State of Florida

Public Service Commission
-M-E-M-O-R-A-N-D-U-M-

DATE: February 21, 2002

TO: John T. Butler, Esquire, for Florida Power & Light Company
James A. McGee, Esquire, for Florida Power Corporation
James D. Beasley, Esquire, for Tampa Electric Company
Jeffrey A. Stone, Esquire, for Gulf Power Company
Florida Industrial Power Users Group
Office of Public Counsel

FROM: Cochran Keating, Senior Attorney WCK

RE: Docket No. 011605-EI - Review of Investor-Owned Electric Utilities' Risk Management Policies and Procedures.

Via U.S. Mail

Please note that staff will conduct an informal meeting in the above-referenced docket at the following time and place:

10:00 a.m., Tuesday, March 12, 2002
Room 309, Gerald L. Gunter Building
2540 Shumard Oak Boulevard
Tallahassee, Florida

Attached to this memorandum is a proposal offered by staff for the potential resolution of Issues 1-4, as listed in the Order Establishing Procedure for this docket. The purpose of this informal meeting is to hear from the parties concerning the attached proposal. If you have any questions concerning this meeting or the attached proposal, please call Cochran Keating at (850) 413-6193.

WCK/jb
cc: Division of Economic Regulation
Division of Auditing and Safety

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Proposal for Resolution of Issues 1-4
Docket No. 011605-EI

1. Each investor-owned electric utility shall provide information that constitutes a "risk management plan" in a form and manner deemed reasonable and appropriate by the Commission.

2. Each investor-owned electric utility shall purchase each fuel at a fixed price in an amount no less than the minimum amount of each fuel that the utility must dispatch on its system in a given year.

   - Fuel shall refer to any fossil fuel that serves as a feedstock for any generation resource (owned or purchased) that the utility dispatches on its system.

   - Fixed price – each utility may establish these fixed price purchases in a manner which the utility deems most appropriate. Alternatives include, but are not limited to: a fixed price forward contract, a futures contract, an options contract, and a swap.

   - Each utility shall calculate the minimum amount of each fuel that the utility must dispatch on its system each year in a manner deemed reasonable and appropriate by this Commission.

3. The Commission shall allow recovery through the fuel and purchased power cost recovery clause of gains and losses from exchange-traded futures contracts made pursuant to a Commission-approved risk management plan to hedge natural gas, coal, and fuel oil prices.

4. The Commission shall allow recovery through the fuel and purchased power cost recovery clause of premiums received and paid for exchange-traded options contracts made pursuant to a Commission-approved risk management plan to hedge natural gas, coal, and fuel oil prices.

5. The Commission shall allow recovery through the fuel and purchased power cost recovery clause of transaction fees associated with futures and options contracts made pursuant to a Commission-approved risk management plan to hedge natural gas, coal, and fuel oil prices.

6. The Commission shall not allow recovery through the fuel and purchased power cost recovery clause of any cash receipts or payments associated with speculation. The Commission shall define speculation as forward, futures, options, and swap contracts in amounts greater than the amount of each fuel that the utility dispatches on its system in a given year.

7. An investor-owned electric utility may engage in futures and options contracts to meet the objectives set forth in Part 2. If so, the utility shall adopt procedures consistent with or better than the internal control guidelines set forth on the attached pages 40-47 in the New York Mercantile Exchange's "A Practical Guide to Hedging: Operational and Accounting Controls, Financial Reporting, and Federal Income Tax" for its and any applicable affiliates' officers and employees.

CHAPTER FOUR – INTERNAL CONTROL

at sufficiently high levels to adequately guard against the risk associated with changing market conditions. A customer's initial margin deposit must be in cash or U.S. government obligations with a maturity of less than 10 years. Government obligations are valued at 95% of par. Margins are subject to change as warranted by market conditions.

Maintenance Margin

Maintenance margin is a sum which customers must maintain on deposit at all times. If the equity in a customer's account drops to or under that level because of an adverse price movement, additional payments must be made to restore the customer's equity. Margins are set by the Exchange based on its analysis of price risk volatility at that time.

