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State of Florida

Public Service Commission

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

DATE: May 26, 2016

TO: Office of Commission Clerk (Stauffer)

FROM: Division of Accounting and Finance (Barrett, Lester)
Office of the General Counsel (Brownless)

RE: Docket No. 160096-EI – Joint petition for approval of modifications to risk management plans by Duke Energy Florida, Florida Power & Light Company, Gulf Power Company and Tampa Electric Company.

AGENDA: 06/09/16 – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Graham

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

Case Background

On April 22, 2016, Duke Energy Florida, LLC (DEF), Florida Power & Light Company (FPL), Tampa Electric Company (TECO), and Gulf Power Company (Gulf) (Petitioners or IOUs) filed a joint petition seeking approval of modifications to their respective Risk Management Plans (Joint Petition). FPL, TECO, and Gulf are seeking approval of modifications to their respective 2016 Risk Management Plans, noting that the 2016 plans were approved in Order No. PSC-15-0586-FOF-EI (2015 Fuel Order).[1] DEF does not join in seeking to modify its 2016 Risk Management Plan, because DEF believes its current Risk Management Plan affords it the ability to meet the goals proposed by the other petitioners. The Petitioners propose modifications to the 2017 Risk Management Plans, which will be considered for approval in November's annual hearing in the Fuel Cost Recovery Clause docket (Docket No. 160001-EI).

[1]Order No. PSC-15-0586-FOF-EI, issued December 23, 2015, in Docket No: 150001-EI, *In re: Fuel and Purchased Power Cost Recovery Clause with Generating Performance Incentive Factor.*

The Petitioners state that in the 2015 Fuel Order (at page 9), the Commission directed the Petitioners to explore possible changes to the current hedging protocol in order to minimize potential losses to customers in periods of falling natural gas prices.

On January 25, 2016, an informal meeting between Commission staff and interested persons was held to discuss options and procedures for possible changes to the hedging process to minimize potential losses to customers. Representatives from DEF, FPL, TECO, and Gulf participated in the meeting, although no specific actions were developed.

The Petitioners contend this joint proposal achieves the objective expressed in the 2015 Fuel Order to bring forward possible changes to the current hedging protocol in order to minimize potential losses to customers. The Petitioners have identified company-specific commitments and each proposes to:

- Reduce their respective annual maximum percentage of fuel purchases targeted for hedges; and
- Reduce the period of time over which hedges may be placed pursuant to each respective Risk Management Plan.

On April 26, 2016, the Office of Public Counsel (OPC) filed its Notice of Intervention. By Order No. PSC-16-0174-PCO-EI, issued April 29, 2016, the Commission acknowledged OPC's intervention.

On May 10, 2016, DEF, FPL, TECO, and Gulf filed responses to staff's first data request.

The Petitioners propose that the Commission consider this Petition on a proposed agency action (PAA) track and approve the IOUs' modified 2016 Risk Management Plans,[2] to be effective within 15 days following the Commission vote and remain in effect during the pendency of any protest of the PAA Order.

The Commission has jurisdiction to consider this matter pursuant to Section 366.06, Florida Statutes (F.S.).

[2]With the exception of DEF, as described in the Analysis to follow.

Issue 1: Should the Commission approve the Joint Petition to modify the IOUs' Risk Management Plans?

Recommendation: Yes, the Commission should approve the Joint Petition to modify the IOUs' Risk Management Plans. (Barrett, Lester)

Staff Analysis: Risk Management Plans, in general, set forth the strategy and parameters each company will adhere to in their company-specific hedging programs for fuel procurement in the forward year and beyond.[3] These annual plans are reviewed as part of the fuel procurement process in the annual Fuel Cost Recovery Clause (Fuel Clause) hearing. As noted in the 2015 Fuel Order, hedging allows utilities to manage the risk of volatile swings in the price of fuel, specifically natural gas.

Background on Fuel Hedging and Risk Management Plans

Prior to 2001, IOUs carried out a small number of financial hedging transactions. In response to significant fluctuations in the price of natural gas and fuel oil during 2000 and 2001, the Commission raised issues regarding the utilities' management of fuel price risk as part of the 2001 Fuel Clause proceeding. The specific issues raised involved the reasonableness of hedging as a tool to manage fuel price risk and the appropriate regulatory treatment of hedging gains and losses. These issues were spun off to Docket No. 011605-EI for further investigation.

