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

**DATE:** July 30, 2008

**TO:** Rosanne Gervasi, Senior Attorney, Office of the General Counsel

**FROM:** William F. Costan, Operations Review Specialist, Division of Regulatory Compliance

**RE:** 080436-EI - Request for confidential classification of portions of staff's *Review of Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities* by Tampa Electric Company.  
Documents: 05269-08 and 05183-08

Attached is a June 18, 2008 request (document 05183-08) and June 19, 2008 supplement request (document 05269-08) from Tampa Electric Company counsel, James Beasley. These documents include the company's request for Specified Confidential Classification on portions of staff's *Review of Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities*. The company cites §366.0963(3)(d) and §366.0963(3)(e), F.S.—which address contractual data and competitive interests, respectively—as the basis for the request.

Staff has reviewed these requests and believe that the specified information is covered by §366.0963(3)(d) and (3)(e), F.S. Staff recommends the approval of Tampa Electric Company's Request for Confidential Classification on portions of staff's *Review of Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities*.

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**AUSLEY & MCMULLEN**

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080436

REDACTED

June 18, 2008

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Ms. Ann Cole, Director  
Office of Commission Clerk  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, Florida 32399-0850

Re: UNDOCKETED - Review of Fuel Procurement Hedging Practices of Florida's  
Investor-Owned Electric Utilities


Dear Ms. Cole:

Enclosed for filing in the above-styled matter are the original and fifteen (15) copies of Tampa Electric Company's Request for Confidential Classification of information contained in the Staff's draft audit report of Review of Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities dated June 2008.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and returning same to this writer.

Thank you for your assistance in connection with this matter.

Sincerely,

  
James D. Beasley

JDB/pp  
Enclosure

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Review of Fuel Procurement )  
Hedging Practices of Florida's. )  
Investor-Owned Electric Utilities. )  
\_\_\_\_\_ )

UNDOCKETED  
FILED: June 18, 2008

**TAMPA ELECTRIC COMPANY'S  
REQUEST FOR CONFIDENTIAL CLASSIFICATION**

Tampa Electric Company ("Tampa Electric" or "the company"), pursuant to Section 366.093, Florida Statutes, and Rule 25-22.006, Florida Administrative Code, hereby requests confidential classification of the highlighted information contained on Bates stamp pages 20, 23, 24, 30 and 31 of the Staff's draft audit report dated June 2008 in the above matter, with the duration of that confidential classification to be a minimum of three years. In support of its request, Tampa Electric states as follows:

1. Tampa Electric is submitting under separate cover a single confidential version of the Staff's draft audit report with confidential information highlighted in yellow and marked "CONFIDENTIAL" in red on Bates stamp pages 20, 23, 24, 30 and 31 of the Draft Audit Report.

2. Subsection 366.093(1), Florida Statutes, provides that any records "found by the Commission to be propriety confidential business information shall be kept confidential and shall be exempt from s. 119.07(1) [requiring disclosure under the Public Records Act]." Proprietary confidential business information includes, but is not limited to "[i]nformation concerning . . . contractual data, the disclosure of which would impair the efforts of the public utility or its affiliates to contract for goods or services on favorable terms." Subsection 366.093(3)(d), Florida Statutes. Proprietary confidential business information also includes "[i]nformation relating to competitive interests, the disclosure of which would impair the competitive business

DOCUMENT NUMBER-DATE

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of the provider of the information.” Section 366.093(3)(e). The designated portions of the Staff's draft audit report fall within these statutory categories and, thus, constitute proprietary confidential business information entitled to protection under Section 366.093, Florida Statutes, and Rule 25-22.006, Florida Administrative Code.

3. Attached hereto as Exhibit "A" is a written justification for the requested confidential treatment of the highlighted portions of the Staff's draft audit report.

4. Attached hereto as Exhibit "B" are two public versions of the Staff's draft audit report with the confidential information redacted.

5. The highlighted information contained in the Staff's draft audit report for which confidential classification is sought is intended to be and is treated by Tampa Electric as private and has not been publicly disclosed.

**Requested Duration of Confidential Classification**

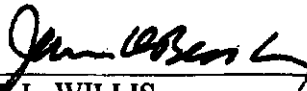
6. Tampa Electric requests that the confidential portions of the Staff's draft audit report be treated by the Commission as confidential proprietary business information for a minimum of three years. The draft report provides detailed hedging strategies and discloses details concerning counterparty relationships, many of which are of a continuing nature and which could be in place well beyond the standard 18 month period that confidential information is treated by the Commission as such. The various risk management strategy components build upon each other and disclosing components of the company's hedging strategy sooner than three years after it is submitted would arm would-be suppliers of goods and services, as well as competitors of Tampa Electric, with significant information regarding the company's risk management strategies. A minimum of three years is essential to prevent those entities in the fuel and purchased power markets from having access to information they could use to the

competitive disadvantage of Tampa Electric, which would increase the fuel and purchased power costs borne by Tampa Electric's customers. A minimum of three years is also necessary to insure that Tampa Electric's counterparty relationships are not harmed and that potential new counterparty relationships are not compromised or discouraged.

WHEREFORE, Tampa Electric Company respectfully requests that the highlighted information set forth on Bates stamp pages 20, 23, 24, 30 and 31 of the Staff's draft audit report dated June 2008 be accorded confidential classification for the reasons set forth above.

DATED this 18<sup>th</sup> day of June 2008.

Respectfully submitted,



---

LEE L. WILLIS  
JAMES D. BEASLEY  
Ausley & McMullen  
Post Office Box 391  
Tallahassee, Florida 32302  
(850) 224-9115

ATTORNEYS FOR TAMPA ELECTRIC COMPANY

**JUSTIFICATION FOR CONFIDENTIAL TREATMENT OF HIGHLIGHTED PORTIONS OF TAMPA ELECTRIC'S RESPONSES TO STAFF'S DRAFT AUDIT REPORT OF FUEL PROCUREMENT HEDGING PRACTICES OF FLORIDA INVESTOR-OWNED ELECTRIC UTILITIES**

<u>Bates Stamp</u> <u>Page No.</u>	<u>Confidential Information</u>	<u>Justification</u>
20	Yellow Highlighted Information	(1)
23	Yellow Highlighted Information	(1)
24	Yellow Highlighted Information	(1)
30	Yellow Highlighted Information	(2)
31	Yellow Highlighted Information	(2)

- 
- (1) The information in question discloses details regarding Tampa Electric's physical or financial hedging strategy in that it discloses a breakdown of actual or targeted natural gas purchases by percentage. Disclosing the highlighted information in the draft audit report would provide highly sensitive information to recipients regarding the manner and timing of Tampa Electric's entry into the fuel market. Knowledge of this information would allow others an opportunity for market manipulation through transactions made in anticipation of the company's natural gas purchasing priorities. Market manipulations based on knowledge of the highlighted information could significantly increase the price of natural gas purchased by Tampa Electric and paid for by its customers. Such disclosure would impair the efforts of Tampa Electric to contract for goods and services on favorable terms for the benefit of its customers. The Commission on a number of occasions has granted Tampa Electric's request for confidential classification of portions of the company's Risk Management Report consisting of the same type of information for which confidential classification is sought in the draft Staff audit report filed this date.
- (2) The information in question discloses details concerning the counterparties with which Tampa Electric has counterparty relationships including the identities of the counterparties and details regarding their credit rankings and credit limits. There are a number of present and potential counterparties with whom Tampa Electric may wish to deal in executing its hedging strategy. Disclosure of the identities of current counterparties, their credit ratings and credit limits would arm other potential counterparties with information concerning what Tampa Electric deems acceptable counterparty qualifications. All of these present and potential counterparties compete with each other for business and disclosure of the details concerning counterparties which whom Tampa Electric currently has relationships could adversely affect Tampa Electric's efforts to retain existing counterparty relationships and/or negotiate new relationships. Disclosure of this type of information could lessen Tampa Electric's ability to negotiate

EXHIBIT "A" NUMBER-DATE

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for goods and services on favorable terms and thereby increase costs to the company's customers. As such, the information in question is entitled to protection against public disclosure pursuant to Section 366.093, Florida Statutes, and the Commission's Rule 25-22.006, Florida Administrative Code.

*Review of*

**Fuel Procurement Hedging Practices  
of  
Florida's Investor-Owned Electric Utilities**

**William "Tripp" Coston  
Project Manager  
Operations Review Specialist**

**Jerry Hallenstein  
Government Analyst II**

**June 2008**

**By Authority of  
The State of Florida for  
The Public Service Commission  
Division of Competitive Markets and Enforcement  
Bureau of Performance Analysis  
PA-07-11-007**

**1  
Exhibit "B"**

DOCUMENT NUMBER DATE

**05183 JUN 18 08**



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# 1.0 Executive Summary

## 1.1 Objectives

At the request of the Florida Public Service Commission's (the Commission) Division of Economic Regulation, the Division of Competitive Markets and Enforcement conducted a review of the fuel procurement hedging programs currently in place within the four investor-owned generating electric utilities operating in Florida: Florida Power & Light Company (FP&L), Gulf Power Company (Gulf Power), Progress Energy Florida, Inc. (PEF), and Tampa Electric Company (TEC). Each of these companies engage in hedging programs as a tool to minimize risk and to manage price volatility associated with the procurement of fuel for utility generation.

The primary objectives of this review were to:

- ◆ Document and assess current and historical hedging strategies of the fuel procurement hedging programs within each company.
- ◆ Document each company's management philosophy toward hedging activities.
- ◆ Determine if each company's hedging program is in compliance with the Proposed Resolution of Issues set forth in Commission Order No. PSC-02-1484-FOF-EI (Hedging Order).
- ◆ Evaluate the hedging objectives set forth in each company's Risk Management Plans filed in the Fuel and Purchased Power Cost Recovery docket each year.
- Quantify the net costs and benefits of each company's hedging programs.
- ◆ Document rules and orders issued by other state commissions regarding electric utilities' hedging programs.

