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Florida Power
A Progress Energy Company

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July 26, 2002

Ms. Blanca S. Bayó, Director
Division of the Commission Clerk
and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

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COMMISSION CLERK

Re: Docket No. 011605-EI

Dear Ms. Bayó:

Enclosed for filing in the subject docket are an original and fifteen copies of the rebuttal testimony of Javier Portuando and Pamela R. Murphy on behalf of Florida Power Corporation.

Please acknowledge your receipt of the above filing on the enclosed copy of this letter and return to the undersigned. Also enclosed is a 3.5 inch diskette containing the above-referenced documents in WordPerfect format. Thank you for your assistance in this matter.

Very truly yours,

James A. McGee

JAM/scc
Enclosure

cc: Parties of record

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FLORIDA POWER CORPORATION

DOCKET NO. 011605-EI

Review of Investor-Owned Electric Utilities' Risk Management Policies and Procedures

REBUTTAL TESTIMONY OF JAVIER PORTUONDO

Q. Please state your name and business address.

A. My name is Javier Portuondo. My business address is Post Office Box 14042, St. Petersburg, Florida 33733.

Q. Did you submit direct testimony in this case on June 24, 2002?

A. Yes, I did.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the testimony of Staff witness Todd F. Bohrmann regarding his position that the Commission should reject the Hedging Program proposed by Florida Power, and instead, require the Company and the other investor-owned electric utilities to adopt a mandated hedging program that (a) provides no affirmative incentive to engage in complex, high risk financial hedging transactions, and (b) fails to address the serious disincentive associated with the substantial incremental capital and O&M costs that a utility such as Florida Power must incur to establish the infrastructure necessary to properly and successfully engage in these transactions.

As was the case with my direct testimony, this rebuttal testimony will be jointly sponsored by Pamela Murphy, who is responsible for the procurement of Florida Power's oil and natural gas requirements. She will address the technical and operational aspects of the hedging issues covered by this testimony, while I will address the regulatory aspects of these issues.

Q. Would the utility hedging proposal described in Mr. Bohrmann's testimony be in the best interest of Florida Power's customers?

A. No. Florida Power believes its customers' interests would be better served by providing utilities an incentive to engage in fuel hedging activities that encompasses the prospect of risk and reward for shareholders rather than mandating a program that provides less risk coverage to customers and no prospect of a reward to shareholders. There are many internal and external factors affecting fuel procurement that need to be taken into consideration when implementing a hedging strategy for utility fuel procurement. These factors, which include such variables as weather, generating unit outages, market prices of generation fuels and their interrelationship, load swings, creditworthiness of hedging counterparties, delivery risks associated with force majeure conditions, etc., require a high degree of flexibility on a utility's part to manage effectively. Moreover, these factor not only vary from time to time, but from utility to utility, since each utility has a different generation portfolio and resultant fuel mix, a different risk tolerance, a different experience level with hedging transactions, and a variety of other significant differences that render a "one size fits all" approach to utility hedging programs contrary to the best interest of ratepayers.

For these reasons, Florida Power believes a far better approach is the one initiated by the Prehearing Officer in Order No. PSC-02-0428-PCO-EI, where each utility was directed to develop and submit a hedging program tailored to its own unique circumstances that included an incentive provision to encourage the utility to devote the resources needed to effectively implement and administer the program. Florida Power's proposed Hedging Program is a result of this directive. While the Company obviously does not suggest that its proposal can only be effective if approved "as is" by the Commission, it strongly suggests that the approach described in the Prehearing Officer's order and that Florida Power has attempted to embody in its Hedging Program, at the very least, points in the proper direction. Florida Power's concern with Mr. Bohrmann's testimony is that his proposed hedging program is not an attempt to refine or enhance this approach, but is instead an entirely different approach that leads in the opposite direction.

Q. What do you mean by your statement that Mr. Bohrmann's hedging proposal "leads in the opposite direction" from the Hedging Program proposal Florida Power filed in response to the Prehearing Officer's order?

