Commonwealth of Virginia

State Corporation Commission

Report to the Commission on Electric Utility Restructuring of the Virginia General Assembly

Stranded Cost Report

Volume I

Pursuant to the Legislative Transition Task Force's
Resolution
Adopted January 27, 2003

July 1, 2003

Transmittal Letter

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STATE CORPORATION COMMISSION

July 1, 2003

The Honorable Thomas K. Norment, Jr.
Member, Senate of Virginia
Chairman, Commission on Electric Utility Restructuring
and
Members of the Commission on Electric Utility Restructuring

Dear Sirs:

The State Corporation Commission is pleased to submit this report prepared by its Staff in response to the Legislative Transition Task Force's Resolution of January 27, 2003, regarding the activities of the stranded cost work group.

The report addresses definitions for "stranded costs" and "just and reasonable net stranded costs," discusses methodologies for monitoring the overrecovery or underrecovery of stranded costs, and discusses administrative and legislative recommendations. No consensus recommendations were reached. Disagreements on appropriate monitoring were apparent early in the process. While the utilities and independent power producers are opposed to any monitoring that includes a calculation of stranded costs, stating that such calculation is inconsistent with the Restructuring Act, consumer groups and competitive service providers generally believe that a calculation is necessary to fulfill the stranded cost monitoring requirement of § 56-595 C (iii) of the Restructuring Act.

As Commissioner Miller pointed out in his October 21, 2002, letter to Senator Norment, the Restructuring Act provides for recovery of just and reasonable net stranded costs via wires charges and capped rates. As written, the current statute providing for recovery of stranded costs neither requires nor includes any definition of stranded costs nor any method to determine what might appropriately be credited to reduce stranded costs, if any. However, § 56-595 C of the Restructuring Act provides that the LTTF monitor "whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs." So, although § 56-584 provides for recovery without the precondition of establishing that stranded costs exist, § 56-595 C requires that stranded cost recoveries be monitored to determine whether an overrecovery or underrecovery of such costs is likely. While the two sections may be inconsistent with each other, they are provisions of the statute. Making a determination of any likely overrecovery or underrecovery requires the measurement of stranded costs and a determination of what may appropriately be credited to reduce or offset any stranded costs. Your Resolution clearly contemplates such determinations particularly in Requested Action Nos. 2 and 3.

As no consensus was reached, our staff has analyzed the recommendations of the work group participants and provided its recommendations for your consideration. The work group is unable to proceed with the second phase of this project (to calculate each incumbent electric utility's just and reasonable net stranded costs and associated recoveries) because no consensus methodology was defined.

We request that you advise us as to whether you wish the Commission to determine stranded cost amounts, if any, and any amounts that may be appropriately credited to reduce or offset any stranded costs for each utility. If so, we further request that you advise us as to whether you wish to request a particular methodology or whether you wish us to determine which methodologies should be employed. We look forward to hearing from you on how to proceed with this project.

Respectfully submitted,

Hullihen Williams Moore

Theodore V. Morrison, Jr.

Clinton Miller

c: Virginia General Assembly
Division of Legislative Automated Services

Executive Summary

EXECUTIVE SUMMARY

This report on stranded cost definitions and methodologies is submitted to the Commission on Electric Utility Restructuring, hereinafter referred to as its predecessor organization the Legislative Transition Task Force ("LTTF"), in response to requirements set forth in its Resolution passed January 27, 2003. It is made in response to Requested Action No. 2 of the Resolution which requires that the State Corporation Commission:

> *By July 1, 2003, present to the Legislative Transition Task Force the work group's consensus recommendations regarding:*
>
> *(a) Definitions of "stranded costs" and "just and reasonable net stranded costs."*
>
> *(b) A methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.*

The report also addresses Requested Action No. 8, requiring Commission Staff analysis of differing recommendations in the event consensus recommendations were not reached and Requested Action No. 9, recommendations for legislative or administrative action that the Commission, work group, or both, determine appropriate to address any over- or under-recovery of just and reasonable net stranded costs.

On March 3, 2003, the Commission entered an Order Establishing Proceeding (the "Order"), docketing Case No. PUE-2003-00062. The Order provided guidelines on establishing the work group, and a schedule for work group activities, setting April 1, 2003 as the first meeting date. The Order requested that interested persons respond to a series of six questions posed by the Commission concerning stranded cost issues.

The work group held four sessions where definitions and methodologies were discussed in depth. In addition, work group members provided written responses to issues brought up during the work group sessions. All comments are included in Volume II of this report. Although no consensus was reached, staff commends the work group members for their hard work and dedication to this project.

The work group first attempted to reach consensus definitions for the terms "stranded costs" and "just and reasonable net stranded costs." In defining stranded costs the differences came down to (1) terminology, for example should such costs be defined as "lost revenues" or "loss in economic value" and (2) whether the definition should include stranded cost components. There were similar differences of opinion regarding the definition of just and reasonable net stranded costs. Additionally, Dominion Virginia

Power believes no further definition of just and reasonable net stranded costs is necessary because such costs are defined by the methodology for determining wires charges as set forth in § 56-583 of the Restructuring Act.

Staff does not believe that the definitions need to include stranded cost components. Staff disagrees with the position that just and reasonable net stranded costs are defined by the Restructuring Act. To the contrary, Staff believes the Restructuring Act neither defines just and reasonable net stranded costs nor provides a methodology for calculating them. It defines only the recovery mechanisms, wires charges and capped rates, and a method for calculating wires charges.

Staff recommends the use of the following definitions:

> <u>Stranded Costs</u> *are a utility's net loss in economic value arising from electric generation-related costs that become unrecoverable due to restructuring and retail competition.*
>
> <u>Just and Reasonable Net Stranded Costs</u> *are a utility's net loss in economic value arising from prudently incurred, verifiable and non-mitagable electric generation-related costs that become unrecoverable due to restructuring and retail competition.*

Several methodologies for monitoring and/or measuring the over- or under-recovery of stranded costs were discussed by the work group. Dominion proposed a methodology for monitoring just and reasonable net stranded costs that includes reporting to the LTTF (1) the over- or under-recovery of stranded costs collected through the wires charges from switching customers, (2) actual "above-market" or "potential" stranded costs exposure under capped rates, (3) the amounts expended from funds available under capped rates to mitigate potential stranded costs, and (4) additional expenditures that negatively impact (increase) such costs during the transition period.

Staff presented two methodologies. The first calculates just and reasonable net stranded costs based on an asset valuation methodology. The second is an accounting approach that (1) measures recoveries of stranded costs from capped rates and wires charges, (2) measures potential stranded costs on an annual historic basis, and (3) after July 1, 2007 could be used to calculate actual stranded costs or benefits on an annual historic basis.

The Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (the "Committees") proposed a methodology for calculating just and reasonable net stranded costs based on an asset valuation methodology for measuring stranded costs and incorporating stranded cost recoveries from both wires charges and capped rates.

Generally, utilities and independent power producers support Dominion's proposal stating that it is easy to administer and consistent with the Restructuring Act. Consumer groups and competitive service providers offer little support for Dominion's proposal because it does not calculate stranded costs nor does it quantify stranded cost recoveries from capped rates.

Regarding Staff's and the Committees' methodologies, the positions of the work group participants are reversed. The utilities state that these methodologies are not consistent with the Restructuring Act and that the asset valuation methodology is too complex, requiring numerous projections. They further state that calculating stranded cost recoveries from capped rates is tantamount to annual rate cases. Conversely, consumer groups and competitive service providers believe the asset valuation methodology is the best method available for calculating stranded costs. These groups agree that this is a complex calculation but can be done with cooperation of all participants. These groups are not in favor of Staff's proposal for calculating potential stranded costs.

Staff believes that to monitor the over- or under-recovery of just and reasonable stranded costs one must calculate two numbers: (1) total just and reasonable net stranded costs; and (2) recoveries of stranded costs from capped rates and wires charges. Staff favors using an asset valuation methodology to determine just and reasonable net stranded costs. Although complex, it is the best tool available. To calculate recoveries of stranded costs from wires charges and capped rates, Staff believes information currently filed annually with the Commission should be used. This information is used to measure a utility's earnings and is much less complex than rate cases.

Should the LTTF determine an asset valuation methodology is not appropriate for calculating just and reasonable net stranded costs, Staff suggests that utilities be required to calculate potential stranded costs annually during the transition period and actual stranded costs annually thereafter. This alternative would also include calculating recoveries from wires charges and capped rates as discussed above.

In regard to Dominion's proposal, Staff agrees with the comments of the utilities that Dominion's methodology is easy to administer; however, the fact that it does not calculate just and reasonable net stranded costs and does not quantify stranded cost recoveries from capped rates makes it unacceptable.

The final issue addressed in the report is whether legislative or administrative action by the LTTF is necessary. Several participants suggest that if a company is found to have over-recovered or it is likely that they will over-recover stranded costs then (1) wires charges should be reduced or eliminated, (2) capped rates should be reduced, or (3) both. Currently, the Restructuring Act does not provide for any of these actions. Legislation would be necessary should the General Assembly desire to take action on the findings made as a result of its stranded costs monitoring. On the other hand, Staff does not believe legislation is necessary to determine any of the stranded cost methodologies identified by the work group.

Staff requests further direction from the LTTF prior to submission of its next stranded cost report currently scheduled to be filed November 1, 2003. Requested Action

No. 3 of the Resolution provides that the Commission present to the LTTF the work group's consensus recommendations regarding each utility's just and reasonable net stranded costs and stranded cost recoveries, using the work group's consensus methodology. Because the work group was unable to reach consensus on a methodology it is unable to move forward with the calculations. The Commission requests that the LTTF provide guidance on the appropriate methodology or instruct the Commission to make such determination. Further, the LTTF should instruct the Commission to begin proceedings to implement the chosen methodology.

Stranded Cost Report

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4 Order Establishing Proceeding, dated March 3, 2003 in Case No. PUE-2003-00062

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- ODEC Member Cooperatives
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8 Staff's E-mail Dated April 02, 2003 and Work Group Participant Responses
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Comments Received:
- Dominion Virginia Power
- ODEC Member Cooperatives
- American Electric Power
- Allegheny Power
- Virginia Independent Power Producers
- Division of Consumer Counsel Office of Attorney General
- Virginia Committee for Fair Utility Rates and Old Dominion Committee for Fair Utility Rates
- Constellation NewEnergy, Inc.

9 Staff's E-mail Dated April 10, 2003 and Work Group Participant Responses

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Comments Received:

- Dominion Virginia Power
- ODEC Member Cooperatives
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- Virginia Independent Power Producers
- Division of Consumer Counsel Office of Attorney General
- Virginia Citizens Consumer Council
- Virginia Committee for Fair Utility Rates and Old Dominion Committee for Fair Utility Rates
- TXI-Chaparral (Virginia) Inc.
- Washington Gas Energy Services, Inc.
- Constellation NewEnergy, Inc.
- National Energy Marketers Association
- New Era Energy

10 Staff's E-mail Dated April 30, 2003 and Work Group Participant Responses

- April 30, 2003 E-mail Requesting Comments on the Methodology Presented by VCFUR/ODCFUR, Staff's Accounting Approach and the Clarification made to Dominion Virginia's Methodology

Comments Received:

- Dominion Virginia Power
- ODEC Member Cooperatives
- American Electric Power
- Allegheny Power
- Virginia Independent Power Producers
- Division of Consumer Counsel Office of Attorney General
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- Virginia Committee for Fair Utility Rates and Old Dominion Committee for Fair Utility Rates
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REPORT TO THE COMMISSION ON ELECTRIC UTILITY RESTRUCTURING OF THE VIRGINIA GENERAL ASSEMBLY

STRANDED COST REPORT

INTRODUCTION

This report on stranded cost definitions and methodologies is submitted to the Commission on Electric Utility Restructuring, formerly the Legislative Transition Task Force ("LTTF"),[1] in response to requirements set forth in its Resolution passed January 27, 2003.[2] A draft report was submitted by the State Corporation Commission ("Commission") Staff ("Staff") to the Commission on May 30, 2003. The report was submitted to the Stranded Cost Subcommittee of the LTTF on June 16, 2003.

