State of Florida

Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

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

DATE: September 5, 2008

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Lester, Matlock, Maurey, McNulty, Springer)
Division of Regulatory Compliance (Vinson, Hallenstein, Coston)
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: 09/16/08 – 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.HDG.RCM.DOC

Case Background

The Commission's current policy regarding risk management and the hedging of fuel prices 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 largest investor-owned electric utilities (IOUs). The settlement was entered into by Florida Power & Light Company (FPL or Company), 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 were filed until FPL filed its petition requesting approval of its improved volatility mitigation mechanism (VMM) or its VMM alternative at the beginning of the year.

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) conducted a hedging review which involved 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) conducted 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 was completed on May 5, 2008, and the CMP review was completed in June 2008.

On January 31, 2008, FPL filed a petition requesting that the Commission approve its proposed VMM as an alternative to FPL's financial and physical fuel price hedging programs. The VMM proposal involved FPL collecting under-recoveries of unhedged fuel costs over two years, instead of one year as is the current practice. FPL intended that if the 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 proposed VMM as a method of achieving the Commission's objective of mitigating fuel price volatility while avoiding certain hedging disadvantages. FPL argued that such disadvantages include uncertainty introduced by 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

was also concerned about the regulatory risk it alleged 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.). Had the Commission approved FPL's VMM petition, FPL would have sought 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 determined not to approve the VMM as proposed, FPL requested two changes to the current hedging approach. First, FPL requested 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 VMM petition). Secondly, the Company proposed that FPL's regulatory risk be reduced by requiring Commission staff to conduct reviews of hedging results monthly. FPL made 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.

Staff filed a recommendation on April 14, 2008, and recommended that the Commission deny FPL's petition and alternative position, in part because it would be premature to make a decision before the Commission's review of the results of ongoing hedging audits by RCA and CMP. FPL concurred with staff that a Commission decision of FPL's petition would be premature, and suggested in a post-recommendation letter that the Commission hold a workshop to consider improvements to our hedging process.

At the April 22, 2008, Agenda Conference, the Commission considered FPL's VMM Petition. By Order No. PSC-08-0316-PAA-EI, issued May 14, 2008, in Docket No. 080001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor, the Commission clarified the Hedging Order. Specifically, the Commission decided that the period of review for utility hedging transactions will be through July 31 of the current year. The Commission will determine the prudence of hedging transactions at the annual fuel clause hearing, typically held every year in November. To facilitate this review, the four largest IOUs are required to file current year hedging results by August 15. The IOUs are required to provide the same hedging information required in Section 5 of the "Proposed Resolution of Issues" in the Hedging Order. The Commission also decided to defer Issues 2 and 3 of the staff recommendation regarding the VMM issue and the alternative to the VMM issue to a later time so that the hedging audits underway at the time could be completed and reviewed, and so that the Commission could have the benefit of the information gathered at an informal workshop.

Subsequently, staff and the parties held two workshops regarding FPL's petition. At the June 9, 2008, workshop, FPL proposed revised hedging guidelines and indicated it now favored pursuing guidelines rather than the VMM. OPC took a position during the workshops that the VMM needed to be more fully analyzed by all four large IOUs as a possible alternative to hedging. At the June 24, 2008, workshop, OPC indicated its objection to portions of the proposed guidelines. The meeting concluded with an understanding that ongoing discussion

among the parties would attempt to resolve whether hedging activity contributes to fuel factor volatility reduction and whether the guidelines as proposed by FPL were acceptable to all parties.

On August 5, 2008, FPL filed its petition for leave to withdraw its January 31, 2008, VMM petition and alternative. With it petition to withdraw, FPL filed a new petition for approval of its proposed hedging guidelines. FPL indicates in its new petition that it proposes the guidelines in response to the asymmetric reactions of certain stakeholders to gains and losses. FPL states that its guidelines are designed to mitigate against this asymmetry by reaffirming and clarifying the Commission's support for hedging as an appropriate means of managing the impacts of fuel price volatility. FPL indicated PEF, TECO, and supported the proposed guidelines. Staff issued a set of data requests regarding FPL's August petition, and all responses were timely filed with the Commission. In addition, staff conducted a telephonic meeting with parties on August 27, 2008, to consider FPL's petition. At the meeting, PEF, TECO, and expressed support for the guidelines, but also indicated that they were not proposing the guidelines. OPC indicated it was not ready to stipulate to FPL's proposed hedging guidelines. Based on staff comments at the meeting, FPL made several revisions and provided its changes to the guidelines to all parties on August 29, 2008, after confirming PEF's, Gulf's, and TECO's support for the changes.

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

Discussion of Issues

Issue 1: Should the Commission acknowledge Florida Power & Light Company's voluntary withdrawal of its Petition for Approval of Improved Volatility Mitigation Mechanism, filed January 31, 2008, in Docket No. 080001-EI?

