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THE PRICE OF POWER IN LAKELAND:

Who Wins as Utility Games the Gas Market?

Efforts to Stabilize Electric Bills Wind Up Costing \$75 Million Extra Over Five Years

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LAKELAND | If you're an average Lakeland Electric customer, for the past five years you have paid about \$90 more a year for an "insurance policy."

The total cost for that policy – called hedging – has been about \$75 million.

That's because the typical residential customer has averaged paying an extra \$7.51 a month since October 2004 so the utility could keep bills from gyrating as natural gas prices have surged and fallen. That typical customer uses 1,300 kilowatt hours a month.

Those averages are based on figures from October 2004 through this April. They were released at The Ledger's request.

Like gasoline, the price of natural gas fluctuates constantly. If you could make a deal today to fill your car's tank three months from now, you would save money if that price went higher than what you agreed to pay.

But if the price dropped, you would lose money.

Whether Lakeland's \$75 million for hedging is out of line is a question with different answers. Experts consulted by The Ledger differ on the wisdom of the practice, or at least the degree to which it is practiced in Lakeland.

This is how hedging works.

In Lakeland Electric's case, it makes deals on the natural gas it needs to fuel its electricity generators. When it hedges, the utility locks in a price for gas that will be delivered at a set time in the future.

City Commissioner Gow Fields, who owns an Allstate insurance office, said hedging provides stability and insurance against events like hurricanes that can disrupt the flow of natural gas and drive prices up dramatically.

It's worth the price Lakeland has paid, he said.

"If you have home insurance but don't make a claim for five years, does that mean you wasted your money?" he asked.

George Lindsey says hold on. A member of the city's Utility Committee, a group that oversees Lakeland Electric, he says money spent on hedging is "needless."

The cost to the utility's 120,000 customers "is beyond the high side of acceptability," he says.

HOW IT GOT STARTED

In late 2003, Lakeland Electric officials pitched the idea of hedging to city commissioners, who gave the plan their blessing.

Commissioners were originally told hedging would save money and stabilize prices passed on to customers.

In the beginning, that was the case. In the 2005 fiscal year, the utility's hedges saved \$1.9 million.

But in the 2006 fiscal year, Lakeland Electric paid \$23 million more for natural gas because of hedging.

It was during this time that any talk of saving money by hedging ended. Price stability and storm insurance were left as the only rationales for continuing the practice.

The decision to hedge isn't made by Lakeland Electric's paid managers.

Utility General Manager Jim Stanfield said in a recent interview that whether to hedge is a policy decision. It's up to city commissioners, who make up a majority of the Utility Committee.

"They want price stability, and that's what we're doing," Stanfield said.

City officials say a hurricane could disrupt the flow of natural gas and cost Lakeland Electric as much as \$10 million in a month because prices would jump as gas becomes harder to get.

Hedging protects against a big storm-fueled price spike, "but that's if you can get the gas here," City Manager Doug Thomas said.

Thomas said \$7.50 per month, the extra paid by the average residential customer, is worth it for stable prices for residents and businesses, which need to forecast their costs in upcoming months.

Lakeland Electric pays The Energy Authority, a Jacksonville-based company commonly called TEA, for hedging advice and to purchase hedges. The company has time and price triggers that determine when to hedge and how much.

"Hedging is not rolling the dice," Thomas said. "It's not a bunch of guys sitting in a room saying, 'Let's bet on this.' Some people think there's a voodoo element to this."

Commissioner Fields said he thinks \$7.50 a month is reasonable.

"But I could be wrong," he said. "We'll have to ask our customers," such as through surveys the city periodically conducts.

In the aftermath of three hurricanes in 2004 when prices fluctuated greatly, Fields said, people, particularly large industrial customers, "screamed and yelled and demanded hedging."

Terry Simmers, a Utility Committee member and a former general manager of the Juice Bowl, said buying fruit futures to control price costs in case of a freeze is similar to Lakeland Electric's practice of hedging.

People in business need to know their costs when agreeing to price-certain contracts, he said. "That includes the cost of electricity."

City officials point to their ranking as having the second-lowest price for electricity in Florida. Prices are low because the utility has a low base rate, the portion of utility bills that accounts for everything except fuel. A rate study is under way now and indications are that rate will increase in October.

About 70 percent of Lakeland Electric's power is generated using natural gas. That's a higher percentage than most Florida utilities.

The rest comes from a coal-fired generator. So, the utility's price for electricity always reflects the price of natural gas.

BUYING HIGH

A year ago, a spike in prices had natural gas trading on what's called the spot market for \$13.50 per MMBtu, and utilities scrambled to buy hedges to protect against continued high prices predicted by experts.

But in the past year, the price of natural gas has swooned steadily, and gas in the past week has traded in the \$3.40 range.

That's why so many utilities are getting clobbered by hedges they booked in the past few years that are now coming due.