## 1.2 Scope

Audit staff's review examines hedging processes designed to mitigate the impact of uncertain fuel prices on consumers. Specifically, audit staff examined the structure and performance of hedging natural gas and fuel oil through the use of physical purchases and/or financial instruments for the years 2003 through 2007.

The scope of the review concentrated on the three main areas within each company's hedging program:

- ◆ Fuel procurement process
- ◆ Hedging strategy

◆ Risk performance

Within these three areas, audit staff focused on examining the company's procurement and hedging planning process along with the evaluation of the creditworthiness of financial relationships.

### 1.3 Methodology

Audit staff's review was conducted from December 2007 to May 2008. The information compiled in this report was gathered via company responses to document requests, on-site interviews with key personnel, documents filed as part of the Commission's fuel and purchased power cost recovery dockets, and various industry resources. Specific information collected includes company policies and procedures, organizational charts, Risk Management Plans, and historical hedging transactions. Analysis of this information is discussed in detail in chapters three through six.

### 1.4 Overall Opinion

Since 2002, the Hedging Order has provided direction on how the state's investor-owned electric utilities formulate their fuel hedging strategies. During the past five years, each company has developed and strengthened its hedging positions within the commodities market. A driving factor towards this increased participation is the overall commodity sector's growing acceptance and reliance on the futures' market.

Each company shares a universal goal in purchasing financial hedges for its fuel procurement; that is, to reduce the impacts of the price extremes that can occur in the natural gas and fuel oil markets. The companies are not attempting to become speculators in the market. Rather each is working to stabilize its annual fuel costs by initiating and settling financial hedging transactions through authorized financial counterparties. As a matter of practice, knowing precisely how much a utility should hedge is difficult to gauge given the highly dynamic nature of natural gas and fuel oil markets.

#### Fuel Procurement

The generating fleets of the four utilities examined differ in fuel consumption and fuel types. These differences directly impact the company's procurement and hedging strategies. Also, because of these differences, audit staff can not make direct comparisons between each company. Overall, companies which are more reliant on natural gas and fuel oils for base load generation have a greater exposure to the negative effects of these markets. These utilities have less room for error if their hedging strategies are off-target. ATTACHMENT A details each company's fuel generation mix. Audit staff believes that each utility has appropriate tools and systems in place to accurately forecast and implement its fuel procurement and generation needs.

## Hedging Strategy

Under the current Commission Hedging Order, each utility is allowed to hedge, in a non-speculative manner, up to 100 percent of its forecasted fuel procurement volume. The annual hedging volumes have differed significantly during the review period, both between companies and within individual companies' year-to-year goals. Some utilities have been more conservative, hedging only half of their fuel volume, while other utilities have hedged a vast majority of their fuel volume. If a utility hedges too little or too high of a percentage of its hedging volume, it could negate the goal of price stability. Hedging too little will allow a greater portion of the market price to impact the company's fuel prices. Hedging up to 100 percent of its fuel forecast does the opposite by eliminating the diversifying impact created by allowing a percentage of the market price to influence fuel costs.

Hedging up to 100 percent of its forecast causes a company to be over-hedged if a decline in actual fuel consumption occurs at the time of the financial settlement. While each company has a formulated process for calculating its anticipated fuel consumption, a number of factors can cause these forecasts to exceed the actual consumption. Audit staff believes that each company's acceptable target hedging range will differ based on such factors as generation and fuel mix. Each company should strive towards achieving its goal of reducing price volatility by establishing a hedging target that maximizes its strategy. A comparison of each company's 2007 hedging strategies is found in ATTACHMENT B.

Audit staff believes that the use of authorized counterparties is an acceptable relationship for initiating financial hedging transactions. Each utility has stringent policies and procedures in place for evaluating and authorizing financial counterparties. Also, each company utilizes the International Swap and Derivatives Association master agreement for its trading standard. The utilities do not pay fees or transaction costs when initiating or settling a swap transaction with these counterparties. They only pay the prescribed premiums for collar and option transactions. Overall, each utility has relationships with the most stable, top-tier financial institutions, which serves to limit exposed risk to the utility. As seen in the recent economic downturn, financial institutions can experience weakness or collapse, but each company has processes in place to minimize the potential impact of such events.

## Risk Assessment

While each of the four Florida investor-owned generating utilities participates in this process, each has a distinct approach to initiating and implementing its hedging strategy. Audit staff recognizes that there is more than one path to achieving a prudent hedging strategy, and differences between companies do not represent inherently correct or incorrect approaches. Audit staff has, however, observed some overall concerns with the companies' hedging processes and their implementation of the Hedging Order.

The Hedging Order requires that each utility annually provides a detailed Risk Management Plan that outlines the company's approach to risk assessment and overall hedging strategy. The Order requires that:

Each investor-owned electric utility shall submit...its risk management plan for fuel procurement. For purposes of this proposed resolution, each risk

management plan shall address the following items set forth in Exhibit TFB-4 to this prefiled testimony...in this docket: items 1, 2, 3 (to the extent possible), 4, 5, 6, 7, 8, 9, 13, 14, and 15. The information provided as part of each risk management plan should emphasize the utility's numerical assessment of an acceptable level of price risk for each type of fuel and for purchased power, the method used to determine the acceptable level of risk, identification of the mechanisms to mitigate risk above the acceptable level, and a valuation of that risk in dollars, where possible. The information provided as part of each risk management plan shall include the quantities of fuel and purchased power that each utility expects to hedge through physical and financial hedging, to the extent such forecast are made. Filing of such risk management plans for informational purposes shall not constitute approval or disapproval by the Commission. In addition, each investor-owned electric utility shall submit, as part of its annual true-up filing in the fuel and purchased power cost recovery docket each year, a report indicating the success of its risk management activities with respect to the objectives set forth in its risk management plan.<sup>1</sup>

While each company has provided annual plans, overall, audit staff does not believe these plans have met the requirements or spirit of the Commission's Hedging Order during the review period. There have been varying degrees of compliance, with some companies providing greater detail than others. However, deficiencies were observed in every instance. The intent of the Risk Management Plan is to provide the Commission staff with necessary information to accurately and independently assess the overall merits of each company's hedging strategy. Without a detailed, robust plan, Commission staff is hindered from assessing the overall prudence of each company's planned strategy. The Hedging Order is also specific as to what criteria should be included within the plan. A copy of the plan requirements is included as ATTACHMENT C.

Specifically, it is critical that each company provides to the Commission its annual hedging volume goals. Each company's Risk Committee establishes its annual goal, and this information should be per the current order, included in its Risk Management Plan. The Hedging Order is specific on what criteria should be included in the Risk Management Plans. Audit staff believes that each company should include the detailed information as required by the Hedging Order to provide the Division of Economic Regulation staff with information to assist in the assessment of the prudence of each company's program. The Division of Economic Regulation should proactively evaluate the Risk Management Plans and provide each company with any concerns regarding goals, plans, or strategies.

Overall, audit staff believes that the use of financial hedges for fuel purchases provides a benefit to utility customers. Each program is appropriately controlled, efficiently organized, and operates under a non-speculative format. There are areas for improvement, which are outlined later in each company's chapter. Generally, each company has successfully mitigated the price volatility for its customers. There have been years in which each company's hedging program provided a gain on its fuel cost, and years when each program has incurred losses. This is to be expected. Hedging commodities involve the risk of higher prices at the expense of attempting to

<sup>1</sup> P 5, *Proposed Resolution of Issues*. Florida Public Service Commission Order No. PSC-02-1484-FOF-EI

reduce price volatility. For each company, there is an acceptable level of risk tolerance between the two. Each utility must continue to gauge its customers' tolerance of the cost associated with hedging versus the benefits of reduced fuel cost volatility and any resulting rate increases.

Chapters three through six contain audit staff's detailed analysis of each company's hedging process. Audit staff's specific opinion for each company is included below.

#### **1.4.1 Florida Power & Light**

#### **1.4.2 Gulf Power Company**

#### **1.4.3 Progress Energy Florida**

#### **1.4.4 Tampa Electric Company**

Audit staff believes that Tampa Electric has developed an effective hedging program. The company has achieved its goal of decreasing volatility of the price of its natural gas purchases during 2003 through 2007. The company's hedging goals and purchases have been consistent and are non-speculative.

Tampa Electric Company's hedging goal is to maintain supply reliability while minimizing fuel price volatility. The company has achieved this goal by implementing a non-speculative financial hedging strategy for its natural gas purchases. Tampa Electric employs a layered hedging strategy that allows its financial hedges to be purchased up to 24 months out from settlement. During the 24 month period, the company will continue to purchase financial hedges up to the maximum established target. This allows the company to be more effective at averaging the impacts of market costs over

Audit staff notes the following positions from its review of the Tampa Electric:

- ◆ The company's policies and procedures provide appropriately detailed and clear understanding of the responsibilities and expectations surrounding the company's hedging program.
- ◆ The company has not incurred any fees associated with purchases of financial swaps from its counterparties.

Tampa Electric's Internal Audit division has placed adequate focus and resources on monitoring its hedging process.

The hedging relationship between Tampa Electric and its affiliate Peoples Gas System should be monitored to ensure neither company's customers are disadvantaged by this relationship.

- ◆ Audit staff believes that TEC's front, middle, and back office organizational structure is adequate and provides the company with the appropriate separation of



duties necessary to prevent variances from the approved trading procedures. Each independent office has detailed procedures outlining its responsibilities.

- There are two points which audit staff does not believe the Risk Management Plans have met the requirements of the Hedging Order:
  - Verify that the utility's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all fuel procurement activities.
  - Verify that the utility has sufficient policies and procedures to implement its strategy.

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## 2.0 Background and Perspective

As part of the Commission's Fuel Cost Recovery filings, electric utilities are required to file with the Commission the estimated costs for fuel procurement for the upcoming year plus any cost true-ups required to align actual costs with estimated costs for the current year. The Fuel Cost Recovery filings are submitted annually, but supplemental midcourse filings may be submitted when intra-year corrections to factors are necessary to ensure that the factors do not become substantially out of line with actual costs.