In part the Resolution states, "As customer choice has commenced in the Commonwealth, it is appropriate for the Legislative Transition Task Force to initiate the process of monitoring whether the recovery of stranded costs has resulted or is likely to result in the overrecovery or uncerrecovery of just and reasonable net stranded costs." In its Resolution the LTTF requested that the Commission "convene a work group...for the purpose of developing consensus recommendations, consistent with the provisions of the Act, regarding the issues listed in Requested Action Nos. 2 and 3 of the Resolution."

This report is made in response to Requested Action No. 2 of the Resolution which requires that the State Corporation Commission:

> *By July 1, 2003, present to the Legislative Transition Task Force the work group's consensus recommendations regarding:*
>
> *(a) Definitions of "stranded costs" and "just and reasonable net stranded costs."*
>
> *(b) A methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.*

The Resolution in Requested Action No. 7 asks that the Commission Staff and work group members act in good faith to develop consensus recommendations on the issues. Pursuant to Requested Action No. 8 of the Resolution, if work group members are unable to develop consensus recommendations, the report to the LTTF shall include

[1] In this report Legislative Transition Task Force or LTTF will be used to refer to the Commission on Electric Utility Restructuring.

[2] The Resolution is included as Attachment No. 1 to this report.

the recommendations of the Commission Staff and other members of the work group and shall include an analysis by Commission Staff of such recommendations.

The Resolution, Requested Action No. 9, states that any report to the LTTF should include, "any recommendations for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any overrecovery or underrecovery of just and reasonable net stranded costs."

BACKGROUND

Section 56-595 C (iii) of the Virginia Electric Utility Restructuring Act (the "Restructuring Act" or the "Act") provides that the members of the LTTF shall:

> *[A]fter the commencement of customer choice, monitor, with the assistance of the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs....*

Section 56-584 of the Restructuring Act in part provides:

> *Just and reasonable net stranded costs, to the extent that they exceed zero value in total for the incumbent electric utility, shall be recoverable by each incumbent electric utility provided each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates as provided in § 56-582 or wires charges as provided in § 56-583.*

In the summer of 2002 the Commission received a letter from the LTTF, regarding stranded cost recovery under the Act and the LTTF's monitoring of the recovery of such costs under § 56-595 C. In a letter responding to LTTF letter, dated October 21, 2002, the Chairman of the Commission noted:[3]

> *...assessment of stranded cost monitoring was summarized in the Commission's second annual report on the status of retail competition, filed with the LTTF and the Governor on August 30, 2002. As we noted in that report, the Restructuring Act provides in § 56-584 that rate caps and wires charges through mid-2007 would reimburse incumbent utilities for their "net just and reasonable stranded costs." Neither this statute nor any other in the Restructuring Act, however, defines stranded costs nor provides any formula or statutory framework for their calculation.*

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[3] The LTTF's letter to the Commission and the Commission's response are included as Attachment No. 2 to this report.

The letter went on to state:

The Commission would note that since measuring the "underrecovery" or "overrecovery" of stranded costs under § 56-595 C requires their quantification, it will be necessary to establish a method for their calculation. Moreover, and with respect to monitoring the levels of their recovery, it will also be necessary to determine what part of the utilities' capped rates and wires charges should be allocated to stranded cost recovery. Simply put, two things must be done in order to monitor the progress Virginia's utilities are making towards recovery of their stranded costs. First, determine the amount of stranded costs; second, allocate some part of wires charges and capped rates to their recovery.

The above paragraph was included in the Commission's August 30, 2002 report, with the addition of the following sentence:

Undertaking any of the foregoing presupposes, however, that authority exists with the Restructuring Act's current statutory framework for doing so.

The LTTF staff document of November 19, 2002, titled "Quantifying Incumbent Electric Utilities' Stranded Costs" provides useful background information and is included as Attachment No. 3 to this report. In discussing the rationale for stranded cost recovery, the LTTF staff document notes:

Neither stranded costs nor stranded benefits could be calculated in advance of restructuring. The market prices for generation, which is a key variable, is unknown until a competitive market for such generation exists.

It was in this general context that the LTTF passed its Resolution directing the formation of a work group to address stranded cost issues.

To establish and initiate a defined work program for this undertaking, on March 3, 2003, the Commission entered an Order Establishing Proceeding (the "Order"), docketing Case No. PUE-2003-00062.[4] The Order provided guidelines on establishing the work group, and a schedule for work group activities, setting the first meeting date as April 1, 2003. The Order requested that interested persons respond to a series of six questions posed by the Commission concerning stranded cost issues.[5]

Pursuant to the Order, any person interested in representing a group in this matter was required to file a letter with the Clerk of the Commission on or before March 15,

[4] The Order Establishing Proceeding is included as Attachment No. 4 to this report.
[5] Responses to the questions posed in the Order are included as Attachment No. 7 to this report.

2003. Attachment No. 5 to this report includes a list of persons filing letters of intent with the Clerk of the Commission and their organizational affiliation.

The work group held four meetings where issues surrounding the definitions and methodologies were discussed. Also, presentations on the various methodologies discussed below were made. Further, work group members were given the opportunity to address each of the methodologies in written comments.

DEFINITIONS

The Commission's Order Establishing Proceeding requested that prospective representatives provide definitions of "stranded costs" and "just and reasonable net stranded costs," including the components and differing characteristics of each. The work group's initial meeting was spent primarily discussing the definitions put forth in the written responses in an attempt to find consensus definitions of the two terms. Subsequent to the meeting Staff proposed, via electronic mail, definitions for each term and written comments were received and further discussed at the second work group meeting. The definitions for which staff requested comment, as proposed by the Consumer Counsel are:

> *<u>Stranded Costs</u> - Stranded Costs are a utility's lost revenues arising from electric generation-related costs that become unrecoverable due to restructuring and retail competition.*
>
> *<u>Just and Reasonable Net Stranded Costs</u> - Just and Reasonable Net Stranded Costs are a utility's lost revenues arising from prudently incurred, verifiable and non-mitagable electric generation-related costs that become unrecoverable due to restructuring and retail competition.*

Several work group participants responded with concerns regarding these definitions as summarized below. A full disclosure of each participant's comments is included in Attachment No. 8 to this report.

Dominion Virginia Power ("Dominion") does not object to the above definition for "stranded costs;" however, it does not believe the definition of "just and reasonable net stranded costs" reflects how the Restructuring Act is implemented. Dominion believes no further definition of "just and reasonable net stranded costs" is needed because such costs are the result of the methodology required by the Restructuring Act.[6]

The Old Dominion Cooperatives[7] are opposed to the above definitions and provided the following alternative definitions:[8]

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[6] Attachment No. 8, Dominion Virginia Power's Response – April 3, 2003.

[7] When used in this report the term "Old Dominion Cooperatives" refers to A&N Electric Cooperative, BARC Electric Cooperative, Community Electric Cooperative, Mecklenburg Electric Cooperative, Northern Neck Electric Cooperative, Northern Virginia Electric Cooperative, Prince George Electric

Stranded costs are an incumbent utility's lost electric generation-related revenues recoverable under traditional cost-of-service regulation but not recoverable in a competitive electric generation market, measured by the difference between the utility's generation-related costs while regulated (subject to fuel adjustments) and the market-based generation-related costs determined annually by the Commission, and recovered through capped rates or wires charges.

Just and reasonable net stranded costs are an incumbent utility's net loss in electric generation-related revenues recoverable under traditional cost-of-service regulation but not recoverable in a competitive electric generation market, measured by the net difference between the utility's reasonably and prudently incurred generation-related costs while regulated (subject to fuel adjustments), and the market-based generation-related costs determined annually by the Commission, and recovered through capped rates or wires charges.

Appalachian Power Company dba American Electric Power ("Appalachian") offered the following definitions in lieu of those stated above:[9]

Stranded costs refer to an incumbent electric utility's costs that are unrecoverable due to restructuring and retail competition.

Just and reasonable net stranded costs refer to an incumbent electric utility's prudently incurred and verifiable Stranded Costs, the mitigation of which is beyond the control of such incumbent electric utility.

The Potomac Edison Company dba Allegheny Power ("Allegheny") offered the following definition for stranded costs:[10]

Stranded Costs - Stranded Costs are the utility's lost generation revenues, transition costs and generation related net regulatory assets that become unrecoverable as a result of restructuring and the transition to retail competition.

Regarding the definition for "just and reasonable net stranded costs, Allegheny believes the proposed definition should be revised to include the costs components included in its definition of "stranded costs."

Cooperative, Rappahannock Electric Cooperative, Shenandoah Valley Electric Cooperative, and Southside Electric Cooperative, Inc., collectively, the Virginia distribution cooperative members of Old Dominion Electric Cooperative.

[8] Attachment No. 8, April 4, 2003 electronic mail from John A. Pirko.

[9] Attachment No. 8, Comments of AEP – Stranded Cost Definitions.

[10] Attachment No. 8, Comments by Allegheny Power.

The Virginia Independent Power Producers ("VIPP") stated that they agreed to the gist of the definitions and that they had no further comments.[11]

As Staff based the definitions distributed for comment on those proposed by the Division of Consumer Counsel Office of the Attorney General ("Consumer Counsel"), Consumer Counsel had no further comment.[12]

Constellation NewEnergy ("NewEnergy") expressed concern with the use of the term "lost revenues" in the definitions and suggests that the phrase "net loss in economic value" be used in its place. NewEnergy believes the term "lost revenues" may imply that utilities are guaranteed a revenue stream.[13]

Staff Analysis of the Proposed Definitions

Based on the comments received the following questions need to be addressed: (1) should stranded costs be characterized as "lost revenues;" (2) should the definition include a listing of stranded cost components; and (3) is the term "just and reasonable net stranded costs" defined by the Restructuring Act?

Staff believes that NewEnergy's concern regarding the use of the term "lost revenues" is legitimate and should be addressed. Staff does not believe that the definition should be written to construe a guaranteed revenue stream. If a stranded cost revenue stream is guaranteed there would be no need to monitor stranded cost recovery as required by § 56-595 C.

Staff does not believe it is necessary to specify the cost components in the definition. A utility may incur stranded costs in a variety of cost components and such costs should not be limited through the definition. It is appropriate to have a general definition with details worked out through the methodology adopted for computing stranded costs.

Staff disagrees with Dominion's assertion that just and reasonable net stranded costs are defined by the methodology for determining wires charges as set forth in § 56-583 of the Restructuring Act. The Act only provides for the recovery of stranded costs; it neither defines nor provides a methodology for calculating stranded costs. To fulfill the LTTF's charge to monitor the recovery of just and reasonable net stranded costs one must begin by defining the term.

Staff recommends the use of the following definitions:

Stranded Costs are a utility's net loss in economic value arising from electric generation-related costs that become unrecoverable due to restructuring and retail competition.

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[11] Attachment No. 8, April 3, 2003 electronic mail from August Wallmeyer.
[12] Attachment No. 8, April 4, 2003 electronic mail from Meade Browder.
[13] Attachment No. 8, April 4, 2003 electronic mail from Eric Matheson.

Just and Reasonable Net Stranded Costs are a utility's net loss in economic value arising from prudently incurred, verifiable and non-mitagable electric generation-related costs that become unrecoverable due to restructuring and retail competition.

METHODOLOGIES

Several methodologies for monitoring and/or measuring the over- or under-recovery of stranded costs were discussed by the work group. Written comments were received on each of the proposed methods.[14] Below are selected quotes from those comments, which are intended to provide a general flavor of the positions of the work group participants regarding each proposed methodology. The reader is encouraged to review the comments in their entirety in order to gain a full understanding of the specific positions of the work group participants.

Dominion proposed a methodology for monitoring just and reasonable net stranded costs that includes reporting to the LTTF (1) the over- or under-recovery of stranded costs collected through the wires charges from switching customers, (2) actual "above-market" or "potential" stranded costs exposure under capped rates, (3) the amounts expended from funds available under capped rates to mitigate potential stranded costs, and (4) additional expenditures that negatively impact (increase) such costs during the transition period.

Staff presented two methodologies. The first calculates just and reasonable net stranded costs based on an asset valuation methodology. The second is an accounting approach that (1) measures recoveries of stranded costs from capped rates and wires charges, (2) measures potential stranded costs on an annual historic basis, and (3) after July 1, 2007 could be used to calculate actual stranded costs on an annual historic basis.

The Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (the "Committees") proposed a methodology for calculating just and reasonable net stranded costs based on an asset valuation methodology for measuring stranded costs and incorporating stranded cost recoveries from both wires charges and capped rates.

