

Exhibit B

080000-0T
REDACTED

REDACTED DOCUMENTS

CMP _____
COM _____
CIR _____
COR 1 _____
CPL _____
CPC _____
CQA _____
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DOCUMENT NUMBER-DATE

05194 JUN 18 88

FPSC-COMMISSION CLERK

CONFIDENTIAL

3.0 Florida Power & Light Company

3.1 Fuel Procurement

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

2 Florida Power & Light's (FP&L) generation fleet is comprised of a combination of
3 natural gas, fuel oil, coal, and nuclear generation. In 2007, approximately 60 percent of its fuel
4 consumption was natural gas. In 2008, the company expects this to increase to upwards of 70
5 percent. In 2007, approximately 10 percent of its consumption was fuel oil, and the company
6 believes that use of fuel oil will decrease in coming years.

7 FP&L is one of the largest purchasers of natural gas in the United States. In 2007, the
8 company forecasted its natural gas consumption at over 436,000,000 MMBtu. Because a large
9 majority of the company's natural gas generation is base load, the company secures between
10 to [REDACTED] percent of its natural gas under long-term supply contracts. These contracts are negotiated
11 for up to three years in terms with the company paying market price at delivery. FP&L also
12 initiates fuel oil contracts for up to one year in term. As with natural gas, these contracts are
13 negotiated for supply, and the company will pay the market index price at delivery. The
14 remaining fuel supply is purchased on a short-term basis at a daily price index. The company's
15 Wholesale Fuel Group monitors the daily generation forecasts and determines the necessary fuel
16 amount to purchase for the upcoming day.

17 FP&L does not have in place any physical, fixed price, long-term contracts for fuel oil or
18 natural gas. The company recognizes that, due to the price volatility of these fuels, producers are
19 less willing to enter into this type of contract. The company has been in discussions with
20 producers and suppliers about the prospects of initiating fixed-price physical contracts and
21 believes that the opportunity may be of value in future procurement decisions. However,
22 management does not believe it would be able to secure a majority of the company's fuel under
23 fixed price contracts.

24 How does the company structure its Fuel Procurement Organization?

25 Florida Power & Light's fuel procurement functions are handled within its Energy
26 Marketing and Trading (EMT) group. The Vice President of the EMT group reports directly to
27 the FP&L president. This group has five units:

- 28 ♦ Project Development
- 29 ♦ Power and Fuel Origination
- 30 ♦ Wholesale Operations
- 31 ♦ Risk Analytics
- 32 ♦ Financial Trading Desk

33 The Financial Trading unit is responsible for all financial hedges related to fuel procurement.

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1 The company also has a separate Risk Management section within the EMT division that
2 is charged with ensuring that the executions of trades are followed and adequate controls are in
3 place for each procurement program. The Vice President of Trading and Risk Management
4 reports directly to the Chief Financial Officer of FP&L Group with an indirect reporting line to
5 the FP&L President as to hedging strategies. This group monitors all the company's trading
6 activities for accuracy. For fuel procurement, the Director of Trading Risk Management
7 oversees the team that directly monitors and evaluates trading transactions.

8 **What is the company's goal in using financial derivatives when purchasing**
9 **fuel?**

10 Florida Power & Light's hedging strategy and goals are to achieve fuel price stability,
11 potential fuel cost minimization, and asset optimization. The company believes it can best meet
12 these goals by implementing a standardized, management-approved program of financial
13 hedging instruments to lock-in natural gas and fuel oil purchase prices. The company establishes
14 a strategy that sets pre-determined hedge price and volume targets which are intended to ensure
15 that a percentage of its fuel costs will fall within its established tolerance.

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

18 As stated, Florida Power & Light's fuel procurement activities are housed within its
19 Energy Marketing and Trading division. This group only handles regulated fuel procurement for
20 the utility. An FP&L Group subsidiary, FP&L Energy Power and Marketing, Inc. handles non-
21 regulated fuel procurement and energy trading functions. The Energy Marketing and Trading
22 Group and Power and Marketing, Inc. do not directly interact and do not share office or trading
23 staff.

24 **3.2 Hedging Strategy**

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

27 FP&L believes that hedging is effective for accomplishing the goal of reducing price
28 volatility. Since the issuance of the Commission's Hedging Order in 2002, FP&L has executed
29 both physical and financial hedges for natural gas and fuel oil as part of its hedging program.
30 However, FP&L believes that financial hedging offers several distinct advantages over physical
31 hedging. Given the size of FP&L's hedging requirements, financial hedging offers more credit-
32 worthy counterparties, additional liquidity, and the reduction of supply risk.

33 In January 2008, FP&L filed a petition with the Commission proposing an alternative to
34 FP&L's hedging program. The proposal is a volatility mitigation mechanism (VMM) that
35 involves collecting FP&L's under recoveries of fuel costs over two years, instead the current
36 practice of one year. This plan would eliminate its currently hedging program.

1 FP&L further suggests an alternative to its current hedging approach if the Commission
2 were to deny approval of the VMM. This option is the approval of a set of general and specific
3 hedging guidelines set forth by FP&L. The purpose of the guidelines would be to provide
4 assurance to FP&L that the Commission recognizes the purpose of hedging and the potential for
5 lost saving. The decision on this petition is not scheduled until after the conclusion of this
6 review.

7 **Does the company employ adequate policies and procedures for its fuel**
8 **procurement hedging program?**

9 FP&L's hedging program is supported by detailed policies and procedures that provide
10 the structure, operating practices, and restrictions for the FP&L staff responsible for the
11 execution of hedging transactions. Numerous procedures control the company's hedging
12 program. The following key documents establishing the everyday practices and procedures
13 necessary to promote efficient and accurate processing of hedging transactions:

- 14 ♦ *FP&L Group, Inc., Energy Trading and Risk Management Policy*
- 15 ♦ *Energy Marketing & Trading, Trading and Risk Management Procedures Manual*
- 16 ♦ *Planned Position Strategy*

17 The *Energy Trading and Risk Management Policy* is a corporate document that describes
18 the business activities for both the FP&L. The document defines the structure, objectives, and
19 policies and procedures to be followed by FP&L's financial trading group responsible for
20 executing hedge transactions. Additionally, the document addresses credit risk management,
21 including appropriate creditworthiness review and credit monitoring processes, and Board of
22 Directors' responsibilities.

