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Many of us have a general idea of what the words "risk management" mean, but how they impact your organization may not be so obvious. This article is the first in a series of articles that will discuss a risk management framework and define how the framework can be applied to help mitigate the many risks inherent to the power industry.

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"The Secret's in the Sauce" **Fuel Adjustment Clause**

You've heard the expression, "**The Secret's In the Sauce.**" Well, if you have ever asked a restaurant for the recipe of their special sauce they are most likely unwilling to share the SECRET ingredients.

Costs included in an electric utility's fuel adjustment clause calculation could be compared to all the various ingredients that go into making a sauce. By using this analogy, I mean that fuel adjustment clauses (FAC) may appear on the surface to be clear-cut based upon the prescribed formula. **However,**

the implementation of the formula can prove to be controversial and complex, like those mysterious ingredients found in the sauce.

These sometimes questionable ingredients /costs makeup fuel and purchased power expense included in the determination of the FAC charges flowed through to wholesale customers; and such costs are not insignificant when considering their relationship to the total operation & maintenance (o&m) expense. In fact, based upon recent industry information, fuel and purchased power expense represent 60% of total electric utility operating expenses; not an insignificant amount of expense charged to electric utility customers.

Over the years the Federal Energy Regulatory Commission (FERC) has provided guidance in its regulations to electric utilities regarding the proper determination of the FAC calculation. The regulations have evolved over time from two of the FERC's orders; the first order, **Order No. 517**, issued in 1974, and the second order, **Order No. 352**, issued in 1983, nine years later.

Order No. 517, issued by the Federal Power Commission (FPC), FERC's predecessor, outlined what was permitted in the calculation of allowable fuel and energy purchases. In 1983, FERC issued **Order No. 352**, amending the existing rules codified in Section 35.14 of the Code of Federal Regulations (CFR). The revised rules allowed electric utilities to recover all expenses associated with purchased power of less than twelve months duration through fuel cost adjustments if two conditions were met. The first provision required that the total cost of the purchase had to be less than the buyer's avoided variable cost. Secondly, the purpose of the purchase must be solely to displace higher cost generation. This second condition excluded from automatic recovery purchases made to maintain reserve levels or otherwise cure any deficiency in capacity. If both of these conditions were met the expenses that could be flowed through included, but were not limited to, capacity or reservation charges, energy charges and any transmission or wheeling charges incurred in delivering the power to the buyer.

The current provisions of Section 35.14, Fuel Cost and Purchased Economic Power Adjustment Clauses, are set forth in Subpart C, Section (a)(2) of Section 35.14 and are listed as follows.



(2) Fuel and purchased economic power costs (*F*) shall be the cost of:

- (i) Fossil and nuclear fuel consumed in the utility's own plants, and the utility's share of fossil and nuclear fuel consumed in jointly owned or leased plants.
- (ii) The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in paragraph (a)(2)(iii) of this section.
- (iii) The total cost of the purchase of economic power, as defined in paragraph (a)(11) of this section, if the reserve capacity of the buyer is adequate independent of all other purchases where non-fuel charges are included in either *F_b* or *F_m*;
- (iv) Energy charges for any purchase if the total amount of energy charges incurred for the purchase is less than the buyer's total avoided variable cost;
- (v) And less the cost of fossil and nuclear fuel recovered through all inter-system sales.

As you will note from the reading of the above language, there are multiple qualifiers and restrictions on the items considered as allowable fuel and purchased power costs. Fuel and purchased power costs are restricted to those listed items, and to be in compliance an electric utility's FAC must meet these prescribed tests.

In today's changing regulatory environment fuel and purchased power traditionally passed through the FAC are, in some cases, being replaced by market-based energy purchases made by wholesale customers. Although these types of purchases are being introduced into the overall power supply arrangements, there continue to be FERC tariffs and negotiated contracts that control the determination of fuel and purchased power expense flowed through FACs. Such contracts and tariffs contain the prescribed FERC FAC, or similarly worded language, controlling the fuel clause treatment. These agreed to fuel clause provisions should be validated and reconciled to the utility's calculated costs to insure that all costs charged to the wholesale customer are following the provisions of the FAC formula. **Unraveling the application of the formula to gain assurance that only the allowable ingredients are flowed through may take considerable time, however, it is necessary in order to assure that only legitimate and verifiable costs are paid by wholesale customers.** Another cost concern lies in increasing volumes of purchased power by utilities, creating an additional challenge to the process of auditing the overall pool of costs flowed through the FAC.