Dominion Methodology

Dominion provided the following summary of its methodology for monitoring just and reasonable net stranded costs.[15]

[14] See Attachment No. 9 for comments regarding Staff's asset valuation methodology and Dominion's methodology. See Attachment No. 10 for comments to Staff's Recovery methodology, the Committee's methodology and further comments on Dominion's methodology as clarified on April 28, 2003.
[15] Dominion methodology revised as of April 28, 2003, and received by Staff via electronic mail.

Dominion Virginia Power's proposed methodology for monitoring "just and reasonable net stranded costs" would require a utility to calculate and report to the LTTF, for each year of the transition period, (1) whether there was an over- or under-recovery of stranded costs collected through the wires charges from switching customers and, if so, the amount thereof, (2) the company's actual "above-market" or "potential" stranded costs exposure under capped rates, (3) the amounts it has expended from funds available under capped rates to mitigate potential stranded costs, and (4) additional expenditures that negatively impact (increase) such costs during the transition period.

To make the determination required under (1), a company would compare the revenue collected annually from customers via the wires charges, based on the projected market prices established by the Commission, to the revenue that would have resulted had wires charges been based on the actual market prices experienced during that year. Projected market prices are based on actual forward market transactions and information prevailing at the time the Commission establishes wires charges, if any, to be in effect for the next calendar year. Actual market prices are based on actual market transactions ("settlement" or "spot" prices) and information prevailing at the time the energy could be delivered for sale. If the revenue collected through the wires charges was greater than the revenue that would have resulted had the actual market price been correctly predicted, the wires charges were set too high, resulting in an over-recovery for that year. If the contrary was the case, then there was an under-recovery.

Under (2), a utility would track the annual potential stranded costs exposure associated with customers still paying capped rates during the transition period. After the close of each year, the Company would compare actual market prices experienced during that year (using the same data as above) to the Company's unbundled generation rate, and a determination would be made of the potential total revenue impact had all sales been made at those market prices rather than at capped generation rates. This calculation would yield the potential stranded costs exposure during each year of the transition period.

Under (3), a utility would annually report to the LTTF the amounts it has expended for mitigation of potential stranded costs and, in (4), expenditures that add to potential stranded costs.

While these measures will provide the LTTF with annual information to monitor stranded cost recovery and the Company's potential stranded cost exposure, the over- or under-recovery of a utility's total stranded costs cannot be finally determined until after July 1, 2007. Until that date, the market prices existing at the end of the transition period cannot be determined.

Summary of Comments on Dominion's Proposal

In general, the incumbent electric utilities and the VIPP support Dominion's methodology.

The Old Dominion Cooperative's state:[16]

...this methodology is consistent with the spirit and the letter of the Restructuring Act...fully accommodates the majority positions expressed by the SJR 91 Drafting Group, the subcommittee as a whole and the General Assembly.... Other benefits of this proposed method are that it is transparent, easy to administer and easily understood. In addition, this method minimizes the financial risk to the incumbent electric utilities and measures the cost impact on the customers.... Finally, this proposed method would accommodate mitigation by the incumbent utility to help minimize over- or under-recovery of stranded costs.

Appalachian states:[17]

While the Company would support the Dominion Virginia Power stranded cost monitoring model as an approach to monitoring stranded cost recovery consistent with the Act, Appalachian continues to be concerned about the lack of development – both to date and anticipated – of a competitive retail market in Virginia and the clear implications of this condition for the LTTF's over/under-recovery assessment.

Allegheny:[18]

...feels this method is an equitable, easy to implement and customer friendly way to collect any stranded costs through the transition period. This method protects the customer from over or under paying the wires charges during the transition period. By providing the utility a chance to recover its capped rates through July 2007 it also allows the utility time to mitigate stranded costs where possible and gives the customers and shareholders time to adjust to the deregulated utility environment.

Allegheny goes on to point out the following disadvantage to Dominion's proposal:

If stranded costs exceed what is collected through capped rates or the wires charges through 2007 then the utility is not made whole. However, this disadvantage also serves as an incentive to the utility to mitigate its stranded costs as much as possible over the transition period.

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[16] See Attachment No. 9, April 18, 2003, letter from John A. Pirko, pages 1-2.
[17] Attachment No. 9, April 17, 2003, letter from Barry L. Thomas, page 1.
[18] Attachment No. 9, Comments by The Potomac Edison Company dba Allegheny Power, page 4.

VIPP expressed similar support for Dominion's proposal:[19]

> *[T]he Virginia Power approach is consistent with the Act...eminently practical and would fulfill the requirements of § 56-595.C (iii) because it would provide a basis for an analysis of whether stranded costs are likely to be over- or under-recovered in the future. Finally, the disclosure of amounts expended for stranded cost mitigation and additional expenditures during the transition period would be valuable. One of the Act's central goals is to ensure that Virginia's utilities would be ready to meet the challenge of retail competition. An evaluation of stranded cost mitigation and additional potential stranded cost exposure would enable the LTTF to consider whether this goal is being met.*

Comments received from competitive energy suppliers and consumer organizations were in contrast to those summarized above.

The Consumer Counsel offers the following comments in regard to Dominion's proposed methodology:[20]

> *The company is apparently seeking to extend the Act's wires charge recovery methodology to a method for calculating actual stranded costs. The company's proposal reflects the fact that stranded costs were not defined and quantified at the time of the Act's passage.*
>
> *The Commission has noted that under § 56-583 of the Restructuring Act, "wires charges serve as a 'proxy,' on a utility by utility basis, of stranded costs. Therefore, no actual determination of stranded costs is necessary as a precondition of receipt of wires charges."*[21] *Thus, while the Act allows utilities to recover any stranded costs via a wires charge (and through capped rates), amounts recovered by a wires charge are not synonymous with a utility's actual stranded costs, but are only a proxy for such costs.*
>
> *Because wires charges serve only as a proxy for stranded costs, this first proposal does not consider a utility's current generation costs in calculating stranded costs, but rather uses its capped rates and wires charges (unbundled generation cost) to represent its current cost of service. As a result, any stranded cost mitigation to date and going*

[19] Attachment No. 10, May 8, 2003, Comments of Virginia Independent Power Producers, Inc., pages 5-6.
[20] Attachment No. 9, Division of Consumer Counsel Office of the Attorney General Comments on Proposed Conceptual Models for Quantifying Just and Reasonable Net Stranded Costs, pages 4-5.
[21] Application of Northern Virginia Elec. Coop., for review of tariffs and terms and conditions of service, Case No. PUE-2002-00086, Final Order at 2, n. 3 (June 18, 2002).

forward due to reduction in operating costs, depreciation, or other factors (or any increased generation costs) are not captured under Proposal 1.

Virginia Citizens Consumer Council ("VCCC") states:[22]

This strategy still allows utilities to avoid identifying and quantifying the actual stranded costs. We need to determine what costs utilities cannot reasonably recover under the future competitive market, their quantity, and then what costs have been recovered through the wires charges and capped rates.

The Committees are also concerned that Dominion's proposal does not calculate just and reasonable net stranded costs. As stated in their comments:[23]

Virginia Power proposes to calculate the amount of revenue collected from wires charges, but not the over- or under-recovery of stranded costs recovered through wires charges. Virginia Power, moreover, proposes to ignore entirely any inquiry into the "under-recovery or over-recovery" of stranded costs through capped rates.

The Committees go on to state:

Virginia Power's proposal, as clarified, still fails to address the two sides of the inquiry required of the LTTF pursuant to Section 56-595.C (iii) of the Act as well as the directive in the LTTF's resolution.... Virginia Power's proposal would calculate neither the amount of "just and reasonable net stranded costs" nor their over- or under-recovery through revenues from wires charges and capped rates.

In regard to Dominion's proposal to calculate an annual stranded cost exposure, the Committees state:

The proposed calculation of annual stranded cost "exposure" is not a calculation of "stranded costs" or "just and reasonable net stranded costs," nor is it a calculation of the recovery of such costs through capped rates and wires charges. Thus, Virginia Power's proposal to calculate annual "exposure" to stranded costs may confuse, and potentially mislead, the inquiry required of the LTTF pursuant to Section 56-595 C (iii)....

Chaparral (Virginia), Inc. ("Chaparral") echoes the concerns of VCCC and the Committees with its statement:[24]

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[22] Attachment No. 9, VCCC Comments on Conceptual Models for Stranded Costs Over/Under Recoveries, dated April 16, 2003.
[23] Attachment No. 10, letter from Edward L. Petrini, dated May 8, 2003, pages 2-3.

Dominion's proposal remains deficient in that it does not address just and reasonable net stranded costs at all and does not include the revenue effects of capped rate recoveries.

VML/VACo APCo Steering Committee ("Steering Committee") has similar concerns with Dominion's proposal:[25]

Dominion's proposal, as clarified, fails to provide a methodology for calculating just and reasonable net stranded costs, nor does it calculate such costs or the amounts available for their recovery. Thus, it fails to meet the requirements of the Resolution.

NewEnergy summarizes its concerns as follows:[26]

In short, the Virginia Power proposal (1) fails to recognize stranded benefits, (2) incorporates a stranded cost methodology that clearly overestimates stranded costs and is fundamentally flawed, (3) fails to determine any stranded cost recovery attributable to collections under capped rates, and (4) provides no means of terminating or reducing wires charges prior to the end of transition period regardless of the level of stranded cost recovery.

Strategic Energy LLC ("Strategic Energy") is concerned that Dominion's methodology is incomplete for determining net stranded costs. They state two specific concerns:[27]

First, DVP proposes a flawed mechanism for determining the market value of assets by relying on the wires charge methodology. The wires charge methodology, fundamentally, uses spot market prices to set a proxy value for market revenues from a utility's generation assets. However, the true market value of any generation asset is based not just on the spot market-clearing price relative to its operating costs. A full and proper valuation must include the option value of the asset that is created by the market[28]. Second, DVP proposes to assess its "actual 'above-market' or 'potential' stranded cost exposure" but not its stranded benefits collected or accrued under the capped rates. The Act clearly requires that "net" stranded costs be monitored, which requires any stranded benefits be added to the equation.

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[24] Attachment No. 10, letter from Michael E. Kaufmann dated May, 8, 2003, page 2.
[25] Attachment No. 10, letter from Thomas B. Nicholson dated May 8, 2003, page 9.
[26] Attachment No. 10, letter from Eric W. Matheson dated May 8, 2003.
[27] Attachment No. 10, letter from Michael Swider dated May 8, 2003, page 1.
[28] For example, an asset owner with a flexible unit can sell into the bilateral market and maximize the option value of the unit by running the unit (covering its short position) only when spot price exceeds the contract price.

Pepco Energy Services makes the following comments:[29]

This proposal is flawed in that it does not measure the over or under recovery of stranded costs but merely compares actual versus forecasted prices. There is no defining of stranded costs or how the wires charges are used to offset those costs.

Pepco Energy Services goes on to state:

Pepco Energy Services would concur that cost mitigation measures should be tracked and reported but would argue that this does not mitigate the need to calculate total stranded costs....

Washington Gas Energy Services ("WGES") discusses five deficiencies to Dominion's model:[30] (1) it fails to meet the fundamental task of computing and quantifying stranded costs; (2) it would omit the recognition of stranded costs recovered or to be recovered through capped rates; (3) the premise that stranded costs are only to be based on revenues collected from wires charges is false; (4) it purports to deal with expenditures to mitigate potential stranded costs and not actual stranded costs; and (5) it does not permit the LTTF to discharge its obligations under § 56-595 of the Restructuring Act.

WGES summarizes it comments as follows:[31]

WGES is not persuaded that Dominion's approach properly deals with over/under recovery of stranded costs through revenues from wires charges only. Further, the methodology proffered would not lead to the calculation of stranded costs for each utility company as intended by the LTTF, further refinements and clarifications included. Therefore, we remain opposed to the Dominion proposal.

The National Energy Marketers Association ("NEM") also expressed concern with Dominion's proposal:[32]

NEM is concerned that the [Dominion] proposal will not provide any future certainty on the level of net stranded costs to be collected through the wires charges and bundled rates until after the transition period has expired.

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[29] Attachment No. 10, letter from A. Glenn Simpson received May 8, 2003, pages 6-7.
[30] Attachment No. 9, letter from Ransome E. Owan, Ph.D., dated April 16, 2003, pages 1-3.
[31] Attachment No. 10, letter from Ransome E. Owan, Ph.D., dated May 7, 2003, page 2.
[32] Attachment No. 10, May 7, 2003 Comments of the National Energy Marketers Association, page 3.