23 The *EMT Trading and Risk Management Procedures Manual* supplements the FP&L
24 Group Energy Trading and Risk Management Policy. The *EMT Trading and Risk Management*
25 *Procedures Manual* provides specific details to ensure the processing of hedging transactions is
26 efficient and accurate. Included in the document are processes for counterparty request and
27 evaluation, deal validation and verification, margining, accounting for financial derivatives, and
28 trader's Standards of Conduct.

29 FP&L's *Planned Position Strategy* establishes the price limits and the hedge percentage
30 targets for both natural gas and fuel oil. The strategy is prepared annually and can be modified if
31 changes in market conditions are sufficient to warrant a change to FP&L's hedging strategies.
32 The *Planned Position Strategy*, and any modifications, requires the approval of the President of
33 FP&L; any transactions outside of the strategy require approval of the President or, in his
34 absence, the CFO of the FP&L Group.

35 Audit staff believes that FP&L's policies and procedures provide appropriate detail and a
36 clear understanding of the responsibilities and expectations surrounding the company's hedging
37 program. Through the documents described above, FP&L has provided a clear understanding of
38 the responsibilities and expectations surrounding the company's hedging program. In short,

1 FP&L has provided its EMT group with well-established rules to support the execution and
 2 management of financial hedges.

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

4 As previously mentioned, the gas and oil markets fluctuated significantly over the period
 5 2003 through 2007. A number of financial instruments can be employed to achieve hedging
 6 objectives. While there is no fundamentally optimal mix of financial instruments, the
 7 determination of the appropriate financial instruments should reflect the management's risk
 8 profile in terms of its desire to avoid rate spikes and willingness to forgo the possibility of lower
 9 prices to obtain that protection.

10 During the period covered in this review, FP&L employed a mix of financial fixed price
 11 swaps and options for both natural gas and fuel oil to manage fuel price volatility. As stated by
 12 FP&L management and the company's policies and procedures, FP&L will not hedge more fuel
 13 than forecasted to meet customer demand. FP&L further contends that its basic approach to
 14 hedging has not changed significantly over time. While the financial instruments used vary from
 15 year to year, the approach taken and the intent behind the program have been consistent from
 16 inception.

Percentage of Annual Financial Transactions by Instrument Type*						
Florida Power & Light						
2003-2007						
Natural Gas						
17	Swaps					
18	Call Options					
19	Collar Options					
20	Total	100%	100%	100%	100%	100%
Fuel Oil						
22	Swaps					
23	Call Options					
24	Collar Options					

(* chart does not reflect any company efforts to rebalance or sell-off any transactions after purchase.)

25 **EXHIBIT 4**

Source: Data Request 2.4

26 Exhibit 4 depicts a historical percentage breakdown of the various types of financial
 27 hedging instruments used by FP&L to reduce price uncertainty for both natural gas and fuel oil.
 28 FP&L has used a combination of financial swaps and calls when implementing its hedging
 29 strategy. As shown in Exhibit 4, from 2003 to 2007 between [redacted] percent and [redacted] percent of
 30 FP&L's natural gas hedging portfolio consisted of financial swaps, whereas the use of call
 31 options ranged from [redacted] percent to [redacted] percent. Natural gas hedging activity for 2007
 32 incorporated the use of collar options to offset call option premium requirements.

1 For fuel oil, FP&L primarily relied on the use of financial swaps to lock-in some measure
 2 of price certainty. From 2003 to 2007, FP&L hedged [redacted] percent to [redacted] percent of its fuel oil
 3 through the use of financial swaps. In 2007, FP&L incorporated call options and collar options
 4 to minimize risk as a result of increased price volatility in the fuel oil market.

5 Although 2008 data was not included in this review, FP&L has indicated that options are
 6 not part of the company's 2008 natural gas and fuel oil hedging planned strategy. Options
 7 provide protection against price moves because owners of options contracts are not obligated to
 8 buy the underlying contract. However, for this added protection, the option buyer must pay a
 9 premium to the option seller.

Annual Cost of Non-Collar Options Florida Power & Light 2003-2007					
Natural Gas					
10	Options Premiums Paid	[redacted]	[redacted]	[redacted]	[redacted]
11	Gain on Options— Excluding Premiums	[redacted]	[redacted]	[redacted]	[redacted]
12	Gain/(Loss)—Including Premiums	[redacted]	[redacted]	[redacted]	[redacted]
Fuel Oil					
14	Options Premiums Paid	[redacted]	[redacted]	[redacted]	[redacted]
15	Gain on Options— Excluding Premiums	[redacted]	[redacted]	[redacted]	[redacted]
16	Gain/(Loss)—Including Premiums	[redacted]	[redacted]	[redacted]	[redacted]
Totals					
18	Options Premiums Paid	[redacted]	[redacted]	[redacted]	[redacted]
19	Gain on Options— Excluding Premiums	[redacted]	[redacted]	[redacted]	[redacted]
20	Gain/(Loss)—Including Premiums	[redacted]	[redacted]	[redacted]	[redacted]
21	Overall Non-Collar Call Option Gain/Loss for 2003-2007: [redacted]				

22 EXHIBIT 5

Source: Data Request 2.8

23 Exhibit 5 shows FP&L's annual cost of non-collar call options for each year 2003
 24 through 2007. The calculation of an option's gain or loss includes two components: the impact
 25 of the option premium and the settlement value. The value of each component is calculated and
 26 they are added together to determine the net gain or loss of a particular transaction. Over the five
 27 year period, the purchase of non-collar call options resulted in a net loss of over [redacted]
 28 This is largely attributable to the decline of natural gas prices from 2006 to 2007. During these
 29 years, FP&L's purchase of non-collar call options netted losses of over [redacted] in 2006 and
 30 over [redacted] in 2007. In 2006, FP&L chose not to execute any of the options contracts due

1 to unfavorable prices in the natural gas market. As a result, the [REDACTED] loss in 2006 was all
2 incurred in premium payments.