During the winters of 2000 and 2001, spikes in natural gas prices across the nation resulted in an unexpected burden to many ratepayers. These fuel price spikes triggered significant midcourse corrections to factors for certain utilities. The best information available at the time was that price volatility would continue for the foreseeable future. This belief was borne out with additional natural gas price spikes in 2003 and 2005.

Following the midcourse corrections in 2000 and 2001, numerous complaints were filed with the Commission by ratepayers regarding impacts to their bills. This prompted the Commission to look for ways to protect consumers from increased fuel prices. At the direction of the Commission, the utilities and interested parties came together to initiate a fuel price volatility reduction program. As a result, a settlement was reached in 2002 regarding physical and financial fuel price hedging which was subsequently approved by the Commission.

### 2.1 Commission Hedging Order

The Commission's current hedging policy, which reflects the 2002 settlement, is embodied in the Hedging Order. This order was issued October 30, 2002 in Docket No. 011605-EL, *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*. It established a framework and direction for the Commission and the parties to follow with respect to fuel procurement risk management for the four investor-owned generating utilities. The settlement was entered into by FP&L, PEF, TEC, the Florida Industrial Users Group, and the Office of Public Counsel. Gulf Power agreed to the settlement upon a modification made during the hearing in the docket held August 12, 2002.

The Hedging Order specifies and describes the filing requirements for each utility in the annual fuel docket, including filings of both Risk Management Plans and results. The order specifies that financial and physical hedging costs are authorized for recovery through the Fuel Cost Recovery clause. These costs include gains and losses on futures contracts, premiums on options contracts, net settlements on swaps, and transaction costs. The Hedging Order also specifies that the incremental operating and maintenance expenses associated with establishing a hedging program are also recoverable through the fuel clause.

## 2.2 Hedging Principles

Hedging fuel procurement is not intended to reduce the overall fuel costs of an electric utility, but rather to level prices over time by mitigating the impact of price volatility. In all hedging strategies, the common denominator is the desire to establish, in advance, an acceptable known price rather than experience the rise or fall in price that occurs over time.

Many firms and business entities that require large volumes of one or more commodities in the production of their products engage in hedging as a tool to manage price volatility risk. Hedging, in its simplest form, is a process whereby a price is established at the time of initiation of a contract for some or all of a commodity that will be bought or sold at some time in the future. Hedging involves the buying or selling of a contract that establishes a future price with the intent of reducing price uncertainty. These contracts are legally binding agreements to buy or sell a commodity or financial instrument at a future date. Hedging contracts are standardized according to the quality, quantity, delivery time, and location for each commodity.

Hedging positions are distinctly different from speculative positions even though the tools used for hedging, for the most part, can also be used for speculation. Hedging is an activity designed to reduce price uncertainty, whereas speculation increases price uncertainty with the anticipation that market movements can be correctly predicted and profits can be made from such predictions. Speculators assume the risk that hedgers try to avoid and usually have no commercial interest in the commodities underlying the futures contracts they trade.

Following issuance of the Commission's Hedging Order in 2002, each of the four utilities developed financial hedging programs as a means of managing price volatility in the fuel it purchases to generate electricity for customers. Today, each IOU hedges a majority of its natural gas and/or residual oil purchases.

## 2.3 Financial Exchange and Over-the-Counter Transactions

The purchase of a financial hedge is a standardized process initiated either in accordance with the International Swaps and Derivatives Association, Inc. (ISDA) or directly through a commodity exchange. However, the prices of contracts for any particular delivery month often change sharply from day-to-day depending on numerous developments that influence market prices. For energy-related commodities, such as natural gas and residual oil, factors such as weather conditions, OPEC pricing policies, and a multitude of technical factors can cause the prices of contracts to change.

There are two types of hedging contracts, which are distinguished by the way they are traded: either directly with a financial exchange or through an over-the-counter financial partner. The prices of commodities are determined in a highly-efficient central marketplace or within financial exchanges.

Exchange market transactions, commonly called *futures* transactions, can be initiated by soliciting open market bids and offers from all interested parties on the exchange floor. The prices are based on the amount that speculators and investors are willing to pay for various commodities on the trading floors of the exchanges. The exchanges provide price information that can be considered the benchmark for determining the value of a particular commodity at a given time. The New York Mercantile Exchange (NYMEX) is the world's largest physical commodity futures exchange. Activity on the NYMEX trading floors and its electronic trading system establishes worldwide benchmarks for energy commodities, such as natural gas. Another financial exchange designed for commodities trading is the Intercontinental Exchange (ICE). ICE is an electronic Internet platform designed specifically for over-the-counter trading. Both NYMEX and ICE provide accessible around-the-clock commodity exchange information.

The process of trading futures through exchange markets can eliminate the risk that comes from unknown future prices. However, manual trading directly with a financial exchange can create burdensome margin requirements for utilities and can also increase the risk of negatively impacting the market once the utility's purchase intent is recognized.

As an alternative to manual trading, hedging contracts can be traded between a utility and a financial institution outside of the exchange. Investment banks and other securities dealers can serve as the contracting party when completing *over-the-counter (OTC)* derivative transactions. These organizations are commonly referred to as *financial counterparties*.

To provide for a safe trading environment with financial counterparties, the International Swaps and Derivatives Association (ISDA) created a contract (the ISDA Master Agreement) for all derivatives transactions. The ISDA Master Agreement is a standardized contract that allows the parties to select certain options. The ISDA Master Agreement provides an extended guarantee that a trade will be settled as originally negotiated. Utilities may have multiple financial counterparty relationships in place to seek the best hedging opportunity at any point in time.

## 2.4 Financial Derivatives and Instruments

Hedging instruments in the form of contractual agreements between two parties to buy or sell assets (e.g., commodities) at a pre-determined price at a future date are known as *financial derivatives*. Their value derives from the price of the underlying asset. The pre-set price is called the *future price*; the future date is called the *delivery date* or *final settlement date*. The parties to the contract are *obligated* to fulfill the contract on the settlement date. There are many hedging instruments that a utility can use to achieve hedging objectives. The more common types of instruments are:

- ◆ Physical hedges
- ◆ Financial swaps
- ◆ Call and Put options
- Collars

### 2.4.1 Physical Hedge

A *physical hedge* is a contract between two parties to buy or sell a commodity (e.g., natural gas) at a pre-agreed future point in time. For example, a utility will secure a fixed price for a quantity of natural gas and agree to pay that price directly to a supplier for receipt of the natural gas at a future date. The natural gas itself is to be delivered upon the specified delivery date and at a specified delivery point, rather than being traded out with offsetting contracts. The purpose of a physical hedge is to lock-in a fixed purchase price for physical delivery of the commodity.

In a physical hedge, either the utility or supplier may either incur a loss or savings depending on the current market value of the fuel at the time of delivery. For example, assume the utility enters into a physical hedge with a supplier to buy natural gas from the supplier at \$7 per MMBtu a year from now. At the time of delivery, the market price of natural gas spikes to \$10 per MMBtu. The supplier must deliver the gas to the utility at \$7 per MMBtu, thus incurring a loss of \$3 per MMBtu. In other words, a large differential can build up between the contracted price and the market price on the day of delivery. If the supplier can not compensate for this loss, the supplier may incur a financial hardship which could jeopardize the delivery of fuel to the utility.