Staff's Analysis of Dominion's Methodology

Requested Action No. 8 of the LTTF's resolution instructs the Commission staff, in the absence of consensus recommendations, to provide an analysis of each work group recommendation. Dominion's proposal for monitoring stranded costs fails to meet the requirements of the LTTF's directive. Although Staff agrees with the comments of the utilities that Dominion's methodology is easy to administer; the fact that it does not calculate just and reasonable net stranded costs and does not quantify stranded cost recoveries from capped rates makes it unacceptable.

The LTTF's resolution Requested Action No. 2 (b) is clear,

> *A methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.*

It seems logical that, to calculate whether an over- or under-recovery of stranded costs has resulted, or is likely to result, one would need two numbers. The first number being a quantification of stranded costs and the second number being recoveries of stranded costs. This is precisely what the LTTF asks for in its Resolution in Requested Action No. 3. Dominion's proposal fails to quantify either of these numbers. Requested Action No. 3 reads:

> *(a) The amount of each incumbent electric utility's just and reasonable net stranded costs.*
> *(b) The amount that each incumbent electric utility has received, and is expected to receive over the balance of the capped rate period, to offset just and reasonable net stranded costs from capped rates and from wires charges.*

Dominion's methodology is based on its premise that just and reasonable net stranded costs are defined within the Restructuring Act as a result of the methodology for calculating wires charges. However, the Restructuring Act only addresses stranded costs in two sections. First, § 56-584 provides a methodology for the recovery of stranded costs and, second, § 56-595 C (iii) instructs the LTTF to monitor that recovery. The Restructuring Act neither defines stranded costs nor does it provide a methodology for calculating stranded costs. Further, the LTTF's Resolution plainly requests that a calculation of just and reasonable net stranded costs be made. Dominion's proposal offers no such calculation.

The second number to be calculated is stranded cost recoveries. Again, Dominion's proposal fails. It provides for no quantification of stranded costs recoveries. Dominion's proposal is simply a true-up mechanism that ensures switching customers pay wires charges based on actual market rates rather than projected. The proposal ignores stranded cost recoveries from capped rates. However, § 56-584 of the Restructuring Act is unambiguous in stating that just and reasonable net stranded costs are recoverable through either capped rates or wires charges. Recoveries via capped rates cannot be ignored. As will be discussed in more detail below, Dominion, while incurring expenses to mitigate stranded costs, has recovered substantial amounts of stranded costs via capped rates. When calculating an over- or under-recovery of stranded costs these recoveries must be accounted for.

Staff's Methodologies

Asset Valuation Methodology

Staff presented an asset valuation methodology for determining just and reasonable net stranded costs. This type of methodology has been used in various jurisdictions throughout the United States to calculate stranded costs. Staff requested written comments on the asset valuation methodology as summarized below:

> *To calculate just and reasonable net stranded costs, compare asset values based on net present value cash flows that arise from remaining in a regulated market (cost plus a fair return) to the net present value cash flows that arise in a competitive market (over the life of the assets). From this amount subtract recoveries via capped rates (to the extent capped rates exceed actual costs including a fair return) and wires charges to determine the over- or under-recovery of just and reasonable net stranded costs.*

Summary of Comments Regarding the Asset Valuation Methodology

As can be seen from the summary below, generally, the incumbent electric utilities and VIPP are opposed to calculating just and reasonable net stranded costs using an asset valuation methodology. The primary concerns expressed are that such a calculation is not consistent with the Restructuring Act and the complexity of the methodology.

Dominion states that the description provided of the asset valuation methodology does not reflect the complexity of its application. Thousands of data inputs would be necessary. A further complication may be requirements placed on an incumbent utility associated with default service.

Dominion states that the Restructuring Act was developed to provide for "flexibility" with respect to policy implementation and administration.[33]

[33] Attachment No. 9, Response of Dominion Virginia Power to the "Generalized Framework" Presentation by Howard Spinner on April 7, 2003, page 6.

...wires charges collected serve to prevent the utility from experiencing lost revenues due to a customer's decision to switch to a CSP. In addition, funds available from capped rates during the transition period may permit a utility to mitigate its above-market costs until July 1, 2007. The amount and timing of such mitigation is the "flexibility" that each utility has under the Act....

Finally, Dominion claims that the asset valuation methodology requires that a determination of a utility's revenue requirement be made annually. Dominion agues that this is contrary to the Restructuring Act which provides only limited options for changes to capped rates and these are held solely by the utilities.[34]

The Old Dominion Cooperatives summarize their opposition to the use of the asset valuation methodology as follows:[35]

The Cooperatives do not endorse this proposed model. Staff's proposed methodology is not consistent with the spirit and the letter of the Restructuring Act, and implementation would require that many of the tasks and analyses specifically rejected by the SJR 91 Drafting Group, the subcommittee and the General Assembly be undertaken now, well into scheduled period for the transition to retail access. The Staff method would require a forecast of asset value as part of the competitive market analysis, an approach not adopted under the Restructuring Act. Further, before implementing Staff's proposal, some agreement would have to be achieved regarding the methodology for forecasting the future market and price, the overall time period to be covered by the analysis and the proper discount rate to use over the period of the forecast.

Appalachian is similarly opposed to the asset valuation methodology. Appalachian states:[36]

Neither of these sections [§§ 56-584 and 56-595 C] says anything about the calculation of stranded costs except that the LTTF monitoring is to be consistent with § 56-584 which, in turn, requires recovery of stranded costs to be in accordance with the capped rates and wires charges sections of the Act.

Appalachian goes on to say:

The fundamental concept of the Act was that incumbent electric utilities would be entitled to, and would accept the risk of, the rate levels

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[34] *Id.*, pages 7-8.

[35] Attachment No. 9, letter from John A. Pirko dated April 18, 2003, page 2.

[36] Attachment No. 9, letter from Barry L. Thomas dated April 17, 2003, page 2. Appalachian states its comments are in regard to both Staff's and the Committees' methodologies, which Appalachian believes are similar.

established in the Act for a limited period of time (until July1, 2007). The Staff model would appear to suggest critical changes in these provisions of the Act based solely on reliance on the single provision that requires monitoring of stranded cost recovery.

Allegheny noted the following disadvantage to the asset valuation methodology:[37]

This model would require a significant amount of resources, projections, opinions regarding pricing and environmental issues, etc., to address the many variables and assumptions that would be necessary to prepare a point in time estimate of stranded costs or benefits of each generation unit. Due to the complexity of such a model and the limitations of a point in time estimate of future values, it is highly unlikely that the net present value result of the calculation would be meaningful.

In its comments, VIPP spends considerable time reviewing the difficulties inherent in the asset valuation approach. VIPP addresses the issues involved in projecting market prices and a utility's cost of service as well as problems associated with determining recovery of stranded costs through capped rates. VIPP provides the following summary:[38]

In sum, the challenges inherent in the post-2007 projections that are an integral part of Proposal Two are vast and unfathomable. The difficulty of these challenges <u>is huge in comparison</u> to those discussed above in the context of the futuristic ratemaking exercise that would be required under the Commission methodology during the pre-2007 period. While the pre-2007 analyses are at least tenuously rooted in present-day facts, the post-2007 projections would be free-floating guesswork, impossible to benchmark against any independent standard.

In providing general comments on the two proposed methodologies (Dominion's and asset valuation), Consumer Counsel states:[39]

Consumer Counsel can support the use of a "lost revenues" approach of quantifying stranded costs. While a lost revenues approach is not perfect, and typically requires many assumptions, it is generally the most appropriate method for calculating stranded costs in Virginia since the Restructuring Act does not mandate or provide for market-based approaches – such as plant divestiture or capacity auctions – to be used to determine stranded costs. A lost revenues method is consistent with Consumer Counsel's definition of "stranded cost"....

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[37] Attachment No. 9, Comments by The Potomac Edison Company dba Allegheny Power, page 2.
[38] Attachment No. 9, April 18, 2003 Comments of VIPP, page 12.
[39] Attachment No. 9, Division of Consumer Counsel Office of the Attorney General Comments on Proposed Conceptual Models for Quantifying Just and Reasonable Net Stranded Costs, page 3.

In reference to Staff's proposed asset valuation methodology, Consumer Counsel goes on to state:[40]

> *While many details regarding the calculation mechanics and assumptions will have to be addressed in order to apply this proposal, it appears the conceptual framework is not inappropriate, and is consistent with lost revenues approaches that have been used in other jurisdictions to quantify stranded costs.... This approach, however, would be difficult to undertake in a work group setting as it most likely would require involved proceedings with expert testimony subject to cross examination.*

The Consumer Counsel recommends that the above description be modified by (1) clarifying the terms "cash flows" and "recoveries" by use of the term "regulated and market-based revenues," (2) to include regulatory assets and liabilities; and (3) to clarify that the methodology should quantify the Virginia retail jurisdictional share of stranded costs. The Consumer Counsel also points out the need for accurate current information, reasonable forecasts, and use of an appropriate discount rate to arrive at a reasonable estimate of stranded costs.[41]

VCCC summarizes the advantages of the asset valuation methodology as follows:[42]

> *This strategy actually is a means to compare income from a regulated market with a competitive market and takes into consideration the full lifetime value of assets. After calculating the stranded costs it requires subtracting excess revenues from capped rates (subtracting actual costs and a fair return from capped rates) and wires charges. This is fair and reasonable.*

VCCC also recognizes the difficulties associated with this methodology:

> *It is based upon future market prices, on which it is likely the various parties will continue to disagree.*

The Committees, while recognizing the limitations on administrative models and the critical importance of the underlying assumptions,[43] support the asset valuation methodology stating:[44]

> *The Commission Staff's proposal recognizes both sides of the inquiry required of the LTTF – i.e., (i) just and reasonable net stranded costs and*

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[40] *Id.*, page 6.
[41] *Id.*, pages 6-7.
[42] Attachment No. 9, VCCC Comments on Conceptual Models for Stranded Costs Over/Under Recoveries, dated April 16, 2003.
[43] Attachment No. 7, The Committees March 21, 2003, Responses to Questions Regarding Just and Reasonable Net Stranded Costs, page 2.
[44] Attachment No. 9, letter from Edward L. Petrini, dated April 16, 2003, page 2.

(ii) the amount available for recovery of such costs through wires charges and capped rates.

The Committees suggest two clarifications to the asset valuation methodology described above.[45] First:

The calculation should be characterized as the NPV of the difference between the market value and the regulated value of the utility's generation assets over their remaining useful lives. In other words, the calculation should be characterized as having only one NPV cash flow (i.e., the difference), not the difference between two NPV cash flows.

and

Second, Staff's methodology might be interpreted to preclude calculation of the "likely" over-recovery or under-recovery of just and reasonable net stranded cost, as provided in Section 56-595.C (iii), because of Staff's reference to "actual costs."

Chaparral offered general support for the asset valuation methodology with the recommendation that the phrase "costs plus (or including) a fair return" be modified to read "*just and reasonable, prudently incurred non-mitigable generation*" costs plus (or including) a fair return."[46]

WGES recognizes the complexity of this methodology, including its data intensiveness and numerous assumptions, but believes these complexities are the inherent nature of establishing total stranded costs. WGES believes:[47]

It is a balanced approach that seeks to establish stranded costs first, set a recovery schedule and determine the over- or under-recovery of just and reasonable net stranded costs, at least annually, until the expiration of the transition period on July 1, 2007. The final recoverable amount for stranded costs should be known by June 30, 2007. And by July 1, 2007 and thereafter, there would be no opportunity to collect stranded costs through capped rates or wires charges by an incumbent utility company.

WGES notes an additional benefit of this method is that it provides for the opportunity to terminate capped rates after January 1, 2004, because once the determination of stranded costs is made it is conceivable to recover those costs on an accelerated basis.[48]

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[45] *Id.*, page 3.
[46] Attachment No. 9, E-mail from Michael Kaufmann dated April 16, 2003.
[47] Attachment No. 9, letter from Ransome Owan, Ph.D., dated August 16, 2003, page 3.
[48] *Id.*, page 3-4.

