State of Florida

Public Service Commission

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

DATE: April 14, 2008

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Lester, Matlock, Maurey, McNulty, Slemkewicz, Springer)
Office of the General Counsel (Bennett, Young)

RE: Docket No. 080001-EI – Fuel and purchased power cost recovery clause with generating performance incentive factor.

AGENDA: 04/22/08 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: McMurrian

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\080001.RCM.DOC

Case Background

On January 31, 2008, Florida Power and Light Company (FPL or the Company) filed a petition requesting that the Commission approve its proposed volatility mitigation mechanism, or VMM, as an alternative to FPL's financial and physical fuel price hedging programs. VMM involves collecting FPL's under-recoveries of unhedged fuel costs over two years, instead of one year as is the current practice. FPL intends that, if FPL's combined final true-up and actual/estimated true-up amounts in any year's fuel proceeding reflects an under-recovery, half of that under-recovery would be collected in the projected year and the remaining half would be collected in the year following the projected year. The Company proposes VMM as a method of achieving the Commission's objective of mitigating fuel price volatility while avoiding certain hedging disadvantages. FPL argues that such disadvantages include uncertainty introduced by

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the uneven reaction shown by certain stakeholders during periods when FPL incurs losses in its hedging program compared to when FPL achieves gains in its program. FPL is also concerned about the regulatory risk it alleges may be associated with the deferral of prudence determinations of hedging losses, as occurred at the November 2007 fuel adjustment hearing (Order No. PSC-08-0030-FOF-EI, issued January 8, 2008, in Docket No. 070001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor.). If the Commission approves FPL's VMM petition, FPL seeks express assurances of recovery and recognition that the Company is prudent in its decision to not acquire physical or financial hedges to mitigate fuel price volatility.

In the alternative, if the Commission does not approve the VMM as proposed, FPL requests two changes to the current hedging approach. First, FPL requests that the Commission reduce the uncertainty associated with the current hedging program by approving a set of general and specific hedging guidelines set forth by FPL (see Exhibit 3 of the petition). Secondly, the Company proposes that FPL's regulatory risk be reduced by requiring Commission staff to conduct reviews of hedging results monthly. FPL makes this second request so that the Commission would be in a position to rule on the prudence of FPL's hedging results at the fuel hearing in November of each year for the twelve months ending September 30th of that year.

The current hedging policy is embodied in Order No. PSC-02-1484-FOF-EI (the Hedging Order), issued October 30, 2002, in Docket No. 011605-EI, In re: Review of investor-owned electric utilities' risk management policies and procedures. The Hedging Order approved a settlement, referred to as the Proposed Resolution of Issues, which established a framework and direction to follow with respect to risk management of fuel procurement by the four investor-owned utilities' (IOUs). The settlement was entered into by FPL, Florida Power Corporation (now Progress Energy Florida, Inc., or PEF), Tampa Electric Company (TECO), the Florida Industrial Power Users Group (FIPUG), and the Office of Public Counsel (OPC). Gulf Power Company (Gulf) agreed to the settlement at the hearing based upon a modification made during the August 12, 2002 hearing. The Hedging Order states:

> It [the Proposed Resolution of Issues] provides for the filing of information in the form of risk management plans and as part of each IOU's final true-up filing in the fuel and purchased power cost recovery docket, which will allow the Commission and the parties to monitor each IOU's practices and transactions in this area. In addition, it maintains flexibility for each IOU to create the type of risk management program for fuel procurement that it finds most appropriate while allowing the Commission to retain the discretion to evaluate, and the parties the opportunity to address, the prudence of such programs at the appropriate time. Further, the Proposed Resolution of Issues appears to remove the disincentives that may currently exist for IOUs to engage in hedging transactions that may create customer benefits by providing a cost recovery mechanism for prudently incurred hedging transaction costs, gains and losses, and incremental operating and maintenance expenses associated with new and expanded hedging programs.

Hedging Order, p. 2.

Following the issuance of the Hedging Order, each of the four largest IOUs developed financial hedging programs. Each IOU now hedges significant portions of their natural gas and/or residual oil purchases. No proposals to modify the terms of the Hedging Order, other than FPL's petition requesting approval of VMM or its alternative, have been filed with the Commission since the issuance of the Hedging Order.

FPL requested as part of its petition that the Commission schedule proceedings on its VMM petition on a timetable that will allow the Commission to render a final decision by no later than May 1, 2008, which would authorize FPL to transition to the VMM effective January 1, 2009. May 1, 2008, is the date by which FPL states it needs to begin placing hedges for 2009 in the event the Commission determines to not approve the VMM. Also, if the Commission does not approve VMM, FPL requests Commission approval of its hedging guidelines by May 1, 2008, so that it may structure its price hedges for 2009 fuel purchases.

FPL also requested the Commission convene a workshop on its VMM proposal at the earliest opportunity in the interest of obtaining stakeholder consensus that would minimize the risk of a protest to proposed agency action approving the VMM. Staff conducted a staff workshop on March 11, 2008. All parties to the 2002 settlement attended and participated. Data requests were issued by staff prior to the workshop, not only to FPL but to all parties to the 2002 hedging settlement. Additional data requests were issued to FPL after the workshop. All parties responded to the data requests in timely fashion.