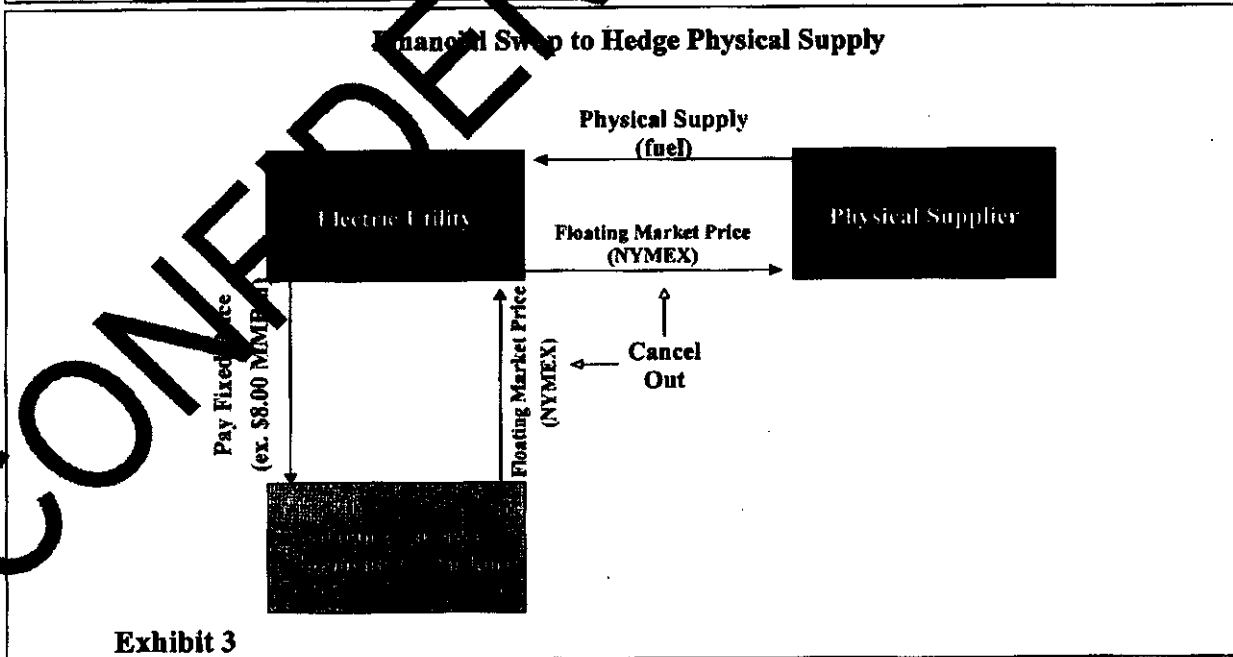
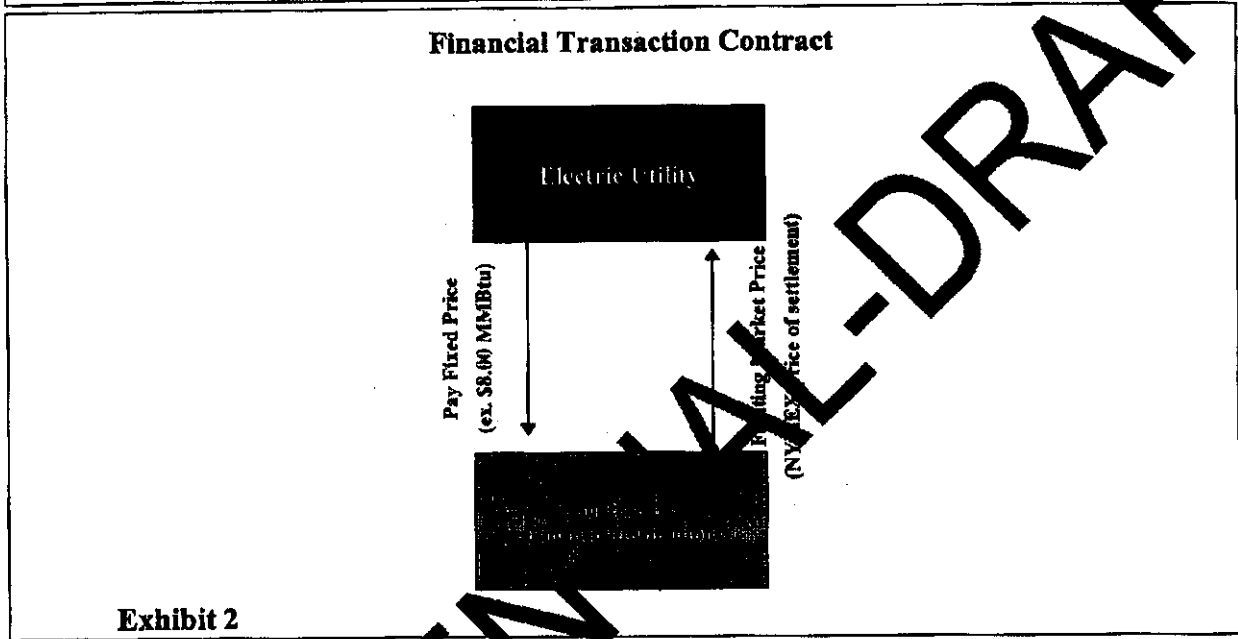
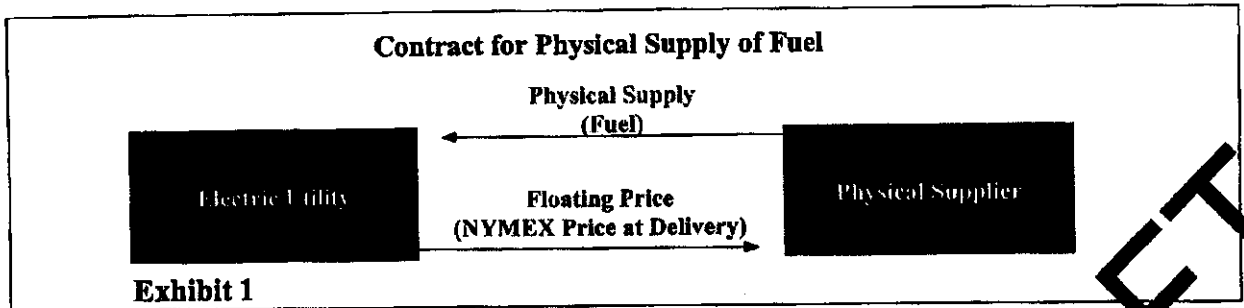
### 2.4.2 Financial Swap

A *financial swap* is a contractual agreement whereby a floating (market or spot) price is exchanged for a fixed price on a future, specified date. A financial swap is initiated directly with an OTC counterparty. Unlike physical hedges, financial swaps are not exercised to take receipt of the commodity being traded. In other words, a financial swap is a futures transaction where no commodity changes hands. These financial swap transactions will offset a separate transaction for the physical fuel.

A swap transaction consists of two separate components: a contract with a physical supplier and a contract with a financial counterparty. This is shown in Exhibit 1. First, the utility contracts with a supplier for a specific quantity of gas to be delivered at an agreed upon date. The utility will pay the market price at the time of delivery.

The utility then negotiates a contract with its financial counterparty to secure a fixed-price of a specific volume of MMBtu. This is shown in Exhibit 2. At the time of settlement, the utility agrees to pay the counterparty the agreed-upon fixed price, and the counterparty agrees to pay the utility the current NYMEX market price.

To complete the swap, the utility will merge these two separate deals to complete the transaction. From the utility's perspective the NYMEX market price will offset both contracts (i.e., the counterparty pays the utility the NYMEX market price, then pays the supplier NYMEX market price upon delivery.) Therefore, the actual cost paid by the utility is the agreed-upon price that it paid the counterparty. The complete transaction is detailed in Exhibit 3.



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### 2.4.3 Call and Put Options

Similar to swaps, options also take the form of a financial contract that is intended to offset a physical gas purchase. However, the purchaser of an Option contract is *not obligated* to buy the underlying contract if it does not hit a target price. The purchaser pays a *premium* at inception for this benefit. Like swaps, options provide price protection against an adverse price move. Additionally, as with swap contracts, for every option buyer there must be a seller to take on the opposite side of the transaction. There are two types of options: *calls* and *puts*. In the case of either a call or put, the option buyer (option holder) must pay the option seller (option writer) a premium to enter the contract. Regardless of how the market swings, the most an option buyer can lose is the option premium. Premiums are typically a percentage of the total transaction, and can vary depending on market conditions.

A *call option* gives the buyer the right, but not the obligation, to *purchase* a particular futures contract at a specific price anytime during the life of the option. Whether or not the buyer executes the option, the seller will still collect the premium. The buyer of a call option wants the price of the underlying instrument to rise in the future. The seller either expects that it will not, or is willing to give up some of the profit from a price rise in return for the premium paid. The seller, or writer, collects the premium. At the time of settlement, if the market price is higher than the contract price, the purchaser will initiate the call. However, if the market price is lower than the contract price, the purchaser will simply let the call expire unexercised.

A *put option* gives the buyer the right, but not the obligation, to *sell* a particular contract at a specific price anytime during the life of the option. The buyer of a put option believes the price of the underlying instrument will fall in the future. The seller does not believe the price will fall. Like a call option, the writer of the *put* collects the premium. At the time of settlement, if the market price is below the contract price, the purchaser will initiate the put. However, if the market price is higher than the contract price, the put will not be transacted by the purchaser.

### 2.4.3 Collars

Options provide for risk-reducing protection since owners of options are not obligated to buy the underlying contract; however, owners must be concerned about the option premiums. A *collar* is a two-part option strategy that involves the combination of a *put* and *call* option. A collar position is made by selling a put option at one strike price<sup>2</sup> while simultaneously purchasing a call option at a lower price. This trade gets its name because the position is essentially "collared" between two prices. Depending on the agreed-upon premiums, the cost to create the collar may be "costless" or offsetting, or there could be a premium differential.

For example, assume natural gas is currently trading at \$7 per MMBtu in June 2008. A utility trader expects that the price of natural gas will decrease within a year. However, the utility trader also remembers the natural gas price spikes in 2003 and 2005. As a result, the trader decides to institute a collar trade. To collar this position for one year out, the utility trader buys a May 2009 call at \$5 per MMBtu with a \$1 premium. The trader simultaneously sells a *put* for \$3 per MMBtu with a \$1 premium. Since the premiums of both options are the same

<sup>2</sup> The fixed price at which the owner of an option can purchase (in the case of a call) or sell (in the case of a put) the underlying commodity is known as the *strike price* or *exercise price*.



price, the net cost of this initial trade is \$0 to the utility trader. The trader now knows that no matter what happens to natural gas prices, the utility, upon settlement, will pay between \$3 to \$5 per MMBtu of natural gas. That is the call creates a cap of \$5 if the market is trading higher in May and the put creates a floor of \$3 if trading is lower.

## 2.5 Margins and Credit Agreements

*Margins* are good-faith deposits required of both buyers and sellers to ensure fulfillment of contract obligations. Margins are determined on the basis of market risk and are normally set at a percentage (e.g., 2 to 5 percent) of the value of the commodity represented in the futures contract. The initial margin requirement is the amount required to be collateralized in order to initiate a trade. Thereafter, the amount required to be kept in collateral until the position is closed is the *maintenance margin*. Trading directly with a commodity exchange, such as the NYMEX, requires the establishment of margin reserves.

Typically, a transaction initiated between a utility and counterparty does not require a margin deposit. When the utility establishes an OTC counterparty relationship, it will assess and evaluate the credit stability of the financial counterparty and, based on its credit evaluation, assign a transaction credit limit with the party. The counterparty will perform the same evaluation on the utility, and a bilateral credit agreement is established. These credit limits may be modified if there is a change in either company's credit stability. If necessary, the companies can establish lines of credit to supplement margin requirements.

## 2.6 Accounting for Hedges

During the life of the hedge transactions, changes in market value must also be properly reflected for management reporting and financial accounting purposes. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) No. 133 *Accounting for Derivative Instruments and Hedging Activities*. FAS 133 represents the framework of accounting rules that standardize the accounting for all derivative instruments. FAS 133 requires that all derivatives are to be *mark-to-market* and recorded on entities' balance sheets as separate assets or liabilities at fair value. Mark-to-market is the value of a hedge settlement price versus the current market price.

## 2.7 Internal Controls

The enactment of the Sarbanes-Oxley Act in 2002 by the U.S. Congress marked major changes to the regulation of financial practice and corporate governance. The Act contains 11 titles, or sections, ranging from additional Corporate Board responsibilities to criminal penalties for inaccurate financial reporting. Furthermore, the Act incorporated formal procedures to strengthen organizational reporting relationship lines and accountability among other functions.