NewEnergy also supports the asset valuation methodology stating that it: (1) addresses the core issue of stranded cost determination; (2) more accurately reflects the change in generation portfolio over time; (3) includes appropriate stranded cost mitigation provisions; and (4) includes a robust examination of market rates to accurately reflect the competitive realities of the stranded costs determination. NewEnergy recognizes this methodology's complexity and data intensiveness as a weakness; however, believes it is necessary in order to ensure an outcome that is in the public interest.[49]

Staff's Analysis of the Asset Valuation Model

Stranded costs are not easy to measure and are invariably controversial. Analysts have used or considered several methods to complete stranded cost determinations. Employed methods differ by whether stranded costs are quantified before or after restructuring takes place, whether they are based on analysts' estimates or on actual market valuations of assets (as determined by asset sales), and whether they look at a firm's individual assets or take a more aggregate, "top-down" approach.

Deciding how to measure stranded costs involves more than just seeking an accurate quantification while avoiding methods that would interfere with efficient actions by market participants. Two other considerations also affect the decision. First, measurement methods may be tied to policies about how to compensate incumbents. For instance, if policymakers decide that incumbents should receive a single, up-front payment or a fixed amount paid over time, then the method will have to be one that can be used before restructuring takes place (an ex ante estimate[50]). If, however, policymakers want to see how restructuring turns out before deciding how much to pay, only later (or ex post) methods of stranded cost determination are feasible.

Second, other decisions about how to restructure the industry affect which measurement methods are feasible. If, for example, policymakers decide that vertically integrated incumbents must divest themselves of their generating assets to avoid excessive market power, then one estimate of stranded costs becomes the difference between the book value of an asset and its selling price. This approach can be used for a single production asset or a "fleet" of generating plants. California and Massachusetts required such divestiture and, at least partly, based estimates of stranded costs on market prices. At one time Arizona linked divestiture of generating assets with compensation for stranded costs. Voluntary or required asset sales have also occurred in many other states[51] and the proceeds of those sales have mitigated previously quantified stranded costs. This path is not contemplated for Dominion Virginia Power or AEP-Virginia.

Virginia's legislatively mandated approach to the stranded cost issue answers many of the basic questions posed by not requiring an up-front determination of stranded

[49] Attachment No. 9, letter from Eric W. Matheson dated April 16, 2003, pages 4-6.
[50] This appears to be the most common approach.
[51] New Jersey, New York, Montana, Maine, New Hampshire, Connecticut, Virginia (Delmarva), Maryland, Pennsylvania, Rhode Island.

costs. Virginia's approach is very different from approaches employed in other jurisdictions. Except as may be required by analysis performed pursuant to § 56-595 C (iii) of the Virginia Electric Utility Restructuring Act ("the Act"), the Act does not require a quantification of stranded costs. Nor does the Act allow the SCC to require divestiture of generation units.

The current work group effort leading to this Report was convened pursuant to § 56-595 C (iii) of the Act. As a general approach, this Report will not comment on the many legal opinions regarding whether the asset valuation method is or is not consistent with the Act or the intent of the Legislature. This Report is tendered to a body of the Legislature that can determine which proposals contained in this Report are or are not consistent with the Act and/or Legislative intent.

This Report will discuss other substantive issues raised in response to the asset valuation method. Those comments generally include the criticism that the asset valuation method is too difficult, too controversial and too data intensive to be beneficially employed to calculate stranded costs in Virginia. The short answer is that the asset valuation method is not too difficult, too controversial or too data intensive to be used to estimate the value of a utility's generation asset portfolio. This method is used everyday by industry participants for a number of business purposes. While the method may be data intensive and based on uncertain forecasts, it is relied upon every day as business is transacted in this and many other industries.

The asset valuation model seeks to arrive at the value of a particular utility's portfolio of generation assets under competition and compare that value to a utility's book value for those same generation assets. For this purpose, the book value is the value of the assets assuming a continuation of cost of service regulation. If the utility's assets are worth more under regulation, the utility has stranded costs. Since the value of a utility's portfolio of generation assets under continued regulation is relatively easy to determine, the hard part of the asset valuation exercise is the quantification of generation asset values under competition.

It is the quantification of asset values under competition that draws the most criticism from the stakeholders. This analysis requires many forecasts and assumptions. While individual firms perform this analysis on a daily basis, the technique is not well suited for a consensus seeking process. Finding a consensus for all of the required inputs will most certainly be next to impossible.

As stated above, individual firms do indeed perform such analyses all the time. Firms undertake a process to determine the necessary assumptions and then perform the analysis. Asset values are thus determined and plants are built, sold, otherwise traded or contracts are negotiated and executed. Business happens. The many assumptions to complete this analysis relate to electricity market price projections, asset lives, plant output (MWH), fuel prices, other variable costs, and discount rates.

Given these assumptions, one of the most widely used models for assessing the value of long-lived assets --- such as generation assets --- is discounted cash flow (DCF) valuation. DCF valuation relates the value of an asset to the present value of expected future cash flows from that asset. In DCF valuation, cash flows are discounted at a risk-adjusted discount rate to arrive at an estimate of value. DCF techniques are relevant whenever a company contemplates an action entailing costs or benefits that extend beyond the current period. Cash flow is the difference between dollars received and dollars paid out. Because money has a time value, it is necessary to adjust investment cash flows for the differing time value through discounting. Discounting is the process of finding the present value of a future sum. The interest rate used in present value calculations is frequently called the discount rate. The discount rate is the rate of return expected by buyers of the securities used to finance the purchase of the asset. The discount rate, also know as the cost of capital, is the expected return that is forgone by investing in a project rather than in comparable financial securities. [52]

To implement a DCF valuation approach, it is necessary to (1) find the present value of cash inflows and outflows (CF) discounted at the asset's cost of capital (k); and (2) sum these discounted cash flows. This sum is defined as the asset's net present value (NPV). NPV is an asset's net contribution to wealth – present value minus initial investment.[53]

The rationale for the NPV is straightforward. A NPV of zero signifies that an asset's cash flows are sufficient to repay the invested capital and to provide the required rate of return on that capital. If an asset has a positive NPV, then it is generating more cash than is needed to service its debt and to provide the required rate of return.

Use of DCF techniques forms the basis for use of the asset valuation method. Once asset values are determined they can be summed and compared to a utility's book generation costs to determine if a utility has any stranded costs. This "total" stranded cost number may next be compared to any recoveries that a particular utility may have collected under capped rates or wires charges to determine whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the over-recovery or under-recovery of just and reasonable net stranded costs.

Staff's Accounting Approach

As discussed above Staff supports the use of an asset valuation methodology to quantify just and reasonable net stranded costs. As the work group progressed in its discussions, Staff believed it was appropriate to provide further explanation of how to best calculate recoveries of stranded costs in the above model. Further, Staff believed Dominion's proposal was inadequate in measuring recoveries as it does not quantify

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[52] Brealey, Richard A. and Myers, Steward C., Principles of Corporate Finance, New York, 1996, p. G9.
[53] The equation for the NPV of an asset is:
$NPV = CF_0 + CF_1/(1+k)^1 + CF_2/(1+k)^2 + \ldots + CF_n/(1+k)^n$, or
$NPV = \sum CF_t/(1+k)^t$
Here CF_t is the expected net cash flow at period t, k is the asset's cost of capital, and n is its life.

recoveries via capped rates. Therefore, Staff requested written comments on the following accounting approach[54] which can be used in conjunction with the asset valuation methodology to calculate stranded cost recoveries, or as an alternative to Dominion's monitoring proposal.

Stranded Costs – An Accounting Perspective

An alternative method that would indicate annual recoveries of stranded costs throughout the transition period is an accounting approach based on an earnings test mechanism. This mechanism could also be used to calculate the level of potential stranded cost exposure existing during each earnings test year. This approach would not provide for an upfront calculation of what total stranded costs are estimated to be, but could work in conjunction with the other proposed methods by providing stranded cost recovery information.

It is important to define stranded cost terms relative to this accounting approach:

- ***Recovery of stranded costs**: Recovery of stranded costs occurs throughout the capped rate period to the extent actual earnings exceed costs plus a fair return. These recoveries can be calculated and monitored using the earnings test mechanism.*
- ***Actual stranded costs**: Defined as the underrecovery of just and reasonable generation costs in a competitive environment. Actual stranded costs would occur after the termination of capped rates and wires charges if actual generation costs exceed market prices.*
- ***Potential stranded costs**: Defined as the annual stranded cost exposure during the capped rate period, assuming all customers are paying market rates for generation service. This amount is represented by the difference between the recalculated, cost-based unbundled generation rates (at a fair return) and the actual market rate for the applicable year, times total annual sales.*

Earnings test[55] information is already required to be filed by investor-owned utilities under the Commission's existing rate case rules and Annual Informational Filing requirements. Earnings tests only recognize limited accounting or regulatory adjustments to per book amounts, and do not encompass going forward adjustments. Generally, earnings test adjustments restate per book results in order to reflect differences between generally accepted accounting principles and how costs are recognized for ratemaking purposes. It would be necessary to agree upon an appropriate fair rate of return to use as a benchmark return on equity from which to measure earnings available for stranded cost recovery.

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[54] Staff proposal sent to work group participants via electronic mail April 28, 2003.
[55] An earnings test measures a utility's earnings on a regulatory basis by making limited adjustments to its financial records.

A bundled earnings test should be used until such time as bundled, capped rates are terminated. It is proper to use a bundled earnings test since all earnings produced under bundled, capped rates that are in excess of actual costs plus a fair return can be used to mitigate stranded cost exposure.

The determination of potential stranded costs will require a functionalized cost of service study that separates out the generation business. The cost of service study would incorporate the earnings test adjustments applicable to the test period. Actual generation costs for the test year including a fair return would then be used to calculate current, cost-based, unbundled generation rates by customer class. These generation rates would be compared to market-based rates applicable to the test year to calculate the potential stranded cost exposure for that year.

Throughout the transition period, comparisons can be made between stranded cost recoveries and potential stranded cost exposure. This will provide insight into the success of mitigation efforts, and the likelihood of whether an over or underrecovery of stranded costs will occur. By the end of the capped rate period, the earnings tests will have quantified the cumulative net recoveries of stranded costs, and we will be able to more accurately determine any stranded cost exposure going forward at that time, based on the same potential stranded cost calculations. Continued earnings monitoring after the termination of capped rates on the unbundled generation business could provide a calculation of actual stranded costs or benefits on an annual basis.

Summary of Comments Regarding Stranded Costs – An Accounting Perspective

Dominion believes that, through this methodology, Staff is attempting to reinstitute ratemaking during the capped rate period:[56]

...the Staff proposes to cap a utility's earnings at a Commission-approved rate of return and to treat any earnings above such return as a "recovery of stranded costs." ...the inevitable disagreements would have to be resolved in a Commission proceeding.

Dominion claims that Staff wants to "manage" stranded cost mitigation efforts. They discuss the flexibility provided by the Act and state:[57]

The Commission Staff is advocating a limit on the Company's flexibility just as the Company has begun to make progress in mitigating its potential stranded costs.

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[56] Attachment No. 10, May 8, 2003 Response of Dominion Virginia Power to Commission Staff's "Stranded Costs – An Accounting Perspective" Method and the Virginia Committee for Fair Utility Rates' Method, page 1.
[57] *Id.* pages 4.

The Old Dominion Cooperatives state that the accounting methodology is inconsistent with the Restructuring Act. Further, they state:[58]

> *...Staff's proposed mechanism has many of the trappings of a traditional rate case and appears essentially to require that an abbreviated rate case be conducted for each incumbent utility. ...not only would the analysis be conducted through the capped-rate period, it apparently would continue from year-to-year after July 1, 2007, and, in spite of the terms of the Act, provide a measure of stranded benefits.*

The Old Dominion Cooperatives also pointed out several problems with applying this methodology to cooperatives. First, cooperatives do not make annual informational filings with the Commission. Second, cooperatives have never used rate of return or return on equity as an earnings measure. Third, the Old Dominion Cooperatives are not vertically integrated.

