FLORIDA POWER CORPORATION

DOCKET NO. 011605-EI

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

DIRECT 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. By whom are you employed and in what capacity?

A. I am employed by Progress Energy Service Company, LLC, in the capacity of Manager, Regulatory Services - Florida.

Q. Have your duties and responsibilities remained the same since your previous testimony was filed in the fuel adjustment docket on the issues that were subsequently deferred to this proceeding?

A. Yes, they have.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to present the position of Florida Power Corporation (Florida Power or the Company) on the pending issues in this docket that have been raised in an attempt to develop a Commission policy regarding the use of physical and financial hedging practices, and

the recovery of related costs, by investor-owned utilities to manage price volatility risks associated with their fuel procurement activities. In particular, I will focus on the risk management incentive proposal submitted by Florida Power on June 5, 2002 in response to the Prehearing Officer's directive in Order No. PSC-02-0192-PCO-EI. A discussion of this proposal will, I believe, effectively encompass or subsume these specifically identified policy issues.

Q. How will your testimony be presented?

A. As background, I will begin by noting the key points from the prior testimony of Florida Power witnesses on the subject of risk management that was filed in last year's fuel cost recovery proceeding before the matter was deferred. I will then address Florida Power's proposed Hedging Program submitted on June 5, 2002 as its risk management incentive plan proposal in response to the Prehearing Officer's directive, which the Company presented at the Commission's June 17th workshop. This portion of my testimony has also been adopted by the testimony of Pamela Murphy who, as the individual responsible for Florida Power's natural gas and oil procurement and its natural gas trading, will respond to questions at the hearing regarding the technical and operational aspects of the Hedging Program, while I will address the Program's regulatory aspects. Finally, I will propose the use of a deferral accounting regulatory practice for the treatment of unrecognized gains and losses associated with the Hedging Program in order to satisfy the recently adopted FAS 133 accounting standard.

Q. Do you have an exhibit to your testimony?

A. Yes. I have prepared an exhibit attached to my prepared testimony as Exhibit No. ___ (JP-1) that provides four examples of the effect of Florida Power's proposed Hedging Program on customers and shareholders under different price scenarios. I will also sponsor the overview of Florida Power's Hedging Program proposal filed on June 5, 2002, as well as the confidential supplement filed with the proposal, which describes and provides examples of the Program's methodology for determining the fixed price charged to customers for a portion of Florida Power's forecasted natural gas and residual oil requirements. For ease of reference, a copy of the June 5th Hedging Program proposal, without the confidential supplement, is attached as Exhibit No. ___ (JP-2).

Background

Q. How has Florida Power approached the use of hedging activities in connection with its fuel transactions to date?

A. Florida Power has been engaged for many years in traditional physical hedging activities to mitigate volatility in the market price of the various types of fuel used in its generating facilities. These activities include such basic hedging practices as the use of long-term contracts for the procurement of varying portions of its coal requirements, and the use of physical fixed pricing options and inventory controls in the procurement of natural gas and oil. The Company's prefiled testimony in last year's fuel adjustment docket described how these hedging activities resulted

in saving of over $19 million in natural gas and oil costs during the two-year period from March 1999 to March 2001.

In general, however, Florida Power has taken a conservative approach to the use of non-traditional financial hedging practices, such as futures and options contracts, derivatives, and other financial instruments.

Q. Why has Florida Power taken a conservative approach to the use of these non-traditional hedging practices?

A. Since the economic consequences of Florida Power's fuel procurement activities are borne by its customers, these activities are obviously, and for good reason, subject to considerable scrutiny by the Commission in the ongoing fuel adjustment proceeding. In the absence of a Commission policy on the appropriateness of these non-traditional hedging practices and recovery of their costs, Florida Power has been reluctant to presume these practices will be viewed with favor by the Commission.

In its prefiled fuel adjustment testimony last year, Florida Power witnesses stated that this reluctance to engage in non-traditional financial hedging practice could be overcome by the Commission's adoption of a clear and fairly balanced policy on hedging and the recovery of related costs. They also suggested that an economic incentive be included in such a policy if the Commission determines that it wants to affirmatively encourage utilities to proactively engage in hedging activities.

Florida Power's Proposed Hedging Program

Q. What led to the development and submittal of Florida Power's Hedging Program?

A. On March 28, 2002, the Prehearing Officer issued a supplemental procedural order that added the following issue to the list of six issues (two of which were company-specific and subsequently resolved) identified in an earlier procedural order.

> What incentive(s), if any, should the Commission establish to encourage investor-owned electric utilities to optimally manage the risks to ratepayers associated with fuel and purchased power price volatility?

