

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Review of investor-owned electric utilities' risk management policies and procedures.

DOCKET NO. 011605-EI
ORDER NO. PSC-02-0919-PAA-EI
ISSUED: July 8, 2002

The following Commissioners participated in the disposition of this matter:

LILA A. JABER, Chairman
J. TERRY DEASON
BRAULIO L. BAEZ
MICHAEL A. PALECKI
RUDOLPH "RUDY" BRADLEY

NOTICE OF PROPOSED AGENCY ACTION
ORDER FINDING FLORIDA POWER CORPORATION TOOK REASONABLE STEPS TO
MANAGE THE RISKS ASSOCIATED WITH CHANGES IN NATURAL GAS PRICES
FOR THE PERIOD MARCH 1999 THROUGH MARCH 2001

BY THE COMMISSION:

NOTICE is hereby given by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are substantially affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code.

By Order No. PSC-01-1829-PCO-EI, issued September 11, 2001, in Docket No. 010001-EI, the following issue was identified:

For the period March 1999, to March 2001, did [Florida Power Corporation] take reasonable steps to manage the risks associated with changes in natural gas prices?

Upon motion, this issue and five related issues were deferred for future consideration pursuant to Order No. PSC-01-2273-PCO-EI, issued November 19, 2001, in Docket No. 010001-EI. Docket No. 011605-EI was established to address the six deferred issues. This

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Order addresses the issue set forth above. For the reasons set forth below, we find that Florida Power Corporation ("FPC") took reasonable steps to manage the risk associated with increases in natural gas prices for the period March 1999 through March 2001.

Our analysis is presented in four parts: description of and reasons for increase in natural gas prices; regulatory treatment regarding financial hedging transactions; FPC's response to increase in natural gas prices; and our analysis of FPC's response.

Description of and Reasons For Increase in Natural Gas Prices

FPC generates a significant percentage of its electricity through natural gas-fired generation. The market price of natural gas changed substantially from March 1999 to March 2001. The monthly average price of natural gas at the wellhead (wellhead price) was \$1.70 per 1,000 cubic feet (MCF) in March 1999. During 1999, the wellhead price did not exceed \$2.68 per MCF. The wellhead price increased steadily throughout 2000 and reached a high of \$8.06 per MCF in January 2001. By March 2001, the wellhead price dropped to \$5.15 per MCF.

In the short term, weather has the largest impact on natural gas demand. Natural gas consumption for many applications is not sensitive to weather conditions. However, a colder-than-normal period during the winter can significantly impact space-heating demand for natural gas as a direct application and as a feedstock for the production of electricity. As the demand for natural gas increases, the wellhead price will increase. The months from November 2000 through March 2001 nationwide were seven percent colder than normal and 23 percent colder than a year earlier. Consequently, natural gas consumption by residential consumers, whose usage is more weather sensitive than other customer classes, increased to 2,618 billion cubic feet (BCF) during this period, a 23 percent increase over the prior year's consumption levels.

In addition, demand for natural gas-fired generation increased in the western United States during this period. Hydroelectric power serves a significant percentage of load in the western United States. During 2000, the Pacific Northwest experienced below normal amounts of rain and snow which impacted the amount of available hydroelectric power. Utilities called upon natural gas-

fired generation to serve load that hydroelectric units would have otherwise served. This increase in natural gas-fired generation placed upward pressure on prices.

On the supply side of the equation, the wellhead price impacts the economic decisions that countless firms make regarding natural gas production and storage. For example, when the wellhead price is low, the incentive for firms to seek out new sources of natural gas is low. As the market price increases, so does the incentive for these firms to seek out new sources of natural gas. The wellhead price during 1999 was \$2.19 per MCF. According to the United States Energy Information Administration, natural gas production nationwide totaled 18,832 BCF in 1999. One year later, the wellhead price rose to \$3.69 per MCF, and natural gas production increased to 18,987 BCF. Last year, the wellhead price rose to \$4.12 per MCF, and natural gas production increased to 19,355 BCF.

As 1998 ended, available natural gas in underground storage totaled 2,730 BCF which was approximately seven percent higher than the 25-year average and the most since 1991. During 1999, the industry experienced a normal pattern of seasonal withdrawals and injections. However, as wellhead prices started relatively high in 2000 and continued to rise steadily throughout the year, this trend had two impacts on available natural gas storage levels. First, owners of the natural gas in storage withdrew more gas than normal from storage to take advantage of the high wellhead prices. Second, these same owners injected less natural gas than normal in the hopes that wellhead prices would eventually fall before the winter. On November 1, 2000, available natural gas in storage was 2,732 BCF, a 24-year low for the start of the winter season. Then, as most areas in the contiguous 48 United States experienced much colder than normal weather in November and December, available natural gas storage fell to 742 BCF by March, 2001.

Regulatory Treatment Regarding Financial Hedging Transactions

Financial hedging is a term of art to describe the purchase or sale of an exchange-traded futures or options contract with the specific intent of protecting an existing or anticipated physical market position from unexpected or adverse price fluctuations. Although individuals and firms have reduced their exposure to price

changes in agricultural products and precious metals for decades, if not centuries, through exchange-traded futures and options contracts, the New York Mercantile Exchange (NYMEX) did not offer a natural gas futures contract until 1990 or a natural gas options contract until 1992. Since 1992, the NYMEX has introduced other products, such as wholesale electricity and coal futures contracts, relevant to electric generation.

