State of Florida

Public Service Commission

CAPITAL CIRCLE OFFICE CENTER ● 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

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

DATE: March 26, 2009

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Lester, Giles, Matlock)
Office of the General Counsel (Brown)

RE: Docket No. 080649-EI – Petition to allow transportation fuel surcharge hedging by Progress Energy Florida, Inc.

AGENDA: 04/07/09 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Skop

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\080649.RCM.DOC

Case Background

The Commission established the framework and direction for utility fuel price hedging programs by Order No. PSC-02-1484-FOF-EI, issued October 30, 2002, in Docket No. 011605-EI, In re: Review of investor-owned electric utilities' risk management policies and procedures. This order approved a Proposed Resolution of Issues that provided authorization for electric utilities to engage in non-speculative fuel price hedging programs for natural gas, fuel oil, and purchased power. The Commission stated that it would allow the utilities to recover prudently incurred hedging gains and losses through the fuel and purchased power cost recovery clause. The Commission also ordered the utilities to file risk management plans. The Commission recognized the importance of managing fuel price volatility.

By Order No. PSC-08-0667-PAA-EI, issued October 8, 2008, the Commission clarified the above order and provided guidelines for utility hedging programs. See Docket No. 080001-EI, In re: Fuel and purchased power cost recovery clause with generating performance incentive factor. By establishing the guidelines, the Commission noted that utility hedging activities can reduce the volatility of fuel prices and thereby reduce the volatility of fuel adjustment charges. The guidelines essentially recognize that prudently managed hedging programs can result in the utility paying above-market and below-market prices at various times for its fuel. The guidelines also state that the utility will only hedge a portion of its fuel purchases, in accordance with its approved risk management plan, and that the utility will not engage in speculation.

Progress Energy Florida, Inc. (PEF) filed a petition on October 22, 2008, requesting that the Commission allow it to expand its hedging program to include transportation fuel surcharges that are part of its coal transportation agreements. The Commission has jurisdiction pursuant to Section 366.05, Florida Statutes.

Discussion of Issues

Issue 1: Should the Commission approve PEF's petition to include coal transportation fuel surcharges in its hedging activities?

Recommendation: Yes. The Commission should allow PEF to include coal transportation fuel surcharges in its hedging activities. (Lester, Matlock, Giles)

Staff Analysis: Coal-fired generation makes up approximately 33% of PEF's 2009 generation mix. PEF's coal facilities are Crystal River Units 1, 2, 4, and 5. PEF ships coal to these units by rail and by barge from domestic and foreign mines. Transportation costs are a significant part of PEF's delivered cost of coal, and, in turn, diesel fuel costs incurred to ship the coal are a significant part of transportation costs.

PEF's transportation agreements with CSX railroad and with Gulf and river barge companies have provisions for fuel adjustments to the overall transportation costs. The railroad engines and barge engines use diesel fuel. The fuel adjustments are based on changes in prices of certain fuel commodities, which allow the railroad and the barge companies to recover their actual cost of diesel fuel. These agreements essentially transfer the risk of fuel price increases and volatility to PEF's customers. PEF's current transportation agreements include fuel adjustment provisions based on the West Texas Intermediate (WTI) crude oil contract and on U.S. Gulf Waterborne Low Sulfur Diesel.

PEF's current fuel price hedging activities include hedging the price of natural gas and fuel oil using financial and physical hedging[1]. Most of PEF's fuel oil for generating units is heavy fuel oil, but the company also uses light fuel oil, which is diesel fuel. PEF uses light fuel oil for smaller generators such as peaking units and for starter fuel for coal and heavy oil generators. PEF has included hedging the price of light fuel oil for generation in its Commission-approved 2009 Risk Management Plan.

In its petition, PEF states that it experienced significant increases in coal transportation costs due to the transportation fuel surcharges. Diesel fuel prices, similar to crude oil prices, are volatile and rose significantly during 2008. Since the fall of 2008, diesel prices have declined significantly.

PEF analyzed the fuel price component of its CSX transportation contract and states that it can use a hedging strategy, similar to what it currently uses for natural gas and fuel oil, to reduce the volatility of transportation fuel surcharges. PEF would use financial hedging instruments – swaps and options[2] – to reduce the volatility of fuel surcharges. PEF believes this will reduce the volatility of delivered coal prices and thereby benefit its customers. PEF

[1] Financial hedging involves the use of financial instruments such as swaps and options to hedge against price increases in fuel. Physical hedging involves the use of fixed price supply contracts to hedge against price increases.
[2] Utilities typically enter into swap contracts with commercial banks and investment banks. Swaps allow utilities to fix the price of fuel for delivery in the future, with the bank assuming the floating price. Options give utilities the right, but not the obligation, to buy or sell fuel at a certain price. Options can be offered by fuel brokers and allow utilities to set a ceiling or floor on its fuel prices.

indicates that a similar reduction to the volatility of fuel surcharges is possible for barge transportation contracts.

PEF notes that, upon receiving Commission approval, it will update its risk management guidelines to include hedging fuel prices for transportation fuel surcharges. PEF proposes to report these hedging activities as part of hedging reports for natural gas and fuel oil. PEF does not intend to hedge the price of transportation fuel longer than 24 months. According to PEF, this additional hedging activity will not cause new costs or require new systems.

Staff has reviewed PEF's analysis of hedging the transportation surcharges associated with the CSX contract. (PEF requested confidentiality for this analysis.) The analysis shows that a reduction in the volatility of transportation surcharges is achievable with the extension of the existing hedging program.

In response to staff discovery requests, PEF provided an analysis showing the estimated effect hedging transportation fuel surcharges would have had on total fuel revenue for 2006, 2007, and 2008. In addition, PEF provided an analysis showing the estimated volume of diesel fuel that it would have hedged for 2009. (PEF requested confidentiality for both analyses.) Staff believes the dollar amounts and the volumes to be hedged could be noteworthy, since transportation costs are a significant part of delivered coal costs, but the ultimate impact on customer bills may not be very significant. However, this will give the utility another method of addressing volatility.

Compared with natural gas and fuel oil prices, delivered coal prices historically are not volatile. However, during 2007 and 2008, U.S. spot coal prices rose sharply due to increased world economic growth and increased U.S. exports of coal. Since the fall of 2008, spot coal prices have declined significantly. To the extent that delivered coal prices have become more volatile, the ability to hedge the transportation fuel component of delivered coal prices would be beneficial. Again, the impact on customers' bills will be less than the effect of PEF's current hedging activities for natural gas and fuel oil for generating units.

In Order No. PSC-08-0667-PAA-EI, the Commission provided guidelines for utility hedging programs. Guideline IV. b. reads as follows:

> 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.

Staff believes PEF's proposal to hedge transportation fuel surcharges would not reduce costs, but would reduce the price volatility of the delivered price of coal. The long-term benefit of this to customers would be less volatile fuel costs and more stable fuel factors. PEF has long-standing experience in using swaps and options to hedge the price of natural gas and fuel oil used for generating electricity, and hedging transportation fuel surcharges will not increase administrative costs.

Conclusion

Staff believes PEF's proposal to include transportation fuel surcharges in its hedging activities is reasonable and would be beneficial to customers. Therefore, staff recommends that the Commission approve PEF's petition.

Issue 2: Should this docket be closed?

Recommendation: Yes. If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order. (Brown)

Staff Analysis: If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order.