3 FP&L implemented collar hedges as part of its hedging program in 2007. These were not
4 costless collars in that FP&L bought at-the-money calls and sold out-of-the-money puts. In
5 addition, the fuel markets were biased towards a higher premium for calls rather than puts.
6 Exhibit 6 summarizes the premiums for both 2007 oil and gas collar-options. Overall, the net
7 impact of collar options resulted in a loss of over [REDACTED]. The negative premiums for calls
8 represent premiums paid out to purchase calls. Positive revenue shown for puts represent
9 premiums received for puts sold.

2007 Collar-Options Florida Power & Light			
	Natural Gas	Fuel Oil	Total
10			
11	Calls Gain/(Loss)		
12	Puts Gain/(Loss)		
13	Total		

14 EXHIBIT 6

Source: Data Request 2.10

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

17 All of FP&L's hedging transactions are executed under the guidance of the corporate
18 *Planned Position Strategy*. As previously stated, the purpose of the *Planned Position Strategy* is
19 to establish the hedging percentage targets and price limits for both natural gas and fuel oil.
20 FP&L's Risk Management group (middle office) is responsible for monitoring and reviewing the
21 traders' (front office) compliance with the *Planned Position Strategy* hedge targets, price limits,
22 and timing of hedge activities.

23 FP&L considers the following factors when establishing its *Planned Position Strategy*:

- 24 ♦ Projections for future burns
- 25 ♦ Forward curves for gas and oil
- 26 ♦ Anticipated market volatilities of gas and oil prices
- 27 ♦ Execution costs – bid/offer ranges and option costs
- 28 ♦ Liquidity in gas and fuel oil markets
- 29 ♦ Credit margin requirements – counterparty performance

30 FP&L management states that the company will not hedge more fuel than forecasted to
31 meet customer demand. Additionally, hedges are placed on a calendar year basis. Beginning in
32 the each year, hedges are placed for the upcoming calendar year. For example, 2008 hedges
33 were entered into beginning in [REDACTED] 2007. FP&L uses outside tracking systems such as the
34 NYMEX and ICE to monitor future markets and determine the current trading ranges for each

1 commodity. This allows the company the ability to negotiate over the counter purchases with its
2 counterparties that are in line with current prices offered on the NYMEX exchange floor.

**Monthly Approved Natural Gas Percent Hedged
Planned Position Strategy
Florida Power & Light
(percent of forecast)**

3	January
4	February
5	March
6	April
7	May
8	June
9	July
10	August
11	September
12	October
13	November
14	December
15	Yearly Average

16 Exhibit 7

Source Data Request 1

**Monthly Approved Fuel Oil Percent Hedged
Planned Position Strategy
Florida Power & Light
(percent of forecast)**

17	January
18	February
19	March
20	April
21	May
22	June
23	July
24	August
25	September
26	October
27	November
28	December
29	Yearly Average

30 Exhibit 8

Source: Data Request 1

1 Exhibits 7 and 8 depict the monthly hedging percentage targets of FP&L's forecasted
2 fuel burns for both natural gas and fuel oil as defined in its *Planned Position Strategy* documents
3 for the years 2003 through 2007. For both natural gas and fuel oil, the hedging percentage
4 targets increased, on average, each year 2003 through 2007. The yearly increases over the past
5 five years reflect FP&L's desire to avoid future price spikes. However, FP&L has informed
6 audit staff that for the year 2008, FP&L's goal is to hedge [redacted] percent of forecasted natural gas
7 and fuel oil burns. Because of the significant swings in actual fuel burns that can result from
8 movements in fuel prices, the company has lowered its 2008 hedging goals to reduce the need
9 for rebalancing and risk of being over hedged at actual burns.

10 **Has the company's fuel procurement hedging program operated in a manner**
11 **that is non-speculative?**

12 FP&L stated that it does not engage in speculative fuel hedging strategies aimed at
13 guessing the market in the hopes of potentially returning fuel savings to customers. Instead,
14 FP&L engages in hedging strategies aimed at reducing fuel price volatility. FP&L agrees with
15 the description of "speculative" as defined in the Commission's Hedging Order which states:
16 "speculative refers to physically and/or financially purchasing more of a commodity than one
17 [purchases or] owns." FP&L further narrowed the definition by adding that speculative fuel
18 trading involves executing transactions with the intent of profiting from an anticipated movement
19 in fuel prices.

20 Audit staff believes that FP&L has developed and operates its hedging strategy in a non-
21 speculative manner. The company establishes monthly and annual hedging goals that are less
22 than its forecast fuel consumption.

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

24 The Commission's Hedging Order allows for each utility to determine the appropriate
25 level of hedging while allowing the Commission to retain the discretion to evaluate the prudence
26 of such program. Exhibit 9 trends FP&L's annual percentage of fuel hedged in relation to the
27 company's forecasted fuel burn volumes for each year 2003 through 2007. The percentages
28 were calculated by dividing FP&L's actual hedge volumes by FP&L's estimated volume
29 requirements from its annual fuel filing. The percentages reflect the combination of hedges
30 placed for both natural gas and fuel oil. For 2003, the exhibit shows only [redacted] percent of FP&L's
31 fuel demand being hedged since its hedging program was not fully implemented at this point in
32 time.