Recommendation: Yes, the Commission should acknowledge Florida Power & Light Company's voluntary withdrawal of its Petition for Approval of Improved Volatility Mitigation Mechanism (VMM petition) as a matter of right. The effect of the voluntary withdrawal is to divest the Commission of further jurisdiction over FPL's VMM petition but not over the subject matter of hedging. (Bennett)

Staff Analysis: The law is clear that a plaintiff's right to take a voluntary dismissal is absolute. Fears v. Lunsford, 314 So. 2d 578, 579 (Fla. 1975). It is also established civil law that once a timely voluntary dismissal is taken, the trial court loses its jurisdiction to act and cannot revive the original action for any reason. Randle-Eastern Ambulance Service, Inc. v. Vasta, 360 So. 2d 68, 69 (Fla. 1978). Both of these legal principles have been recognized in administrative proceedings.[1] In Saddlebrook Resorts, Inc. v. Wiregrass Ranch, Inc., 630 So. 2d 1123, 1128 (Fla. 2d DCA 1993), the court concluded that "the jurisdiction of any agency is activated when the permit application is filed . . . . [and] is only lost by the agency when the permit is issued or denied or when the permit applicant withdraws its application prior to completion of the fact-finding process."

In this case, the Commission deferred its decision regarding the petition pending receipt of additional audit information. The Commission had not reached its final decision on FPL's VMM petition. Thus, FPL can dismiss its petition as a matter of right. This is consistent with past Commission decisions.[2] Staff recommends that the Commission approve FPL's voluntary withdrawal of its VMM petition.

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[1] Orange County v. Debra, Inc., 451 So. 2d 868 (Fla. 1st DCA 1983); City of Bradenton v. Amerifirst Development Corporation, 582 So. 2d 166 (Fla. 2d DCA 1991); Saddlebrook Resorts, Inc. v. Wiregrass Ranch, Inc., 630 So. 2d 1123 (Fla. 2d DCA 1993) aff'd, 645 So. 2d 374 (Fla. 1994).

[2] See Order No. PSC-07-0725-FOF-EU, issued September 5, 2007, in Docket No. 060635-EU, In re: Petition for determination of need for electrical power plant in Taylor County by Florida Municipal Power Agency, JEA, Reedy Creek Improvement District, and City of Tallahassee; Order No. PSC-07-0877-FOF-EI, issued October 31, 2007, in Docket No. 070467-EI, In re: Petition to determine need for Polk Unit 6 electrical power plant, by Tampa Electric Co.; Order No. PSC-07-0485-FOF-EI, issued June 8, 2007, in Docket Nos. 050890-EI, In re: Complaint of Sears, Roebuck and Company against Florida Power & Light Company and motion to compel FPL to continue electric service and to cease and desist demands for deposit pending final decision regarding complaint and 050891-EI, In re: Complaint of Kmart Corporation against Florida Power & Light Company and motion to compel FPL to continue electric service and to cease and desist demands for deposit pending final decision regarding complaint; Order No. PSC-94-0310-FOF-EQ, issued March 17, 1994, in Docket No. 920977-EQ, In re: Petition for approval of contract for the purchase of firm capacity and energy from General Peat Resources, L.P. and Florida Power and Light Company; Order No. PSC-97-0319-FOF-EQ, issued March 24, 1997, in Docket No. 920978-EQ, In re: Complaint of Skyway Power Corporation to require Florida Power Corporation to furnish avoided cost data pursuant to Commission Rule 25-17.0832(7), F.A.C.; Order No. PSC-04-0376-FOF-EU, issued April 7, 2004, in Docket No. 011333-EU, In re: Petition of City of Bartow to modify territorial agreement or, in the alternative, to resolve territorial dispute with Tampa Electric Company in Polk County. But see Order No. PSC-07-0297-FOF-SU, issued April 9, 2007, in Docket No. 020640-SU, In re: Application for certificate to provide wastewater service in Lee

Although the effect of the withdrawal of a petition is to divest the agency of jurisdiction over the petition, it does not divest the agency of subject matter jurisdiction. The Commission always has the discretion to review its hedging policy and make changes after affording all stakeholders the appropriate due process.

County by Gistro, Inc. and Order No. PSC-96-0992-FOF-WS, issued August 5, 1996, in Docket No. 950758-WS, In Re: Petition for approval of transfer of facilities of Harbor Utilities Company, Inc., to Bonita Springs Utilities and cancellation of Certificates Nos. 272-W and 215-S in Lee County (voluntary dismissal cannot be utilized to divest the Commission as an adjudicatory agency of its jurisdiction granted to it by the legislature)

Issue 2: Should the Commission approve FPL's proposed Hedging Order Clarification Guidelines?