Appalachian expresses concerns similar to those of Dominion. It states that:[59]

> *Rather than monitor the performance of the capped rate and wires charges provisions of the Act each of these methodologies appears directed at re-evaluation of the reasonableness of capped rate revenue levels.*

Appalachian continues:

> *The only objective reading of the current legislation as a whole is to conclude that the General Assembly intended neither to increase nor decrease capped rates prior to July 1, 2007 except in the limited manner expressly stated in the Act. For this reason, the methodology suggested by the Staff and the Committees is either inconsistent with the capped rate provisions of the Act because it would contemplate changing capped rates for reasons not set forth in the Act, or it would require time-consuming and expensive rate analyses and proceedings, with little or no impact on customers and raising utilities' costs without tangible benefit for either customers or companies.*

Appalachian points out one further concern relative to the use of a bundled earnings test:

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[58] Attachment No. 10, May 8, 2003 Stranded Cost Comments of the Virginia Electric Cooperatives, page 2-3.

[59] Attachment No. 10, May 8, 2003 Stranded Cost Comments of Appalachian Power Company in Response to the SCC Staff's April 30, 2003 Request for Comments, page 7-10. It should be noted that in these comments Appalachian considers the Staff and Committee proposals to be similar and addresses them simultaneously.

The suggestion that cost reductions in distribution and transmission functions should be used to offset stranded generation costs is inconsistent with the provisions of § 56-590 prohibiting one utility function from subsidizing another.

Allegheny provides general comments stating that it would be inappropriate to require a quantification of stranded cost recoveries from capped rates for their company because it entered into a memorandum of understanding[60] wherein, among other things, it waived its right to assess a wires charge. Allegheny claims that calculating stranded costs and recoveries via capped rates will substantially increase the risk it agreed to in the memorandum of understanding.[61]

In regard to Staff's proposal to measure potential stranded costs Allegheny states the following:[62]

AP feels that the above methodology may be an exercise that provides information that has little practical value. If market prices are low after the transition period, utilities may be better able to compete if they have successfully mitigated costs to at or near or below market levels. If market prices are high, a utility may enjoy the benefits of a lower cost product relative to the market price through its successful cost mitigation efforts.

Allegheny suggests that:

...a better indicator of the potential stranded cost exposure is reflected by how customers have responded since competition began in Virginia. If the Commission requires the use of the recovery of stranded cost calculation, the better estimate of an over or underrecovery of potential stranded costs may be to compare any recovery of stranded cost amounts to the amount collected through the wires charge each year.

VIPP offered comments[63] similar to those expressed by the electric utilities including that Staff's use of excess earnings to measure stranded costs is inconsistent with the Restructuring Act. VIPP believes this proposal will penalize a utility for implementing cost-cutting measures. Finally, resolution of issues in annual informational filings would effectively require utilities to "engage in complex annual rate cases."

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[60] The memorandum of understanding was entered into in the functional separation plan, Case No. PUE-2000-00280.

[61] Attachment No. 10, May 8, 2003, Comments by The Potomac Edison Company dba Allegheny Power, page 1.

[62] *Id.*, pages 3-4.

[63] Attachment No. 10, May 8, 2003, Comments of Virginia Independent Power Producers, Inc., to the Stranded Costs Working Group, pages 3-4.

In regard to the earnings test approach the Consumer Counsel sees value in its use in measuring recoveries through capped rates stating:[64]

> *Because the Restructuring Act provides that stranded costs are recovered through both capped rates and wires charges, an approach that considers recoveries through capped rates could be beneficial inasmuch as there is currently little customer switching and thus limited stranded costs recovery via wires charges.*

Concerning continued monitoring beyond July 1, 2007, the Consumer Counsel states it is unclear what benefits would be realized since stranded cost recoveries are limited to the capped rate period.

VCCC believes the method could work, but may be undermined by participants that may contest the number of assumptions that will be necessary.[65]

The Committees state that the proposal to use an earnings test based on a utility's annual information filing is an acceptable means to measure stranded costs recoveries via capped rates. However, the Committees do not support the proposal to measure a utility's potential stranded costs exposure. The Committees do not see what additional "insight" would be gained from this information.[66]

Chaparral offers support in using the earnings test approach in conjunction with an asset valuation methodology, but states it is "inferior" as a stand alone methodology because it does not make an initial calculation of stranded costs.[67]

Similarly, the Steering Committee supports the earnings test proposal to measure stranded cost recoveries from capped rates. However, the Steering Committee does not support the calculation of potential stranded cost exposure proposed as part of this methodology. It believes that it is similar to Dominion's proposal and fails to calculate stranded costs.[68]

Several competitive service providers[69] also provided comments on Staff's Accounting Approach. With the exception of WGES, these participants are generally in favor of using an earnings test methodology, based on annual informational filings, to determine historical stranded cost recoveries from capped rates. However, they believe an asset valuation methodology must be used to calculate just and reasonable net stranded costs and generally disagree with the calculation of potential stranded costs. NewEnergy

[64] Attachment No. 10, May 8, 2003, Division of Consumer Counsel Office of the Attorney General Supplemental Comments, page 1-2.
[65] Attachment No. 10, May 13, 2003, Virginia Citizens Consumer Council Comments, page 2.
[66] Attachment No. 10, May 8, 2003 letter from Edward L. Petrini, page 4.
[67] Attachment No. 10, May 8, 2003 letter from Michael E. Kaufmann, page 2.
[68] Attachment No. 10, May 8, 2003 letter from Thomas B. Nicholson, pages 5-7.
[69] Constellation NewEnergy, Strategic Energy, Pepco Energy Services, Washington Gas Energy Services and the National Energy Marketers Association provided comments on the Staff's proposed Accounting Approach. See Attachment No. 10.

states that the calculation of potential stranded costs is of no value because as long as there is a wires charge, there are no stranded costs.

Pepco Energy Services disagrees with the definition of actual stranded costs provided in this methodology in that stranded costs are defined to occur after the end of capped rates, if a utility's actual generation cost exceeds market. Pepco Energy Services states that it is the end of the monopoly franchise, not the end of capped rates that creates stranded costs. Pepco Energy Services also disagrees with Staff's calculation of potential stranded costs stating that its use will:[70]

> *...(a) impair the functioning of a competitive market by creating price uncertainty, and (b) necessitate further complication by making it a certainty that there will be either over or under recovery, and rates will have to be developed to address this eventuality.*

WGES is opposed to Staff's Accounting Approach. WGES summarized its concerns as follows:[71]

> *Although Staff's proposal was presented as complimentary to the Asset Valuation Model, WGES could neither support a method that fails to compute stranded costs nor a new recovery mechanism outside capped rates and wires charges. It would also not be appropriate to assume that actual stranded costs would occur after the expiration of any recovery mechanism as the accounting approach would entail. The public interest and that of the orderly development of competition in the Virginia electricity market would be well served if potential and actual stranded costs considerations are concluded within the transition period without further meddling with "cost-based unbundled generation rates (at a fair return)" as the model also contemplates. The latter would seem an unacceptable cost-of-service scenario to deal with stranded costs. Based on the aforementioned, WGES is not in favor of the accounting perspective presented by Staff on April 29, 2003.*

NEM did not provide specific comments to Staff's Accounting Approach, but stated that properly unbundled rates, if properly mitigated, provide recovery of stranded costs over a reasonable period of time.[72]

<u>Staff's Analysis of the Accounting Approach</u>

The primary purpose of the accounting approach is to provide a means of calculating stranded cost recoveries from capped rates and wires charges. It should be used in conjunction with the asset valuation methodology described above. This

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[70] Attachment No. 10, May 8, 2003 letter from A. Glenn Simpson, page 6.
[71] Attachment No. 10, May 7, 2003 letter from Ransome E. Owan, Ph.D., page 2.
[72] Attachment No. 10, May 8, 2003, Comments of the National Energy Marketers Association, page 3.

approach does not require annual rate cases, and does not remove any "flexibility" from utilities in their stranded cost mitigation efforts.

As discussed above, the total just and reasonable net stranded cost calculated using the asset valuation methodology must be compared to stranded cost recoveries from capped rates and wires charges. As a basis to determine such recoveries Staff recommends using the information currently provided by investor-owned electric utilities in annual informational filings (AIF) made with the Commission. Part of the AIF filing requirements is an earnings test. An earnings test measures a utility's earnings on a regulatory basis by making limited adjustments to its financial records. By providing earnings on a regulatory basis this analysis provides the Commission with a measure of how a utility is performing as compared to the earnings opportunity level provided in that utility's most recent rate proceeding. Historically, the AIF and earnings test monitoring conducted by the Commission have been relatively non-controversial. This is not to say that such an analysis will be easy. Staff expects disagreements to arise over various issues, including appropriate return on equity. However, the Commission has considerable experience in such matters and is fully equipped to handle them.

Staff has conducted earnings test analyses on Dominion since 1987. Since 1999 such analyses have been aimed at measuring recoveries of stranded costs, including generation-related regulatory assets.[73] Staff proposes to continue this type of analysis to quantify stranded cost recoveries. Dominion has recently filed with the Commission its AIF based on calendar year 2002 operations. The filing includes an earnings test of which Staff has conducted a cursory review. Attachment No. 6 to this report reflects the level of stranded costs recovery, by year, based on Dominion's filings since 1999. On a cumulative basis the attachment reflects $886 million of net stranded cost recoveries.[74] It is important to note that this recovery level is after substantial mitigation costs incurred by Dominion.[75] Although Staff does not have the total cost of mitigation incurred between 1999 and 2002, an example of such expense is amounts spent to mitigate contracts with non-utility generators. Dominion has incurred approximately $173 million of costs to mitigate contracts with non-utility generators between 1999 and 2002.[76]

Conducting annual earnings test analyses does not lessen the flexibility of utilities to mitigate stranded costs. Staff believes it is reasonable for utilities to continue their mitigation efforts. The earnings test analysis measures a utility's earnings based on actual results with only limited regulatory adjustments. Therefore, the costs associated with mitigation efforts would be included in the current year expenses and the Commission would be assessing earnings remaining after the cost of mitigation efforts. Staff does not propose that the Commission limit mitigation efforts or manage those efforts.

[73] A generation-related regulatory asset is an example of a stranded cost.
[74] The amounts stated on this page are reflected on a Virginia jurisdictional basis.
[75] Earnings test information for other electric utilities is not fully available at this time.
[76] Above market non-utility generator contracts is another example of stranded costs. The majority of this expense was incurred in 2001 when Dominion bought out its contract with LG&E.

Together the asset valuation methodology and the earnings test measure of stranded cost recoveries provide an estimate of any current or potential over- or under-recovery of just and reasonable net stranded costs. Some work group participants expressed concern that the Commission might adjust capped rates as a result of this analysis; however, the Restructuring Act does not provide for such Commission action.

The annual determination of potential stranded costs caused some work group participants distress. Should the LTTF find that determining just and reasonable net stranded costs using an asset valuation approach is inappropriate, Staff offers this methodology as an alternative. Potential stranded costs would be determined by comparing a utility's generation rates, based on its current cost of service, to market rates. The difference would be multiplied by total kWh sales to determine potential stranded costs. Staff proposes making this calculation annually on a historic basis during the transition period. This potential stranded cost amount could then be compared to cumulative stranded cost recoveries as determined by the earnings test analysis. Additionally, the annual calculation of potential stranded costs would show the effects of changing market prices and utility mitigation efforts.

One concern with this alternative approach is that, if it terminates at the end of the capped rate period, it does not consider benefits that may accrue to the utility after the capped rate period. While a utility may spend large sums of money in mitigation efforts today, it may benefit from those efforts over the next 20-30 years. The advantage of the asset valuation methodology is that it projects both costs and benefits over the life of a utility's assets. Any method that is limited to the capped rate period would include the cost of most mitigation efforts, but a large portion of the benefits would likely be excluded. This issue could be dealt with by continuation of earnings monitoring after July 1, 2007.

Although several participants expressed concern regarding this alternative proposal, such monitoring after the termination of capped rates could provide a means to calculate actual stranded costs or benefits on an annual basis, as well as the cumulative over- or under-recovery of stranded costs. Such monitoring should be performed on the unbundled generation business and continue throughout the remaining life of existing generation assets. Generation-related revenues recorded after the transition period should represent market prices if the Commission sets default service rates as is currently prescribed by the § 56-585 of the Restructuring Act. Therefore, any under-recovery of generation-related costs below a benchmark rate of return as depicted by the earnings test would represent an annual level of actual stranded costs.[77] The cumulative amount of these stranded costs, if any, as compared to cumulative stranded cost recoveries that occurred during the capped rate period, would show the net over- or under-recovery of stranded costs that has occurred to date.