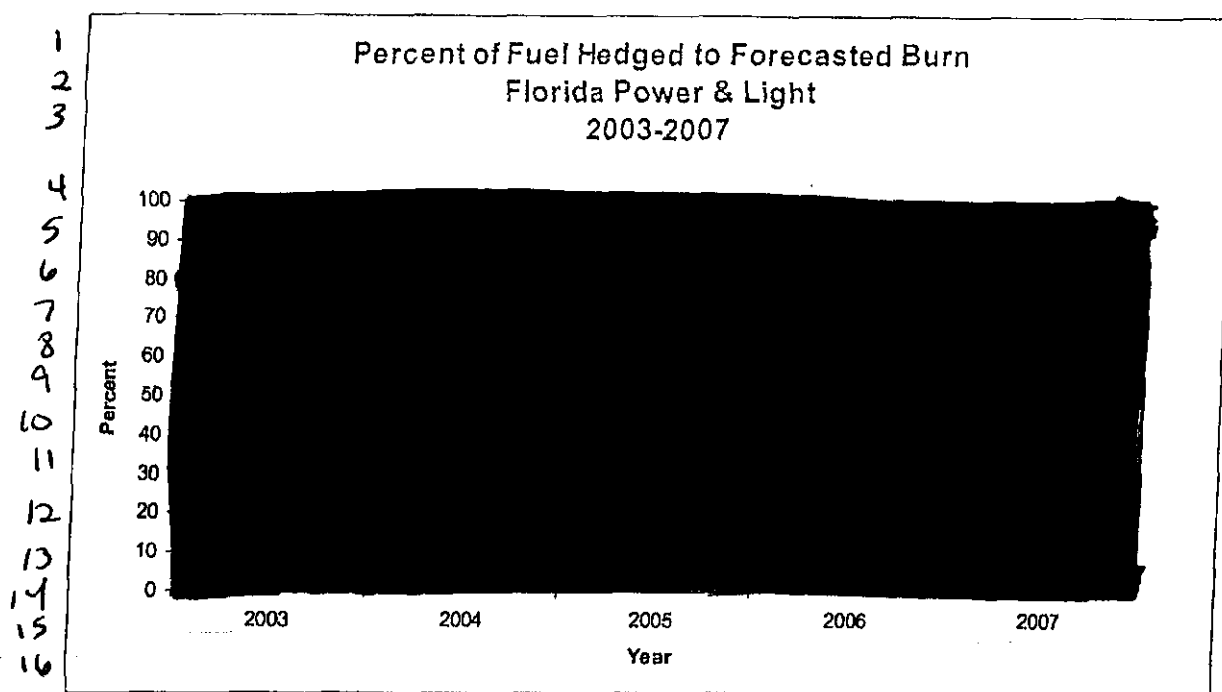


Exhibit 9

Source: Data Request 2.3

Exhibits 10 and 11 depict the monthly and annual percent of fuel hedged by FP&L in relation to the total fuel burn for each year 2003 through 2007. The goal of FP&L's traders is to stay within a tolerance band (e.g., plus or minus 5 percent) of the monthly percentage hedging targets set forth in FP&L's management approved *Planned Position Strategy*. If FP&L realizes that its natural gas or fuel oil needs are going to be lower than anticipated when financial hedges are initiated, FP&L will "rebalance" its hedge positions to stay within the pre-determined tolerance bands around its PPS. The rebalancing strategy accounts for adjustment to actual fuel burns in relation to forecasted burns. However, in some cases, hedges may exceed the tolerance bands when actual fuel burns are significantly lower than the fuel projections which determined the initial hedging percentages.

**Monthly Percent of Natural Gas Hedged in Relation to Total Fuel Burned
Florida Power & Light
2003-2007**

1	January					
2	February					
3	March					
4	April					
5	May					
6	June					
7	July					
8	August					
9	September					
10	October					
11	November					
12	December					
13	Yearly					
14	Average					

15 Exhibit 10

Source: Data Request 2.5

**Monthly Percent of Fuel Oil Hedged in Relation to Total Fuel Burned
Florida Power & Light
2003-2007**

16	January					
17	February					
18	March					
19	April					
20	May					
21	June					
22	July					
23	August					
24	September					
25	October					
26	November					
27	December					
28	Yearly					
29	Average					

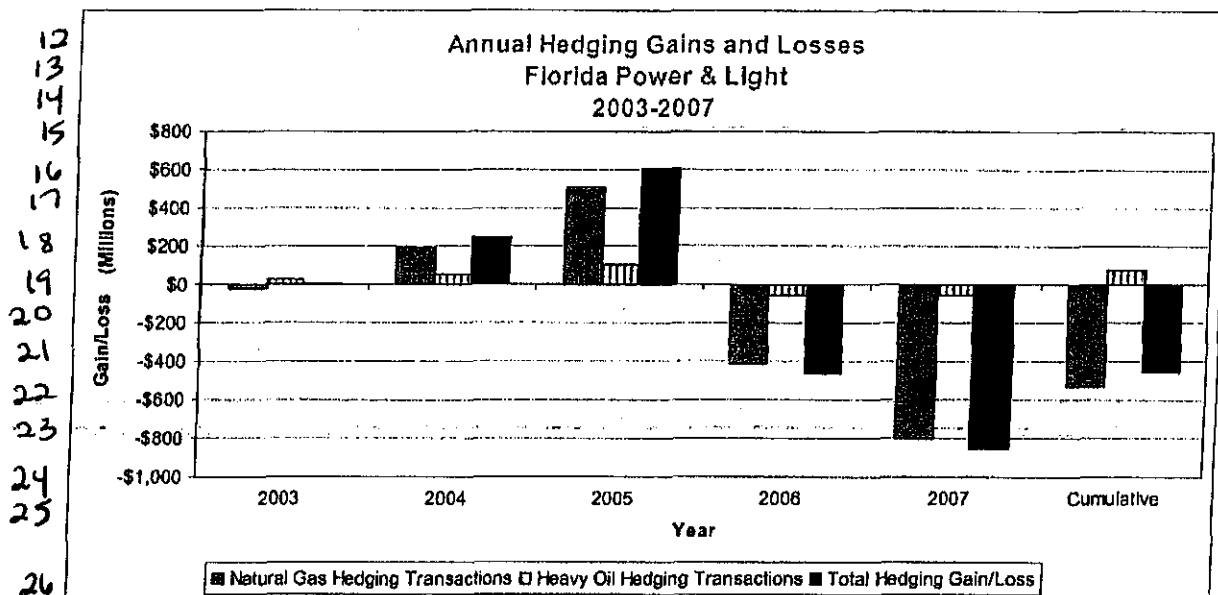
30 Exhibit 11

Source: Data Request 2.5

1 For those values shown in Exhibits 10 and 11 that exceed [REDACTED] the reason is two-
 2 fold: [REDACTED]
 3 Changes in the company's fuel consumption needs account for the difference in the initial
 4 hedging projections and the actual burn percentages.