A. The objective of Florida Power's proposal and Mr. Bohrmann's proposal is essentially the same; namely, to enhance the utilities' ability to manage the risks to ratepayers associated with fuel price volatility through the use of effective hedging practices. At this point, the similarity between the two proposals ends. Florida Power's proposal is based on the additional issue established in the Prehearing Officer's supplemental order (currently identified as Issue 7A) regarding the use of incentives to encourage utilities to manage the risk to ratepayers of fuel price volatility. Mr. Bohrmann's proposal, on the other hand, would mandate that utilities engage in hedging practices pursuant to a risk management plan with Commission-prescribed contents.

However, the main point of departure between the two proposals centers on who, customers or shareholders, is responsible for the consequences of the utility's hedging activities. Under Florida Power's Hedging Program, the Company first calculates a fixed price for a predetermined portion of its natural gas and residual oil requirements for the upcoming year based on a mechanistic formula that can be easily verified. With this price guarantee, the customers' price volatility risk is completely eliminated for the fixed price quantity of these two fuels. At this point it becomes the responsibility of Florida Power to manage the price volatility risk previously borne by its customers through the use of effective hedging practices. This includes shareholder cost responsibility for the consequences of the Company's hedging practices, which gives rise to the Hedging Program's two-way, reward/penalty incentive. This shareholder responsibility also eliminates the need for Commission oversight and review of Florida Power's hedging activities, since any adverse cost consequences that may result from these activities will be borne solely by the Company's shareholders.

Under Mr. Bohrmann's proposal, a utility's customers, not the utility itself, would be responsible for the consequences of its hedging activities. Compared to Florida Power's Hedging Program proposal, this fundamentally different approach to the assignment of responsibility for a utility's actions is the source of two significant problems or shortcomings inherent in his proposal.

The first stems directly from assigning to customers the cost responsibility for the consequences of a utility's hedging activities, which in turn necessitates the establishment of additional regulatory oversight and review procedures and requirements of the kind proposed in Mr. Bohrmann's testimony. These additional procedures and requirements are burdensome at best, and more likely, counterproductive, which is all the more disturbing when one considers that they could be avoided all together by simply assigning cost responsibility for a utility's hedging activities to the utility itself.

The second problem concerns the general subject of incentives, including the absence of an affirmative incentive in Mr. Bohrmann's proposal, which I will address later in my testimony, as well as the failure of his proposal to eliminate or at least mitigate a significant and inherently unfair disincentive.

Q. What is this disincentive that Mr. Bohrmann's proposal fails to eliminate?

A. Mr. Bohrmann's proposal expressly provides that recovery of a utility's incremental capital and O&M costs required to implement an effective hedging capability should not be allowed through the fuel clause. Since his proposal would require utilities to engage in hedging activities for at least some specified minimum quantities of fuel, the failure to provide a means to recover the incremental costs that must be incurred to carry out this requirement is unfair to say the least. Moreover, it leaves unremedied a significant disincentive for a utility such as Florida Power to develop the enhanced infrastructure needed to fully and effectively engage in the sophisticated, high risk financial hedging market.

The failure of Mr. Bohrmann's proposal to remedy this disincentive is particularly surprising, since he has constructively addressed the other major disincentive identified by the utilities. While he does not believe that an affirmative incentive should be provided to utilities, to his credit, he has taken an important step to minimize the disincentive regarding regulatory uncertainty over the absence of a clearly articulated Commission policy on the recoverability of hedging related costs. If his objective is to provide a balanced, neutral regulatory environment for utility hedging activities -- no regulatory incentives, no regulatory disincentives -- then he has stopped one significant step short of completing his task. The failure to constructively address this counterproductive and unfair disincentive should be corrected by the Commission.

Q. Why do you say that Mr. Bohrmann's proposal only minimizes, instead of eliminates, the disincentive regarding regulatory uncertainty?