Recommendation: Yes. However, evaluation of hedging results can be problematic since they are not reported on a calendar basis similar to the original plans. Therefore, IOUs should address the comparability of reported results to their original plans by structuring their plans to match reporting periods, or otherwise show the comparability of objectives and results. (Lester, McNulty)

Staff Analysis: FPL's purpose in proposing these guidelines is to reaffirm and clarify the Commission's support for hedging as an appropriate means of managing the impacts of fuel price volatility. FPL seeks this reaffirmation of the Commission's support based on its observation that the reaction of certain stakeholders to hedging results has been asymmetric. FPL states in its petition that "[s]upport for hedging has generally been strong during periods of rising fuel prices, when hedging programs are showing gains, but has waned when prices are falling and hedging programs are showing losses." FPL Petition, p. 3.

FPL believes this "observed asymmetry" can increase the perceived financial (regulatory) risk for IOUs and could increase their cost of capital. FPL believes the proposed guidelines will reduce regulatory risk.

The Guidelines

FPL's proposed guidelines (see Attachment A) are the result of meetings with staff and parties after the April 22, 2008, Agenda Conference. FPL last revised the guidelines after meeting with staff and parties on August 27, 2008.

The approved risk management plans will be the basis for the Commission's review of the performance of utility hedging programs. Under the guidelines, a utility's plan may deviate from one or more of the guiding principles set forth in Section IV, therefore allowing a utility to tailor its plan for its particular circumstances. The guidelines reiterate the timing of the Commission's review of hedging results that was approved by Order No. PSC-08-0316-FOF-EI, issued May 14, 2008, in Docket No. 080001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor. Under the guidelines, the hedging program would apply to both financial and physical hedging transactions for natural gas and fuel oil.

Section I

The proposed guidelines clarify the timing of the Commission's annual review of utility hedging programs. The Hedging Order requires the four IOUs to file hedging/risk management plans but does not require such plans to be approved by the Commission. The proposed guidelines would have the Commission approve each utility's risk management plan in advance. For example, in 2008, the Commission would approve utility risk management plans that would describe hedging activities during 2009, affecting activities during 2009 and subsequent years. The risk management plans will be filed in early August with the Estimated/Actual Testimony filing.

Sections II & III

Section II of the guidelines defines hedging activities, which will primarily involve financial transactions for fuel oil and natural gas, including natural gas provided to generators under purchased power agreements. Section III of the guidelines notes that the Commission will determine the prudence of each IOU's hedging activities for the year ending July 31, as clarified by Order No. PSC-08-0316-FOF-EI. To facilitate the prudence review, the IOUs will file monthly hedging data in two reports: a Hedging Activity True-Up Report filed in April that covers the previous calendar year, and a Hedging Activity Supplemental Report filed by August 15, covering the months of the current year through July 31.

Section IV

Finally, the Guidelines set forth guiding principles that the Commission would employ in reviewing utility hedging programs and results. This section states that the purpose of hedging is to reduce fuel factor volatility, not just fuel price volatility. Section IV notes that hedging does not involve speculation, that fuel prices are volatile, and that hedging can result in lost opportunities for fuel savings. Importantly, Section IV notes that the approved risk management plans will be the controlling document for the Commission's review of hedging activities. The plans, with the approval of the Commission, may deviate from one or more of the guiding principles. The risk management plans would designate a range of volumes to be hedged for natural gas and fuel oil within which the IOU normally will operate.

Parties' Comments

OPC filed comments regarding FPL's proposed hedging guidelines on September 3, 2008 (see Attachment B). OPC states that it opposes FPL's proposed hedging guidelines. OPC argues that hedging activities are of very limited value to customers. OPC argues that the Commission should evaluate the six years worth of historical hedging information now available to determine whether hedging activities are needed to achieve the purpose of reducing the volatility of fuel price on the retail customer. OPC indicates that the levelized fuel adjustment charge already has the effect of insulating the customer from the changes in the price of fuel, and that little additional "tempering" of volatility seen and felt by customers through their bills is accomplished by hedging activities. Meanwhile, OPC argues that hedging costs have not been quantified satisfactorily, but notes such costs could be substantial by FPL's own admission.

In addition, OPC argues that the guidelines sacrifice the Commission's ability to conduct full, after-the-fact prudence reviews. If the Commission adopted such guidelines, the IOUs would enjoy the benefit of lower regulatory risk and should, as a consequence, be restricted to a lower authorized return on equity. OPC notes that FPL did not include any such quid pro quo proposal in its proposed hedging guidelines petition.

Regarding other parties to the fuel docket, FPL states in its current petition that the Office of Attorney General, AARP, the Florida Retail Federation, and FIPUG have all stated that they

take no position at this time on the Hedging Guidelines.[3] These parties reserve their right to take a position at a later time.

PSC Audits Regarding Hedging and FPL's Petition

The staff audits of IOU hedging activities are now complete. Regarding utility hedging practices, the management audit concluded:

> 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 of 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 in which each program has incurred losses. This is to be expected. Hedging commodities involves the risk of higher prices at the expense of attempting to 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.

Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities, June 2008, Staff Management Audit, pp. 10-11

The financial audits did not identify any problems with the IOUs' hedging program. The PSC auditors verified that FPL's hedging transactions are in compliance with Commission Orders and Rules and with applicable Financial Accounting Standards Board statements.

Staff Review

The Hedging Order authorized the IOUs to charge hedging gains and losses to the fuel clause and provided initial support for utility hedging programs. Since 2003, the IOUs have charged or credited large amounts of hedging gains and losses to the clause. However, due to the volatility of fuel prices, this cumulative measurement depends on the period in question and the actual day of fuel price quotes.

The Hedging Order did not and could not address all issues and questions that have arisen concerning hedging. For example, such issues as whether the Commission should approve the risk management plans and the appropriate periods for the Commission's review of hedging results are not addressed in the hedging order. FPL proposes answers to these questions and others in its proposed hedging guidelines.

The proposed guidelines also intend to address the issue of regulatory risk. Staff notes that, at any particular moment in time, IOUs can carry substantial amounts of hedging gains or losses on their books. This introduces the issue of regulatory risk into consideration of hedging

[3] "FPL attempted to contact White Springs concerning its petition on the Hedging Guidelines but was unable to do so before filing this petition." Petition, p. 5.

as a Commission policy, since those amounts may not have been determined to be prudent for cost recovery purposes.

Below, staff presents its review of specific sections of the guidelines. Staff has also analyzed the guidelines with particular attention to regulatory risk and whether hedging is in the public interest.

Section I.c. This section would revise the filing date of the risk management plans. According to the guidelines, each IOU would file an annual Risk Management Plan for Fuel Procurement as part of its Actual/Estimated Fuel Filing each August. In its original guidelines petition, FPL indicated that the risk management plans should continue to be part of the IOU's Fuel Projection Filing each September. At the August 27 meeting, staff commented that this does not allow sufficient time for regulatory review. Staff argued that a comprehensive annual review of hedging plans, as contemplated in the proposed guidelines, would require more time for discovery and potential opposing testimony than the two months afforded by a September filing. The Hedging Order did not state that the Commission's prior approval was required, only that the IOUs must file a plan. In its response to a staff data request issued August 14, FPL stated that its future risk management plans will be highly detailed. The IOUs agreed to shift the date of the plan from the Projection Filing Date to the Actual/Estimated Filing Date in accord with staff's suggestion.

Section III. The petition states that this section codifies the timing of the Commission's review of hedging results set forth in Order No. PSC-08-0316-PAA-EI. It clarifies that the period to be reviewed for prudence of each IOU's hedging activities includes August 1 of the prior year through July 31 of the current year. Staff believes such clarifying language is helpful and consistent with the Commission order.

However, staff notes that the guidelines fail to address the timing mismatch between the period of the hedging plans (calendar year) versus the time period included in hedging reports (August to December and January to July). According to the Hedging Order, the period addressed by hedging plans is January through December of the projection year. Thus, targeted quantitative objectives for hedging plans are designed for the calendar year. According to Commission Order No. PSC-08-0316-PAA-EI, hedging reports address the quantitative results of hedging activities for August to December and January to July. Staff believes it is important for the Commission's review that the timing of the plan objectives matches the timing of the information in the reports.

Staff believes that the IOUs can address this matter in its hedging plans and reports. Staff believes IOUs that establish monthly hedging objectives in their filed hedging plans, such as FPL, should be encouraged to bifurcate their hedging objectives into two segments within the calendar year to match the periods of the reported results. Other IOUs that do not establish monthly objectives, such as Gulf, should be encouraged to address this timing matter in both their risk management plans and in their hedging reports so that comparability of the targeted hedging objectives and hedging results are achieved.

Section IV. FPL's guiding principal IV-d would clarify that "the Commission does not expect the IOU to predict or speculate on whether markets will ultimately rise or fall and actually

settle higher or lower than the price levels that existed at the time hedges were put into place." FPL's guiding principal IV-e would clarify that the Commission does not expect the IOU to attempt to "outguess the market." Staff is in general agreement with these guidelines. However, it became clear at the August 27 meeting that at least one IOU (Gulf) did not agree with being precluded from utilizing market timing as part of its hedging strategy. Staff believes the correctness of whether to exclude market timing in the Commission's review is highly dependent upon the approved hedge plan for the IOU in question. Subsequent to the August 27 meeting, FPL filed amended guidelines which clarify that that Commission may approve plans notwithstanding deviations from one or more of the guiding principles. If a plan deviates from the guidelines in some way, and the plan is approved by the Commission, the IOUs recognize that the plan controls for purposes of evaluating hedging actions.