5 What are the total costs associated with the company's fuel procurement
 6 hedging program?

7 The effectiveness of financial hedging is measured by the reduction in fuel price
 8 volatility that is achieved by implementing the hedge. Although merely calculating the gains and
 9 losses associated with hedge transactions is an inadequate measure of the effectiveness of
 10 hedging, the gains and losses are in fact direct results of hedging. Over time, the expectations
 11 are that the cumulative impact will be neutral, and gains and losses would offset.

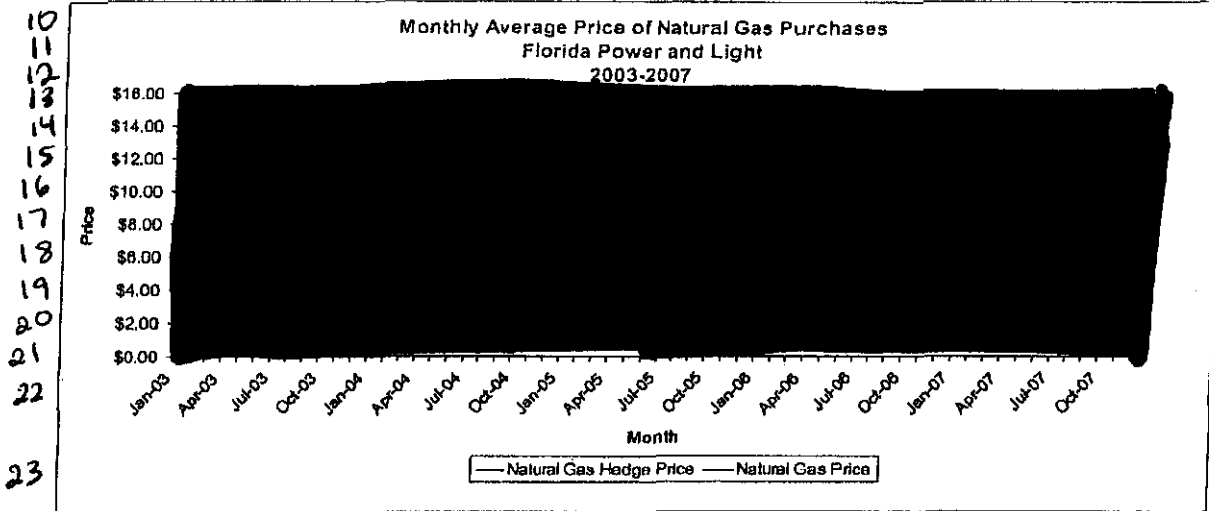


27 Exhibit 12

Source: Data Request 1.10

28 Per the Hedging Order, each company is required to report gains and losses that result
 29 from its hedging activities. Hedging gains and losses are calculated as the difference between
 30 the original contracted purchase price and the market price at settlement. Exhibit 12 shows
 31 FP&L's annual cumulative hedging gains and losses for each year 2003 through 2007. For the
 32 years 2003 through 2005, the results of hedging showed a net gain of \$6 million, \$247 million,
 33 and \$610 million. Conversely, for the years 2006 and 2007, FP&L reported hedging losses of
 34 \$463 million and \$856 million. Over the five-year period, the hedging program accumulated a
 35 net loss of \$455 million. The losses can be attributed to natural gas prices falling dramatically in
 36 2006 and 2007 on top of the fact FP&L's strategy was to hedge up to [REDACTED] percent of the
 37 company's annual forecasted natural gas burn during this same period. As a result, significant
 38 losses are evident.

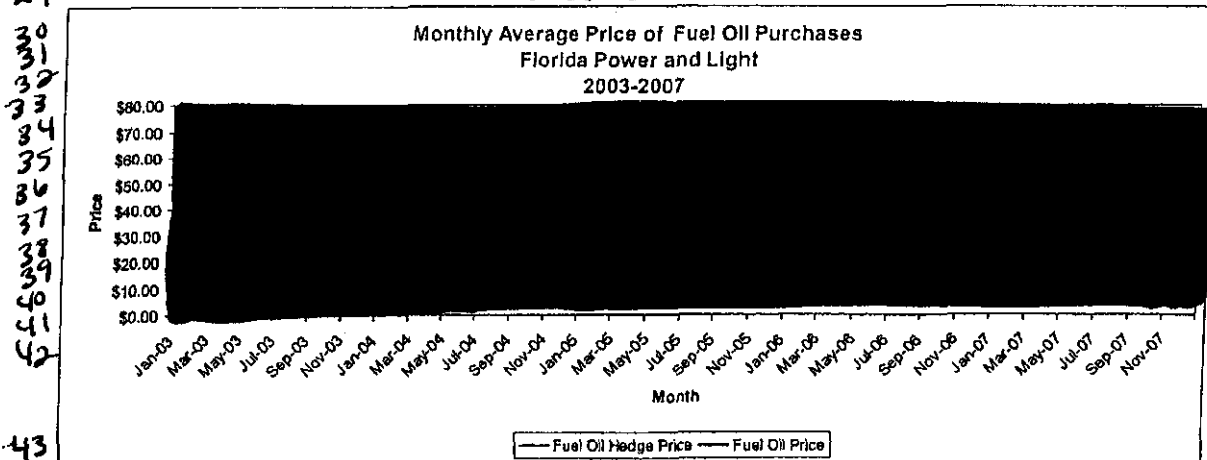
1 The declining natural gas prices in 2006 and 2007 in relation to hedging costs are
 2 exemplified in Exhibit 13. Beginning in February 2006, FP&L's natural gas hedges were
 3 settling at a higher cost than market prices. From February 2006 through December 2007,
 4 FP&L hedges settled at an average of [REDACTED] per MMBtu, whereas the average market price of
 5 natural gas over the same period averaged \$7.08 per MMBtu. However, in contrast to the
 6 declining prices of natural gas over the past two years, FP&L's hedging program served its
 7 purpose of mitigating additional customer fuel charges in the late summer of 2005 through the
 8 beginning of January 2006. Over this period, the market price for natural gas averaged \$11.60
 9 in comparison to the average hedging settlement price of [REDACTED]



24 Exhibit 13

Source: Data Request 3.1

25 The exhibit demonstrates the volatility in natural gas prices. Over a one year period
 26 alone, the market price for natural gas prices peaked at \$14.09 per MMBtu in October 2005 and
 27 dropped to a low of \$4.52 per MMBtu in October 2006. The extreme volatility of prices shown
 28 here, along with the fact that FP&L is one of the largest consumers of natural gas, reinforces the
 29 need for FP&L to continue with its hedging program.