By Order No. 14546, issued July 8, 1985, in Docket No. 850001-EI-B, this Commission delineated those fuel-related expenses eligible for recovery through the fuel clause. The Order states, in pertinent part:

As a result of our determinations in this proceeding, prospectively, the following charges are properly considered in the computation of the average inventory price of fuel used in the development of fuel expense in the utilities' fuel cost recovery clauses:

1. The invoice price of fuel.
2. Any revisions to the invoice price.
3. Any quality and/or quantity adjustments to the invoice price.
4. Transportation costs to the utility system, including detention or demurrage.
5. Federal and state taxes and purchasing agents' commissions.
6. Port charges.
7. All quantity and/or quality inspections performed by independent inspectors.
8. All additives blended with fuel prior to burning or injected into the boiler firing chamber along with fuel.
9. Inventory adjustments due to volume and/or price adjustments.
10. Fossil fuel-related costs normally recovered through base rates but which were not recognized or anticipated in the cost levels used to determine current base rates and which, if expended, will result in fuel savings to customers. Recovery of such costs should be made on a case-by-case basis after Commission approval.

Because that Order was issued approximately five years prior to the NYMEX's introduction of the natural gas futures contract, these cost recovery guidelines do not contemplate cash flows associated with financial hedging transactions. Until now, this Commission has not been asked for guidance as to whether and how a utility can charge and credit these cash flows to the fuel clause. We note that the other issues established for consideration in this docket would address such matters.

FPC's Response to Increase in Natural Gas Prices

As natural gas wellhead prices rose, FPC implemented two strategies to mitigate the impact of these rising prices on its ratepayers. First, FPC partially mitigated the wellhead price increases by increasing generation at its other generating units that do not burn natural gas, to the extent available capacity existed at those units. FPC's current generation assets are divided approximately equally among nuclear, coal-fired, oil-fired, and natural gas-fired generation, with the remainder comprised of wholesale energy purchases. FPC increased generation of its residual oil, distillate oil, and nuclear units during this period. However, FPC decreased generation at its four coal-fired units. FPC's decrease in coal-fired generation was mainly the result of higher than expected forced outage and maintenance outage hours at these units. Upon review of FPC's documentation of its unit availability for coal-fired generation during this period, we find that FPC has reasonably explained the greater-than-expected outage hours at its coal-fired units during this period.

Second, FPC minimized its use of natural gas by using the "fuel-switching" capabilities of several generating units to burn oil instead of natural gas. Excluding its nuclear units, FPC estimates that over 40 percent of its generation capacity can switch between oil and natural gas.

Analysis of FPC's Response

From 1998 through 2000, FPC purchased 100 percent of its natural gas requirements at, or indexed to, the spot market price for natural gas. When the price of natural gas was less than \$2.00 per MCF at the wellhead during March 1999, this strategy appeared prudent. As wellhead prices rose above \$10.00 per MCF briefly

during January 2001, FPC took reasonable steps, as described above, to mitigate this price increase. Although FPC may have been able to engage in financial hedging to a greater extent, cost recovery guidelines for the cash flows associated with financial hedging transactions have not yet been established, leaving FPC with uncertainty as to how these cash flows may be treated. Neither FPC nor this Commission recognized the full potential for a dramatic rise in natural gas prices. Due to the circumstantial nature of this event, we find that FPC should not be held accountable on this occasion for not engaging in financial hedging.

In conclusion, based upon FPC's expectations of future changes in natural gas prices and regulatory treatment of its fuel procurement activities, we find that FPC took reasonable steps to manage the risk associated with changes in natural gas prices.

Based on the foregoing, it is

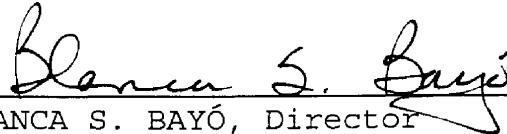
ORDERED by the Florida Public Service Commission that the steps taken by Florida Power Corporation to manage the risks associated with changes in natural gas prices for the period March 1999 through March 2001 are hereby found to be reasonable. It is further

ORDERED that the provisions of this Order, issued as proposed agency action, shall become final and effective upon the issuance of a Consummating Order unless an appropriate petition, in the form provided by Rule 28-106.201, Florida Administrative Code, is received by the Director, Division of the Commission Clerk and Administrative Services, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on the date set forth in the "Notice of Further Proceedings" attached hereto. It is further

ORDERED that in the event this Order becomes final, this docket shall be closed.

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By ORDER of the Florida Public Service Commission this 8th day
of July, 2002.



BLANCA S. BAYÓ, Director
Division of the Commission Clerk
and Administrative Services

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NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing that is available under Section 120.57, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing will be granted or result in the relief sought.

Mediation may be available on a case-by-case basis. If mediation is conducted, it does not affect a substantially interested person's right to a hearing.

The action proposed herein is preliminary in nature. Any person whose substantial interests are affected by the action

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proposed by this order may file a petition for a formal proceeding, in the form provided by Rule 28-106.201, Florida Administrative Code. This petition must be received by the Director, Division of the Commission Clerk and Administrative Services, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on July 29, 2002.

In the absence of such a petition, this order shall become final and effective upon the issuance of a Consummating Order.

Any objection or protest filed in this docket before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.