Commission staff initiated two separate audits of the IOUs' hedging programs following the conclusion of the 2007 fuel adjustment hearing, but prior to FPL's filing of its petition on the VMM. At the request of the Division of Economic Regulation (ECR), the Division of Competitive Markets and Enforcement (CMP) is conducting a hedging review which involves an assessment of the IOUs' fuel hedging program costs and benefits realized since the issuance of the Hedging Order. Also at the request of ECR, the financial Division of Regulatory Compliance and Consumer Assistance (RCA) is conducting an audit of the accounting treatment and results of each IOU's 2007 hedging activities for consistency with each IOU's 2007 hedging plan filed in 2006. The RCA audit is scheduled to be completed by May 7, 2008, and the CMP review is scheduled to be completed by June 30, 2008.

The Commission has jurisdiction pursuant to Sections 366.04, 366.041, and 366.05, Florida Statutes.

Executive Summary

By Order No. PSC-02-1484-FOF-EI (the Hedging Order), the Commission approved a resolution that established a framework and direction for IOUs' risk management programs. The Hedging Order allows each IOU the flexibility to create and implement appropriate risk management programs for fuel procurement. The Commission sought to remove disincentives for IOUs to engage in hedging transactions and create customer benefits by providing a cost recovery mechanism for hedging costs.

FPL's petition proposes to end its physical and financial hedging activities and substitute a method of mitigating fuel factor volatility it describes as the Volatility Mitigation Mechanism (VMM). The heart of the VMM is that under-recoveries of fuel costs typically would be spread over two years rather than the current practice of one year. Over-recoveries of fuel cost would continue to be refunded over one year. FPL claims that the VMM would reduce the volatility of customers' fuel charges, thereby accomplishing the same goal as hedging.

FPL filed its petition because of its concern over regulatory risk. FPL notes that parties to the fuel clause proceeding have been critical regarding hedging losses but the same parties were not critical when FPL had hedging gains. FPL also believes the review period considered at the November 2007 fuel adjustment proceeding for determining the prudence of hedging transactions has increased FPL's regulatory risk. In the 2007 fuel clause hearing, the Commission only reviewed hedging transactions through the end of 2006, reserving ruling on the prudence of 2007's hedging results for the 2008 fuel proceeding. FPL notes that, if this policy were to continue, it would delay the determination of prudence for substantial amounts of hedging gains and losses, which potentially could harm FPL's credit ratings.

Based on FPL's concerns, staff is recommending in Issue 1 a clarification to the Hedging Order. As written, the Hedging Order does not specify timing of the review of hedging results. Staff recommends that the Commission clarify the Hedging Order to allow for prudence reviews through July 31 of the current year. To facilitate this review, the IOUs should be required to file current year hedging results by August 15th.

Staff believes this change to the procedure will, in part, address FPL's concern regarding regulatory risk while giving the Commission time to review hedging programs as a whole. Staff is currently conducting two comprehensive audits of the hedging programs. The reports from these audits are due in May and June of this year. The audits will examine transaction costs, 2003-2008 program performance, cost allocations, and hedging policies in other states. Upon completion of the hedging audits, staff intends to assess the results, consider possible revisions to the currently stipulated hedging policy, and advise the Commission accordingly.

Therefore, staff is recommending in Issue 2 that the Commission deny FPL's proposal to substitute the VMM for its current hedging practices. First, the petition is premature because the Commission is currently conducting financial and management audits of the IOUs hedging activities and decisions on the merit of the hedging program should await those audits' results. Without the benefit of the audits, staff's current opinion of the petition is that FPL has not shown that the VMM is superior to FPL's current hedging practices. Also, the VMM appears to routinely spread recovery of under-recoveries over two years, thereby compromising the

Commission's practice of considering fuel cost recovery deferrals on a case by case basis. Finally, FPL's concern regarding the timing of prudence reviews can be alleviated by extending the period for determining the prudence of hedging transactions through July 31 of the current year, assuming FPL provides sufficient supporting cost documentation. For the 2008 fuel hearing, the Commission would consider hedging transactions through July 31, 2008. With this change, the Commission will consider the prudence of FPL's hedging transactions through the most recent point in time for which the actual hedging data is available and can be reviewed, thereby continuing to allow parties and staff adequate time for discovery.

Issue 3 addresses FPL's proposed alternative to the VMM, wherein the Commission would approve specific volumes of oil and gas to be hedged, the timing of those hedges, and the specific hedging instruments to be used. FPL's proposal would also involve submission of monthly hedging reports so that the Commission could review the prudence of current year hedges through September 30th. Staff believes the Commission should deny this alternative. The alternative is also premature given the Commission's on-going review of hedging. Without the benefit of the audits, staff is of the opinion that this alternative appears to be a very rigid and mechanical methodology that lacks the flexibility afforded Company management pursuant to the Hedging Order.

Discussion of Issues

Issue 1: Should the Commission clarify the Hedging Order with regard to prudence reviews of current year hedging results?

Recommendation: Yes. To facilitate such reviews, the Commission should require each IOU to file a Hedging Information Report by August 15 of each year detailing its hedging transactions during the months of January through July of that year. The Hedging Information Report should provide the same hedging information identified through July of the actual/estimated year (i.e. the current year) as is required for the final true-up year (i.e. the prior year) per Section 5 of the "Proposed Resolution of Issues" of the Hedging Order. (Bennett, Lester, McNulty)

Staff Analysis: At the November 2007 fuel hearing, the Commission determined that the prudence of current year hedging results would be considered at the November 2008 fuel hearing. FPL indicates in its petition that the deferral of the prudence determination of current year hedging results to a later fuel hearing represents an increase in the Company's regulatory risk and is one of the primary reasons for the Company's VMM petition (addressed in Issue 2), which includes the proposed elimination of the utility's hedging activities. FPL's alternative proposal to VMM (addressed in Issue 3) includes a request that the Commission revise its procedure so that it would be in a position to make a finding of prudence regarding hedging transactions for the twelve months ending September 30 of the current year.