Each utility included in this review has implemented internal controls and evaluation systems to facilitate compliance with the Sarbanes-Oxley Act. One internal control implemented

is the establishment of a three-tier organizational structure: separate *front*, *middle*, and *back* offices. Each office is designed to provide oversight of the other. The *front* office is responsible for executing hedging transactions. The *middle* office ensures data integrity of the transactions as well as assessing credit worthiness of counterparties. The *back* office is the financial reporting entity for the utility and regulates the accounting functions (receivables/payables) to ensure that all hedging transactions are recorded in compliance with accounting standards (i.e., FAS 133).

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## 6.0 Tampa Electric Company

### 6.1 Fuel Procurement

#### What types of fuel does the company purchase for its generation fleet?

Tampa Electric Company's generation fleet is comprised of a combination of coal, natural gas, and fuel oil units. In 2007, approximately 55 percent of its fuel consumption was coal, 45 percent natural gas, and 1 percent oil.

For its natural gas physical supply portfolio, Tampa Electric has historically used a combination of long-term, base-load contracts, take-or-release monthly contracts, and daily call purchases. In 2007, Tampa Electric secured approximately █ percent of its natural gas under base-load contracts, █ percent through take-or-release contracts, and █ percent with daily contracts. Each contract stipulates that Tampa Electric will pay market price at delivery. Tampa Electric does not currently have any fixed price, long-term physical contracts in place.

#### How does the company structure its Fuel Procurement Organization?

Tampa Electric Company's fuel procurement functions are handled within its Fuel Management Division. This division is headed by the Vice-President of Fuel Management. The Fuel Management division is comprised of three units:

- ◆ Gas Supply and Wholesale
- ◆ Fuel Services and Systems, and
- ◆ Wholesale Marketing and Sales

The division is responsible for the fuel transactions for both Tampa Electric Company and Peoples Gas Systems, Inc.

#### What is the company's goal in using financial derivatives when purchasing fuel?

TECO's fuel purchasing goal is to minimize supply risk to ensure the reliability of electric service to its customers at a reasonable price. To maintain supply reliability, the company takes measures to minimize fuel price volatility. The company believes it is able to best achieve this goal through the use of financial hedging derivatives. Tampa Electric states that its approved hedging plan allows the company to reduce the price fluctuations common in the natural gas commodities market.

#### How does the company separate its fuel procurement responsibilities for its regulated and non-regulated entities?

The Fuel Management division is only responsible for TECO Energy's regulated companies. This includes both Tampa Electric Company and Peoples Gas Systems, Inc. The

division is responsible for both the financial and physical purchasing of fuel for both entities. While both companies, Tampa Electric and Peoples Gas, are regulated by the Commission, each is regulated under different industry-specific cost-recovery rules. Tampa Electric is regulated as an investor-owned electric utility and Peoples Gas as an investor-owned local gas distribution company. Currently, the staff of the Fuel Management division transact business for both entities and allocate their work distribution accordingly.

## 6.2 Hedging Strategy

### What is the company's current and historical management philosophy and strategy toward fuel procurement hedging activities?

Tampa Electric views its fuel procurement hedging program as risk-reducing in nature, and believes that hedging is effective for accomplishing the goal of reducing natural gas price volatility. Tampa Electric does not initiate hedges for fuel oil since it represents only 1 percent of the company's total fuel consumption. The company historically and currently operates its hedging program with the objective of managing risk to ensure reliability of electric service to its customers at a reasonable price.

Tampa Electric executes its management philosophy by implementing an executive management approved natural gas hedging program. This includes the installation of controls that are consistent with industry practices and requirements. Such controls include contracting with qualified counterparties to increase liquidity, maintaining a minimum forward hedge volume percentage by month, maintaining databases and reports to monitor activity, and maintaining separation of duties.

### Does the company have adequate policies and procedures for its fuel procurement hedging program?

Tampa Electric's hedging program is supported by detailed policies and procedures that provide the structure, operating practices, and restrictions for the Tampa Electric staff responsible for the execution of hedging transactions. The following practices and procedures promote efficient and accurate processing of hedging transactions:

- TECO Energy Risk Management Policy
- Tampa Electric Company Wholesale Marketing and Fuels Policies and Procedures

TECO Energy's Risk Management Policy applies to TECO Energy, Inc. and to all of its subsidiaries. The objective of the *Energy Risk Management Policy* is to establish guidelines for limiting, monitoring, and controlling the financial risks related to energy commodity transactions. Within this context, the objective of risk management and internal control is to assure that TECO Energy's trading transaction activities do not expose the company to unacceptable losses. The *Energy Risk Management Policy* is approved by the Board of

Directors. It requires the approval of the Risk Authorizing Committee for all of Tampa Electric's derivative transactions. Specific procedures featured in the *Energy Risk Management Policy* address organizational responsibilities, data management, deal transactions and validations, and the methodology to evaluate, measure, mitigate, and report credit risk.

The purpose of the company's *Wholesale Marketing and Fuels Policies and Procedures* is to provide management direction for assessing long and short-term capacity and energy markets. Included in the procedures are the company's fuel procurement strategy, process descriptions for forecasting fuel and transportation requirements, and contract administration.

Audit staff believes that these policies and procedures provide appropriately detail and provide a clear understanding of the responsibilities and expectations surrounding the company's hedging program. Management policies appear to be consistent with the expectations of TECO Energy's Board of Directors and TECO Energy's overall tolerance of risk. Audit staff believes that Tampa Electric's policies and procedures that support the company's hedging program efficiently track, monitor, and evaluate the company's hedging strategies.

**What are the types of financial instruments used by the company?**

Since 2004, Tampa Electric has used over-the-counter swaps to initiate hedging transactions. Tampa Electric chose swaps because these transactions do not require margin calls or a premium. The number of financial hedges executed is driven directly by the forecasted quantity of natural gas expected to be consumed. Each year this quantity is forecasted as part of the projected fuel and purchase power cost recovery clause filing. EXHIBIT 36 shows Tampa Electric's reliance on swaps during the review period. The chart also shows the number of settled transactions.

Annual Financial Transactions by Instrument Type Tampa Electric Company 2003 - 2007					
Swaps	100%	100%	100%	100%	98%
Options	-	-	-	-	-
Collars	-	-	-	-	1%
Total Number of Settled Transactions	247	359	280	180	99

Exhibit 36

Source: Data Request 2.3

**What are the company's targets and threshold limits for its financial hedging program?**

The volume of natural gas Tampa Electric hedges falls between preset minimum and maximum percentages of the expected natural gas consumption level. Hedging targets are established to account for the fluctuations in natural gas usage because of weather, unit

performance, market dynamics, and other factors that may impact the company's original natural gas forecasts.

Tampa Electric's hedging strategy is to use a sliding scale approach as shown in EXHIBIT 37. The hedging percentage targets represent the minimum and maximum tolerance levels for Tampa Electric's hedging portfolio. Similar to the other utilities in this review, Tampa Electric's policy not to hedge more fuel than forecasted to meet customer demand.



Exhibit 37

Source: Interviews

Tampa Electric's natural gas hedges are layered over time. As shown in the exhibit, the cumulative volume of natural gas hedges should increase as the actual burn month approaches. For example, assume Tampa Electric traders are initiating hedges to offset July 2008 natural gas forecasted requirements. Within seven to twelve months out (July 2007 to December 2007), Tampa Electric's traders should have accumulated hedges to offset somewhere between [redacted] percent and [redacted] percent of the July 2008 natural gas forecasted burn. Within six months of 2008, (January through June 2008) traders are expected to have accumulated hedges within a range of [redacted] percent to [redacted] percent of the July 2008 forecast. The hedging contract must settle and offset against the corresponding month burn.

The company uses several automated systems to track and monitor its financial hedging options. Tampa Electric also uses the services of tracking systems such as the NYMEX, ProphetX, and ICE to monitor the futures markets and determine the current trading ranges for each commodity. This access allows the company to negotiate purchase prices with its counterparties that are in line with the current prices on the NYMEX Exchange floor.

#### Has the company's program operated in a manner that is non-speculative?

Tampa Electric states that it does not engage in speculative hedging strategies aimed at outguessing the market. Tampa Electric further defined speculation as the execution of transactions that create risks which are incremental and unrelated to the company's normal business operations. The *Energy Risk Management Policy* requires systematic consistent hedging that is not driven by price speculation. Additionally, Tampa Electric points to the use of separation of duties to control speculative trading.

Audit staff does not believe that the company's hedging strategy includes any speculative activities. Its overall hedging forecast and the actual hedges to burn ratios are in line with the company's overall strategy. Audit staff believes the company has the necessary controls in place to limit potential speculative activity.

**What volume of each fuel type has been hedged for the period 2003-2007?**

Tampa Electric's hedging strategy is to implement financial transactions for [redacted] of its forecast fuel consumption. The maximum hedging percentage target represents the maximum tolerance levels that Tampa Electric's hedging portfolio is not expected to exceed.

EXHIBIT 38 details Tampa Electric's annual percentage of natural gas hedged in relation to the company's forecasted burn volumes for each year 2003 through 2007. For 2003, the exhibit shows 21 percent of Tampa Electric's fuel demands being hedged. During this year, Tampa Electric's hedging program was not fully implemented and Tampa Electric customers experienced a midcourse correction as a result. However, during the remaining years, Tampa Electric has increased the percent of financial hedges initiated under its program. Even with this increase, Tampa Electric has maintained the boundaries of the [redacted] hedging target.