A. Because the regulatory policy Mr. Bohrmann proposes, while better than no policy, creates a specific regulatory uncertainty regarding the standard to be applied in reviewing a utility's hedging activities for prudence. Since customers would directly experience the results, positive or negative, of each utility's hedging transactions under Mr. Bohrmann's proposal, the utility will be faced with the risk of disallowance in an after-the-fact review to determine whether any of these transactions were imprudent. While some may view the risk of disallowance following a prudence review to be simply "business as usual" in fuel clause proceedings, the standard proposed by Mr. Bohrmann for reviewing the prudence of utility hedging transactions is both new and, from Florida Power's perspective, disturbingly uncertain. According to Mr. Bohrmann, the Commission would compare a utility's hedging activities with the utility's risk management plan. He then states:

> "If an activity is reasonably consistent with the utility's plan, the utility would recover this cost through the fuel clause. Conversely, if an activity is not reasonably consistent with the utility's plan, the utility would not recover this cost through the fuel clause." (Testimony, pp. 10 and 11.)

To begin with, the "utility's plan" referred to by Mr. Bohrmann is not really the utility's plan. It is a plan *for* the utility approved by the Commission based on the plan's compliance with the detailed 15-point list of specifications contained in Mr. Bohrmann's Exhibit TFB-4. Of concern to Florida Power is whether a plan that meets this level of detail and specificity can also provide the flexibility needed to effectively address the many variables a hedging decision must take into account, as I discussed earlier. If not, a hedging decision that was an appropriate response to emerging conditions when made could later be found imprudent because of a perceived inconsistency with some plan detail, or because the plan simply did not address the specific circumstances that lead to the hedging decision.

Hedges are by design a form of insurance against price volatility. We do not think it would be wise to adopt a policy that puts a utility at risk of disallowance for hedges, or insurance, that turn out after the fact not to have been necessary, particularly when these hedges are judged against a plan that the utility had only a limited role in developing. Under Florida Power's proposal customers would be certain of greater price stability, while the Company would face the prospect of losses or gains as a result of its hedging activities. If the Commission does, in fact, decide that utilities should utilize hedging practices for a portion of their fuel supply, Florida Power believes this provides a more fair alignment of risk and reward to its customers.

Q. Earlier you stated that one of two significant shortcomings in Mr. Bohrmann's hedging proposal is the absence of an affirmative incentive for utilities to engage in effective hedging practices. Why is the absence of an incentive a shortcoming?

A. An affirmative incentive to encourage utilities to manage the risks to customers associated with fuel price volatility as effectively as possible would benefit customers. In the case of Florida Power's proposed Hedging Program, the incentive is implicit, as opposed to an explicit incentive mechanism. By this, I mean that It simply provides Florida Power the opportunity to rise or fall based on its ability to effectively engage in sophisticated, high risk hedging transactions. This opportunity to succeed of fail is the *quid pro quo* provided to Florida Power for its assumption of the customers' price volatility risk on the portion of natural gas and residual oil requirements subject to the Company's fixed price guarantee. Since the underlying premise of this entire proceeding is that minimizing the customers' exposure to the risk of fuel price volatility serves their best interests, Florida Power's proposal to completely eliminate the customers' risk of price volatility on this portion of the two fuels is, by definition, a benefit to its customers.

As I described earlier, an additional benefit from Florida Power's incentive proposal is that it insulates customers from cost responsibility for the consequences of the Company's hedging activities. This, in turn, avoids the need to establish an added layer of regulatory oversight and the associated inefficiencies that can result from this process.

Finally, to the extent that concerns exist regarding the use incentives to encourage maximum hedging performance, Florida Power's has proposed that its Hedging Program be implemented only as a pilot program. At this juncture, the pros and cons of hedging incentives have been debated only theoretically. Approval of Florida Power's Hedging Program on a trial basis would allow the Commission's ultimate decision on the use of incentives, as well as other important hedging issues, to be supplemented by the knowledge gained from actual experience, without the need for a long term commitment by the Commission or Florida Power at this time.

Q. Does this conclude your testimony?

A. Yes.

DOCKET NO. 011605-EI

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of the rebuttal testimony of Javier Portuondo and Pamela R. Murphy has been furnished to the following individuals by regular U.S. Mail this 26th day of July, 2002:

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