The Hedging Order authorized the IOUs to develop and implement physical and financial hedging programs. This was done via a settlement known as a Proposed Resolution of Issues approved by the Hedging Order. According to the Hedging Order, "[t]he Proposed Resolution of Issues provides a framework and a direction for parties and the Commission to follow with respect to risk management for fuel procurement.... in addition, it maintains flexibility for each IOU to create the type of risk management program for fuel procurement that it finds most appropriate, while allowing the Commission to retain the discretion to evaluate, and the parties the opportunity to address, the prudence of such programs <u>at the appropriate time</u>." See Hedging Order, Page 2 (emphasis added). It is the meaning of "appropriate time" that staff recommends the Commission clarify.

The Hedging Order is unclear regarding the period of time to be included in hedging prudence reviews. The Hedging Order states that "The Commission will review the prudence of IOUs' hedging transactions, including financial transactions, as part of its annual fuel and purchased power cost recovery proceedings. Prudence shall be determined under established legal standards." Again, it does not state with specificity the time period for which prudence will be established.

A review of prior fuel proceedings illustrates the need to clarify the Hedging Order. Since the Hedging Order was issued in 2002, the timing of prudence reviews of hedging transactions has been variable. In the 2003 and 2007 fuel hearings, the timing of the prudence reviews was through December 31 of the prior year (2002 and 2006, respectively). The timing of the prudence reviews in the 2004 and 2005 hearings was not <u>specifically</u> addressed in any issue for the IOUs, except for Gulf in 2005, when its actions were found to be prudent through

September 30 of that year. In the 2006 fuel hearing, the IOUs were found to have adequately mitigated price risk through September 1, 2006.

The Hedging Order requires prior year hedging information filed in April as part of each utility's final true-up testimony. Notably, the Hedging Order does not require utility filing of current year hedging information. The type of hedging information required to be filed for the prior year is identified in Section 5 of the "Proposed Resolution of Issues." The required hedging information includes volumes of fuel actually hedged using a fixed price contract or instrument, the types of hedging instruments the utility used, the volume and type fuel associated with each hedging instrument, the average period of the hedge, and the actual total costs of hedging for each hedging instrument. This is the basic hedging information that allows staff and parties to initiate a prudence review.

The Hedging Order states that "[t]he Proposed Resolution of Issues appears to remove disincentives that may currently exist for IOUs to engage in hedging transactions that may create customer benefits by providing a cost recovery mechanism for prudently incurred hedging costs, gains and losses, and incremental operating and maintenance expenses associated with new and expanded hedging programs." Upon review, staff believes deferring prudence determinations of hedging losses to a following year's fuel proceeding may create a disincentive for utilities to engage in hedging. Staff believes current year hedging information should be required for the purpose of allowing the IOUs to prove the prudence of their current year hedging transactions. This would facilitate prudence reviews and remove, at least in part, the aforementioned disincentive to hedge. Staff plans to conduct such prudence reviews and present its findings for the annual fuel cost recovery hearing.

For this reason, staff recommends that the Commission clarify the Hedging Order to allow for prudence reviews of hedging results through July 31 of the current year. To facilitate such reviews, the Commission should require each IOU to file a Hedging Information Report by August 15 of each year, detailing its hedging transactions during the months of January through July of that year. The Hedging Information Report should provide the same hedging information identified through July of the actual/estimated year (i.e. the current year) as is required for the final true-up year (i.e. the prior year) per Section 5 of the "Proposed Resolution of Issues" of the Hedging Order.

Issue 2: Should the Commission approve FPL's proposed Volatility Mitigation Mechanism to replace FPL's use of physical and financial hedging to mitigate volatility in the prices FPL pays for fuel, commencing January 1, 2009?

Recommendation: No. The Commission should deny FPL's proposed VMM at this time for the following reasons: (1) FPL's petition is premature because the Commission is conducting management and financial audits of FPL's hedging program. (2) FPL has not shown that the VMM is superior to FPL's current hedging practices. (3) The routine of spreading under-recoveries of fuel costs over two years will compromise the Commission's traditional consideration of deferrals of recovery of fuel costs on a case-by-case basis. (4) As addressed in Issue 1, FPL's concern regarding the timing of prudence reviews can be alleviated by extending the period of review for hedging transactions through July 31st of the current year contingent on sufficient and timely filing of hedging information. FPL should continue to manage fuel price risk according to the direction provided by Order No. PSC-02-1484-FOF-EI (the Hedging Order) until such time that the stipulated policy stated in that order is modified. The flexibility extended by the Hedging Order allows FPL to revise its hedging program to affect any changes it deems necessary in addressing fuel price volatility. (Lester, McNulty, Matlock, Slemkewicz, Maurey, Springer)

Staff Analysis: FPL proposes the VMM as an alternative for its current hedging program. Under its proposed VMM, FPL would eliminate its hedging program and collect under-recoveries of its fuel costs over two years instead of one year as is currently practiced in most instances. More specifically, FPL intends that, if FPL's combined final true-up and actual/estimated true-up amounts in any year's fuel proceeding reflects an under-recovery, half of that under-recovery would be collected in the projected year and the remaining half would be collected in the year following the projected year. Under the VMM, FPL proposes to continue to refund over-recoveries of its fuel costs over one year. FPL explains that all other aspects of the fuel clause would continue to work as they currently do, including interest applied to over-recoveries and under-recoveries, the filing of true-up and projection filings, and procedures for mid-course corrections.