That's the downside of hedging – missing out on low prices.

The textbook example of the trouble with hedging is the Orlando-based Florida Municipal Power Agency, which has the city of Fort Meade, in an uproar.

There, City Manager Fred Hilliard has roundly criticized hedging and the FMPA. **(See related story.)**

Both the FMPA and Lakeland Electric rely on energy-trading professionals to help them make decisions on how to buy natural gas.

Lakeland's contractor, TEA, charges it \$168,000 per year for its hedging advice. That company's Web site boasts "greater rewards and savings" and "an unparalleled record of success" in energy trading. That hasn't been the result in Lakeland. Repeated attempts to get an explanation from TEA were unsuccessful.

TEA officials said they could make no comment, citing customer confidentiality. Since it started hedging in October 2004, Lakeland Electric has relied on two energy firms, hiring TEA in March 2007.

Before then it used Chicago-based RMI.

In the nearly five years it has hedged, Lakeland Electric supervisors say they have hedged between 50 percent and 75 percent of the natural gas the utility bought.

That gas cost \$726 million. Buying at higher prices through hedging cost \$75 million of that total. That means hedging accounted for 10 percent of the cost of natural gas bought by Lakeland Electric from October 2004 through this April.

The cost of hedging has escalated recently.

From the beginning of this fiscal year, which started Oct. 1, through April, the cost of hedging billed to customers is \$13.2 million and rising, utility records show.

Despite the recently increasing costs, financial reports provided to city Utility Committee members lately have contained short notes, such as “TEA is still bullish on the market,” meaning that the company still believes hedging is a good idea.

EVERYBODY DOES IT

Hedging on natural gas is a nationwide practice for utilities that generate their own power.

The Ledger obtained natural gas hedging performance numbers from two utilities that generate about the same amount of power as Lakeland Electric.

For the period from October 2004 through this April, natural gas hedging cost the FMPA \$74.8 million. That’s 8.6 percent of what it spent on all natural gas.

The FMPA spent little to hedge in the first four fiscal years of the five, spending almost all of that \$74.8 million this fiscal year. From Oct. 1 through April, the FMPA’s cost to hedge is \$73.4 million.

Gainesville Regional Utilities spent \$15.4 million on hedging, 5.6 percent of its 5-year purchases of natural gas.

Sixty percent of the power generated at Gainesville comes from coal, so although the utility is similar in size to Lakeland Electric, it hedges much less on natural gas.

The city-owned Tallahassee utility didn’t provide public records to The Ledger about hedging costs. The failure to provide the records was despite repeated assurances from David Byrne, director of energy services, that he would do so.

Byrne did provide a lengthy defense of hedging. He said that, over time, there’s going to be a cost.

“You can get lucky for awhile,” Byrne said. “But in the long run, you’re paying someone to take a risk” and that comes with a price.

HOW MUCH ISTOO MUCH?

Jeremy Oller, an economics professor at the University of Central Oklahoma, said Lakeland Electric’s 10 percent hedging cost is too high.

“I would consider that a very high premium,” Oller said, adding the utility is “missing” the mark for properly hedging.

Oller said he thinks electric consumers are generally willing to pay 2 percent to 3 percent to stabilize prices, but not more.

Ted Kury, director of energy studies at the University of Florida's Public Utility Research Center, said there is no set hedging percentage cost that is acceptable. He said all utilities that generate power should ask certain questions of themselves.

"How much is a utility willing to pass along to its customers? And how much are the customers willing to pay?" Kury asked.

He said those questions are answered differently everywhere.

"It depends on the needs of the utility and the tolerance for risk," Kury said.

Lindsey, the lone Lakeland Utility Committee member opposed to hedging, said there's no real way to insulate customers from costs, so why add to them by hedging?

Lindsey said if Lakeland Electric insists on hedging, "there should be limits," and there aren't.

Lakeland city and utility officials say the \$75 million the city spent may not be accurate because it assumes the utility would usually buy its natural gas on the spot market, which it does not.

But the hedges are paid, either way, based on the market. And the market is the only realistic tool to use as a measurement. "It's close," city Finance Director Greg Finch said. "It's very close."

City Commissioner Justin Troller, a proponent of hedging, said it's time to take a good look at how it's done in Lakeland.

"We need to re-evaluate this and see whether it's working," Troller said. "We need to see if we can do it better."

LOCKED IN THE GAME

Lakeland Electric is locked into hedging that, at least for now, doesn't look promising.

Since April, Lakeland Electric paid \$4.5 million to cover its May hedging costs. The June figure, released Monday, was \$4 million.

The utility has hedged 78 percent of its expected fuel purchases for the 2010 fiscal year, which begins Oct. 1.

Because the natural gas market can be volatile, the worth of the hedges owned by any utility can quickly change.

Right now, if Lakeland Electric were to sell the hedges it owns, its customers would pay \$23.4 million.

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