030001-EI

**FLORIDA POWER & LIGHT COMPANY**
**DOCKET NO. 030001-EI**
**AUDIT OF BASE COSTS FOR SECURITY AND HEDGING**
**(AUDIT CONTROL NO. 02-340-4-1)**
**RESPONSE TO AUDIT DISCLOSURES**
**August 15, 2003**

FPL disagrees with the Audit Disclosures included in the Final Audit Report regarding the Base Costs for Security and Hedging that was issued on June 30, 2003. In general, FPL disagrees with the recommendations that the audit report suggests for two main reasons:

1. **Costs should be compared to projected test year data.**

   When comparing incremental power plant security or hedging costs to base costs, the appropriate comparison is to projected test year data; specifically FPL's 2002 MFRs filed in Docket No. 001148-EI. The auditors are trying to substitute 2002 actual results for the test year projections, which represents a back-door base rate adjustment that is inconsistent with the Rate Settlement Agreement (Docket No. 001148-EI), as well as the Hedging Resolution in Docket No. 011605–EI. The essential purpose of the MFRs in Docket No. 001148-EI was to provide information on FPL's *base-rate* revenues, expenses and investment for the test year in question, making it the logical base period for comparing incremental expenses. Consistent with this emphasis on using 2002 MFRs to define what constitutes "incremental" expenses, the Commission has approved in Docket No. 011605 the following definition of base costs:

   > "The base period for determining incremental expenses as described above is the year 2001 (using actual expenses), except for utilities with rates approved based on Minimum Filing Requirements (MFR) in rate reviews since 2001, *in which case the projected rate year is the base period (using projected expenses)*".

2. **Like categories of costs should be compared, not broad categories of costs across various functions.**

   Where FPL is entitled to recover incremental power plant security or hedging costs through a cost recovery clause, the proper focus for evaluating whether the costs proposed for recovery are indeed incremental is on the level of *those particular costs* in the MFRs, in order to be sure that FPL would not be double recovering the costs (*i.e.,* recovering them in both base rates and through a cost recovery clause). For example, in defining what constitutes "incremental" expenses for the purpose of allowing recovery of incremental operating and maintenance expenses associated with a hedging program, the Commission has approved in Docket No. 011605 the following procedure:

(See DN 04500-04) All base year and recovery year FERC sub-account

DECLASSIFIED
CONFIDENTIAL
ALL 4-13-04



DOCUMENT NUMBER-DATE
07528 AUG 15 03
FPSC-COMMISSION CLERK

operating and maintenance expense amounts associated with financial and physical hedging activities shall be included in the Fuel Clause Final True-up filing each April during the years 2003 through 2007, including the difference between the base year and recovery year expense amounts, then summed, yielding a total incremental hedging amount which may be compared for cost recovery review purposes to the requested cost recovery amount produced in the Projected Filing for the recovery year.

This procedure focuses on the specific accounts where the costs for which recovery is sought are recorded, not on the entire range of a utility's operations. It would be completely inconsistent with this procedure to conduct the "mini rate case" that the auditors are suggesting.

**Audit Disclosure No. 1**
**RE: Incremental Power Plant Security**

The Audit Opinion in Audit Disclosure No. 1 states that:

"We compiled all the charges for all business units to EAC 694 for 2001 and determined a base amount for 2001 excluding additional costs after 9/11/01. We also determined an incremental amount for 2002.

| | |
|---|---|
| Actual 8 months 2001 | $ 7,019,052.93 |
| Annualized 2001 (without 9/11 effect) | $10,528,579.39 |
| Actual 2002 | $14,844,201.82 |
| Incremental 2002 for EAC 694 | $ 4,315,622.43 |
| Total incremental costs per company in filing | $ 8,754,766.31 |
| Difference | $ 4,439,143.88 |

The above difference is due to the other EAC's that are included in these accounts as discussed above.

Beginning in 2002, the company identified specific security costs as incremental and records these in the new accounts. This process does not include a specific comparison to the base year to determine if any costs have been reduced or are included in both the base year and as an incremental cost. Therefore, we recommend that all nuclear and fossil security costs go into the same account and the base cost of $10,528,579.39 (EAC 694 security costs for 8 months of 2001 annualized) be removed from the total".