FPL maintains that its hedging program has worked as intended. The Company maintains that the program has been successful in achieving the goal of mitigating fuel price volatility. It states that the vast majority of its hedges have been done through financial transactions rather than through physical hedges because financial hedges are more readily available at low transaction costs and from parties with acceptable credit profiles.

FPL's petition proposing the VMM is based on FPL's view that a new level of regulatory risk has been created that was not contemplated by FPL or its shareholders at the inception of the hedging program. First, FPL has observed that the reaction of various stakeholders is not symmetric when its hedging program shows gains and when it shows losses. (FPL uses the term "stakeholder" in its petition to include not only FPL shareholders, but also parties to the fuel clause, and consumers.) FPL cites as an example the reaction of FIPUG, which took the position in the 2007 fuel adjustment proceeding that the effectiveness of IOU hedging programs should be subject to a detailed review and that customers appear not to derive benefit from hedging activities because the annual fuel factor removes fuel cost volatility.

Second, FPL states that its concern regarding asymmetric risks of its hedging program was exacerbated by the decision in the 2007 fuel adjustment docket to defer ruling on the prudence of FPL's 2007 hedging results until the 2008 fuel adjustment proceeding, to be conducted in November 2008. The Company states that this decision leaves its shareholders in doubt as to the final recovery of hundreds of millions of dollars in hedging results, i.e., losses. FPL maintains that decisions to defer ruling on the prudence of hedging losses, if perpetuated in future clause recovery cycles, increases regulatory risk and will ultimately result in higher capital costs to FPL and its customers. FPL maintains that credit rating agencies reflect this increase in regulatory risk in credit assessments of FPL and that investors include this risk in establishing their required returns.

Finally, FPL cites its direct and indirect hedging costs as additional reasons for considering a price volatility mitigation alternative to its hedging program. FPL states the direct costs are transaction costs and the indirect costs are possible premiums associated with FPL's status as a large buyer of gas and heavy oil and a significant user of swaps and options.

FPL states that it proposes the VMM because it will achieve the same aims as hedging while avoiding some of the disadvantages of hedging. FPL reasons that, if a mechanism (VMM) can adequately dampen the volatility in fuel charges to customers, it is unimportant whether it is achieved via hedges that mitigate the volatility in what FPL pays for fuel or by some other means (e.g. the VMM). FPL has concluded that the volatility in customer fuel charges can be mitigated almost as effectively under the VMM as it has under FPL's current hedging program. According to FPL, its proposed VMM has the following advantages over the current hedging program: (1) FPL would be exposed to less perceived credit risk than under the current hedging program, (2) customers would avoid operational and transaction costs associated with implementing a hedging program, (3) customers would avoid risk premiums paid for purchasing hedges on a fuel short basis, (4) customers would in essence "borrow" from FPL for deferred under-recoveries at the very favorable commercial paper interest rate, yet retain the flow back of over-recoveries in a single year.

FPL says a requisite for its agreement to implement the VMM is regulatory certainty as to the recovery of the amounts that are deferred. FPL states that it needs the following specific assurance of recovery from the Commission:

1. The Commission recognizes that FPL will no longer acquire physical or financial hedges to mitigate fuel price volatility.

2. The Commission recognizes that FPL is entitled to charge and collect from customers interest at the commercial paper rate on outstanding under-recovery balances while those balances are being recovered over the two-year period contemplated by the VMM, regardless of the amount of the accumulated balance. FPL contends that this represents a benefit to ratepayers because FPL's actual cost of money substantially exceeds the commercial paper rate.

3. The Commission recognizes that, once the amount of the final true-up under-recovery is determined, FPL is entitled to recover the full amount over the two years contemplated by the VMM.

Timing of FPL's Petition

The VMM is a significant change to FPL's current practice, in that FPL proposes to eliminate all physical and financial hedging. Staff believes the VMM as proposed by FPL is, at best, premature. Staff believes the Commission should consider such a change only after it has an opportunity to review the financial and management audit reports of the four electric IOUs' hedging practices and results. The audit reports and reviews will be completed in May and June of 2008. The financial audit will examine 2007 hedging transaction costs, consistency of hedging practices with the Hedging Order, and cost allocations. The management audit will review 2003-2008 program performance, and transaction costs as well as hedging policies in other states. Upon completion of the hedging audits, staff will assess the results, consider possible revisions to the current stipulated hedging policy, and advise the Commission accordingly.

Regulatory Risk and VMM

With fuel price hedging, the expectation is that gains and losses will cancel out over the long-run. At various times since 2002, FPL has had either cumulative hedging losses or cumulative hedging gains. While price volatility is reduced, hedging is not expected to create long-run profits or losses. Thus the appropriate review of hedging programs requires a balanced, disciplined, and long-term view of hedging transactions. The most recent fuel order (as quoted by FPL in its petition) states:

> Hedging program[s] are designed to assist in managing the impacts of fuel price volatility. Within any given calendar period, hedging can result in gains or losses. Over time, gains and losses are expected to offset one another.