44 Exhibit 14

Source: Data Request 3.1

1 Exhibit 14 trends the market price of fuel oil against hedging settlement costs of fuel oil
 2 over the same five-year period, January 2003 through December 2007. Over the last two years
 3 of reported hedging losses, FP&L was slightly over-hedged, on average, when compared to the
 4 average market price for fuel oil. Its hedging price per barrel of fuel oil averaged to [REDACTED]
 5 while the market price averaged \$50.19. However, over the entire five-year period shown,
 6 FP&L's average hedge price for fuel oil is lower when compared to the average market price.
 7 Hedges averaged [REDACTED] per barrel and the average market price was \$40.54. As a result,
 8 FP&L's fuel oil hedges resulted in a gain of [REDACTED] per barrel of fuel oil, while at the same time
 9 achieving the objective of producing less volatility in the actual prices customers paid.

10 Audit staff requested FP&L to provide any transaction costs associated with financial
 11 derivatives. In response, FP&L stated that the company does not pay fees or transaction costs
 12 when initiating or settling a swap transaction with counterparties, and only pays the prescribed
 13 premiums for collar and option transactions. However, FP&L believes that the price differential
 14 within the bid-ask range can be used as an approximation of potential indirect transaction costs.
 15 The bid-ask are values observed by FP&L within ICE and NYMEX daily transactions and reflect
 16 the difference in price between the highest price and lowest price paid for an equivalent
 17 transaction as being considered by the company. It should be noted that FP&L traders do use
 18 multiple counterparties to create a competitive environment to obtain the best possible negotiated
 19 price and furthermore have the right to transact directly with the market exchanges. Exhibit 15
 20 provides an approximation of the potential indirect transaction costs after assuming bid-ask
 21 spreads. FP&L calculates this cost by determining the differential between the transaction price
 22 and the mid-range for each corresponding bid-ask spread. For the period 2003 through 2007, the
 23 company estimates that [REDACTED] of indirect transaction costs was associated with the bid-ask
 24 spread differential from the over-the-counter transactions.

**Estimated Differential of Bid-Ask Spread
 to
 Fuel Cost of System Net Generation
 Florida Power & Light
 2003-2007**

25	26	Estimated Bid-Ask Spread Differential	[REDACTED]				
27	28	Fuel Cost	\$5,643,771,725	\$5,011,482,076	\$4,492,787,702	\$3,129,102,007	\$3,023,893,034
		Percent of Total Fuel Cost	[REDACTED]				

Exhibit 15 Source: Document Request 2, and FP&L Annual A1 Filings

Audit staff believes that the amounts provided by FP&L in Exhibit 15 do not represent a direct hedging cost, and staff does not believe that the company incurs any direct costs for the use of OTC counterparty financial hedging instruments. Audit staff believes that the annual amounts in Exhibit 15 are estimated totals calculated by the company based on its annual

hedging activities. The Commission does not track these amounts in its annual fuel clause, and audit staff does not believe it would be beneficial to monitor these over time.

As part of the 2002 Hedging Order, each utility was allowed to recover incremental hedging operating and maintenance costs through the Commission's Fuel Cost Recovery Clause through 2006. However, FP&L has since entered into a settlement with interested parties to allow for continued recovery of incremental operating and maintenance costs beyond 2006. Exhibit 16 examines the annual operating and maintenance costs for the company's hedging program for each year 2003 through 2007. The operating and maintenance costs, on average, represent less than one-tenth of one percent of the company's system net generation annual fuel costs.

Percentage of Hedging Operating and Maintenance Costs to Fuel Cost of System Net Generation Florida Power & Light 2003-2007					
O&M Hedging Cost	\$510,708	\$523,005	\$411,228	\$647,399	**
Fuel Cost	\$5,643,771,725	\$5,011,482,076	\$4,492,787,702	\$3,129,102,007	\$3,023,893,034
Percent O&M to Total Fuel Cost	0.01%	0.01%	0.01%	0.02%	0.00%

Exhibit 16

Source: FP&L Annual AI Filings

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

FP&L management believes its hedging program has been successful in achieving the Commission's objective of mitigating fuel price volatility. The net effect has been a smoother path of overall fuel costs than would have been the case in the absence of hedging. Before hedging was implemented and approved by the Commission, FP&L frequently required midcourse corrections to its annual fuel factor due to cost increases. The frequency of midcourse corrections has been reduced by hedging. The company believes that its hedging program has been able to circumvent the need for such corrections for some years during the review period.

The company does not believe the program is designed to provide a net cost saving for its customers; rather, it is designed to eliminate the peak-and-valley price fluctuations that are common in the natural gas and fuel oil markets. During the review period, the company has experienced years in which its hedging program has concluded with a "gain" based on its hedging transactions, and years in which the company recorded a "loss" for these transactions. Overall, the company believes that as the program continues over time, these "gains" and "losses" will balance. Florida Power & Light believes that the success of the program is evidenced by the company not requesting from the Commission any midcourse corrections since

the program's inception, though the unique fuel price trend of 2008 may require a correction this year.

3.3 Risk Performance

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

FP&L Group has a Risk Exposure Management Committee that is responsible for establishing a hedging strategy for fuel procurement. This committee is comprised of FP&L executive and senior management charged with developing and approving the company's risk strategies and objectives. This includes the overall hedging strategy for the EMT.

The company's employees operate under a three-layer operations structure within the EMT to ensure adequate separation of duties and oversight. The company commonly refers to each area as the front, middle, and back office units. The front office is responsible for initiating the company's hedging strategy. The middle office provides risk oversight of all financial trading transactions. The back office staff evaluates and reconciles the accounting transactions for fuel procurement and financial transactions.

The Trading Risk Management group, or middle office, is a separate division that falls under FP&L Group. The Vice President of EMT Risk Management reports directly to the CFO of FP&L Group. This group ensures that the authorized hedging *Planned Position Strategy* is executed and followed by the front office. The Trading Risk Management group has formal policies and procedures that specifically relate to the fuel hedging program.