In addition, the Prehearing Officer announced a Commission workshop to consider this new issue and directed the utilities to file either a proposed incentive plan for discussion at the workshop or a statement explaining why such an incentive is not appropriate.

Florida Power viewed the establishment of this new issue as entirely consistent with the suggestion in its earlier testimony that the Commission consider the adoption of an incentive to encourage the use of hedging practices, particularly non-traditional practices. The Company therefore welcomed the opportunity to develop and submit its Hedging Program in response to this issue.

Q. What objective does Florida Power intend to achieve through its proposed Hedging Program?

A. The Hedging Program is intended to reduce the volatility of fuel costs charged to its customers. Florida Power believes this objective can best

be achieved by designing the Program to provide the Company with an incentive to maximize the benefits and minimize the risks of the Program to customers through a sharing of these benefits and risks.

Having said this, I think it is important to keep in mind the distinction between price volatility and price level. A program that is successful in reducing the volatility of fuel prices will not necessarily result in reduced fuel price levels. Volatility can produce downward price spikes, as well as upward spikes. A program that effectively reduces price volatility will minimize the spikes in both directions.

Q. How will the Hedging Program achieve a reduction in the volatility of fuel costs charged to Florida Power's customers?

A. The way in which the Hedging Program will reduce the overall price volatility of Florida Power's fuels is by targeting the Program's application to natural gas and residual oil, the two fuels of the Company's four primary fuel types (coal and nuclear fuel are the other two) that clearly display the most price volatility. This will allow us to concentrate our efforts on the commodities with the greatest potential benefit in terms of reduced price volatility.

With this focus on natural gas and residual oil, the way in which the Hedging Program will achieve this potential benefit is by fixing the price of a predetermined portion of each fuel's forecasted annual volume requirements. The fixed price multiplied by the predetermined volume will be the cost charged to customers through the Company's fuel clause for that volume of each fuel, irrespective of the price actually paid by Florida

Power for these volumes. In this manner, the Hedging Program will eliminate the risk of any price volatility for the predetermined fixed price volumes, which will be at least 20% of the forecasted annual quantities for each fuel, and possibly a much greater portion (as high as 50%) as the Company gains experience with the Program.

Q. How and when will the fixed prices and the fixed price volumes of natural gas and residual oil be determined under the Hedging Program?

A. The specific method and timing for determining the fixed prices and fixed price volumes is described in the methodology is contained in the confidential supplement to the Company's June 5, 2002 filing, which also includes examples of the methodology's application. In general, the Hedging Program contemplates that after the methodology is initially approved by the Commission, its ongoing application would be essentially ministerial and would require no additional action by the Commission.

Under this methodology, the determination of the fixed prices and fixed price volumes for natural gas and residual oil applicable to a given fuel cost recovery period would begin early in the preceding year. Using natural gas and the 2004 cost recovery period as an example, early in 2003 the Company will determine the percentage of its forecasted 2004 natural gas requirements that will be subject to fixed prices. At the same time, the Company will establish a phased, or staggered, schedule of weekly time periods over the remainder of 2003. Thereafter, during each of these previously established weekly periods, the future price of natural

gas listed on the New York Mercantile Exchange (NYMEX) for each month in 2004 will be recorded. The average of these future prices, plus a risk premium approved as a part of the methodology, will determine the fixed price that will be charged to customers for the predetermined fixed price volume of natural gas in 2004.

Q. What effect will variances between the forecasted and actual volumes of natural gas and residual oil have on the fixed price quantities of each fuel?

A. None. Once the fixed price quantities have been determined early in the year before the cost recovery period, they will remain unchanged by changes in volume of fuel actually required during the cost recovery period. For example, if the forecasted volume of natural gas in a given cost recovery period is 40,000,000 mmbtu and the Company determines that 25% of this amount will be subject to fixed pricing under the Hedging Program, the fixed price quantity for the cost recovery period will be permanently set at 10,000,000 mmbtu. If the actual volume of natural gas burned during the cost recovery period is 45,000,000 mmbtu, 10,000,000 mmbtu will still be charged to customers at the fixed price and the remaining 35,000,000 mmbtu will be charged based on actual costs.

Q. What effect will variances between the fixed price and the actual price paid by Florida Power for the fixed price quantities of natural gas and residual oil have on the fuel costs charged to customers?