At the hearing for Docket No. 011605-EI, parties reached a settlement of all issues. By Order No. PSC-02-1484-FOF-EI (Hedging Order),[4] the Commission approved a settlement that provided a framework that incorporated hedging activities into fuel procurement activities. For natural gas, fuel oil, and purchased power, the settlement allowed Florida's generating IOUs to charge prudently incurred hedging gains and losses to the fuel clause. The Hedging Order specified that the Commission would review each IOU's hedging activities as part of the annual fuel proceeding.

The Hedging Order required utilities to file Risk Management Plans as part of their true-up filings. The intent of this requirement was to allow this Commission and parties to the Fuel Clause docket to monitor utility hedging activities. As part of the annual final true-up filings, utilities were required to state the volumes of fuel hedged, the type of hedging instruments, the average length of the term of the hedge positions, and fees associated with hedging transactions.

Although the Hedging Order allowed utilities flexibility in the development of Risk Management Plans, the order also set forth guidelines utilities were to follow. For example, the order required that Risk Management Plans identify the objectives of the hedging programs and the minimum quantities to be hedged. The order also required that plans provide mechanisms and controls for

[3]Risk Management Plans are generally filed annually in the third quarter of each year, and are subject to approval in the fuel clause hearing, usually scheduled for early November. The 2016 Risk Management Plans, which were reviewed in the fuel clause proceeding in 2015, were approved in the 2015 Fuel Order. Even though DEF presents information about its 2017 Risk Management Plan, the 2017 plans have not been filed with the Commission as of the date of this recommendation.

[4]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.*

the proper oversight of hedging activities within the utility, as well as include the method for assessing and monitoring fuel price risk.

In tandem with Docket No. 011605-EI, Commission staff conducted a review of the internal controls of the IOUs and published the findings in a report entitled "Internal Controls of Florida's Investor-Owned Utilities for Fuel and Wholesale Energy Transactions." This study examined the practices, procedures, controls, and policies these companies followed when purchasing fossil fuels and wholesale energy. The study period looked at data from 1998 through 2001. The study concluded that Florida's IOUs had engaged in physical hedging in fuel procurement but very limited financial hedging. At the time, the IOUs had not set up the proper controls to engage in extensive financial hedging.

The next time the Commission reviewed the policy on hedging was at the 2007 Fuel Clause hearing. Parties raised questions regarding the period over which the Commission was determining the prudency of costs of hedging activities. The Commission deferred the decision on the prudence of 2007 hedging activity costs to 2008 to allow for sufficient development of data and review of the matter.

Following the 2007 Fuel Clause hearing, two audits of the IOUs' hedging programs were conducted by Commission staff. First, staff conducted a management audit reviewing the IOUs' hedging programs to assess the costs and benefits realized since the entry of the Hedging Order. The IOUs' accounting treatment of 2007 hedging activities was also audited to determine compliance with their risk management plans filed in 2006.

The management audit assessed the current and historical strategies of the fuel procurement hedging programs within each company at that time, evaluated hedging objectives set forth in each company's Risk Management Plan, and quantified the net costs and benefits of each company's hedging program. Specifically, 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 was examined. Information was collected regarding each company's policies and procedures, organizational charts, Risk Management Plans, and historical hedging transactions. An analysis was conducted of each company's hedging program. In June 2008, a report was issued entitled "Fuel Procurement Hedging Practices of Florida's Investor-Owned Electric Utilities."

In its 2008 report, Commission staff found that each company shared a universal goal in securing financial hedges for fuel procurement; that is, to reduce the impacts of price extremes that can occur in the natural gas and fuel markets. In their hedging activities, the companies were not attempting to speculate on price movements in the market. Rather, each was working to stabilize annual fuel costs by initializing and settling financial hedging transactions through authorized financial counterparties. The volumes of natural gas and fuel oil hedged were less than the total volumes expected to be purchased. Overall, staff believed that the use of financial hedges for fuel purchases provided a benefit to utility customers.

On January 31, 2008, in response to the deferral of the determination of prudence related to 2007 hedging costs, FPL filed a petition requesting that the Commission approve FPL's proposed volatility mitigation mechanism (VMM) as an alternative to FPL's hedging program. The VMM

proposal involved FPL collecting under recoveries of fuel costs over two years instead of one year, as was, and is, the current practice. On March 11, 2008, a workshop was held to get stakeholder input on this proposal. All parties to the 2002 settlement attended.