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

The Energy Marketing and Trading group's Financial Trading desk staff, commonly called the front office, is responsible for executing the financial transactions. The front office has detailed procedures that prescribe the protocol for initiating the financial hedging transactions. Also, the front office will utilize the approved *Planned Position Strategy* for its limit and purchasing parameters.

The EMT Risk Management staff, commonly referred to as the middle office, is an independent group with a separate management hierarchy from the front office personnel. This allows the group to remain autonomous from the trading staff unit's role of monitoring and ensuring the integrity of the trading transactions. This is accomplished through daily audits and verifications of the front office's work.

Within this group, the EMT risk staff conducts routine audits of front office phone conversations to confirm that all transactions are conducted according to the company's standards and procedures. This group is also in charge of establishing and monitoring the

counterparty credit limits that are established by the risk management committee. Credit monitoring is an important component of the financial oversight duties. The middle office staff reviews the daily exposure for each counterparty, and notifies the front office traders of the amount of available exposure for each counterparty. This process allows the company to monitor and limit any potential overexposure and risk with any particular counterparty.

The middle office also establishes and monitors the credit risk associated with the financial hedging transactions. The office performs routine credit analysis to ensure that the company's credit exposure remains at acceptable levels. This group also conducts the necessary assessment models to monitor and ensure that an acceptable level of risk is maintained by the company.

The EMT accounting staff, known as the back office, conducts oversight through the reconciliation of fuel and financial transactions. This group handles the accounting transactions for the Fuel and Energy Procurement Division. The back office has an independent verification process that ensures that the detail of each transaction and contract is verified and accurate. Also, this group reviews and monitors the financial settlement process to ensure the portfolio remains in balance. This group reports up through FPL Group.

Audit staff believes that FP&L's front, middle, and back office organizational structure provides the company with the appropriate segregation of responsibilities and ensures that adequate monitoring and verification of its financial transactions occur. Each independent office has detailed procedures outlining the responsibilities of its staff.

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

Florida Power and Light has annually filed its Risk Management Plan as prescribed in the Hedging Order. The company has not made any significant changes to its plans submitted during the period 2003-2007. The Hedging Order specifies that each plan addresses certain requirements from Exhibit TFB-4 of the Order (ATTACHMENT C), along with "the quantities of fuel and purchased power that each utility expects to hedge through physical and financial hedging, to the extent such forecasts are made."³ Overall, audit staff does not believe that FP&L has met the expectations of the Hedging Order through its Risk Management Plan.

For the period reviewed, FP&L's Risk Management Plan has been filed within the testimony of its Fuel Cost Recovery witnesses. FP&L does address each of the 11 points within Exhibit TFB-4, *Components of a Utility's Fuel Procurement Risk Management Plan*; however, the responses do not contain detailed information on how the company executes and implements its program. The plan is scant, consisting of less than two pages of typed text. While FP&L does have detailed *internal* policies, procedures, risk evaluations, and hedging strategies in place to effectively operate a hedging program, the company does not represent these efforts within its Plan. A more detailed explanation is necessary for the Commission and staff to evaluate the company's overall hedging strategy and process. Specifically, audit staff does not believe the

³ P5, TFB-4. Florida Public Service Commission Order No. PSC-02-1484-FOF-EI.

company's responses to the following requirements from the Hedging Order were adequately addressed within the 2003-2007 plans:

- ◆ Describe the utility's oversight of its fuel procurement activities.
- ◆ Verify that the utility provides its fuel procurement activities with independent and unavoidable oversight.
- ◆ Describe the utility's corporate risk policy regarding fuel procurement activities.
- ◆ Verify that the utility's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all fuel procurement activities.
- ◆ Describe the utility strategy to fulfill its risk management objectives.
- ◆ Verify that the utility has sufficient policies and procedures to implement its strategy.
- ◆ Verify that the utility's reporting system consistently and comprehensively identifies, measures, and monitors all forms of risk associated with fuel procurement activities.

Additionally, the company has not included within its Risk Management Plans the quantities of fuel it plans to hedge each year. The Order specifically states that this information should be included in each plan. Its omission limits staff's ability to assess the company's overall hedging strategy. FP&L does operate using its *Planned Position Strategy* which prescribes the amount of forecasted fuel it plans to hedge each year. Audit staff believes this information should be included in the company's future plans filed with the Commission.

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

Florida Power & Light has a group of financial counterparties that the company uses to transact its over-the-counter financial hedging transactions. The company has in place a set of procedures that directs its EMT group on how to select and qualify these counterparties. The front office staff works directly with these counterparties, and is responsible for identifying and recommending a new counterparty relationship. Once a new counterparty is identified, the middle office staff will take the necessary steps to verify the financial stability and creditworthiness of this party.

The middle office conducts a risk evaluation for each counterparty to verify the counterparty meets the minimum credit standards set by the Risk Committee. FP&L gathers outside credit rating information (i.e., Standards and Poor's, Moody's, etc.) for each counterparty. This information is used to determine the counterparty's credit transaction

1 threshold. If the middle office determines that counterparty meets FP&L's required criteria, the
2 parties enter into a master International Swaps and Derivatives Association agreement. This
3 agreement establishes the necessary security trading guidelines.

4 The middle office also conducts routine credit evaluations of its existing counterparties.
5 For its top 30 counterparties (both physical and financial relationships), the company reviews its
6 credit viability monthly. For its remaining counterparties, the company conducts reviews on a
7 quarterly schedule. FP&L conducts a full reassessment of each counterparty every two years, or
8 on an annual basis for counterparties with credit rating below BBB-. If FP&L determines that a
9 counterparty's credit stability has weakened, the company will place the party on a watch list,
10 and may limit or suspend its trading relationship. Currently, all of FP&L's financial
11 counterparties have credit ratings of A or higher. A list of current FP&L counterparties and
12 their credit ratings is detailed in EXHIBIT 17.

13 FP&L has a dual relationship with [REDACTED] and [REDACTED] allowing these
14 counterparties to initiate financial hedging transactions and also contracts for physical supply of
15 natural gas and fuel oil. These counterparties maintain separate financial and physical
16 operations; FP&L also avoids commingling its physical and financial operations.