Regarding Allegheny's argument that it should not be subject to a measurement of stranded costs and recoveries of those costs though capped rates because it entered into a

[77] Should market rates produce earnings in excess of a utility's generation costs, including a fair return, the excess earnings would represent an annual level of actual stranded benefits.

memorandum of understanding is without merit. Section 56-584 of the Restructuring Act states that stranded costs are recovered through capped rates and wires charges. The memorandum of understanding has no effect on the capped rate recovery mechanism. It is interesting to note that, to date, market rates have exceeded Allegheny's capped rates so based on § 56-583 of the Restructuring Act no wires charge would have been assessed.[78]

As noted above the Old Dominion Cooperatives point out several concerns specific to cooperatives. It is true that cooperatives do not file AIFs and the Commission generally uses a times interest earned ratio (TIER), instead of return on equity, to set rates. However, this does not change the fact that the cooperatives may over- or under-recover stranded costs. A cooperative could incur stranded costs to the extent they do not recover all of their generation-related costs of which purchased power expense is the primary component. An alternative method for measuring stranded cost recoveries can be developed. Staff recommends that the Rural Utility Service Form 7 (currently filed with the Commission monthly by most cooperatives) and TIER be the bases for such an analysis.[79]

VCFUR/ODCFUR Methodology

The Committees provided the following methodology for consideration. This proposal is similar to the Staff methodologies discussed above in that it incorporates an asset valuation methodology to calculate total just and reasonable net stranded costs, and an earnings test analysis to calculate recoveries of stranded costs via capped rates. In its May 8, 2003 comments, the Committees state that Chaparral, the Steering Committee, VCCC, WGES, Strategic Energy, NewEnergy, and Pepco Energy Services support the proposal, which is summarized as follows:[80]

- *Section 56-595.C (iii) of Virginia's Electric Utility Restructuring Act ("Act") provides that the members of the Legislative Transition Task Force ("LTTF") " ... shall: ... monitor ... whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.*

- *To monitor an "over-recovery" or "under-recovery," the LTTF must determine and compare two amounts: first, the amount that has been, or will be, available for recovery of just and reasonable net stranded*

[78] Appalachian's generation rates are also below market prices and the Company has not yet assessed any wires charges.
[79] Because cooperatives are member-owned it is true that should they over-recover stranded costs members would eventually receive those funds through capital credit rotations.
[80] Proposal of the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates distributed at the April 29, 2003 work group meeting.

costs, and, second, the amount of just and reasonable net stranded costs.

- *Section 56-584 of the Act provides for two sources of revenue for the recovery of just and reasonable net stranded costs – capped rates and wires charges.*

- *Thus, the amount that has been, or will be, available for recovery of such costs is the net revenue collected from wires charges and capped rates. Because the incumbent utility must collect sufficient revenue to recover its costs of providing service, the net revenue available for the recovery of just and reasonable net stranded costs is the revenue from capped rates and wires charges in excess of the revenue needed by the utility to recover its costs of providing service (i.e., the utility's revenues in excess of its "revenue requirement").*

- *The following approach recognizes both sides of the inquiry required of the LTTF – i.e., (i) the amount of just and reasonable net stranded costs and (ii) the amount available for recovery of such costs through wires charges and capped rates.*

- *To calculate just and reasonable net stranded costs compare asset values based on the net present value of the difference between the revenues that arise from remaining in a regulated market (cost plus a fair return) and the revenues that arise in a competitive market (over the life of the assets). From this amount subtract revenues via capped rates (to the extent capped rates exceed actual and likely costs including a fair return) and wires charges to determine the over- or under-recovery of just and reasonable net stranded costs.*

- *The above approach represents an acceptable, administrative methodology for the calculation of both just and reasonable net stranded costs and their recovery under the Act. By reference to the "regulated market (cost plus a fair return)," the methodology incorporates traditional ratemaking concepts in a regulated environment, including consideration of a utility's regulated cost of service used in setting "just and reasonable" rates, and including concepts of "prudence," mitigation, verification, and the "netting" of stranded costs and margins. The methodology properly requires consideration of the useful life of assets.*

- *As is true of any administrative method of determining stranded costs, the above approach involves estimates based on long-term revenue and cost projections. Such estimates are data-intensive and highly sensitive to the underlying assumptions and models used in making them. Long-term projections, however, are almost always used,* *implicitly or explicitly, in valuing assets for commercial purposes. Reasonable forecasts of items affecting such calculations and the development of estimates under reasonable scenarios would be required.*

- *Incumbent electric utilities must make annual informational filings ("AIFs") that include specified financial information with the State Corporation Commission. The Commission reviews such AIFs for compliance with Commission requirements for accounting and ratemaking treatment of costs and revenues. As approved by the Commission, AIFs would provide an acceptable basis for calculating a utility's historical cost of providing service and any revenues in excess of those costs that may be available for recovering stranded costs.*

Summary of Comments Regarding the VCFUR/ODCFUR Methodology

Dominion opposes the Committees' proposal for all the reasons it opposes Staff's asset valuation methodology and earnings test as discussed above, including that it is not consistent with the Act or with the Act's legislative background and it is dependent on projections of various elements that could be manipulated by various participants to reach specific goals. Dominion states that the Committees' proposal:[81]

> *...ignores the Act's most critical feature: the utilities' discretion to use available funds from the capped rates and wires charges, without the burden of Commission rate cases.*

The Old Dominion Cooperatives agree with Dominion that the Committees' proposal is not a new proposal, but a restatement of Staff's, in summary stating:[82]

> *The Cooperatives continue to believe that any projection of total stranded costs, coupled with stranded cost recovery based on a re-evaluation of what has occurred in the past few years and highly speculative long-term future market projections, could prove disastrous.*

Appalachian commented on both the Staff's and Committees' methodologies together.[83] Those comments will not be restated here, suffice to say that Appalachian opposes the Committee's proposal.

Similarly, Allegheny did not provide specific comment to the Committees' proposal. Allegheny opposes this method for the same reasons it opposes the Staff's methodologies discussed above.[84]

[81] Attachment No. 10, Response of Dominion Virginia Power to Commission Staff's "Stranded Costs – An Accounting Perspective" Method and the Virginia Committee for Fair Utility Rates' Method, page 6.
[82] Attachment No. 10, May 8, 2003 Virginia Electric Cooperatives Stranded Cost Comments, page 2.
[83] Attachment No. 10, May 8, 2003 Stranded Cost Comments of Appalachian Power Company in Response to the SCC Staff's April 30, 2003 Request for Comments, page 7-10.

VIPP agrees with the electric utilities that the Committees' proposal is similar to Staff's and is opposed to it for the same reasons. VIPP goes on to state:[85]

> *The VCFUR proposal, however, would go far beyond the staff Proposal and would repeat the mistakes of other regulatory jurisdictions by attempting to project both generation market prices and the embedded cost-based prices for generation for every year of the approximately thirty-year time horizon constituting the remaining life of current generations assets.*

Consumer Counsel provided no additional comments regarding the Committees' proposal since it is essentially a restatement of Staff's proposal.[86]

As stated above, Chaparral, the Steering Committee, VCCC, WGES, Strategic Energy, NewEnergy, and Pepco Energy Services support the Committees' proposal.[87] Each of these participants believes this proposal is consistent with the Restructuring Act and that meets the needs of the LTTF by calculating stranded costs, measuring recoveries from capped rates and wires charges, and providing for a comparison of these amounts to determine whether an over- or under-recovery of stranded costs has occurred, or is likely to occur.

Pepco Energy Services notes that several details are not addressed in the Committees' proposal. For example, the date at which to calculate stranded costs has not been defined. Pepco Energy Services believes that the measurement date should not be set at any time beyond 2003.[88]

<u>Staff's Analysis of the Committees' Approach</u>

As discussed above, Staff believes an asset valuation methodology is appropriate for calculating just and reasonable net stranded costs and that an earnings test is the appropriate basis for determining stranded cost recoveries. With the exception of the following paragraph, which discusses one difference between the asset valuation methodologies between Staff and the Committees, the analysis of these approaches has been discussed above and will not be restated here.

The Committees' method calculates the net present value of the difference between the revenues that arise from remaining in a regulated market and the revenues that arise in a competitive market. Staff's model calculates the net present value of each

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[84] Attachment No. 10, May 8, 2003, Comments by The Potomac Edison Company dba Allegheny Power, page 2.
[85] Attachment No. 10, May 8, 2003, Comments of Virginia Independent Power Producer, Inc. to the Stranded Costs Working Group, page 4.
[86] Attachment No. 10 May 8, 2003, Division of Consumer Counsel Office of the Attorney General Supplemental Comments, page 1.
[87] The comments of each of these participants is included in Attachment No. 10.
[88] Attachment No. 10, May 8, 2003 letter from A. Glenn Simpson, page 4.

revenue stream and then determines the difference. The discount rate used in net present value calculations will differ based on risk. Certainly risk associated with regulated and competitive markets differ. Therefore, Staff believes that separate net present value calculations are appropriate.

LEGISLATIVE OR ADMINISTATIVE ACTIONS

Requested Action No. 9 of the LTTF's Resolution reads as follows:

> *Include in its reports to the Legislative Transition Task Force any recommendations for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any overrecovery or underrecovery of just and reasonable net stranded costs.*

Summary of Comments on Legislative or Administrative Actions

Staff requested that each work group participant provide a discussion of any such action they believed was necessary based on the definitions and methodologies discussed by the work group.

Dominion states that its proposal may be implemented by a resolution adopted by the Commission on Electric Utility Restructuring. On the other hand, Dominion states that the Committees' and Staff's proposed methodologies would require amendments to the Act as it does not provide for authority to proceed with them.[89]

Appalachian did not offer comments on the methodologies put forth by the work group. Rather, Appalachian expressed concern regarding the development of a competitive market in Virginia and suggests that the LTTF:[90]

> *...adopt a resolution providing for an ongoing assessment of whether customer choice and market-based pricing will be implemented as provided by the act, and thus whether stranded cost recovery by incumbent utilities continues to be appropriate.*

Appalachian suggests that the LTTF take action to identify and propose legislation by January 1, 2005 if the LTTF finds it unlikely that all customers will have choice and market-based pricing by July 1, 2007.[91]

[89] Attachment No. 10, Response of Dominion Virginia Power to Commission Staff's "Stranded Costs – An Accounting Perspective" Method and the Virginia Committee for Fair Utility Rates' Method, pages 9-10.
[90] Attachment No. 10, May 8, 2003 Stranded Cost Comments of Appalachian Power Company in Response to the SCC Staff's April 30, 2003 Request for Comments, page 1-2.
[91] *Id.*, page 3.

Allegheny believes that the asset valuation methodology would require an amendment to the Restructuring Act, as currently the Act does not require or provide for quantification of stranded costs.[92]

VCCC believes that the Legislature must decide whether a calculation of stranded costs should be made. The decision must be made before further work is undertaken by the work group.[93]

The Committees make the following recommendation:[94]

> *...the Committees' recommend consideration of the elimination of wires charges, and if appropriate, a reduction in capped rates if the LTTF concludes from its monitoring of just and reasonable net stranded costs and their recovery that revenue from capped rates and wires charges is likely to result in an over-recovery of such costs.*

Chaparral states that administrative action would be necessary to provide for proceedings at the Commission to implement any stranded cost monitoring adopted by the LTTF. Chaparral suggests that an asset valuation methodology be adopted and believes that such method will reveal that an over-recovery of stranded costs has occurred and will continue to occur. Chaparral suggests:[95]

> *Should the LTTF wish to address and rectify such overrecoveries, new legislation would be warranted and appropriate. Such legislation should implement the reduction and/or elimination of the wires charge and the reduction of the capped rates as necessary to eliminate overrecoveries.*

The Steering Committee also believes that an asset valuation methodology will reveal an over-recovery of stranded costs and offers a proposal for legislation similar to Chaparral's:[96]

> *...the Restructuring Act should provide for the Commission to take action, either by reducing or eliminating a utility's wires charges, if any, and/or by reducing a utility's capped rates.*

NewEnergy recommends clarifying language be added to the Restructuring Act to eliminate wires charges, if the method adopted by the LTTF shows net benefits, until a utility can demonstrate that net stranded costs are positive using the method employed by the LTTF.[97] The specific language recommended is:

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[92] Attachment No. 10, May 8, 2003 Comments by The Potomac Edison Company dba Allegheny Power, pages 1- 2.
[93] Attachment No. 10, May 8, 2003 Virginia Citizens Consumer Council Comments, page 1.
[94] Attachment No. 10, May 8, 2003 letter from Edward l. Petrini, page 5.
[95] Attachment No. 10, May 8, 2003 letter from Michael E. Kaufmann, pages 1-2.
[96] Attachment No. 10, May 8, 2003 letter from Thomas B. Nicholson, page 13.
[97] Attachment No. 10, May 8, 2003 letter from Eric W. Matheson, page 2.

