State of Florida

Public Service Commission

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COMMISSION CLERK

DATE: March 28, 2013

TO: Office of Commission Clerk (Cole)

FROM: Division of Accounting and Finance (Bullard, Carbonell, Cicchetti)
Office of the General Counsel (Brown)

RE: Docket No. 120303-EI – Petition for approval for an accounting order to record in a regulatory asset or liability account the unrealized and realized gains and losses resulting from financial accounting requirements related to interest rate derivative agreements by Progress Energy Florida, Inc.

AGENDA: 04/09/2013 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Administrative

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\AFD\WP\120303.RCM.DOC

Case Background

On December 12, 2012, Progress Energy Florida, Inc. ("PEF" or "the Company") filed a petition requesting approval for an accounting order to create a regulatory asset or liability account to record the realized and unrealized gains and losses associated with interest rate derivative agreements the Company must record in accordance with Generally Accepted Accounting Principles (GAAP). PEF asserts that approval of this request will allow the Company to continue to manage its interest rate risk but with reduced accounting complexity. The Company states that with the Commission's approval, the regulatory assets or liabilities will be amortized to interest expense over the life of the related debt instrument. In addition, the recognized costs would be included as a cost of service for ratemaking and surveillance purposes as a component of interest expense. PEF also asserts that the recording of the gains and losses associated with interest rate hedges does not contradict the 2012 settlement agreement approved by the Commission in Order No. PSC-12-0104-FOF-EI.[1]

The Commission has jurisdiction pursuant to Sections 366.04, 366.05(9), 366.06, and 366.07, Florida Statutes.

[1] See Order No. PSC-12-0104-FOF-EI, issued March 8, 2012, in Docket No. 120022-EI, In re: Petition for limited proceeding to approve stipulation and settlement agreement by Progress Energy Florida, Inc.

Discussion of Issues

Issue 1: Should the Commission authorize PEF to use deferral accounting to create a regulatory asset or liability account to record the realized and unrealized gains and losses associated with interest rate derivative agreements the Company must record in accordance with GAAP?

Recommendation: Yes. The Commission should authorize PEF to use deferral accounting to create a regulatory asset or liability account to record the realized and unrealized gains and losses associated with interest rate derivative agreements the Company must record in accordance with GAAP. Further, the Commission should find that the approval to record the regulatory asset or liability for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings. This accounting treatment should be approved prospectively for the reporting period beginning January 1, 2013. (Bullard, Carbonell)

Staff Analysis: Hedging is an investment strategy that uses financial instruments to minimize potential investment losses by taking an offsetting position in a related derivative whose value changes inversely with respect to the underlying investment. The goal of the strategy is not to make money but to minimize volatility. Since GAAP requires all derivatives be reported on the financial statements at fair value and fair value can change from period to period, the primary issue associated with accounting for derivatives is the treatment of gains and losses resulting from the requirement of mark-to-market. In addition, with respect to derivative accounting, results of hedging transactions are deemed to be effective or ineffective. Hedge effectiveness is defined as the extent to which a hedge transaction results in offsetting changes in fair value or cash flow that the transaction was intended to provide. A hedge is considered to be effective if the change in fair value or cash flow of the hedged item and the hedging derivative offset each other to a significant extent, e.g., plus or minus 20 percent. Any portion of a derivative transaction that is not considered effective is deemed ineffective.

PEF accounts for the hedging costs it incurs, in connection with the financial obligations associated with interest rate derivative agreements, as unrealized gains and losses that occur during the period prior to settlement of the transaction. Any fluctuation in the fair market value that is hedged prior to close out of the instrument is considered an unrealized gain or loss. Once the instrument is settled, the loss or gain becomes realized. The mark-to-market of these unrealized gains and losses results from the requirement to reflect the interest rate hedges on the balance sheet at fair value, since they are considered to be derivatives under GAAP. Settlement of the instruments results in realized gains and losses.