Order No. PSC-08-0030-FOF-EI, p. 4

The preceding quote demonstrates the Commission's support for the long-term view of hedging programs. Further support for utility hedging practices and the long-term view of such practices is stated in the 2006 fuel order:

> After evaluating the exhibits and testimony filed by PEF, staff recommended that the Commission find that Progress, through its hedging activities, has adequately mitigated the price risk for natural gas, residual oil [sic] and purchased power through September 1, 2006. Staff summarized that each utility presented testimony that the objective of the hedging programs is to minimize price volatility, and that prices are uncertain and volatile, particularly for natural gas, so there will be periods when the companies have hedging gains and other periods where the companies will have hedging losses. Staff also found that the utilities follow risk management plans to avoid speculation. Staff's belief is that minimizing price volatility produces customer benefits.

Order No. PSC-06-1057-FOF-EI, issued December 22, 2006, Docket No. 060001-EI, <u>In re: Fuel and purchased power cost recovery clause with generating performance incentive factor.</u>, p. 5.

Therefore, while parties to the fuel clause proceeding have made various statements regarding hedging activities, the Commission has been supportive of the long-term view of hedging gains and losses. Staff recommends the Commission continue with this long-term view. In response to staff data requests, none of the parties to the resolution approved by the Hedging Order other than FPL recommended the elimination of hedging.

Staff considered FPL's concern of increased regulatory risk related to the decision to defer determining the prudence of current year hedging transactions. Order No. PSC-08-0030-FOF-EI explains the procedure for determining the prudence of a utility's hedging transactions. The order states:

> Order No. PSC-02-1484-FOF-EI, however, requires us to review the prudence of a company's hedging results based upon yearly filings received in April.[1] [The order states that "expense amounts associated with financial and physical hedging activities shall be included in the Fuel Clause Final True-up filing each April."] Specifically, the order states that we will review the prudence of subject companies' hedging transactions "as part of . . . [our] annual fuel and purchased power cost recovery proceedings." It further states that "[p]rudence shall be determined under established standards."
>
> Thus, the obligation to determine, on an annual basis, the prudence of a company's hedging transactions is tempered by the need to apply appropriate standards to such review. This includes, for example, the need to review in sufficient detail the company's hedging transaction results. This year's review departs from some prior years with respect to our review of the current (2007) year's data for purposes of determining prudence. This difference is procedural and not intended to suggest that we have identified reasons for concern over this year's hedging results. We have not found imprudence for the 2007 hedging year, but prefer to defer our decision for 2007 to the 2008 fuel proceeding where we will have available the last four months of data for 2007.

Order No. PSC-08-0030-FOF-EI, p. 4.

While FPL argues in its petition that this change in the period for determining the prudence of hedging transactions creates regulatory risk, FPL could not cite any report from bond rating agencies (Moody's, Standard and Poor's, or Fitch) that specifically suggests such risk. Instead, FPL argues that the regulatory risk will be created if the procedure for review and determination of prudence continues with future fuel clause proceedings. FPL states that the current procedure creates uncertainty regarding the recovery of hedging gains and losses, the amounts of which can be substantial.

Staff believes FPL's concern over the period of review of hedging transactions has some merit. The amounts of hedging gains and losses can be substantial. Delays in the determination of prudence of gains and losses could increase risk for FPL. The Hedging Order states:

> Further, the Proposed Resolution of Issues appears to remove disincentives that may currently exist for IOUs to engage in hedging transactions that may create

> customer benefits **by providing a cost recovery mechanism for prudently incurred hedging transaction costs, gains and losses, and incremental operating and maintenance expenses associated with new and expanded hedging programs.**

Hedging Order, p. 2 [emphasis added]. By determining the prudence of gains and losses for current year hedging transactions, the Commission will reduce regulatory uncertainty and still be consistent with the intent of the Hedging Order. Of course, expedient determinations of prudence are contingent upon the availability of sufficiently detailed actual hedging transaction results as provided by the Company. Also, parties and staff should have adequate time to conduct discovery on hedging issues.

The procedure recommended in Issue 1 will reduce uncertainty for FPL. FPL can report actual hedging results through July 31 of the current year in a timely manner. This will allow staff and parties to the fuel clause proceeding adequate time to conduct discovery regarding FPL's hedging activities.

Treatment of Over-recoveries and Under-recoveries

At this point, it is important to note the potential impact of FPL's VMM petition on the treatment of over-recoveries and under-recoveries. FPL's VMM proposal would spread an under-recovery over two years on a routine basis. In response to staff's data requests, FPL clarified that, if the Commission decides any particular under-recovery amount does not warrant a two-year recovery, the Commission could mandate a one-year recovery period. At the workshop, the Company further clarified that the default recovery period would be two years barring some special circumstance.

Currently, the default is to allow for the under-recoveries or over-recoveries to be included in the calculation of the fuel factors for the projected year. Thus the current recovery period typically is one year.

However, in past fuel clause proceedings, the Commission has deferred portions of under-recoveries to later periods, i.e., spread the under-recovery over more than one year. The Commission has proceeded carefully with such deferrals. In Order No. PSC-05-1252-FOF-EI, issued December 23, 2005, in Docket No. 050001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor, the Commission considered a request by FPL to collect a large under-recovery over a two-year period, rather than one year. The Commission weighed differing policies: the effects of rate shock, and sending accurate rate signals to consumers. The Commission in 2005 chose not to defer recovery over the two-year period for numerous reasons. A review of the factors the Commission considered in reaching its decision (See Attachment A) makes it clear that the Commission should retain its discretion to consider each year's factual circumstances in making its decision. In 2005, the Commission decided that an attempt to reduce rate shock in one period might magnify rate shock in a later period, i.e., a compounding effect. A further concern with deferrals in 2005 was that an accurate price signal would not be sent to customers.