By Order No. PSC-08-0316-PAA-EI,[5] the Commission clarified the Hedging Order in several areas. IOUs were required to file a Hedging Information Report by August 15th of each year. This order also specified that the Commission would make a determination of prudence of hedging results for the twelve month period ending July 31 of the current year. Additional workshops were held on June 9, 2008, and June 24, 2008, regarding FPL's VMM petition and guidelines for hedging programs. FPL withdrew its VMM petition on August 5, 2008.

Following the workshops, the Commission established guidelines for Risk Management Plans by Order No. PSC-08-0667-PAA-EI.[6] At that time, the Commission determined that utility hedging programs provide benefits to customers. The guidelines clarified the timing and content of regulatory filings for hedging activities, but allowed the IOUs flexibility in creating and implementing Risk Management Plans.

Each year in the Fuel Clause, staff auditors review utility hedging results for the twelve month period ending July 31 of the current year. In addition, each year the Commission votes on the IOUs' proposed Risk Management Plans for hedging transactions the utility will enter the following year and beyond. As noted earlier, the 2016 Risk Management Plans were approved in the 2015 Fuel Order, which found:

> Each plan provides the appropriate governance for a well-disciplined and prudently managed utility hedging program and is consistent with the Hedging Guidelines. These plans are structured to reduce price volatility risk in a structured manner.[7]

In the hearing for the 2015 Fuel Clause, the Commission evaluated the evidence presented in that record, which in large part consisted of arguments to either completely eliminate hedging or to continue the hedging procedures in place at that time. In the 2015 Fuel Order, the Commission decided to continue hedging with the specific directive to staff to explore possible changes to the current hedging protocol to minimize potential losses to customers. Additionally, the 2015 Fuel Order set forth that any changes to the hedging protocol should be prospective and that the current hedges should be allowed to terminate on their original contract dates.

Petition

As stated in the Joint Petition, DEF, FPL, TECO and Gulf estimate that 66 percent, 71 percent, 50 percent, and 65 percent, respectively, of their forecasted generation in 2016 will be from natural gas. This dependence on natural gas means customers have significant exposure to the uncertainties of natural gas prices. Even though natural gas prices have trended downward in

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[5]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 inventive factor.*
[6]Order No. PSC-08-0667-PAA-EI, issued October 8, 2008, in Docket No. 080001-EI, *In re: Fuel and purchased power cost recovery clause with generating performance inventive factor.*
[7]2015 Fuel Order at 9.

recent years, neither future gas prices nor the level of price volatility can be predicted with any certainty. The Petitioners believe the recent downward trend in natural gas market prices cannot continue indefinitely, and factors such as production costs, weather, environmental regulations, and exportation will impact natural gas supply and demand, as well as natural gas price volatility.

The Petitioners recognize that the amount of hedging undertaken by a utility is a matter of business judgment reflecting a necessary balance between the benefits of reduced fuel price volatility on customers' bills through hedging and, the cost of those hedges if prices fall. That balance is reflected in the amount of fuel hedged.[8] Accordingly, and in response to the Commission's directive to explore possible changes to the current hedging protocol, the Petitioners propose a two-step initiative to minimize potential losses to customers in periods of falling fuel prices.

Targets

The Petitioners propose to adjust hedging target ranges. For fuel purchases in 2017 that would be hedged under the Commission-approved 2016 Risk Management Plans, FPL, TECO and Gulf propose to reduce by up to 25 percent the maximum percentage limits planned for procurement with hedging instruments.[9] As noted previously, DEF proposes to implement target reductions beginning with the targets that will be included in its 2017 Risk Management Plan. Acknowledging that a portion of these hedges for 2017 have already been executed, this proposed limitation only applies to the portion that remains unhedged for 2017.