A. Again, none. Under the Hedging Program, Florida Power will have effectively guaranteed the customers' total cost for these fixed price quantities, since both the price and quantity will be established in advance. Since Florida Power will have assumed the risk of price volatility for the fixed price quantities of natural gas and residual oil, it will bare the full responsibility for developing and implementing strategies to hedge the price of these quantities. As a result, the Company's success or lack thereof in its hedging activities will have no effect on the cost of fuel charged to its customers.

This is illustrated by the examples, Tables 1 through 4, shown in my Exhibit No. ___ (JP-1). Tables 1 and 4 are examples of unsuccessful hedging results by Florida Power, where the actual price paid by the Company exceeds the fixed price. In both examples, however, customers experience a better result under the Hedging Program than under the current fuel cost recovery procedure. Tables 2 and 3 show examples of successful hedging results by the Company, which also produces a favorable experience for customers under the Hedging Program in Table 2, but an unfavorable customer experience in Table 3.

Q. Will Florida Power use financial hedging practices for quantities of natural gas or residual oil above the fixed price quantities subject to the Hedging Program?

A. No. Florida Power does not intend to execute any more financial hedging instruments than are necessary to effectively manage the fuel quantities subject to the Hedging Program.

Q. Will the Hedging Program apply to any costs beyond those of natural gas and residual oil commodities themselves?

A. No, the fixed prices established under the Hedging Program will include only the direct commodity costs. Non-commodity costs related to the procurement of natural gas and residual oil (such as demand and transportation charges, taxes, etc.) will be recovered through the fuel clause in the traditional manner based on Florida Power's actual costs. Traditional fuel clause recovery will also apply to hedging transaction costs (such as commissions and fees, margin requirement costs, basis charges, risk premiums, etc.).

Q. What term does Florida Power propose for its Hedging Program?

A. Florida Power considers its Hedging Program to be in the nature of a pilot project, where the decision on the project's ultimate duration is based in large part on the experience gained over an initial pilot period. Given the lack of actual hands-on operational and regulatory experience by Florida Power or the Commission with the more extensive and sophisticated hedging practices contemplated by the Company's proposed Program, it

is likely that neither has a sufficient comfort level to undertake a long term commitment.

Florida Power therefore proposes an initial two-year term for its Hedging Program, beginning with the 2003 fuel cost recovery period. For the 2005 cost recovery period, the Company or the Commission would have the option to unilaterally terminate the program outright or subject to modification at the fuel cost recovery hearing in 2003. (This lead time is needed because the Company would have implemented its Hedging Program for 2005 prior to the hearing in 2004.) The same option would be available at each fuel cost recovery hearing thereafter. If the Hedging Program is terminated, cost recovery would revert back to the traditional manner based on Florida Power's actual costs.

Q. Are there any other key elements of Florida Power's proposed Hedging Program?

A. Yes. The Hedging Program includes an important expansion of the existing mechanism for sharing the gains on short term wholesale power sales. This expansion will provide a means to partially offset the substantial incremental costs that will have to be incurred to establish the infrastructure necessary for the implementation and administration of the Company's Hedging Program. These costs include the hiring of high salaried, experienced professionals needed to implement the hedging strategies and execute the related financial transactions, as well as the mid and back office personnel needed to perform the monitoring, accounting, and risk assessment functions associated with these financial

transactions, and the enhancement of sophisticated software trading systems.

In consideration of these incremental infrastructure costs, Florida Power's Hedging Program proposal includes an expansion of the current mechanism for the sharing of gains on non-separated wholesale sales established by Order No. PSC-01-2371-FOF-EI. The expanded sharing mechanism would apply to the Company's savings from non-separated wholesale purchase, as reported on Schedule A9, as well as to the gains from its wholesale sales, as reported on Schedule A6. Under this proposal, all of the savings and gains from non-separated wholesale transactions would be shared between customers and shareholders on a 2/3-1/3 basis.

The only other key significant element of the Program is a standard force majeure clause covering such things as acts of God, government, war and terrorism, as well as extended unscheduled outages of base load plants. The costs associated with a force majeure event would be recovered in the traditional manner based on Florida Power's actual costs.

Q. Will the recently adopted statement of the Financial Accounting Standards Board, FAS 133, have an accounting impact the proposed Hedging Program?

A. Yes. FAS 133 will require Florida Power to record on its income statement the unrealized gains or losses resulting from Marking-to-Market (MTM) any financial derivatives acquired under the Company's Hedging

Program from the inception of each derivative to its expiration. This will result in a timing issue between cost recovery and the unrealized MTM income statement impact.