PEF is seeking the Commission's approval of deferral accounting and acknowledgement of the likelihood of recovery of the previously incurred costs in order to meet the requirements of Financial Accounting Standards Board's Accounting Standards Codification 980 Regulated Operations (FASB ASC 980). FASB ASC 980 allows regulated companies to defer costs and create regulatory assets, provided that it is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes. This concept of deferral accounting allows companies to defer costs due to events beyond their control and seek recovery through rates at a later time. The alternative would be for the company to seek a rate case each time it experiences an exogenous event.

There is precedent for the requested treatment. In Order No. PSC-O2-1484-FOF-EI,[2] the Commission authorized PEF, then Florida Power Corporation, to create a regulatory asset and liability account to record mark-to-market unrealized gains and losses for fuel hedging activities. In addition, in Order No. PSC-06-1042-PAA-EI,[3] the Commission authorized PEF to use deferral accounting to create a regulatory asset or liability account to record pension and postretirement benefit charges or credits that would have otherwise been recorded in equity.

In the instant petition, PEF states that the fundamental principles underlying the Commission's previous orders remain the same. The present treatment of the effective portion for gains and losses on interest rate hedges is amortized to interest expense over the life of the associated debt. Currently, the ineffective portion is not amortized but instead is recorded directly to interest expense in the period incurred. The Company states that upon the Commission's approval of such regulatory asset or liability account, the gains and losses for the ineffective portion will also be amortized to interest expense over the life of the related debt instrument. There would be no change to the current treatment of the effective portion. In addition, the recognized costs would be included as a cost of service for ratemaking and surveillance purposes as a component of interest expense. PEF also asserts that approval of this request will allow the Company to avoid the complex hedge designation and documentation criteria pursuant to FASB ASC 815. Approval of this petition would exempt PEF from the documentation criteria pursuant to FASB ASC 815 and allow the Company to amortize both the effective and ineffective portion of the realized and unrealized gains and losses.

PEF states that recording the realized and unrealized gains and losses in a regulatory asset or liability account will have no impact on customer rates. PEF's current accounting treatment for the ineffective portion of the gains and losses are recorded directly to interest expense which makes the Company solely responsible for any market volatility associated with hedging. PEF also states that the unrealized gains and losses would be netted against the associated derivative asset or liability, with no rate base effect. Staff notes that PEF's request to amortize the effective and ineffective unrealized gains or losses could affect the cost of debt and thus has the potential to increase or decrease the cost of capital and possibly impact customer rates in the future. That said, by amortizing the ineffective portion of the unrealized gains and losses to interest expense over the life of the associated debt, the impact, up or down, is levelized over time rather than realized in the period incurred.

Staff believes PEF's request to create a regulatory asset or liability account to record realized and unrealized gains and losses associated with interest rate derivative agreements meets the requirements of FASB ASC 980. Staff notes that although no immediate impact on customer rates is evident, there may be some future impact related to shifting volatility from PEF to the

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[2] See 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.

[3] See Order No. PSC-06-1042-PAA-EI, issued December 19, 2006, in Docket No. 060674-EI, In re: Petition for authority to use deferral accounting for creation of a regulatory asset or regulatory liability to record changes or credits that would have otherwise been recorded in equity pursuant to balance sheet treatment required by Statement of Financial Accounting Standards (SFAS) No. 158 by Progress Energy Florida, Inc.

customer with the Commission's approval to allow the Company to amortize both the effective and ineffective portions of the realized and unrealized gains and losses. Staff recognizes the Company has requested the application of this treatment to its 2012 financial reports. Staff recommends it be approved prospectively for the reporting period beginning January 1, 2013. Finally, staff recommends that the Commission find that approval to record the regulatory asset or liability for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings.

Issue 2: Should the Commission require PEF to retain and provide documentation of all interest rate derivative activities once granted approval to record in a regulatory asset or liability account the realized and unrealized gains and losses related to interest rate derivative agreements? If so, what type of documentation is required?