Minor Wording Changes

Staff recommends several minor changes to the wording of FPL's proposed guidelines. These wording changes do not change the substance of the guidelines but do help in clearly stating the purpose and intent of the guidelines. Staff notes that on Section I of the Hedging Order guidelines, it begins with the word "File." Although I.a. indicates that the IOU will file a comprehensive plan, for purposes of clarity the Section should begin with the instructions "Investor-owned utilities shall [f]ile." Likewise, in Section IV., the section begins with the word "Establish" without giving guidance to who established the guiding principles. The guidelines should reflect that the Commission approved these principles. In Subsection III. A., the guidelines require the utility to file a Hedging Activity Final True-Up Report in April, covering the prior calendar year. However, after this year's fuel proceeding, the Commission will have already ruled on the prudence of a portion of the hedging activities for that calendar year. Accordingly, the guidelines should reflect that the utility will only file a true-up report for August through December of the prior year. Finally Section 1.a makes reference to an Exhibit TFB-4 which was included in the original Hedging Order. That exhibit, for purposes of reference, should be attached to the new Hedging Order Clarification Guidelines.

Regulatory Risk and Hedging

Section IV of the guidelines acknowledges that hedging can reduce the volatility of fuel adjustment charges paid by customers and that a well-managed hedging program does not involve speculation. 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 that, "[h]edging 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, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor, p. 5.

Further, by Order No. PSC-08-0316-PAA-EI, the Commission clarified the Hedging Order by stating that at the annual fuel clause hearings it will rule on the prudence of utility hedging transactions through July 31 of the current year. This addressed in part FPL's concern regarding regulatory risk.

Section IV of the Guidelines clarifies the Commission's support for prudently managed hedging programs and acknowledges the principles in the orders cited above. Staff believes the guidelines do not compromise the Commission's ability to review hedging programs and results, and to make appropriate adjustments where necessary. The Guidelines will provide additional clarity regarding the timing and scope of the review of hedging results. In doing so, any regulatory risk that could be associated with hedging should be minimized.

In its comments, OPC alleges that hedging reduces risk for the company and thereby benefits its shareholders. Staff believes any such risk reduction that might occur will be reflected in the company's overall risk profile, which the Commission could consider in the cost of equity issue during a base rate proceeding.

Hedging, Volatility Mitigation, and the Public Interest

FPL buys more gas than any other electric utility in the nation. In general, Florida IOUs burn large quantities of natural gas, and their use of natural gas will increase over the next five years. Natural gas prices are volatile and are influenced by weather (winter and summer temperatures), industrial demand, power generation demand, the price of alternative fuels, and tropical storms and hurricanes. Global influences may begin to affect natural gas prices as future gas supply could become more dependent upon the import of liquefied natural gas (LNG). Similarly, FPL buys large quantities of residual fuel oil. The price of this fuel oil depends on the price of crude oil, which, in turn, depends on global supply and demand, the price of alternative fuels, and geopolitical risks. Given these circumstances, staff believes having hedging available as part of FPL's fuel procurement strategy is appropriate.

In its comments, OPC states "[w]ith respect to reducing fuel price volatility felt by retail customers, which is the single purpose of hedging identified by the utilities, the hedging activities are of very limited value to customers, while the costs of those activities have never

been quantified satisfactorily" (see Attachment B, p. 1). In response to a staff data request, FPL stated that hedging reduces the volatility of fuel costs over time and that this reduction generally should reduce the volatility of annual fuel adjustment factors. In support of this contention, FPL provided the following chart.

RESIDENTIAL FUEL ADJUSTMENT CHARGES WITH AND WITHOUT HEDGING		
	Hedging 1 year in advance ($/1000 kWh)	W/O Hedging ($/1000 kWh)
2003	37.11	40.63
2004	37.50	33.07
2005	40.09	42.76
2006	58.41	51.43
2007	52.95	48.87
2008[4]	52.27	57.14

Staff notes that in the recent mid-course corrections for PEF, FPL, and Gulf hedging gains significantly reduced the projected under-recoveries. In these particular cases, hedging significantly reduced the amount of the mid-course factor increases. Of course, the opposite case can apply as well. Hedging losses, typically in times of declining fuel prices, can reduce the amount of factor reductions. In either case, hedging gains and losses affect fuel factors. FPL notes that hedges have reduced the need for mid-course corrections. In its petition FPL states, "[d]uring periods of rising prices, the IOUs' fuel costs have risen more slowly than market prices, and hedges have shown gains; during periods of declining prices, the IOUs' fuel costs have declined more slowly than market prices, and hedges have shown losses." Petition, page 2.

The Commission has found that customers benefit from receiving accurate price signals through cost-based rates, and that customers benefit from stable rates that allow the customer to budget for electric bills. Staff believes hedging has contributed to the stability of fuel factors.