Q. How should the Commission address the income statement impact resulting from this MTM accounting?

A. The Commission should authorize Florida Power to defer the MTM impact to a balance sheet regulatory asset or liability similar to the Commission's current policy authorizing the deferral of fuel cost under and over recoveries from the income statement to the balance sheet. This new deferred asset or liability would not be included in the Company's fuel clause over or under recovery calculation, since it represents an unrealized amount.

Q. Does this conclude your testimony?

A. Yes.

EXAMPLE - ANNUAL

Exhibit No. ___ (JP-1)

Line No.	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)	(M)	(N)	(O)	(P)	(Q)	(R)
1	**NATURAL GAS**																	
2	Total Annual Mmbtu	40,000,000																
3	Volume subject to Hedging Program	10,000,000																
4																		

TABLE 1.

	UNSUCCESSFUL HEDGE			
	Current Recovery Method $/mmbtu	Proposed Recovery Method $/mmbtu	Current Recovery Method $ in millions	Proposed Recovery Method $ in millions
FORECAST - for setting factor				
Hedging Program - Fixed Price	$0.00	$4.00	$0	$40
Non-hedging Program - est of actual cost	$4 00	$4 00	$160	$120
ACTUAL				
Hedging Program - actual cost	$0 00	$4 50	$0	$45
Non-hedging Program - actual cost	$4 50	$4 50	$180	$135
TRUE-UP TO CUSTOMER (U)/O	($0 50)	($0 50)	($20)	($15)
IMPACT TO SHAREHOLDER (U)/O	$0 00	($0.50)	$0	($5)

EXAMPLE - SINGLE MONTH

28	**NATURAL GAS**																	
29	Total Annual Mmbtu	40,000,000																
30	Volume subject to Hedging Program	10,000,000																
31																		
32	**Assumption:**																	
33	Total Single month mmbtu requirements of	5,000,000																
34	Hedged mmbtu of	1,000,000																

TABLE 2.

	SUCCESSFUL HEDGE			
	Current Recovery Method $/mmbtu	Proposed Recovery Method $/mmbtu	Current Recovery Method $ in millions	Proposed Recovery Method $ in millions
FORECAST - for setting factor				
Hedging Program - Fixed Price	$0 00	$4.00	$0 0	$4 0
Non-hedging Program - est. of actual cost	$4 00	$4 00	$20.0	$16.0
ACTUAL				
Hedging Program - actual cost	$0.00	$4.00	$0 0	$4.0
Non-hedging Program - actual cost	$4.50	$4.50	$22 5	$18 0
TRUE-UP TO CUSTOMER (U)/O	($0.50)	($0.50)	($2 5)	($2 0)
IMPACT TO SHAREHOLDER (U)/O	$0 00	$0.00	$0 0	$0 0

TABLE 3.

	SUCCESSFUL HEDGE			
	Current Recovery Method $/mmbtu	Proposed Recovery Method $/mmbtu	Current Recovery Method $ in millions	Proposed Recovery Method $ in millions
	$0 00	$4 00	$0.0	$4.0
	$4 00	$4 00	$20 0	$16.0
	$0.00	$3.50	$0.0	$3 5
	$3.50	$3.50	$17.5	$14 0
	$0 50	$0.50	$2.5	$2 0
	$0.00	$0 50	$0 0	$0.5

TABLE 4.

	UNSUCCESSFUL HEDGE			
	Current Recovery Method $/mmbtu	Proposed Recovery Method $/mmbtu	Current Recovery Method $ in millions	Proposed Recovery Method $ in millions
	$0.00	$4.00	$0 0	$4.0
	$4 00	$4.00	$20 0	$16 0
	$0.00	$4 50	$0 0	$4.5
	$4 50	$4 50	$22 5	$18.0
	($0 50)	($0 50)	($2.5)	($2 0)
	$0 00	($0.50)	$0.0	($0.5)

(U) = under-recovery
O = over-recovery

EXHIBIT NO. ___ (JP-2)

FLORIDA POWER CORPORATION

DOCKET NO. 011605-EI

FLORIDA POWER CORPORATION'S RISK MANAGEMENT INCENTIVE PLAN PROPOSAL

In accordance with the directive of the Prehearing Officer in Order No. PSC-02-0428-PCO-EI, issued March 28, 2002 in the above docket, Florida Power Corporation (Florida Power or the Company) submits the following Hedging Program overview description as its proposed risk management incentive plan for discussion at the Commission workshop scheduled for June 17, 2002. If appropriate, based on the outcome of the workshop, Florida Power will prepare and file a detailed plan document for Commission approval.

