inventory
   How much residual oil did the utility have in inventory at year-end? Please provide response in barrels (or million BTUs) and days supply.

C. Distillate Oil

1. Procurement Requirements
   a. How much distillate oil did the utility or utility affiliate, on the utility's behalf, procure during the previous year? Please provide response in barrels and million BTUs.
   b. How much distillate oil did the utility or utility affiliate, on the utility's behalf, procure during the previous year on the spot market? Please provide response in barrels and million BTUs.

2. Inventory
   a. How much distillate oil did the utility have in inventory at year-end? Please provide response in barrels (or million BTUs) and days supply.
   b. What was the minimum amount of the utility's distillate oil inventory during the previous year? Please provide response in barrels (or million BTUs) and days supply.

D. Natural Gas

1. Procurement Requirements
   a. How much natural gas did the utility or utility affiliate, on the utility's behalf, procure during the previous year? Please provide response in million BTUs.
   b. How much natural gas did the utility or utility affiliate, on the utility's behalf, procure during the previous year on the spot market? Please provide response in million BTUs.
2. Inventory
   a. How much natural gas did the utility have in inventory at year-end? Please provide response in million BTUs and days supply.
   b. What was the minimum amount of the utility's natural gas inventory during the previous year? Please provide response in million BTUs and days supply.

E. Purchased Power

How much wholesale power did the utility or utility affiliate, on the utilities behalf, purchase during the previous year? Please provide the response in MWH.

III. Fossil and purchased power future needs (this information would be confidential beyond the first year already included in the fuel projection)

A. Coal

How much coal does the utility plan to purchase for the current year and the following two years? List by units and MMBTU for each year.

B. Residual Oil

How much residual oil does the utility plan to purchase for the current year and the following two years? List by units and MMBTU for each year.

C. Distillate Oil

How much distillate oil does the utility plan to purchase for the current year and the following two years? List by units and MMBTU for each year.

D. Natural Gas

How much natural gas does the utility plan to purchase for the current year and the following two years? List by units and MMBTU for each year.

E. Purchased Power

How much wholesale power does the utility plan to purchase for the current year and the following two years? List by MWH for each year.

IV. Risk Management Strategy

A. Risk Identification

1. Identify each substantive change in risk that the utility may encounter other than those previously identified when procuring:
   a. Coal
   b. Residual Oil
   c. Distillate Oil
   d. Natural Gas
   e. Purchased Power
2. Separately identify the utility's goal(s) in managing the recognized risks associated with each fuel or power purchases.
3. Describe how the utility decides what an acceptable level of risk is when associated with fuel procurement and purchased power transactions.

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

<u>General</u>

1. Types of fuel used and power purchased
2. Quantities and mix and by percent
3. How purchased (contract vs. spot) and by percent
4. Describe all purchasing strategies in items 1-3.

<u>Specific</u>

1. What financial instruments will be used and how?
2. What will be hedged and how?

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.
2. Outside Auditors
   a. Indicate which outside auditors, if any, provide oversight to 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.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Review of investor-owned electric utilities' risk management policies and procedures	))))	Docket No. 011605-EI

Certificate of Service

I HEREBY CERTIFY that a true copy of the foregoing was furnished by hand delivery or the U. S. Mail this 4th day of June 2002 on the following:

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