Hedging Costs

The Staff Management Audit indicates that direct transactions costs for each of the four IOUs are minimal or nonexistent. Regarding indirect transaction costs, OPC is correct that FPL indicated in its VMM petition that indirect transaction costs have not been quantified but could be substantial. However, staff noted in its recommendation regarding the VMM petition filed April 14, 2008, that FPL referred to these costs as "potential" costs, and such costs are largely theoretical. The indirect transaction costs noted by FPL include the price differential between the bid-ask range for swap transactions. The bid-ask range is the difference in price from the lowest and highest price for an equivalent daily transaction on the New York Mercantile Exchange (NYMEX) or the IntercontinentalExchange (ICE). According to the Staff Management Audit, PEF, Gulf, and TECO agree that the bid-ask range does not constitute a transaction cost. Another type of cost associated with hedging is incremental operations and maintenance costs associated with establishing and maintaining a hedging program. Such costs

[4] 2008 pre-mid course correction fuel factors..

were approved for recovery through the fuel clause by the Commission in the Hedging Order. Staff notes that such costs are not significant relative to the total fuel costs of the utilities. In addition, three of the IOUs (PEF, TECO, and Gulf) no longer recover these costs via the fuel clause. In sum, staff does not believe the four IOUs' transaction costs (direct or indirect) or incremental costs of maintaining their hedging programs as currently established are substantial relative to the total fuel costs of the utilities.

Conclusion

By approving FPL's proposed guidelines, the Commission will demonstrate its support for hedging. The Commission will retain its discretion to determine the prudence of hedging results.

Staff recommends that the Commission approve FPL's proposed Hedging Order Clarification Guidelines as revised. The proposed guidelines clarify the regulatory process regarding utility hedging programs, including the timing and content of filings. In addition, the guidelines allow the utilities flexibility for creating and implementing risk management plans. Staff believes utility hedging programs provide benefits to customers. Therefore, staff recommends that the Commission provide regulatory support and guidance regarding these programs.

However, evaluation of hedging results can be problematic since they are not reported on a calendar basis similar to the original plans. Therefore, IOUs should address the comparability of reported results to their original plans by structuring their plans to match reporting periods, or otherwise show the comparability of objectives and results.

Issue 3: Should this docket be closed?

Recommendation: No. If no person whose substantial interests are affected by the proposed agency action issues files a protest within 21 days of the issuance of the order, a Consummating Order should be issued. However, the docket should remain open as it is an on-going docket. (Bennett)

Staff Analysis: If no person whose substantial interests are affected by the proposed agency action issues files a protest within 21 days of the issuance of the order, a Consummating Order should be issued. However, the docket should remain open as it is an on-going docket.

EXHIBIT 1
Hedging Order Clarification Guidelines

I. File an annual Risk Management Plan for Fuel Procurement (the "Plan") as part of the IOU's Annual Estimated/Actual Fuel Filing. The Plan would be submitted for Commission approval at the annual Levelized Fuel Cost Recovery and Capacity Cost Recovery Hearing held in November (the "Annual Fuel Hearing").

   a. Each IOU will file a comprehensive Plan as part of its annual Levelized Fuel Cost Recovery and Capacity Cost Recovery Estimated/Actual True-up filing ("Estimated/Actual Filing", which typically occurs in early August) that includes the level of detail the IOU feels is appropriate for the risk management/hedging program to be executed. As has been the case with risk management plans filed to date, the Plan will address Items 1, 2, 3 (to the extent possible), 4-9 and 13-15 of Exhibit TFB-4 (ref. Paragraph 2 of the Proposed Resolution of Issues approved in Order No. PSC-02-1484-FOF-EI, Docket No. 011605-EI, dated October 30, 2002). The Plan will cover the activities to be undertaken during the following calendar year for hedges applicable to subsequent years (e.g., file Plan in August 2008 describing the hedging program to be executed during calendar year 2009 for hedges applicable for on-going activities for 2009 and subsequent years included in the hedging program).
   b. The Plan may be filed with a request for confidentiality to ensure that an IOU's anticipated hedging activities are not broadcast to the market prior to execution.
   c. The Commission will review for approval each IOU's Plan during the Annual Fuel Hearing, which approval is required to proceed with the hedging activities proposed in that Plan. This is consistent with page 18 of the Staff recommendation, dated April 14, 2008, on FPL's VMM proposal: "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."

II. "Hedging Activities" that are appropriately reported by IOU's in their hedging information reports are defined to be natural gas and fuel oil fixed price financial or physical transactions; instruments include fixed price swaps, options, etc. If an IOU is responsible under a power purchase agreement for providing the natural gas or fuel oil required to generate the power purchased thereunder, the IOU will report on any hedging activities that it undertakes with respect to such fuel.

III. At the Annual Fuel Hearing, the Commission will review and determine the prudence of each IOU's hedging activities for the year ending the immediately preceding July 31 (e.g., at the November 2009 Annual Fuel Hearing, the Commission will review and determine the prudence of hedging activities for the period August 1, 2008 though July 31, 2009). To facilitate this review, each IOU will file the following each year:

a. A Hedging Activity Final True-Up Report in April, covering the prior calendar year; and
b. A Hedging Activity Supplemental Report by August 15, covering the period January 1 to July 31 of that year.