Two preliminary comments are warranted. First, the Company wishes to be clear that its Hedging Program is a Florida Power-specific proposal and carries no suggestion that it is the appropriate risk management plan for the other investor-owned utilities. To the contrary, Florida Power believes it to be highly desirable that each of the utilities have the latitude to tailor a risk management plan to its own circumstances and comfort level when entering this new and potentially high risk area of fuel procurement.

Second, the description of Florida Power's proposed Hedging Program below is, of necessity, lacking in details and specifics due to the highly sensitive nature of this information. To aid the Commission's understanding of the proposed program's workings, Florida Power has separately filed supporting documentation that provides details and examples of the hedging methodology that is subject to protection under the Commission's confidentiality rule.

The Proposed Hedging Program

Program Objective

Minimize fuel price volatility for customers through the use of hedging strategies that allow customers and shareholders to share in the risks and benefits of implementing the program, with the understanding that an effective price volatility mitigation program will not necessarily result in lower costs to customers.

Key Program Elements

- The Hedging Program will be applied to the procurement of natural gas and residual (No. 6) oil, the two fuels used by Florida Power that display the greatest price volatility.

- Prices will be fixed for a predetermined portion (not greater than 60%) of the Company's forecasted annual natural gas and residual oil requirements. The percentage for each fuel will be established early in the year prior to the forecast year and the resulting quantities of fixed price fuel will remain constant and unaffected by changes in the actual quantities of fuel required.

- The fixed prices will be established for the predetermined quantities of natural gas and residual oil at phased, or staggered, time intervals based on indices of future commodity market prices. An average of the prices established for each time interval, plus a risk premium, will determine the final fixed price for natural gas and residual oil. Because Florida Power anticipates entering the market at these same intervals for risk mitigation purposes, the intervals will be varied at irregular times as a safeguard against predictability and market distortions.

- Florida Power will submit the fixed price for natural gas and residual oil established in this manner with its projections filed in the fuel cost recovery proceeding. These fixed prices will be charged to customers through the fuel clause for the predetermined quantities of each fuel, irrespective of the prices actually paid by Florida Power. Additional volumes of natural gas and residual oil above these fixed price quantities will be charged to customers in the traditional manner based on the Company's actual costs, subject to true-up.

- The fixed natural gas and residual oil prices established under the Hedging Program will apply only to the two fuel commodities themselves. Non-commodity costs related to the procurement of these fuels (*e.g.*, demand and transportation charges, taxes, etc.) will be recovered in the traditional manner based on Florida Power's actual costs. Traditional fuel clause recovery will also apply to hedging transaction costs (*e.g.*, commissions and fees, margin requirement costs, basis charges, risk premiums, etc.). However, the costs associated with speculative trading (*e.g.*, contracts for futures, forwards, options, swaps, etc.) in amounts greater than the quantity of each fuel consumed annually on the Company's system will not be recoverable through the fuel clause.

Expanded Wholesale Power Sharing Mechanism

Substantial incremental costs will have to be incurred to establish the infrastructure necessary for the implementation and administration of the Hedging Program. These costs include the hiring of high salaried, experienced professionals needed to implement the hedging strategies and execute the related financial transactions, as well as the mid and back office personnel needed to perform the monitoring, accounting, and risk assessment functions associated with these financial transactions, and the enhancement of sophisticated software trading systems.

As a means to partially offset to these incremental infrastructure costs, Florida Power's Hedging Program proposal includes an expansion of the current mechanism for the sharing of gains on non-separated wholesale sales established by Order No. PSC-01-2371-FOF-EI. The expanded sharing mechanism would apply to the Company's savings from non-separated wholesale purchase, as reported on Schedule A6, as well as to the gains from its wholesale sales, as reported on Schedule A9. Under this proposal, all of the savings and gains from non-separated wholesale transactions would be shared between customers and shareholders on a 2/3-1/3 basis.

Program Term

Florida Power considers its Hedging Program to be in the nature of a pilot project, where the decision on the project's ultimate duration is based in large part on the experience gained over an initial pilot period. Given the lack of actual hands-on operational and regulatory experience by Florida Power or the Commission with the more extensive and sophisticated hedging practices contemplated by the Company's proposed program, it is likely that neither has a sufficient comfort level to undertake a long term commitment.

Florida Power therefore proposes an initial two-year term for its Hedging Program, beginning with the 2003 fuel cost recovery period. For the 2005 cost recovery period, the Company or the Commission, on its own motion or upon the request of an intervenor, would have the option to unilaterally terminate the program outright or subject to modification at the fuel cost recovery hearing in 2003. (This lead time is needed because the Company would have implemented its Hedging Program for 2005 prior to the hearing in 2004.) The same option would be available at each fuel cost recovery hearing thereafter.