For fuel purchases for 2018 and extending to future periods that would be hedged under the Commission-approved 2016 Risk Management Plans, all four Petitioners propose to reduce by 25 percent the upper limit targets and ranges planned for procurement with hedging instruments.[10] Beginning with the 2017 Risk Management Plan for 2018 procurement and continuing thereafter, each of the IOUs will reduce the annual percentage of its fuel purchases for the ensuing 12-month period that are targeted to be hedged by 25 percent from the target and/or range approved in its 2016 Risk Management Plan. Because the Petitioners have requested confidential classification for the hedging target ranges identified in their 2016 Risk Management Plans, staff cannot disclose the actual ranges in those plans.[11]

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[8]FPL clarified that the reduced hedging targets apply to the total targets and ranges for all hedges, and the reduced hedging targets and ranges have no impact on the gas reserves guidelines approved in Order Nos. PSC-15-0038-FOF-EI and PSC-15-0284-FOF-EI. See: Order No. PSC-15-0038-FOF-EI, issued January 12, 2015, in Docket No. 150001-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor,* and Order No. PSC-15-0284-FOF-EI, issued July 14, 2015, in Docket No. 150001-EI, *In re: Fuel and purchased power cost recovery clause with generating performance incentive factor.*

[9]DEF agrees with and joins FPL, TECO, and Gulf in the proposed plan to reduce the maximum projected fuel purchases for calendar year 2017 that would be hedged during the remainder of 2016. However, DEF believes its 2016 Risk Management Plan affords it the ability to meet this goal without amending its plan, and for this reason, DEF does not join in the request to modify its 2016 Risk Management Plan.

[10]Staff notes that although a small portion of these hedges for 2018 and extending to future periods may have already been executed under the applicable 2016 Risk Management Plan, this proposed limitation only applies to the unhedged portions. The 2017 Risk Management Plans are due to be filed on August 4, 2016, in the Fuel Clause docket.

[11]The Petitioners individually requested confidential classification pursuant to Section 366.093, F.S., and Rule 25-22.006, Florida Administrative Code.

The Petitioners also propose commitments regarding the time horizon over which hedges are placed. Generally speaking, the time horizon for hedging activities is a risk mitigation tool whereby the longer into the future that hedges are placed, the more price risk is attached. The opposite is true as well, and each Petitioner evaluates risk versus reward considerations in executing their hedging programs in a non-speculative, structured manner. The proposed commitments about time horizons varies by Petitioner.

Duration

In concert with their proposal to reduce hedging targets, TECO and Gulf commit to shortening their respective time horizons for hedging, contending that this strategy shift carries some risk. TECO currently hedges into a 24 month time frame, and is proposing to reduce that to an 18 month period. In its response to staff's first data request, TECO states that a 18 month window reduces the exposure to hedging losses during periods of declining natural gas prices, while still providing a measure of price stability, as well as some protection against price spikes. Gulf states that by reducing the time horizon for placing fixed priced swaps, the opportunity to lock in fixed prices in future years is diminished.

DEF and FPL acknowledge similar risk considerations, but do not propose specific commitments regarding the time horizon for placing hedges. DEF currently hedges into a rolling 36 month time frame, and acknowledges that with lowered targets in each rolling period, its customers will bear a greater portion of fuel cost risk. FPL states that its 2016 Risk Management Plan permits it to use hedging instruments for projected natural gas requirements up to, but not beyond, the end of the subsequent calendar year in which hedges are being placed (December 2017). Although FPL is proposing to modify its hedging targets, FPL is not proposing any changes to its time horizon for placing hedges.

Analysis

In the 2015 Fuel Order, the Commission approved the current (2016) Risk Management Plans each Petitioner filed, acknowledging, however, that the costs of the Petitioners' hedging programs is significant and deserves further analysis to consider methods to minimize potential losses to customers on a prospective basis.

The joint proposal the Petitioners are now advocating can reduce potential losses to be recovered from customers. Reducing the respective annual maximum percentage of fuel purchases targeted for hedges and shortening the period of time over which hedges may be placed pursuant to each respective Risk Management Plan continues the Commission's hedging objective, which is to reduce customers' exposure to price volatility. Imposing these limiting parameters will shield customers during times when uncertain market prices for natural gas are lower than hedged prices. On balance, however, because hedging volumes will be reduced, customers may experience less price stability, and if natural gas prices increase, customers may experience higher overall fuel costs.

Conclusion

Staff recommends the Commission approve the Joint Petition to modify the IOUs' Risk Management Plans.

Issue 2: Should this docket be closed?

Recommendation: If no protest is filed by a person whose substantial interests are affected within 21 days of the issuance of the Order, this docket should be closed upon the issuance of a Consummating Order. (Brownless)

Staff Analysis: If no protest is filed by a person whose substantial interests are affected within 21 days of the issuance of the Order, this docket should be closed upon the issuance of a Consummating Order.