Recommendation: Yes. The Commission should require PEF to track and record both the effective and ineffective portions of its realized and unrealized gains and losses. The Commission should authorize the Company to record such transactions as regulatory assets or liabilities in the Accounts 182.3 and 254, respectively. The Commission should require PEF to submit a Risk Management Plan within 90 days of the date of the final order in this docket and then annually with its application to issue securities. PEF also should file a report delineating the interest rate hedging results for the previous year with its securities consummation report each year. (Bullard, Ciccheti).

Staff Analysis: Derivatives are a form of risk management and are common in business operations in many industries.[4] In its petition, PEF states that it enters into various interest rate management agreements which "include, but are not limited to, interest rate swaps, caps, collars, floors, options or other hedging products such as forward or futures." Losses on these transactions are possible so it is appropriate to examine mechanisms which control the use of derivatives. Control over the use of derivatives and procedural guidelines are essential. It is PEF's responsibility to establish proper internal controls to ensure risk management procedures are followed. Regulatory monitoring of those procedures provides oversight to lessen the negative impact of the risk undertaken by the utility. Account 182.3 - Other Regulatory Assets requires that:

> … Records supporting the entries to this account shall be kept so that the utility can furnish full information as to the nature and amount of each regulatory asset included in this account, including justification for inclusions of such amounts in this account.

Similar to the requirements for fuel hedging in Order No. PSC-02-1484-FOF-EI,[1] staff recommends that PEF submit a Risk Management Plan (the Plan) for its interest rate derivative agreements and retain a copy onsite for audit purposes. Subsequently, the Company should file the Plan annually with its petition to issue securities. This will allow the Commission to monitor PEF's practices and transactions in this area. The Plan, filed each year with the Company's securities application, will cover future activities for the upcoming year for interest rate hedging applicable to subsequent quarters. Additionally, PEF should file each year with its securities consummation report, a report delineating the interest rate hedging results for the previous year.

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[4] According to the NARUC Quarterly Bulletin, Vol. 16 No. 3, "a derivative is a financial instrument (security) that derives its value from the value of other financial instruments or an underlying asset such as a commodity futures contract, stock, bond, currency, index, or interest rate."

Staff recommends that the Commission require PEF to submit a Risk Management Plan within 90 days of the date of the final order in this docket and then annually with its application to issue securities. The granting of PEF's petition would establish a precedent for interest rate hedging. As such, staff recommends the Commission use guidelines previously established under Order No. PSC-02-1484-FOF-EI[1] and Order No. PSC-08-0667-PAA-EI[5] for documenting fuel hedging. Consistent with the documentation requirements for fuel hedging, staff recommends the Company include the following items in its Risk Management Plan for interest rate hedging.

Components of the Risk Management Plan

Item 1: Identify the overall quantitative and qualitative Risk Management Plan objectives;

Item 2: Identify and quantify each risk, general and specific that the Company may encounter when seeking a fixed rate through interest rate hedging;

Item 3: Describe the Company's oversight of its interest rate hedging activities;

Item 4: Verify that the Company monitors its interest rate hedging activities with independent and unavoidable oversight;

Item 5: Describe the Company's corporate risk policy regarding interest rate hedging activities;

Item 6: Verify that the Company's corporate risk policy clearly delineates individual and group transaction limits and authorizations for all interest rate hedging activities;

Item 7: Describe the Company's strategy to fulfill its risk management objectives;

Item 8: Verify that the Company has sufficient policies and procedures to implement its strategy;

Item 9: Describe the Company's reporting system for interest rate hedging;

Item 10: If the Company has current limitations implementing certain hedging techniques that, if removed, would provide a net benefit to rate payers, provide a plan detailing the resources, policies, and procedures for acquiring the ability to effectively use the hedging techniques;

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[5] See 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 incentive factor.

Item 11: Verify the Company's reporting system and other tools used to identify, measure, and monitor all forms of risk associated with interest rate hedging activities; and

Item 12: Verify that the Company has a sufficient number and type of personnel who can fulfill its risk management objectives.

Issue 3: 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 administratively upon the issuance of a Consummating Order and staff's verification of receipt of the Risk Management Plan recommended in Issue 2. (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 administratively upon the issuance of a Consummating Order and staff's verification of receipt of the Risk Management Plan recommended in Issue 2.