In addressing this petition, staff solicited input from the other parties echoing these same concerns regarding the routine deferral of one-half of each under-recovery until the cost-recovery period following the projected year. The other three IOUs point out that: (1) other variables, such as changes in fuel cost, can affect period-to-period changes in a utility's fuel-cost recovery factor (Gulf); (2) deferred balances are accompanied by additional interest charges and automatic deferrals may result in intergenerational inequities (PEF); and (3) the extended deferral of an under-recovery disrupts the concept of sending the right price signals (TECO). PEF points out that possible future conditions should be considered before deciding to defer part of a large under-recovery beyond the projected cost recovery period.

Staff believes the concerns expressed in the above-referenced order and by other parties to the settlement approved by the Hedging Order are relevant to FPL's VMM proposal. The VMM proposal, in a routine manner, would spread under-recovered fuel cost over two years. In doing so, the proposal could compromise the Commission's discretion to consider rate impact, rate stability, and accurate price signals to customers.

Transaction Costs and Hedging Premiums

FPL notes that elimination of hedging would eliminate direct costs such as transaction costs associated with hedging. However, in its petition, FPL acknowledges that transaction costs are small. In addition, staff is reviewing transaction costs as part of the financial and management audits regarding hedging.

In its petition, FPL states that it is the largest gas short utility in the country, meaning it buys more gas than any other electric utility in the country. FPL further notes that, to the extent entities that buy oil and gas place a greater value on mitigating volatility than oil and gas producers, markets will build a hedging premium into prices. FPL suggests a slight bias against buyers of gas during periods of generally rising prices. In theory, in periods of rising prices, producers may wait to sell at higher prices. Conversely, in theory, producers may sell at a discount in periods of falling prices.

Staff notes price volatility involves rising and falling prices. As such, the bias, to the extent it exists, could shift between buyers and sellers of oil and gas. Further, FPL's petition indicates FPL does not know the exact relationship between buyers and sellers regarding this bias. FPL can only offer that "there is some reason to believe this balance may favor the sellers." Since FPL is not certain regarding the hedging premium, staff does not believe the claim of such a premium is an appropriate reason to curtail all physical and financial hedging. None of the other IOUs has alleged this bias in hedging oil and gas price volatility.

Capital Structure and Earnings Surveillance Effects of VMM

On page 9 of its petition, FPL included the following footnote:

> In order to justify continuing to allow customers to "borrow" at the commercial paper rate over the VMM's two-year recovery period, FPL will need to reach agreement with the Commission on a fair approach to reflecting the impact of these low-interest loans on FPL's earnings for surveillance purposes. For the

> Commission's regulatory accounting purposes it is assumed that FPL funds these loans at its overall cost of capital, yet FPL collects interest from customers only at the much lower commercial paper rate. The difference between those rates can significantly impact FPL's actual earned return in periods of large under-recoveries, but the Commission's currently approved regulatory accounting for under-recoveries does not take this into account. This is especially inappropriate because the Commission's regulatory accounting reflects the full *positive* impact on earned return when the same difference in rates is applied to over-recoveries.

In this footnote, FPL stated that it would have to "reach agreement with the Commission" concerning the treatment of any under-recoveries for surveillance purposes. However, the footnote did not provide any information regarding what that agreement might entail.

In its response to staff's March 5, 2008, data request, FPL provided the following clarification:

> The fuel cost recovery clause provides that FPL pay interest to its customers for over-recoveries and collect interest from customers for under-recoveries at the commercial paper rate. In order to accurately reflect the impact of over/under recoveries on FPL's earned return, both should be excluded from rate base for surveillance reporting purposes (presently only under-recoveries are excluded). Additionally, adjustments to working capital to remove over/under recoveries from rate base should be made using the same funding sources assumed for recovery through the fuel clause.

In its petition regarding the VMM proposal, FPL is not proposing that the Commission revise its established treatment of over-recoveries and under-recoveries in working capital at this time. Instead, the matter could be addressed in the next fuel cost recovery proceeding.[1] The issue of excluding under-recoveries from, and including over-recoveries in, working capital has been fully litigated in numerous electric utility rate case dockets[2] since this treatment was first implemented. This treatment is also applied to the over-recoveries and under-recoveries of natural gas utilities. The working capital and capital structure reconciliation treatments of over-recoveries and under-recoveries are generic issues that affect both electric utilities and natural gas utilities. The Commission included clause over-recoveries in working capital as an additional counter to any bias that might exist to over-project expenses. As such, staff believes it would be inappropriate to revise the established treatment in any single proceeding without the input and participation of all affected and interested parties.

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[1] FPL response to staff's 03/05/08 Hedging Data Request No. 18 in Docket No. 080001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor.

[2] Order No. 11437, issued December 22, 1982, and Order No. 11980 (Reconsideration), issued May 26, 1983, in Docket No. 820097-EU, In re: Petition of Florida Power and Light Company to increase its rates and charges; Order No. 11628, issued February 17, 1983, in Docket No. 820100-EU, In re: Petition of Florida Power Corporation to increase its rates and charges; Order No. 12663, issued November 7, 1983, in Docket No. 830012-EU, In re: Petition of Tampa Electric Company for an increase in rates and charges and approval of a fair and reasonable rate of return; Order No. 13537, issued July 24, 1984, in Docket No. 830465-EI, In re: Petition of Florida Power and Light Company for an increase in its rates and charges; and Order No. 14030, issued January 25, 1985, in Docket No. 840086-EI, In re: Petition of Gulf Power Company for authority to increase its rates and charges.