For 2002 FPL included $8,754,766 in the capacity clause specifically for incremental "power plant" security requirements that have been imposed since and in response to the events of 9/11/01. The Audit Opinion expressed in Audit Disclosure No.1 suggests that a $10,528,579 downward adjustment be made to adjust for the annualized security costs for all business units in Expense Analysis Code (EAC) 694 that were incurred in the first 8 months of 2001. FPL disagrees with this adjustment because it does not compare incremental power plant security costs to like categories of cost. EAC 694 is used for security costs but also includes security costs for non-power plant locations. The focus should be on the specific accounts (524.220 for nuclear and 506.075 for fossil) where the incremental power plant security costs for which recovery is sought are recorded, not on the entire range of a utility's operations, or a compilation of "all the charges for all business units to EAC 694" that the auditors propose.

Furthermore, when evaluating whether the 2002 power plant security costs are eligible for recovery through the capacity clause, the proper comparison is to the projected test year data. The 2002 MFRs filed in Docket No. 001148-EI do not include any of the incremental power plant security costs as a result of 9/11/01 or other Homeland Security responses that FPL has included for recovery through the capacity clause. On November 9, 2001, FPL filed adjustments to its 2002 MFRs to reflect the impact of the 9/11/01 events. However, the footnote on Attachment 1 of this filing stated that the adjustments "Reflects recovery of additional security costs through the fuel clause as filed 11/05/2001 in Docket 010001-EI." The "additional security costs" reflected in the fuel clause were the initial estimate of the costs of power plant security. Thus, from the outset the incremental power plant security costs as a result of 9/11/01 and other Homeland Security responses have been accounted for and recovered through the adjustment clauses and are not reflected in base rates. In contrast, the auditors would essentially ignore the 2002 MFRs and instead focus on actual 2002 expenditures, thus improperly effecting a back-door base rate adjustment of the sort discussed above.

**Audit Disclosure No. 2**
**RE: Incremental Power Plant Security**

The Audit Opinion expressed in Audit Disclosure No. 2 states:

> "There is a difference of $465,098 between the forecasted and actual amounts shown above. The company was permitted to recover capital expenditures in expense for this new filing per Order PSC 02-1761-FOF-EI, and therefore has expensed some plant (capital) related projects. The company received the benefit of the additional forecasted plant addition figures in the MFR filing, so an adjustment should be made to reduce the amounts charged to expense through the capacity clause by $465,098 and increase plant. This would ensure that the amount capitalized in the forecast MFR's was adhered to".

The audit opinion suggests that the $8,754,766 that FPL has included for 2002 power plant security costs be reduced by $465,098 for the difference between forecasted and actual 2002 Transmission and Distribution (T&D) security costs. Again, this would amount to an inappropriate back-door base rate adjustment. Moreover, the auditors' suggestion of comparing power plant security costs to T&D security costs is an inappropriate "apples to oranges" comparison.

**Audit Disclosure No. 3**

DECLASSIFIED

**RE: Incremental Hedging Expenses**

The Audit Opinion in Audit Disclosure No. 3 states that:

> "The mission of the entire EMT division is similar to the goal of the hedging program and therefore, it is difficult to separate the incremental costs specifically for hedging when any costs incurred help the division meet its goals. The 2002 total base budget is $1,784,623 higher than actual 2002 base expenses. Since rates were set based on the budget amount, the company received a benefit by having a higher budget amount than the actual. It does not appear reasonable that the company would be allowed to recover an additional $2,726,054 through the fuel clause for incremental hedging expenses. Therefore, we recommend that the entire difference of $1,784,623 be used as base hedging costs when calculating the incremental hedging costs for the fuel filing".

FPL disagrees with this opinion. FPL's expanded hedging program is a robust program that includes financial hedging. This program is clearly different than the hedging activity that FPL had been engaged in prior to the Hedging Resolution in Docket No. 011605-EI which was primarily physical hedging. The more robust expanded hedging program has required use of consultants, new reporting systems and additional personnel that were not included in FPL's MFR filing in Docket No. 001148-EI.

Furthermore, FPL disagrees with this recommendation to reduce any amount requested through the fuel clause for incremental hedging expenses by $1,784,623 to reflect the difference between EMT's total 2002 budget and its actual 2002 expenses. This adjustment does not compare the cost sought for recovery through the clause to projected test year data, nor does it compare like categories of costs. The appropriate comparison is to projected test year data. Once again, the adjustment would be an inappropriate true-up of base rates which is completely inconsistent with both the Rate Settlement Agreement and the Hedging Resolution which states "the projected rate year is the base period (using projected expenses)". Furthermore, the procedure approved in the Hedging Resolution properly focuses on those particular costs in the MFRs, not on the entire range of a utility's operations or in this case the entire EMT Department budget, as the auditors are suggesting.