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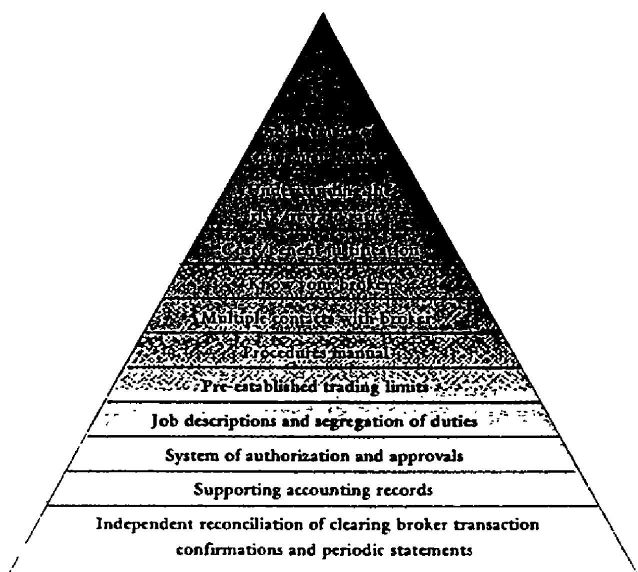
Overview of the Control Environment

Figure 3



open on the day prior to the expiration of the futures contract. COMEX Division spot-month assessments are decided on a case-by-case basis as warranted by market conditions.

Policies and Procedures Manual

To establish an effective hedging program, a company should write formal policies and procedures stating the responsibilities of each associated person within an organization. Procedures must be established for actual execution of the futures trading activities, as well as the post-execution process in which futures transactions are recorded and verified.

These policies and procedures are necessary to ensure that hedging activities are properly documented and that the program is in compliance with accounting, tax, and regulatory requirements and practices. Policies and procedures need to be developed for each stage of the trading cycle.

There are three main processes that make up the futures function: (1) the planning that takes place before an order is actually placed with a futures broker; (2) the execution process, which encompasses all of the activities that take place as an order is placed and when the transaction is recorded on the books, and (3) the post-execution process, which entails the verification and control of the futures transaction.

The procedures manual should also outline the company's policies for training and supervision of employees to ensure that all personnel involved in futures trading are thoroughly familiar with the concepts, terminology, and trading practices of the markets

Futures hedging and arbitrage transactions, like any other transactions, require authorization and approval prior to execution. After the transaction is executed and recorded, the open futures positions and related items being hedged (inventory, for example) should be maintained until the hedge transaction is closed. During the life of the hedge transaction, changes in futures value must also be accounted for management reporting and financial accounting purposes. (The accounting and financial reporting requirements are analyzed in Chapter 5.) A system of internal accounting controls should provide reasonable assurance that (1) only approved and relevant transactions are authorized, initiated, executed, and recorded; (2) the transactions are initiated, executed, valued, and recorded properly and on a timely basis; and (3) errors in execution and recording are detected as early as possible (Figure 3).

Control Objectives, Procedures, and Segregation of Duties

An important aspect of internal controls is to segregate the duties of operational and accounting tasks to help prevent misappropriation, fraud, or error Segregation of duties is intricately linked to the company's overall system of internal control. The records maintained by personnel independent of the actual trading functions should contain all necessary information to (1) verify positions with the company's FCMs; (2) provide a record of all journal entries to the subsidiary and general ledgers on variation margin, realized and unrealized gains and losses, etc , and (3) monitor futures positions, reflected on memorandum ledgers, during the life of the contract A company engaging in futures trading should create a set of records that mirror those of the FCM, just as the FCM's records mirror those of the Exchange clearinghouse

The following sections detail individual control objectives and indicate which functions should be performed to ensure these objectives are met These control objectives and procedures should be monitored by the company's internal audit department

Control Objectives

- Futures transactions and open positions are appropriate given the company's inventory levels or firm sales commitments (existing or anticipated)
- The number of futures contracts, long or short, represents an underlying quantity of the physical commodity that relates to the quantity at risk in terms of a sale or purchase at a future date.
- The delivery month or months selected in the futures market are consistent with the month in which the user or producer either expects to have physical goods available for delivery in the cash market, or will be buying crude oil, refined products, natural gas, electricity, or metals to fulfill an obligation to supply these commodities or to refine them
- The internal trade ticket documents the purpose and all other relevant details of the futures trade
- The futures order is executed in a timely fashion
- The execution price is consistent with the price limit placed by the company's trader

- The transaction, once executed, is properly recorded. The trading strategy is within approved guidelines.
- Trading strategies are updated on a timely basis.
- Changes in value of the futures contract are recorded daily on the company's books.
- An increase or decrease in the company's original margin deposit with the executing broker or FCM due to contract value changes is recorded in a timely fashion.
- The change in value of the futures contract is verified by the company before variation margin deposits, made by wire transfer or check, are authorized and approved.
- Financial accounting for the change in value and cash flow between the broker and the company is properly reflected in the internal and external financial statements in accordance with generally accepted accounting principles.