Conclusion

Staff recommends that the Commission deny FPL's VMM proposal. FPL's petition to eliminate hedging is premature since the Commission currently is conducting audits of FPL's hedging program. FPL has not shown that the VMM will reduce customers' exposure to fuel price volatility more effectively than hedging. Further, approval of the VMM proposal would unnecessarily create a rigid policy regarding the treatment of deferrals of under- recovered fuel costs and the effect such deferrals has on customers' bills. The asymmetric risks of FPL's hedging program, to the extent such risks are real, can be adequately addressed in the review process within the fuel cost recovery proceeding. Staff believes extending the review period through July 31 of the current year will eliminate uncertainty that could be associated with the recovery of prudently-incurred hedging gains and losses. Upon completion of the hedging audits, staff will assess the results, consider possible revisions to the currently stipulated hedging policy, and advise the Commission accordingly.

Issue 3: Should the Commission approve FPL's alternative proposal to the Volatility Mitigation Mechanism to reduce alleged regulatory risk associated with the current hedging program, including the hedging guidelines appearing in Exhibit 3 of its petition and revised procedures for review of FPL's hedging results set forth in Paragraph 19 of its petition?

Recommendation: No. The Commission should not approve FPL's proposed hedging guidelines because FPL's alternative proposal is premature and too constraining. FPL should continue to manage fuel price risk according to the general direction provided by Order No. PSC-02-1484-FOF-EI (the Hedging Order), until such time as the Commission modifies that order. FPL's proposal for revising the procedures for reviewing its hedging results should not be approved. Regarding the review period for FPL's hedging transactions, as discussed in Issue 1, the Commission should review hedging transactions for determination of prudence through July 31 of the current year contingent on sufficient and timely filing of hedging information. (Lester, McNulty, Matlock, Slemkewicz, Maurey, Springer)

Staff Analysis: If the Commission determines to not approve the VMM as proposed, FPL requests two changes to reduce the uncertainty and regulatory risk it maintains are associated with the current hedging program. First, FPL requests that the Commission reduce the uncertainty associated with the current hedging program by approving a set of general and specific hedging guidelines set forth by FPL. Secondly, the Company proposes that the Commission reduce FPL's regulatory risk by requiring Commission staff to conduct reviews of hedging results to be filed monthly so that the Commission would be in a position to timely rule on the prudence of FPL's hedging results.

In its first request under this alternative approach, FPL asks the Commission to approve the proposed hedging guidelines that are set forth in Exhibit 3 of its petition. Exhibit 3 contains both proposed general principles and proposed specific parameters of FPL's hedging program. FPL states that the guidelines, if approved, would provide clear direction to FPL as to the specifics of the nature and timing of the hedging approach to be used. Exhibit 3 states that all hedging decisions made subject to the specific parameters will be presumed to be prudent unless a showing is made that FPL had actual, advance knowledge of objectively verifiable information demonstrating that acting within the parameters would result in higher costs to customers than another course of action. In no event would projections of future fuel prices or other data constitute "objectively verifiable information."

FPL's proposed general principles provide the assurances that the Commission recognizes (1) that the purpose of hedging is to control price volatility, (2) that the potential for lost savings opportunities is a reasonable trade-off for reducing exposure to price increases, (3) that FPL is not expected to speculate on the direction of markets, and (4) that it is appropriate for FPL to hedge a portion of the total expected volume of fuel purchases. FPL's proposed specific parameters are confidential, but they generally provide a prescriptive formula for the Company's hedging program.

In FPL's second request under this alternative approach, FPL asks the Commission to revise its procedure for reviewing FPL's hedging results in order to the reduce regulatory risk of its hedging program. By Order No. PSC-08-0030-FOF-EI, the Commission deferred consideration of the prudence of the hedging results for 2007 until the November 2008 fuel adjustment hearing. FPL proposes that, on a going-forward basis, it file monthly information on hedging results pursuant to the current A-Schedule procedure, wherein monthly fuel data is filed on approximately the 20th of each month for the prior month. FPL asks that Commission staff conduct ongoing reviews of such monthly information as it is filed so that the Commission would be in the position at the fuel hearing to rule on the prudence of hedging results for the twelve months ended September 30 of that year.

FPL's proposed general principles of its hedging guidelines resemble in many respects the current practice regarding hedging as stated in the Hedging Order and subsequent fuel clause orders. The Commission recognizes through those orders that the purpose of fuel price hedging is to reduce customer's exposure to price volatility, hedging is not speculation, and that hedging per such orders can result in gains and losses in significant amounts. However, the Hedging Order does not contain FPL's proposed guideline that "[t]he Commission endorses the goal of controlling volatility of fuel adjustment charges and finds that hedging is a useful tool for this purpose."

As noted under Issue 1, staff is currently reviewing utility hedging activities via two separate audits. The CMP hedging audit will include a review of any preapprovals of the prudence of hedging guidelines (principles and parameters) which may have been granted by other state commissions. FPL stated at the workshop that California has preapproved hedging guidelines. The CMP hedging audit is still underway at this time. Once completed, the audit should provide a comprehensive review of other state's hedging guideline preapprovals. Staff believes FPL's alternative proposal for Commission approval of hedging guidelines is premature because it proposes to modify the guidelines of the hedging order prior to the completion of the ongoing hedging audits.