Hedging Activity Final True-Up Reports and Hedging Activity Supplemental Reports will present the data on hedging activities by month, for each month covered by the reports.

IV. Establish the following guiding principles that the Commission recognizes as appropriate and will follow in reviewing Plans and an IOU's hedging actions; provided, however, that the Commission may approve a Plan notwithstanding deviations from one or more of the guiding principles, and the terms of an approved Plan will control for the purpose of reviewing hedging actions:

a. The Commission finds that the purpose of hedging is to reduce the impact of volatility in the fuel adjustment charges paid by an IOU's customers, in the face of price volatility for the fuels (and fuel price-indexed purchased power energy costs) that the IOU must pay in order to provide electric service.
b. The Commission finds that a well-managed hedging program does not involve speculation or attempting to anticipate the most favorable point in time to place hedges. Its primary purpose is not to reduce an IOU's fuel costs paid over time, but rather to reduce the variability or volatility in fuel costs paid by customers over time.
c. The Commission endorses the goal of controlling volatility of fuel adjustment charges and finds that hedging is a useful tool for this purpose.
d. The Commission acknowledges that hedging can result in significant lost opportunities for savings in the fuel costs to be paid by customers, if fuel prices actually settle at lower levels than at the time that hedges were placed. The Commission recognizes this as a reasonable trade-off for reducing customers' exposure to fuel cost increases that would result if fuel prices actually settle at higher levels than when the hedges were placed. The Commission does not expect an IOU to predict or speculate on whether markets will ultimately rise or fall and actually settle higher or lower than the price levels that existed at the time hedges were put into place.
e. The Commission recognizes that market prices and forecasts of market prices have experienced significant volatility and are expected to continue to be highly volatile and, therefore, does not intend that an IOU will try to "outguess the market" in choosing the specific timing for effecting hedges or the percentage or volume of fuel hedged.
f. In order to balance the goal of reducing customers' exposure to rising fuel prices against the goal of allowing customers to benefit from falling fuel prices, the Commission finds that it is appropriate to hedge a portion of the total expected volume of fuel purchases; the volume and timing of such hedges will be implemented within the parameters of an approved Plan, subject to any

modifications or exceptions to the approved Plan that have been filed with and approved by the Commission.

g. The Commission understands that each respective company's forecast of fuel burns is an on-going process and forecasts do change over time. As a result, the volume to be hedged within the hedging program is based on a point-in-time forecast and the actual hedge percentages will vary from forecasts.

OPC'S COMMENTS ON PROPOSED HEDGING GUIDELINES

The Office of Public Counsel submits its observations and comments on the proposed hedging guidelines submitted by Florida Power & Light Company in Docket No. 080001-EI on August 5, 2008. For the following reasons, OPC opposes the request of FPL and the other major investor-owned electric utilities for approval of the proposed guidelines. With respect to reducing fuel price volatility felt by retail customers, which is the single purpose of hedging identified by the utilities, the hedging activities are of very limited value to customers, while the costs of those activities have never been quantified satisfactorily. However, by FPL's own admission, the hedging costs could be substantial. While the hedging programs do not add materially to the insulation against fuel price volatility already in place in the form of the levelized fuel cost recovery charge, it appears to OPC that the hedging transactions provide financial benefits to the utilities themselves. That being the case, if the utilities continue to hedge their fuel prices, the Commission should not relinquish its full ability to gauge the prudence of the utilities' transactions. The proposal contained in FPL's petition and the attached guidelines goes far beyond "clarifying" the Commission's 2002 order. It would sacrifice the Commission's ability to conduct full, after-the-fact prudence reviews in order to accede to the utilities' desire to reduce their regulatory risk through an "up front" sign-off. Even if the Commission were to entertain the request, such an explicit lowering of regulatory risk should be accompanied by a commensurate lowering of the authorized return on equity, but that is not part of the proposal.

The data indicate that the utilities' hedging programs do not add materially to the customers' insulation against fuel cost volatility already in place in the form of the levelized fuel cost recovery factor.

During all meetings held to discuss the value of the utilities' fuel hedging programs, utilities have emphasized that the limited purpose of their fuel hedging programs—the sole benefit that they identify as the justification for their hedging programs, and the costs thereof--- is to reduce the impact of the volatility of fuel prices on the retail customer. OPC believes a first step in the Commission's appraisal of the "clarifying" new hedging guidelines is to take stock of information available six years after the Commission issued its original hedging order. It should consider, based on historical information, whether the hedging activities are needed to accomplish that purpose. Said differently, the appropriate starting point is to consider whether data gained from experience indicate that there is a problem (volatility in fuel costs felt by the customer) for hedging to solve. This is the same question that FPL raised initially in its "VMM" petition of January 31, 2008. In that pleading, FPL asserted that the levelized fuel adjustment charge has the effect of insulating the retail customer from changes in the price of fuel. In a meeting held to discuss the "VMM" proposal, FPL compared its customers' bills *with* hedging to the customers' bills as they would have been if there had been *no* hedging. The comparison showed that the existing levelized fuel cost recovery mechanism already protects customers from volatility of fuel prices as measured by the customers' monthly bills, and little additional "tempering" of volatility seen and felt by customers through their bills is

accomplished by the hedging activities. Additional information that Gulf Power provided to OPC, in response to an informal request for information, reinforces the conclusion to which FPL's data leads.