These control objectives may be achieved by implementing the procedures described below.

Control Procedures – Pre-Execution

- Board and hedge committee policies are documented.
- Hedging strategies are properly documented.
- The broker or FCM is chosen based on specific criteria (reputation, research capability, execution capability, margin requirements and commissions, stability of personnel, and credit worthiness).
- Traders are specifically authorized in writing to transact business with the broker or FCM.
- The broker or FCM has written authorization from the company to accept orders only from authorized persons.
- Pre-established trading limits are documented.
- A procedures manual is established describing how the futures contract's original margin deposit and subsequent changes in value are recorded in the books and records.

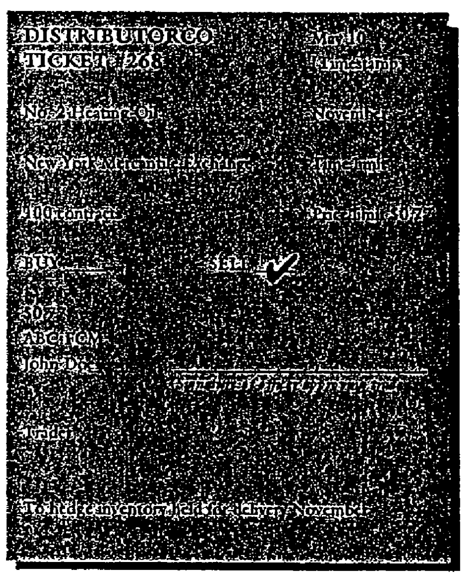
- Appropriate controls and a monitoring system is in place and operational

Execution and Post-Execution Controls

- Persons independent of the trader receive broker or FCM confirmations for verifications to the internal trade ticket
- An independent department logs differences between broker confirmations and the internal trade ticket, and provides copies to the trader for resolution with the broker or FCM
- A separate department (such as accounting or operations) prepares daily buy

Internal Trade Ticket

Figure 4



and sell activity ledgers, updates cumulative open position reports and contract settlement prices, and reconciles month-end open positions and money balances to the monthly statement from the executing broker or FCM

- Variation margin withdrawals and additional deposits are verified by persons independent of bookkeeping responsibilities.
- Reinvestment of margin deposit increases are approved by the treasurer.
- Reports are furnished periodically to senior management and the board summarizing activity, open positions, and hedge performance (change in spot versus future prices)
- Internal audit reviews are performed to help ensure compliance with the policies and procedures

If these procedures are followed on a timely and accurate basis, it is possible to identify errors early and optimize the effectiveness of the futures hedging program. See Page 47 for a summary of the paperwork flow and related control procedures from the time a hedging transaction is authorized (trading ticket) to the production of the hedge performance tracking ledger

Unauthorized Futures Trading

A frequently voiced concern of companies contemplating use of futures markets for hedging purposes is the potential for unauthorized trading. One method to detect this is for the company to set up a system of multiple contact with the broker or FCM who executes the order. Key procedures include authorization of all new accounts by the company treasurer, not the trader; approval of all new accounts, original margin deposits, and approval of all cash movements by responsible officers independent of the trading function. Additionally, original confirmations of transactions, monthly statements, and any other correspondence from the FCM should be sent to a person independent of the trading function, with copies sent to the trader to check against his personal records and logs

Furthermore, senior management should have a thorough understanding of the risks associated with futures trading, the relationship between futures market positions and cash market positions being hedged (basis risk, inventory, etc.), and related commitments and anticipated transactions. Given such knowledge, senior management will be in a better position to monitor and evaluate futures market hedging activity

Books and Records and Procedures

Overview of Paperwork Flow and Related Control Procedures

- Place order with FCM or the broker on the floor of the Exchange, or through the NYMEX ACCESS® electronic trading system
- Prepare internal trading ticket
- Copy of trading ticket forwarded to:
  - Accounting department
  - Auditing (broker reconciliation) department
- Record trade on daily buy and sell registers for updating of open position reports
- Account for numerical sequence of all trade tickets
- Prepare listing of trades by broker for use in daily confirmation process
- Update open futures position report
- Reconcile open futures position report to prior day's report
- Notify independent officer of any discrepancies
- Produce reports by trader with daily, weekly, and year-to-date results, realized and unrealized and open contracts
- Compare to pre-established trading limits
- Enter settlement prices and produce mark-to-market report
- Produce daily variation margin report
- Compare broker's advice of variation margin due or owed
- Request/transmit funds
- Reconcile monthly brokerage account statements to appropriate internal reports
- Produce hedge performance report