In addition, Staff finds two significant problems with the requested specific parameters contained within FPL's proposed hedging guidelines. First, FPL's proposed specific parameters as identified are inflexible and mechanical. The guidelines are specific as to the volumes hedged and when the hedges are placed. Oil and gas markets are dynamic and continuously react to global economic, environmental, and political events. In a somewhat similar manner, FPL's forecasted fuel requirements change every day. The proposed guidelines, however, are rigid in that the timing of hedging transactions and the volumes hedged would be set in advance and adhered to regardless of changes in market conditions. The approach is not responsive to the inevitable dynamics of fuel markets and FPL fuel requirements.

Second, the specific parameters for which FPL requests approval detract from FPL's fundamental obligation to manage its activities in a prudent manner. Staff believes FPL is obligated to manage all aspects of its fuel procurement activities, including management of price volatility. This proposal invites the Commission to micromanage FPL's hedging activities. The Commission has supported utility hedging activities, but the Commission's job is not to micromanage. In the Hedging Order, the Commission stated:

> In addition, it [the Proposed Resolution of Issues] maintains flexibility for each IOU to create the type of risk management program for fuel procurement that it finds most appropriate while allowing the Commission to retain the discretion to

> evaluate, and the parties the opportunity to address, the prudence of such programs at the appropriate time.

Hedging Order, p.2

The Order allows flexibility for utility hedging programs. Each IOU is different regarding customers, fuel mix, and type and age of generators; therefore, each IOU's hedging program will be unique. Likewise, FPL has the flexibility to design its hedging program to meet its particular circumstances and to respond to changes in market conditions. Staff believes the more appropriate approach is for the Commission to approve in advance company risk management plans that identify ranges for the percentages of volumes to be hedged and the types of hedging instruments. Acting within those guidelines, the Company can rebalance its hedge positions in response to changes in market conditions.

In Issue 1, staff addressed FPL's concern regarding the timing of prudence reviews. Staff believes that the appropriate period for review of hedging results is through July 31 of the current year based on FPL's filing of hedging results by August 20 of the current year and in testimony. This allows parties and staff to review the results and conduct any discovery they believe necessary. Staff believes an on-going review of hedging results up to September 30 of the current year would not allow time for appropriate discovery and review.

Issue 4: Should this docket be closed?

Recommendation: No. This docket is an on-going docket and should remain open. (Bennett, Young)

Staff Analysis: This docket is an on-going docket and should remain open.

II. COMPANY-SPECIFIC FUEL COST RECOVERY ISSUES

A. Florida Power & Light Company

Deferral of Underrecovery

FPL requested that it be authorized to spread its total underrecovery equally over a two-year period, 2006 and 2007, which means that FPL would defer collecting $486,367,268 until 2007. FPL maintains that spreading out the underrecovery would mitigate the impact on customer bills. While we understand FPL's concerns, we believe that it is not appropriate to defer any portion of FPL's 2004 final true-up or the 2005 actual (January-September) true-up to 2007, since these are known costs. The level of FPL's underrecoveries for the period of October through December of 2005 is estimated to be $229,594,406. If a midcourse correction is warranted during 2006 these costs would be considered at that time, otherwise we will examine these costs during the annual fuel hearing to be conducted in November 2006. This approach balances the concerns FPL has regarding high bill impacts in 2006 with our concerns regarding high bill impacts in 2007, a concern that FPL itself recognizes as valid.

When rates increase dramatically, as is being proposed by FPL, we will sometimes approve step increases over a period of time to reduce rate shock to the extent we find the costs to be prudent and reasonable. We have taken such action at times when there is a reasonable expectation that fuel rates would stay the same or decline in the year to which costs are being deferred. We believe there is considerable risk that further bill increases may occur in mid-2006 and 2007 for FPL related to its request for storm cost recovery for Hurricanes Wilma and Katrina, storm reserve renewal, and the inclusion of Turkey Point Unit 5 revenue requirements into the fuel rates. These bill impacts may result in overall bills being higher in 2007 than 2006. Deferring collection of underrecovery amounts from 2005 would only serve to compound this problem. There is also the unquantified risk of hedging gains included in the 2007 fuel rates and whether or not they would be lower than the hedging gains in 2006. As a result, we do not believe that deferral of fuel costs to the extent proposed by FPL is advisable at this time.

We have other concerns, including the impact of interest rates on consumers when a deferral of this magnitude is made. There was an estimate provided during the hearing of approximately $19 million in interest expense that would be associated with the deferral of $486,367,268 as proposed by FPL. There are also intergenerational inequities, which is very important in this instance because of the size of the proposed deferral. In addition, it is important to send accurate price signals to customers. All of these concerns must be balanced against the customer impact of a very large immediate increase in fuel rates due to the dramatic increase in fuel costs if it were all recovered in one year, 2006. We believe allowing deferral of only the estimated October-December 2005 underrecoveries in this case will serve to mitigate the bill impacts in early 2006, while at the same time allow the opportunity for us to consider the other recovery needs of FPL for late 2006 and 2007 at a time when more information is available.

Therefore, based on the evidence in the record, we find that FPL shall not defer its January-September 2005 actual underrecoveries and instead shall recalculate its 2006 fuel factors to reflect an increase of $256,772,862 to its total jurisdictional fuel costs, thereby including all outstanding actual underrecoveries in the 2006 fuel factors. This amount is the increase required to bring FPL's total fuel adjustment true-up amount to be collected in 2006 to $743,140,130, which reflects recovery of FPL's 2004 final true-up and 2005 actual true-up amounts.