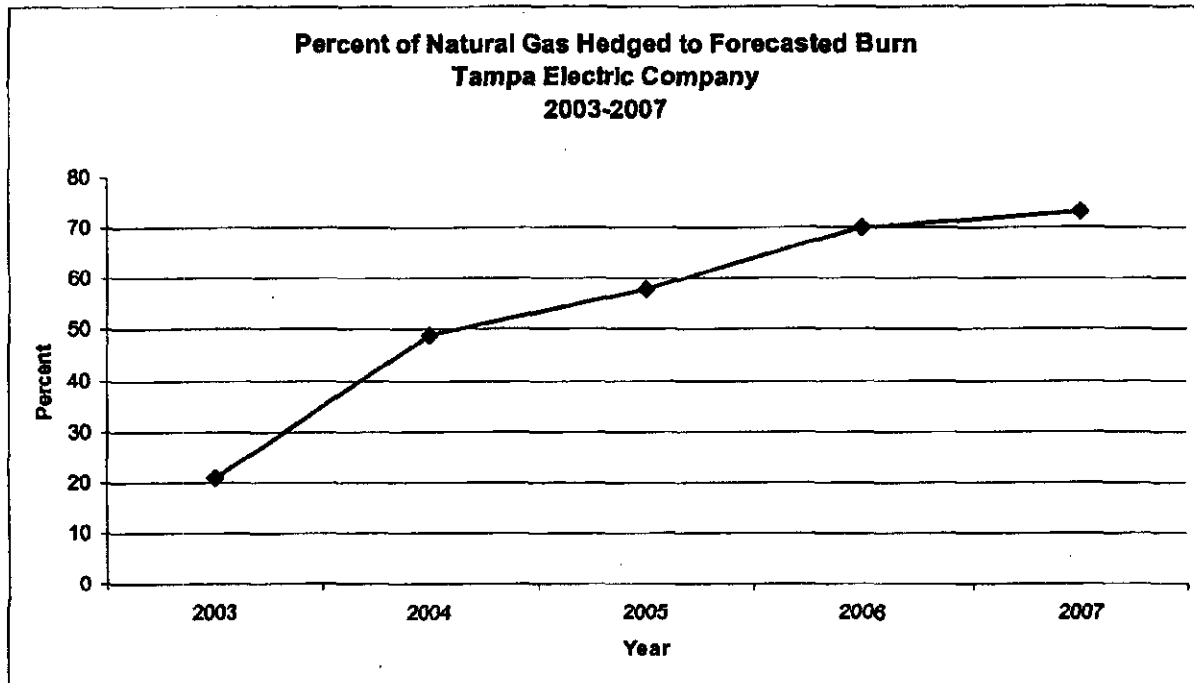


Exhibit 38

Source: Data Request 2.3

EXHIBIT 39 shows the monthly and annual percentage of fuel hedged by Tampa Electric in relation to the total fuel burn for each year 2003 through 2007. Hedges may exceed the percentage targets when actual fuel burns are significantly lower than the fuel projections. Factors that influence the variance between forecasted and actual burn include weather, unplanned unit maintenance requirements, and unit outages. Additionally, Tampa Electric does not attempt to sell hedged positions prior to settlement to adjust for actual fuel burns in relation to forecasted burns.

Audit staff believes that the yearly averages of fuel hedged against forecast and actual burn demonstrate that the company provides enough flexibility within its strategy to allow for fluctuations in its fuel consumption. As shown in the exhibit, the highest yearly average percentage of fuel hedged in relation to total fuel burned did not exceed 76 percent.

**Monthly Percent of Fuel Hedged in Relation to Total Fuel Burned**  
**Tampa Electric Company**  
**2003-2007**

January	86%	75%	44%	30%	41%
March	65%	56%	38%	52%	28%
May	69%	80%	61%	39%	12%
July	68%	82%	58%	37%	8%
September	74%	88%	59%	69%	33%
November	97%	81%	48%	81%	31%
<b>Yearly Average</b>	<b>73%</b>	<b>76%</b>	<b>52%</b>	<b>51%</b>	<b>27%</b>

Exhibit 39

Source: Data Request 2.5

**What are the total costs associated with the fuel procurement hedging program?**

Tampa Electric has historically initiated financial swaps through its approved financial counterparties. Under this structure, the company does not incur any direct transaction costs or fees for this service. The company experienced hedging gains of \$8.4 million in 2004 and \$53.2 million in 2005. The company had losses of \$54.4 in 2006 and \$59.7 million in 2007. For the review period, Tampa Electric has a net loss of approximately \$55.1 million. EXHIBIT 40 details the annual hedging gains and losses for the period 2003 through 2007.

The stabilizing impact of the company's hedging program is shown in EXHIBIT 41. This chart details the average monthly cost of natural gas purchased by Tampa Electric and the corresponding average monthly hedging settlement price. As shown, for 2003 through 2006, the company's hedging settlements were consistently stable while the market experienced several spikes in price. Also, the hedging settlements were less than the corresponding market prices. As an example, in 2005, Tampa Electric paid an average \$ 9.09 per MMBtu for natural gas, yet its corresponding hedging prices averaged \$6.03 per MMBtu. In early 2007, the company did experience a rise in its hedging costs, but overall, its hedging costs minimized the spikes that occurred within its natural gas prices during the review period.



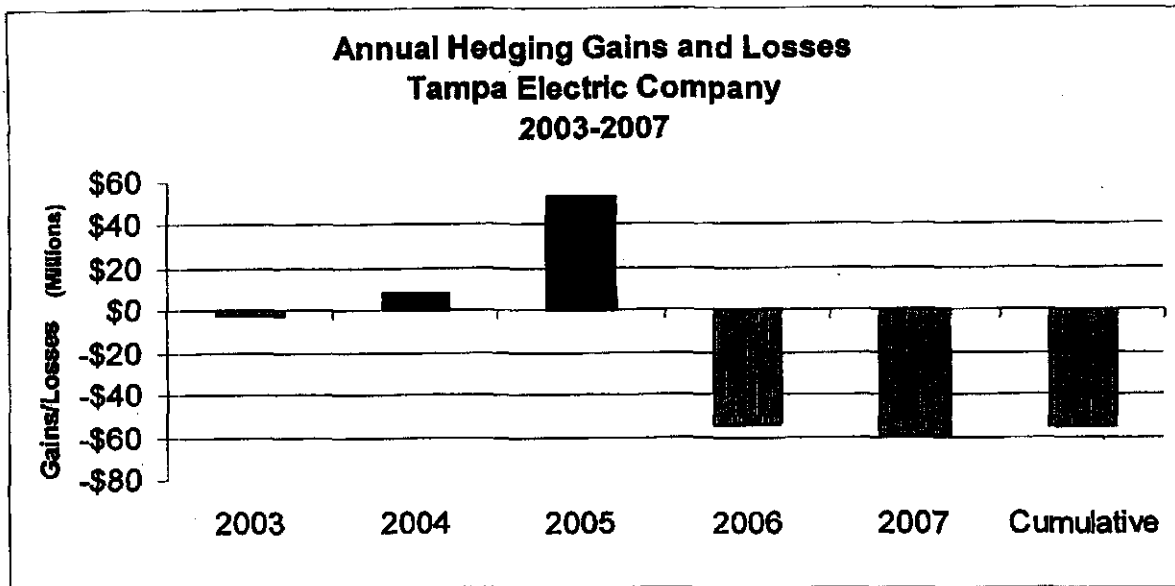


Exhibit 40

Source: Interviews

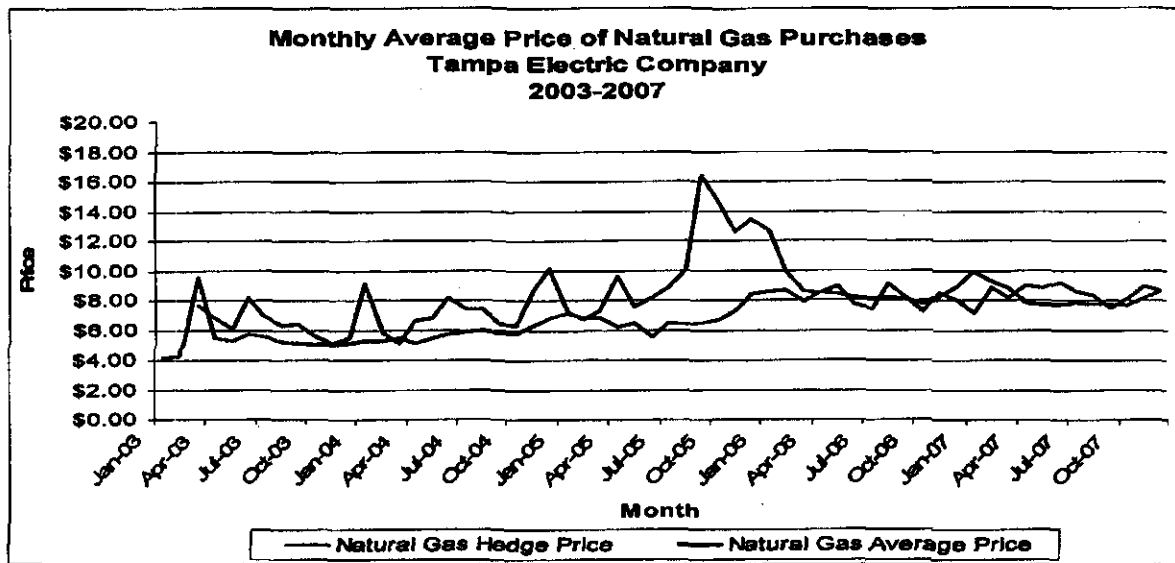


Exhibit 41

Source: DR 3.1

Audit staff requested for TEC to provide any perceived transaction costs associated with financial derivatives. In response TEC stated it does not pay transaction fees or commissions when initiating or settling a swap transaction with counterparties. Additionally, like the other utilities in this review, TEC utilizes multiple financial counterparties to negotiate the best possible strike price when executing hedging transactions. Furthermore, TEC does not believe the price differential within the bid-ask range equates to transaction costs.

As part of the Commission's Hedging Order, Tampa Electric recovered incremental hedging operating and maintenance costs through the Commission's Fuel Cost Recovery docket through 2006. Exhibit 42 shows Tampa Electric's annual operating and maintenance costs for the company's hedging program for each year 2003 through 2006. On average, the operating and maintenance costs represent less than one-third of one percent of the company's system net generation annual fuel costs.