A detailed analysis and reconciliation of supporting fuel and purchased power data is critical to remove any improper costs. Examples of improper or questionable costs include unallowable capacity-related expenses, fuel and purchased power hedges and incorrect booking of non-production related o&m expense. Finally, shades of ENRON place an aura of suspicion on whether all costs charged by the utility and included in the FAC calculation have properly met the FERC's FAC requirements. **Assurance is paramount to know that only the prescribed costs are recoverable through the FAC, similar to the analogy of the prescribed ingredients being used to successfully make the sauce.**

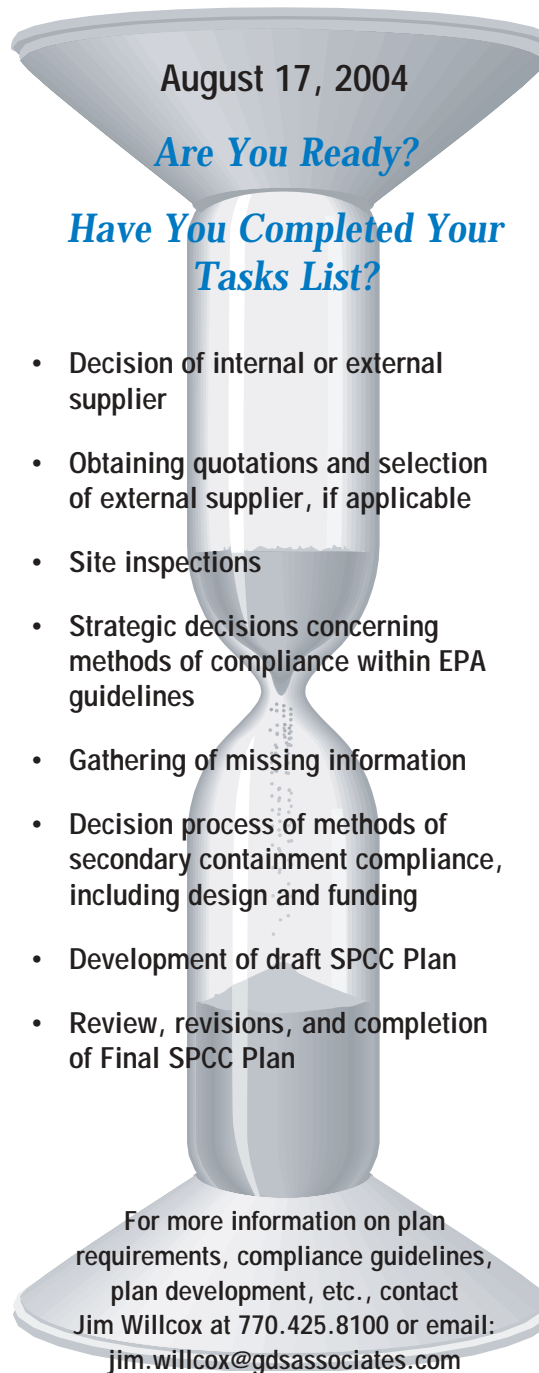
Various measures can be taken by wholesale customers with FACs in their rates to confirm that only the FERC allowable costs are flowed through. Such measures range from a detailed analysis of fuel and purchased power data provided by the host utility to filing of a Section 206 Complaint at FERC.

For more information regarding proper implementation of fuel adjustment clauses contact: Cary Cook, CPA, Senior Project Manager at 770-425-8100 or email: cary.cook@gdsassociates.com



SPCC Reminder Time is Running Out...

The EPA's Oil Spill Prevention, Control and Countermeasures Plan (SPCC) Deadline is Approaching *Fast!*



At Risk?

One does not have to wait long during a conversation with others involved in the power industry to hear the word "risk" or the phrase "risk management." Many of us have a general idea of what the words "risk management" mean, but how they impact your organization may not be so obvious.

In the next several issues of *TransActions*, we will define a risk management framework and discuss how the framework can be applied to help mitigate the many risks inherent to the power industry.

With a great deal of attention being paid to the area of risk management, it is easy to become overwhelmed or confused about what it really means.

So, what exactly is Risk Management?

A simple way to define risk management is:

The process of identifying, evaluating, and mitigating the risks that threaten the strategic and financial goals of your business.

Since the power supply industry is an inherently risky one, the focus on risk management will only continue to increase as a response. Both RUS and the SEC have begun to recognize the importance a risk management program may have in managing our business.

Every business is vulnerable to a wide array of risks that may or may not be specific to its particular industry, although only some choose to actively acknowledge and address those risks in an attempt to reduce exposure to them. In our business, risks can be identified in virtually all segments of the power supply industry, and can be divided more simply into the three general categories: **1) supply side; 2) demand side; and 3) business-related.** These three categories of risks will be discussed in greater depth in subsequent articles.

Effective risk management encourages decision makers to examine their business process to identify the various risks that can affect it, and to begin thinking about how the exposure to these risks can be best mitigated or minimized. Before embarking on a risk management program, one of the most important concepts to understand is that **risk management does**



not necessarily guarantee the lowest cost, but rather reduces volatility, thereby providing more stable costs overtime.

The next several editions of *TransActions* will address how the various segments of our business are affected by the three categories of risks mentioned earlier. These future articles will also discuss how to take a more active approach in addressing such risks, as well as the various issues surrounding the design, development, and implementation of an effective risk management program.

For more information on risk management or to comment on this article, contact Paul Wielgus, Managing Director, GDS 512-494-0369 or paul.wielgus@gdsassociates.com

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2. Financial Analysis and Rate Services
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7. Electric Planning and Design Services (Hi-Line Engineering, LLC)
8. Environmental Management Services (GreenLine Environmental)
9. Deregulation and Retail Energy Procurement Services
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