At one point during a more recent meeting to discuss hedging, someone suggested that there are only two relevant "data points" –December, when one approved factor expires, and January, when the replacement factor takes its place--to consider when evaluating the contribution of hedging to the objective of moderating the fuel price volatility felt by customers. That is not true. Customers receive bills monthly. Therefore, customers are exposed to volatility of fuel costs monthly. Each monthly bill is, therefore, a "data point" that must be observed in ascertaining the extent to which the volatility of the fuel markets reaches and affects customers. In Florida, the volatility that would otherwise register on customers' bills each month is reduced by the application of a levelized annual charge on each of the monthly bills, regardless of differences in prices paid by the utility from month to month. While it is certainly true that bills rise or fall in conjunction with the establishment of a new levelized factor in January, it is incorrect to state that December and January are the only relevant data points. Accurately viewed, the situation is that, because of the levelizing that is done independent of hedging, 12 of 13 relevant data points reflect minimal volatility in fuel costs. Further, as FPL demonstrated in the VMM petition, there are means other than hedging—such as spreading a large underrecovery over a period longer than the following 12 months—with which the Commission and utilities may manage any issue of rate shock at the outset of the calendar year. In short, retail customers are called upon to bear the costs of hedging programs, but derive little value from hedging in the form of an additional layer of protection against volatility.

The costs of hedging programs have not been quantified, but, according to FPL, "could be quite substantial." At the same time the value of hedging in accomplishing the only purpose ascribed to it by the utilities is demonstrably very small, we know that the utilities incur costs associated with hedging activities. OPC believes a comparison of benefits and costs should be a fundamental component of any consideration of a utility-proposed and utility-serving revamping of the regulation of hedging programs. OPC has seen no precise quantification of the total costs that customers bear as a result of utilities' hedging programs. However, in its original petition FPL said the indirect costs associated with hedging (i.e., costs other than direct transactional costs) "could be quite substantial." (FPL's "VMM" petition, at page 6.) The unquantified, but likely "quite substantial," costs of hedging transactions should be taken into account when considering a request to diminish the Commission's ability to gauge the prudence of the utilities' activities.

The utilities benefit from their hedging programs. While the utilities like to characterize hedging as a means of reducing volatility of fuel costs from the customers' perspective, to OPC's knowledge the utilities have never described or even acknowledged the benefits that *they* receive from hedging. The hedging of fuel costs can lead to more stable cash flow and more predictable earnings, both of which are valued highly by corporate management and investors, separate and apart from any claimed benefit to customers. Rather than leading to a higher perceived risk, as asserted (but not supported) by FPL in

its pending petition, the hedging activities provide distinct financial advantages to the utilities. At the same time, the proposed guidelines would shift more financial risk away from the utilities and onto their customers. The advantages and benefits of hedging that inure to utility management and investors should be taken into account when considering a request to diminish the Commission's ability to protect customers' interests.

The proposed guidelines would reduce the utilities' regulatory risk, at the cost of the Commission's ability to conduct the oversight role necessary to protect customers' interests fully, without achieving a concomitant reduction in the utilities' authorized rate of return.

Each time the Commission accommodates the utilities' desire for expedited, up-front approval of the utilities' transactions and conduct, the ability of the Commission to conduct a comprehensive prudence review with the requisite time and attention is diminished, to the detriment of its ability to protect customers' interests fully. If the Commission were to approve the proposed guidelines, the effect would be to lower the utilities' regulatory risk. Inasmuch as the utilities are compensated for the level of risk they bear through an approved rate of return, any approval by the Commission should be reflected in a rate of return on equity that is commensurately lower. But the utilities have not proposed to lower the rate of return (or lower rates that would be needed to generate the lower return) in their proposal. The Commission should not implement one side of the equation without implementing the other.

SUMMARY

In conjunction with its consideration of FPL's pending petition to approve hedging guidelines, the Commission should use the six years of experience gained since it issued its 2002 hedging order to evaluate whether the utilities' hedging programs are providing benefits to customers that are justified by the costs of hedging that customers bear. It should recognize the benefits and advantages of hedging that inure to the utilities and their investors rather than customers. It should maintain its full ability to protect customers' interests with a procedure that provides the full time and attention that the subject matter requires. It should ensure that any steps taken to reduce the utilities' risk profile is accompanied with a corresponding reduction in the authorized return on equity that customers are required to support through the rates they pay. Based on OPC's view of these considerations, OPC opposes the proposed guidelines.

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