**Financial Counterparty Relationships
Florida Power & Light**

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Exhibit 17

Source: Data Request: 2.13

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

FP&L Group has an Internal Audit division that utilizes a combination of risk-based and scheduled reviews to ensure the company is in compliance with internal and external policies and applicable regulation. The EMT trading group is not under a scheduled review cycle, but is included in the company's risk model and evaluation. In 2005, the Internal Audit group conducted an audit entitled *FP&L Energy Marketing & Trading Program Audit*. The audit noted some minor findings related to how the company captured its daily market results for calculating its mark-to-market ratios. Company management has made corrective changes to this process as a result.

Along with this risk-based audit of FP&L's hedging program, the internal audit group conducts annual audits to comply with the requirements of the Sarbanes-Oxley Act. This act requires specific financial oversight and compliance monitoring requirements and includes many of the financial aspects of the company's hedging programs. The company's internal audit group works with its external auditors to ensure adequate controls and compliance are maintained.

The company has also employed an outside consultant firm to conduct an independent review of its procurement hedging program. The *Review of Florida Power and Light's Program to Hedge Natural Gas and Fuel Oil Commodity Risk Associated with Utility Generation* was completed in November 2007. The review examined the "structure and performance of the hedging activity conducted by FP&L to mitigate the impact of uncertain fuel prices on FP&L's electric consumers."⁴

The external audit determined that given the volatility of the natural gas and oil fuel markets, hedging is a useful tool for FP&L to manage its fuel costs and limit the risk to its customers. The external audit found that FP&L's program is well developed and that adequate controls and oversights are in place. The external auditors stated that FP&L has gone to great effort to avoid any elements of speculation in its hedging process.

The external audit also concluded that the company and the Commission should "collaborate to provide clarity in the broad objectives and scope of hedging activity [to] advance the public interest."⁵ The audit envisions an approach in which FP&L management could provide its strategy and viewpoints to the Commission so staff could provide guidance on what level of volatility mitigation the Commission deems prudent. The external auditors state that this would limit regulatory risk and potentially reduce regulatory costs.

Audit staff believes that FP&L has placed adequate focus on evaluating and auditing its fuel procurement and hedging programs. The company has initiated a combination of internal and external reviews of its processes in recent years. This allows the company to identify concerns and make appropriate modifications to its process as the program evolves.

⁴ *Review of Florida Power and Light's Program to Hedge Natural Gas and Fuel Oil Commodity Risk Associated with Utility Generation*, p ii.

⁵ *Review of Florida Power and Light's Program to Hedge Natural Gas and Fuel Oil Commodity Risk Associated with Utility Generation*, p v.

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

1 FP&L is one of the largest purchasers of natural gas in the United States. Because of
2 this, the company is extremely susceptible to the volatility of the natural gas markets. The
3 company has implemented a financial hedging strategy to stabilize these fuel prices. The
4 company accomplishes this by establishing a set of pre-determined hedging volume targets.
5 Over the review period 2003 to 2007, the company has adjusted these targets and has increased
6 the percentage of overall fuel forecast it secures through hedging.

7 Overall, audit staff believes that FP&L's hedging operation is appropriately focused on
8 reducing the price volatility in the natural gas and fuel oil markets for its customers. The
9 company believes it has achieved this goal during the period. However, the company has
10 requested that the Commission consider an alternative to its current plan. Audit staff believes
11 that if FP&L continues under its current process, the company has adequate procedures and
12 processes in place to effectively implement its strategy.

13 Audit staff does not believe that FP&L's hedging practices were speculative. Staff
14 believes that FP&L has taken, at times, an aggressive approach to its hedging strategy. In 2006,
15 the company hedged [redacted] percent of its natural gas forecast. During this period, the company used
16 a combination of swaps, call options, and collars to implement its hedging strategy. However in
17 2008, the company reduced the percent of hedges to [redacted] percent, and eliminated the use of
options. Audit staff believes that the company should continue to evaluate its hedging strategy to
maximize its hedging goals through appropriate hedging targets.

Audit staff notes the following positions from its review of the company:

- ◆ FP&L's policies and procedures provide appropriately detailed and clear understanding of the responsibilities and expectations surrounding the company's hedging program.
- ◆ FP&L's front, middle, and back office organizational structure provide the company with appropriate segregation of responsibilities and ensure that adequate monitoring and verification of its financial transactions occur.
- ◆ FP&L has not incurred any direct costs associated with the purchases of financial swaps from its counterparties.
- ◆ FP&L's Risk Management Plan did not include the following detail required of the Hedging Order:
 - ◆ Describe the utility's oversight of its fuel procurement activities.
 - ◆ Verify that the utility provides its fuel procurement activities with independent and unavoidable oversight.

- ◆ Describe the utility's corporate risk policy regarding fuel procurement activities.
- ◆ Verify that the utility's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all fuel procurement activities.
- ◆ Describe the utility strategy to fulfill its risk management objectives.
- ◆ Verify that the utility has sufficient policies and procedures to implement its strategy.
- ◆ Verify that the utility's reporting system consistently and comprehensively identifies, measures, and monitors all forms of risk associated with fuel procurement activities.
- ◆ The quantities of fuel plans to be hedged each year.

**Companies' Hedging Strategies
Comparative Analysis**

1	Types of Fuel Hedged	-Natural Gas -Fuel Oil			
2					
3	2007 Hedging Instruments	Natural Gas:			
4		-Swaps [REDACTED]			
5		-Call Options [REDACTED]			
6		-Collar Options [REDACTED]			
7					
8		Fuel Oil:			
9		-Swaps [REDACTED]			
10		-Call Options [REDACTED]			
11		-Collar Options [REDACTED]			
12	Hedging Tenure	Up to 1 year			
13	2007 Average Hedging Target	Natural Gas:			
14		Up to [REDACTED]			
15		Fuel Oil:			
16		Up to [REDACTED]			
17	Percent of 2007 Fuel Hedged to Forecasted Burn	Combined Natural Gas and Fuel Oil:			
18		[REDACTED]			
	Cumulative Hedging Gains/Losses 2003-2007	-\$455,452,955			
	Number of Financial Counterparties	23			