Percentage of Hedging Operating and Maintenance Costs Fuel Cost of System Net Generation Tampa Electric Company 2003-2006				
O&M Hedging Cost	\$210,649	\$164,960	\$210,045	\$108,746
Percent of O&M to Total Fuel Cost	0.03%	0.02%	0.03%	0.02%

Exhibit 42

Source: TEC Annual A1 Filings

**Does the company believe its fuel procurement hedging program has been successful, and what are the benefits associated with the program?**

Due to the significant number of natural gas market price variances since 1999, and the increased concern about the availability of energy commodities, Tampa Electric believes, as shown in Exhibit 41, that the financial hedging market has helped reduce peak-and-valley price fluctuations. The company believes that the program has met its goal of reducing fuel price volatility for its customers. The net effect has been more consistent fuel cost for its customers, which would not have been the case without its hedging program.

Tampa Electric states that since the inception of financial hedging, Tampa Electric has become a more effective purchaser of fuel oil and natural gas. Specific to hedging activities, the company has expanded the number of counterparties, enhanced natural gas procurement flexibility and reliability through pipeline and receipt point diversification, and extended the time line for natural gas hedging.

### 6.3 Risk Performance

**Does the company employ adequate management oversight and controls of the fuel procurement hedging program to ensure prudent operations?**

The TECO Energy Board of Directors is responsible for approving the company's Risk Management policies and its overall tolerance for risk. TECO Energy also has a Risk Advisory Committee, appointed by the Chief Executive Officer, which is responsible for developing the

company's risk policies. The committee reports to the Audit Committee of the Board of Directors.

The Risk Advisory Committee reviews the company's Risk Management policy and recommends any changes to the Board. This Committee establishes guidelines for the risk management group and establishes the credit underwriting and credit exposure standards. This group reviews and approves the transacting strategy and the counterparty credit and threshold limits for Tampa Electric Company's hedging program. The committee meets at least monthly and is chaired by the CFO of TECO Energy. The director of the Independent Risk Oversight group works with the Risk Advisory Committee on all relevant risk-related events.

### **How does the company segregate responsibilities between its front, middle, and back office divisions?**

Tampa Electric operates using a three-layer structure to ensure adequate separation of duties and oversight. The company implemented in 2004 its front, middle, and back office organizational structure for its financial hedging functions. This structure establishes a mechanism for the company to independently monitor and review the financial transactions initiated by the Fuel Management division staff.

The front office staff is responsible for initiating and executing the financial hedging transactions. This office staff uses an approved set of guidelines and procedures when initiating a financial hedging transaction. The traders must initiate transactions in accordance with the Risk Oversight Committee's approved strategy. All transactions must be documented and recorded by the trader for independent verification and confirmation.

The Risk Oversight group, commonly referred to as the middle office, is an independent group whose Director reports to the Treasurer of TECO Energy. The middle office is charged with verifying all daily trading transaction completed by the front office. This group monitors the compliance with the company's Energy Risk Policy. Its staff negotiates the acceptable terms for each financial counterparty relationship and monitors and verifies internal daily transactions. Also, middle office staff monitors and evaluates the counterparty's credit limits and ensures that the internal thresholds are maintained.

The TECO Energy Settlements group, commonly referred to as the back office, is responsible for the accounting transactions for the financial hedges, coal, natural gas, oil, propane and transportation costs of the company. The back office verifies that the volume of receivables and deliverables balances, including the financial derivatives of each hedging transaction. This group processes each transaction invoice and verifies the accuracy of each transaction.

Audit staff believes that TEC's front, middle, and back office organizational structure is adequate and provides the company with the appropriate separation of duties necessary to prevent variances from the approved trading procedures. Each of the independent offices has detailed procedures that outline its responsibilities.

## Does the company have an adequate fuel procurement Risk Management Plan?

Tampa Electric Company has annually filed its Risk Management Plan as prescribed in the Hedging Order. The company has not made any significant changes to its plans submitted during the period 2003-2007. The Order specifies that each plan address elements of Exhibit TFB-4 of the Order (ATTACHMENT C), along with "the quantities of fuel and purchased power that each utility expects to hedge through physical and financial hedging, to the extent such forecasts are made."<sup>3</sup>

TEC's plan addresses the majority of the eleven elements within Exhibit TFB-4, *Components of a Utility's Fuel Procurement Risk Management Plan*. The company's plan provides specifics of the company's hedging objectives and the risk assessment of implementing its plan. The company does adequately describe the corporate oversight of its hedging strategy. Tampa Electric also does include the annual quantities of fuel it estimates will be covered by financial hedges. For 2007, this amount is consistent with the company's approved hedging strategy presented to audit staff during this review.

There are two requirements which audit staff does not believe the company's plans have met the requirements of the Hedging Order. These are:

- ◆ Verify that the utility's corporate risk policy clearly delineates individual and group transactions limits and authorizations for all fuel procurement activities,
- ◆ Verify that the utility has sufficient policies and procedures to implement its strategy,

The risk plans make reference to these points, but do not contain the detail necessary to verify that adequate processes are in place. During the course of this review, audit staff did verify that Tampa Electric has the procedures in place to meet these requirements. However, inclusion within its plan is necessary for staff to evaluate its process going forward.

## How does the company evaluate and select the counterparties with which it conducts financial hedging transactions?

Tampa Electric Company uses a group of financial counterparties to transact its over-the-counter financial hedging transactions. The front office group identifies any potential financial counterparties with which Tampa Electric would like to conduct business. The middle office conducts a risk evaluation and to evaluate the potential counterparty's credit stability. If the counterparty meets TEC's criteria, the middle office negotiates and executes the International Swaps and Derivatives Association agreement and activates the relationship.

<sup>3</sup> P 5, TFB-4. Florida Public Service Commission Order No. PSC-02-1484-FOF-EL.

Both the financial hedging transactions for Tampa Electric Company and Peoples Gas Systems are purchased under the Tampa Electric Company ISDA relationship. Tampa Electric management states that Peoples Gas Systems, Inc. does not have a stand-alone credit rating; therefore, it must conduct transactions under the umbrella Tampa Electric Company. Tampa Electric management states that Peoples Gas System is a division of Tampa Electric Company that is also an incorporated entity within the State of Florida. Typically, when the Fuel Management division initiates a hedging transaction with a counterparty, a portion will be allocated to Tampa Electric and a portion to Peoples Gas System, Inc. On average, Tampa Electric underwrites the majority of each transaction.

Tampa Electric management states that since both entities are regulated by the Commission, the Peoples Gas transactions being purchased under the Tampa Electric Company name should not cause concern. The allocation of transactions is monitored and evaluated to ensure that all costs incurred are accurately allocated to the correct company. Because of this unique arrangement, audit staff believes that the Commission should monitor this arrangement to ensure that neither customer-base is directly or indirectly disadvantaged by this relationship.

Financial Counterparty Relationships  
Tampa Electric Company

Exhibit 43

Source: Data Request 2.2

Currently, Tampa Electric has 23 counterparty relationships. EXHIBIT 43 lists each counterparty, its S&P and Moody's credit rating, and its internal Tampa Electric credit limit.

Tampa Electric Company

Along with its financial counterparty relationships, Tampa Electric has a dual relationship with eight counterparties in which the company initiates both financial hedging transactions and also contracts for physical supply of natural gas. The counterparties with dual relationships are:

◆ [REDACTED]

In 2006 and 2007, Tampa Electric initiated both financial and physical transactions with three counterparties. In 2005 the company initiated both with five counterparties and in 2004, four counterparties.

**Does the company conduct audits of its fuel procurement program and hedging instruments?**

TECO Energy's Internal Audit Division utilizes a combination of risk-based assessments and a five-year planned review cycle to ensure the company is in compliance with internal and external policies and regulation. In 2007, the company conducted a *Derivatives and Hedging Audit*, as a part of its risk-based evaluation process. The audit included all of the TECO Energy's operating companies. There were some minor findings related to how the company was documenting accounting transactions. Management states it has addressed all of the findings listed in the report. The company did not complete any hedging related audits during 2003 through 2006 other than the annual Sarbanes-Oxley based reviews.

Overall, audit staff believes that the company's Internal Audit division has placed adequate focus and resources on monitoring its hedging process. Continued focus on this area is necessary to ensure that the risks associated with the program are evaluated and contained to an acceptable level.

**In summary, what changes should the company make to its hedging program?**

Audit staff believes that Tampa Electric has developed an effective hedging program. The company has achieved its goal of decreasing volatility of the price of its natural gas purchases during 2003 through 2007. The company's hedging goals and purchases have been consistent and are non-speculative.

Tampa Electric Company's hedging goal is to maintain supply reliability while minimizing fuel price volatility. The company has achieved this goal by implementing a non-speculative financial hedging strategy for its natural gas purchases. Tampa Electric employs a layered hedging strategy that allows its financial hedges to be purchased up to 24 months out

from settlement. During the 24 month period, the company will continue to purchase financial hedges up to the maximum established target. This allows the company to be more effective at averaging the impacts of market costs over time.

Audit staff notes the following positions from its review of the Tampa Electric:

- ◆ The company's policies and procedures provide appropriately detailed and clear understanding of the responsibilities and expectations surrounding the company's hedging program.
- ◆ The company has not incurred any fees associated with purchases of financial swaps from its counterparties.
- ◆ Tampa Electric's Internal Audit division has placed adequate focus and resources on monitoring its hedging process.
- ◆ The hedging relationship between Tampa Electric and its affiliate Peoples Gas System should be monitored to ensure neither company's customers are disadvantaged by this relationship.
- ◆ Audit staff believes that TEC's front, middle, and back office organizational structure is adequate and provides the company with the appropriate separation of duties necessary to prevent variances from the approved trading procedures. Each independent office has detailed procedures outlining its responsibilities.
- ◆ There are two points which audit staff does not believe the Risk Management Plans have met the requirements of the Hedging Order:
  - Verify that the utility's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all fuel procurement activities.
  - Verify that the utility has sufficient policies and procedures to implement its strategy.