In 2002 the only incremental hedging costs that FPL included for fuel cost recovery were consultant fees. Therefore, the appropriate adjustment compares the hedging related consultant fees that FPL included for fuel cost recovery to the hedging related consultant fees in the MFRs. This is precisely the adjustment that FPL has made. Specifically, FPL included $2,726,054 for recovery through the fuel clause for incremental operation and maintenance expenses for its expanded hedging program. This amount represents the Dean & Company, Iconnix, and E-Systems consultant fees reduced by $250,000 for Contractor & Professional Services for Special Projects that was already included in the MFR filing. To support the $250,000 adjustment, FERC point account and EAC documentation was included in FPL's August 20, 2002 fuel filing and is also attached to this response. Page 1 of

Attachment I shows that EMT makes up $8.896 million of the O&M budget in the MFR filing for the 2002 test year. Page 2 of Attachment I provides this $8.896 million by FERC point account. FPL-EMT does not budget by FERC point account for Business Unit O&M expenses. The FERC point accounts for the MFR filing were developed based upon the FERC point account allocation for year end 2000 actual expenses. EMT prepared its 2002 budget by EAC group, which is also provided on Page 2 of Attachment I. One can see from the Recap by EAC group that FPL projected to spend $1,088,000 for Contractor & Professional Services. The detail build up of Contractor & Professional Services is also provided on Page 2 of Attachment I. Of the $1,088,000 for Contractor & Professional Services, $250,000 is for Special Projects Consultants. Therefore, FPL reduced its consultant fees related to its expanded hedging program by this $250,000 already included in the 2002 MFR filing to produce the incremental hedging cost of $2,726,054 included for fuel cost recovery.

**Audit Disclosure No. 4**
**RE: Incremental Hedging Expenses**

In 2003, FPL has included the salaries of two new employees dedicated to the expanded hedging program in its fuel cost recovery calculation. The Audit Opinion expressed in Audit Disclosure No. 4 states that:

> "Base rates were set including $1,800,000 in incentives. The unpaid incentives more than cover the budgeted hedging salaries that start in 2003".

This is yet another instance of the auditors suggesting an inappropriate back-door base rate adjustment. Certainly all would agree that the Company should minimize costs whenever possible. In essence, if this recommendation were adopted, FPL would be penalized for minimizing its costs. Moreover, keep in mind that the purpose of the Commission approving the recovery of incremental operating and maintenance expenses associated with new or *expanded* hedging programs is to remove any disincentives that may currently exist for IOUs to engage in hedging transactions that may create customer benefits. Refusing to allow FPL to recover legitimate, new costs associated with its expanded hedging program because FPL had reduced costs elsewhere in EMT would hardly provide that incentive.

**Audit Disclosure No. 5**
**RE: Incremental Hedging Expenses**

The opinion expressed in Audit Disclosure No. 5 states that:

> "The interviews revealed that hedging was done in 2002, but we were not able to determine from the interviews the exact amount of time that related to hedging in 2002, which was the base year. Although the new employees are refining the hedging process and are spending more time than the employees did in 2002, the company should have proposed allocating the salary for the associate financial trader, the physical trader and the manager as part of base costs. When the senior financial trader completes the development of

the hedging programs, the hedging duties may be split among this position and the associate financial trader. In addition, the duties of the quantitative analyst benefit hedging but also appear to benefit the overall fuel planning. His salary may need to be allocated."

FPL disagrees that an allocation adjustment needs to be made. Although hedging was done in 2002, the new employees are dedicated to the expanded hedging program, were not hired until 2003, and the salary expense for these new employees was not included in the MFR filing. In other words, without the expanded hedging program the two new employees would not have been hired.

**Audit Disclosure No. 6**
**RE: Incremental Hedging Expenses**

The opinion expressed in Audit Disclosure No. 6 states that:

> "The 2001 actual costs for EMT included $419,750 for hedging program consulting for Dean & Company. The company included this cost in 2001 base costs but transferred these costs to fuel hedging in 2002. The company budgeted $420,000 for internal system development as recoverable costs in 2002...The $420,000 in the 2002 budget appears to be the rounded amount for Dean & Company for 2001 and should have probably been identified as base costs instead of the $250,000 the company had identified."

This conclusion is incorrect. The accrued incremental hedging program cost of $419,750 that was related to Dean & Company activities during 2001 is completely unrelated to the $420,000 budgeted for user support and internal system development & production support for 2002. The $420,000 represents activities that are not part of the incremental hedging program. The $250,000 adjustment that the company identified and described in response to Audit Disclosure No. 3 is the appropriate adjustment.