**CONFIDENTIAL-DRAFT**



**2007 Fuel Generation Mix**  
(%MWH)

FP&L	60.68%	9.91%	7.04%	22.41%
Progress Energy	23%	8%	51%	17%

Source: Annual Schedule A filings, 080001-100000

**CONFIDENTIAL**

DOCKET NO. 011605-EI  
ORDER NO. PSC-02-1484-FOF-FI  
EXHIBIT TFB-4

**COMPONENTS OF A UTILITY'S FUEL PROCUREMENT RISK MANAGEMENT PLAN**

When a utility files its fuel procurement risk management plan with the Commission, this plan should include information regarding the following components:

1. Identify overall quantitative and qualitative risk management objectives;
2. Identify minimum quantity of fuel to be hedged;
3. Identify and quantify each risk, general and specific, that the utility may encounter with its fuel procurement;
4. Describe the utility's oversight of its fuel procurement activities;
5. Verify that the utility provides its fuel procurement activities with independent and unavoidable oversight;
6. Describe the utility's corporate risk policy regarding fuel procurement activities;
7. Verify that the utility's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all fuel procurement activities;
8. Describe the utility's strategy to fulfill its risk management objectives;
9. Verify that the utility has sufficient policies and procedures to implement its strategy;
10. Indicate the number and type of personnel who are responsible for fulfilling the utility's risk management objectives;
11. Verify that the utility has sufficient number and type of personnel who can fulfill its risk management objectives;
12. Describe the utility's cost effective response to each general and specific risk associated with its fuel procurement;
13. Describe the utility's reporting system for fuel procurement activities;
14. Verify that the utility's reporting system consistently and comprehensively identifies, measures, and monitors all forms of risk associated with fuel procurement activities; and
15. If the utility has current limitations in implementing certain hedging techniques that would provide a net benefit to ratepayers. Provide the details of a plan for developing the resources, policies, and procedures for acquiring the ability to use effectively the hedging technique.

## Hedging Strategies of Other State Commissions

Audit staff collected data from other state utility commissions to gather a sampling of how other utilities' hedging programs are regulated throughout the country. Audit staff was able to obtain limited information on the practices of other states, but determined that hedging programs vary throughout the country. Approaches range from required pre-approval of a utility's hedging program to establishing the percentage of recoverable cost from hedging based on total fuel volumes.

Specifically, the California Utilities Commission has established rules that require Pacific Gas and Electric to file its hedging program prior to implementation. Regulators work with the utility to verify and approve the overall hedging strategy. Once the approval is granted, the utility will initiate its hedging program under the agreed upon plan. PG&E is allowed to recover all hedging gains and losses through its annual fuel docket.

The Georgia Public Service Commission has recently implemented a change to its hedging rules that establishes a similar process for Georgia Power Company. Georgia Power must submit its hedging strategy to the Georgia Commission on a quarterly basis prior to implementation. The Georgia Commission evaluates and determines the viability of the strategy plan. Once approved by the Commission, Georgia Power implements its plan and can pass 100 percent of its gains and losses through its fuel clause. The Georgia plan requires a volume-cost averaging approach to hedging, which eliminates the subjectivity that can arise in the hedging process.

Two other southern states, Mississippi and Alabama, also have hedging rules in place. Both states allow the utilities to hedge their fuel procurement. Each state allows up to 75 percent of the utilities' fuel budgets to be hedged. The utilities are allowed to pass 100 percent of gains or losses through the fuel clause. The hedging plans are not pre-approved by either state Commission.

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MATTHEW M. CARTER II, CHAIRMAN  
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NANCY ARGENZIANO  
NATHAN A. SKOP

STATE OF FLORIDA



OFFICE OF COMMISSION CLERK  
ANN COLE  
COMMISSION CLERK  
(850) 413-6770

Public Service Commission

ACKNOWLEDGEMENT

DATE: June 18, 2008

**CONFIDENTIAL**

TO: James D. Beasley, Esquire/Ausley & McMullen

FROM: Marguerite H. McLean, Office of Commission Clerk

RE: Acknowledgement of Receipt of Confidential Filing

This will acknowledge receipt of a **CONFIDENTIAL DOCUMENT** filed in Docket Number undocketed or, if filed in an undocketed matter, concerning information contained in staff's draft audit report of review of fuel procurement hedging practices of Florida's investor-owned electric utilities, and filed on behalf of Tampa Electric Company. The document will be maintained in locked storage.

If you have any questions regarding this document, please contact Marguerite McLean, Deputy Clerk, at (850) 413-6770.

DOCUMENT NUMBER - DATE  
05184 JUN 18 08  
FPSC-COMMISSION CLERK

**AUSLEY & MCMULLEN**

ATTORNEYS AND COUNSELORS AT LAW

227 SOUTH CALHOUN STREET  
P.O. BOX 391 (ZIP 32302)  
TALLAHASSEE, FLORIDA 32301  
(850) 224-9115 FAX (850) 222-7560

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June 19, 2008

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080436

Ms. Ann Cole, Director  
Office of Commission Clerk  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, Florida 32399-0850

Re: UNDOCKETED - Review of Fuel Procurement Hedging Practices of Florida's  
Investor-Owned Electric Utilities

Dear Ms. Cole:

Enclosed for filing in the above-styled matter are the original and fifteen (15) copies of Tampa Electric Company's Supplement to Request for Confidential Classification of information contained in the Staff's draft audit report of Review of Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities dated June 2008.

Please acknowledge receipt and filing of the above by stamping the duplicate copy of this letter and returning same to this writer.

Thank you for your assistance in connection with this matter.

Sincerely,

  
James D. Beasley

JDB/pp  
Enclosure

1 conf records

DOCUMENT NUMBER-DATE

05269 JUN 19 08

FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Review of Fuel Procurement )  
Hedging Practices of Florida's. )  
Investor-Owned Electric Utilities. )  
\_\_\_\_\_ )

UNDOCKETED  
FILED: June 19, 2008

**TAMPA ELECTRIC COMPANY'S SUPPLEMENT TO  
REQUEST FOR CONFIDENTIAL CLASSIFICATION**

Tampa Electric Company ("Tampa Electric" or "the company"), pursuant to Section 366.093, Florida Statutes, and Rule 25-22.006, Florida Administrative Code, supplements its June 18, 2008 Request for Confidential Classification submitted in the above undocketed matter and, in support thereof, says:

1. In its June 18, 2008 Request for Confidential Classification Tampa Electric inadvertently omitted a one-page document identified as Attachment B to the Staff's draft audit report dated June 2008. Attachment B has the heading "Companies' Hedging Strategies Comparative Analysis."

2. Tampa Electric is submitting under separate cover a single confidential version of said Attachment B with confidential information highlighted in yellow and marked "CONFIDENTIAL" in red. Attached hereto as Exhibit "A" are two public versions of the page in question with the confidential information redacted.

3. Tampa Electric hereby requests that said Attachment B be treated as confidential proprietary confidential business information with the same requested duration of confidential classification as set forth in the company's June 18, 2008 submission. Tampa Electric adopts and incorporates herein by reference the same justification for Attachment B as is contained in the June 18, 2008 filing for Bates stamp page numbers. 20, 23 and 24 of the draft audit report, that

DOCUMENT NUMBER DATE

05269 JUN 19 08

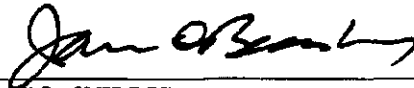
FPSC-COMMISSION CLERK

being justification (1). The company also incorporates herein by reference the rationale set forth in the company's June 18, 2008 filing, at pages 2 and 3 thereof, for keeping the information in Attachment B confidential and exempt from public disclosure for a minimum of three years.

WHEREFORE, Tampa Electric submits the foregoing as its supplement to the company's June 18, 2008 Request for Confidential Classification.

DATED this 19<sup>th</sup> day of June 2008.

Respectfully submitted,



---

LEE L. WILLIS  
JAMES D. BEASLEY  
Ausley & McMullen  
Post Office Box 391  
Tallahassee, Florida 32302  
(850) 224-9115

ATTORNEYS FOR TAMPA ELECTRIC COMPANY

ATTACHMENT B

Companies' Hedging Strategies Comparative Analysis				
Types of Fuel Hedged				-Natural Gas
2007 Hedging Instruments				Natural Gas: - Swaps 100%
Hedging Tenure				Up to 2 years
2007 Average Hedging Target				Natural Gas: ██████████
Percent of 2007 Fuel Hedged to Forecasted Burn				Natural Gas: 73%
Cumulative Hedging Gains/Losses 2003-2007				-\$55,100,000
Number of Financial Counterparties				23

Exhibit "A"



ATTACHMENT B

Companies' Hedging Strategies Comparative Analysis				
Types of Fuel Hedged				-Natural Gas
2007 Hedging Instruments				Natural Gas: - Swaps 100%
Hedging Tenure				Up to 2 years
2007 Average Hedging Target				Natural Gas: ██████████
Percent of 2007 Fuel Hedged to Forecasted Burn				Natural Gas: 73%
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(850) 413-6770

**Public Service Commission**

**CONFIDENTIAL**

**ACKNOWLEDGEMENT**

DATE: June 19, 2008

**TO:** James D. Beasley, Ausley Law Firm  
**FROM:** Ruth Nettles, Office of Commission Clerk  
**RE:** Acknowledgement of Receipt of Confidential Filing

This will acknowledge receipt of a **CONFIDENTIAL DOCUMENT** filed in Docket Number 080000 or, if filed in an undocketed matter, concerning Supplement to Request for Confidential Classification of information contained in staff's draft audit report of Review of Fuel Procurement Hedging Practices, and filed on behalf of Tampa Electric Company. The document will be maintained in locked storage.

If you have any questions regarding this document, please contact Marguerite Lockard, Deputy Clerk, at (850) 413-6770.

DOCUMENT NUMBER-DAT  
05270 JUN 19 2008  
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