Consistent with Section 56-595 C, in the event the LTTF, in consultation with the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, determines that the recovery of stranded costs has resulted or is likely to result in the over-recovery of just and reasonable net stranded cost, then the applicable utility's wires charge shall be zero until such time that the Commission revises its determination.

Pepco Energy Services states that should a utility be found to be significantly over- or under-recovering stranded costs that legislative action may be necessary. In the case of an over-recovery then wires charges should be reduced or eliminated. In the case of an under-recovery, the Commission should have the ability to consider whether capped generation rates should be increased.[98]

WGES believes that at this time no action is required by the LTTF relative to the definitions and methodologies discussed by the work group. WGES suggests that, if over- or under-recoveries of stranded costs are found to exist then the Commission could recommend a true-up mechanism to the LTTF in the next phase of this project.[99]

NEM believes that § 56-583 (b) presents a major statutory constraint to the work group in that it provides that wires charges be assessed to only retail access customers. NEM suggests that this section of the Restructuring Act be re-examined to provide for recovery of net stranded costs on a competitively neutral basis.[100]

Staff Analysis of Legislative or Administrative Actions

Several participants suggest that if a company is found to have over-recovered or it is likely that they will over-recover stranded costs then (1) wires charges should be reduced or eliminated, (2) capped rates should be reduced, or (3) both. Currently, the Restructuring Act does not provide for any of these actions. Should the General Assembly desire to have authority to act on the findings made as a result of its stranded costs monitoring legislation would be necessary.

On the other hand, Staff does not believe legislation is necessary to implement any of the stranded cost methodologies identified by the work group. The LTTF has been instructed to monitor stranded cost recoveries; no methodology has been prescribed. The LTTF has the expertise, and it would be logical for it to determine the appropriate methodology administratively.

Staff requests further direction from the LTTF prior to submission of its next report regarding stranded costs, currently scheduled to be filed November 1, 2003. Requested Action No. 3 of the Resolution requires that the Commission present to the LTTF the work group's consensus recommendations regarding each utility's just and

[98] Attachment No. 10, May 8, 2003 letter from A. Glenn Simpson, page 8.
[99] Attachment No. 10, May 7, 2003 letter from Ransome E. Owan, Ph.D., page 1.
[100] Attachment No. 10, May 8, 2003 Comments of the National Energy Marketers Association, page 2.

reasonable net stranded costs and stranded cost recoveries, using the work group's consensus methodology. Because the work group was unable to reach consensus on a methodology it is unable to move forward with the calculations. The Commission requests that the LTTF provide guidance on the appropriate methodology or instruct the Commission to make such determination. Further, the LTTF should instruct the Commission to begin proceedings to implement the chosen methodology.

SUMMARY OF STAFF ANALYSES

Definitions

In defining stranded costs the differences were in (1) the terminology proposed by the individual work group members, for example should such costs be defined as "lost revenues" or "loss in economic value" and (2) whether the definition should include stranded cost components. There were similar differences of opinion regarding the definition of just and reasonable net stranded costs. Additionally, Dominion Virginia Power believes no further definition of just and reasonable net stranded costs is necessary because such costs are defined by the methodology for determining wires charges as set forth in § 56-583 of the Restructuring Act.

Staff does not believe that the definitions need to include stranded cost components. Staff disagrees with the position that just and reasonable net stranded costs are defined by the Restructuring Act. To the contrary, Staff believes the Restructuring Act neither defines just and reasonable net stranded costs nor provides a methodology for calculating them. It defines only the recovery mechanisms, wires charges and capped rates, and a method for calculating wires charges.

Staff recommends the use of the following definitions:

> *Stranded Costs are a utility's net loss in economic value arising from electric generation-related costs that become unrecoverable due to restructuring and retail competition.*
>
> *Just and Reasonable Net Stranded Costs are a utility's net loss in economic value arising from prudently incurred, verifiable and non-mitagable electric generation-related costs that become unrecoverable due to restructuring and retail competition.*

Methodologies

Dominion proposed a methodology for monitoring just and reasonable net stranded costs that includes reporting to the LTTF (1) the over- or under-recovery of stranded costs collected through the wires charges from switching customers, (2) actual "above-market" or "potential" stranded costs exposure under capped rates, (3) the amounts expended from funds available under capped rates to mitigate potential stranded costs, and (4) additional expenditures that negatively impact (increase) such costs during the transition period.

Staff believes that Dominion's methodology does not meet the requirements of the LTTF's Resolution. It does not adequately monitor the over- or under-recovery of just and reasonable stranded costs. It does not measure a utility's stranded costs and it ignores recoveries from capped rates.

Staff presented two methodologies. The first calculates just and reasonable net stranded costs based on an asset valuation methodology. The second is an accounting approach that (1) measures recoveries of stranded costs from capped rates and wires charges, (2) measures potential stranded costs on an annual historic basis, and (3) after July 1, 2007 could be used to calculate actual stranded costs or benefits on an annual historic basis.

Staff believes that to monitor the over- or under-recovery of just and reasonable stranded costs one must calculate two numbers: (1) total just and reasonable net stranded costs; and (2) recoveries of stranded costs from capped rates and wires charges. Staff favors using an asset valuation methodology to determine just and reasonable net stranded costs. Although complex, it is the best tool available and it is widely used for various business purposes. To calculate recoveries of stranded costs from wires charges and capped rates, Staff believes information currently filed annually with the Commission should be used. This information is currently used to measure a utility's earnings.

Should the LTTF determine an asset valuation methodology is not appropriate for calculating just and reasonable net stranded costs, Staff suggests that utilities be required to calculate potential stranded costs annually during the transition period and actual stranded costs annually thereafter. This alternative would also include calculating recoveries from wires charges and capped rates. Cumulative cost recoveries would be compared to potential stranded costs during the transition period and to actual stranded costs thereafter.

The Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (the "Committees") proposed a methodology for calculating just and reasonable net stranded costs based on an asset valuation methodology for measuring stranded costs and incorporating stranded cost recoveries from both wires charges and capped rates. This method is very similar to Staff's favored approach. It differs in the application of a discount rate. The Committees propose the use of one discount rate while the Staff's includes two, possibly different, discount rates.

Administrative and Legislative Actions

The final issue addressed in the report is whether legislative or administrative action by the LTTF is necessary. Currently, the Restructuring Act does not provide for any action to be taken as a result of the LTTF's stranded cost monitoring. If the General

Assembly desires to provide for a means to respond to any over- or under-recovery of just and reasonable net stranded costs, legislation will be necessary. On the other hand, Staff does not believe legislation is necessary to implement any of the stranded cost methodologies identified by the work group; however, administrative action may be necessary to adopt an appropriate methodology.

Staff requests further direction from the LTTF prior to submission of its next stranded cost report currently scheduled to be filed November 1, 2003. Because the work group was unable to reach consensus on a methodology it is unable to move forward with the calculations. The Commission requests that the LTTF provide guidance on the appropriate methodology or, alternatively, require that the Commission determine the appropriate methodology. Further, the LTTF should instruct the Commission to begin proceedings to implement the LTTF's decision.

Resolution of the Legislative Transition Task Force

Adopted January 27, 2003

Attachment 1

STRANDED COSTS WORK GROUP

Background

Section 56-584 of the Virginia Electric Utility Restructuring Act (the "Act") provides:

> Just and reasonable net stranded costs, to the extent that they exceed zero value in total for the incumbent electric utility, shall be recoverable by each incumbent electric utility provided each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates as provided in § 56-582 or wires charges as provided in § 56-583.

Subdivision C, clause (iii) of § 56-595 of the Act provides that the members of the Legislative Transition Task Force shall:

> [A]fter the commencement of customer choice, monitor, with the assistance of the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs . . .

As customer choice has commenced in the Commonwealth, it is appropriate for the Legislative Transition Task Force to initiate the process of monitoring whether the recovery of stranded costs has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.

Requested Actions

The Legislative Transition Task Force hereby requests the State Corporation Commission to:

1. Convene a work group, consisting of Commission staff and such persons as the Commission deems appropriate to represent the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, for the purpose of developing consensus recommendations, consistent with the provisions of the Act, regarding the issues listed in paragraphs 2 and 3. The chairman of the Legislative Transition Task Force will designate two of its members to monitor the progress of the work group.

2. By July 1, 2003, present to the Legislative Transition Task Force the work group's consensus recommendations regarding:

(a) Definitions of "stranded costs" and "just and reasonable net stranded costs."

(b) A methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs; and

3. By November 1, 2003, present to the Legislative Transition Task Force the work group's consensus recommendations, developed using the methodology developed pursuant to paragraph 2 (b), regarding:

(a) The amount of each incumbent electric utility's just and reasonable net stranded costs.

(b) The amount that each incumbent electric utility has received, and is expected to receive over the balance of the capped rate period, to offset just and reasonable net stranded costs from capped rates and from wires charges.

4. Report to the Legislative Transition Task Force's Subcommittee on Stranded Costs, which will be reactivated to oversee the implementation of this resolution, regarding the matters described in paragraphs 2 and 3, which reporting shall be made prior to the submission of the reports to the Legislative Transition Task Force that are due by July 1, 2003, and November 1, 2003, respectively.

5. Determine whether the work group has access to information necessary for the development of recommendations on the issues set out in paragraphs 2 and 3, and, if the work group has been unable to obtain necessary information, give prompt written notice of the issue to the chairman of Legislative Transition Task Force, with a copy to its staff.

6. Take all reasonable and appropriate actions to ensure that State Corporation Commission staff and other work group participants do not make unauthorized disclosures of information regarding incumbent utilities' stranded costs and amounts received to offset stranded costs that is provided in confidence to the work group.

7. Request that the Commission staff and persons who are invited to participate in the work group act in good faith to develop consensus recommendations on the issues set out in paragraphs 2 and 3.

8. If the work group members are not able to develop consensus recommendations regarding the issues set out in paragraphs 2 and 3, include in its reports to the Legislative Task Force and the Subcommittee on Stranded Costs, as appropriate, (i) the recommendations of the Commission staff and other members of the work group regarding the issues and (ii) an analysis by Commission staff of such recommendations.

9. Include in its reports to the Legislative Transition Task Force any recommendations for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any overrecovery or underrecovery of just and reasonable net stranded costs.

Adopted by the Legislative Transition Task Force on January 27, 2003.

Legislative Transition Task Force Letter to the Commission

Commission's Response to the Legislative Transition Task Force

Attachment 2

SENATE OF VIRGINIA

THOMAS K. NORMENT, JR.
3RD SENATORIAL DISTRICT
JAMES CITY, ACCOMACK AND NORTHAMPTON
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GLOUCESTER AND YORK COUNTIES; AND PART
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COMMITTEE ASSIGNMENTS
COMMERCE AND LABOR
COURTS OF JUSTICE
FINANCE
PRIVILEGES AND ELECTIONS
RULES

December 21, 2001

The Honorable Clinton Miller, Chairman
State Corporation Commission
Post Office Box 1197
Richmond, Virginia 23218

Re: Stranded Cost Recovery Information/ Rule 20 VAC 5-202-40 B 6 c

Dear Judge Miller:

On October 19, 2000, the State Corporation Commission entered its final order in Case No. PUA000029 concerning the functional separation of incumbent electric utilities under the Virginia Electric Utility Restructuring Act. By this order, the Commission has adopted rules applicable to the implementation of § 56-590 of the Code of Virginia.

The provisions of the Commission's order that address the extent to which the Commission is authorized to control the costs of incumbent utilities' generation assets used to support default service have received a great deal of attention. However, the Legislative Transition Task Force notes that the order, at pages 4 and 5, also addresses requirements that incumbent electric utilities provide information regarding the fair market value of generation assets and long term power contracts.

As noted in your order, proposed 20 VAC 5-202-40 B 6 would have required that incumbent electric utilities provide the fair market value of generation assets, even if they intend to transfer these assets at book value. Incumbent utilities opposed the requirement on grounds that, to the extent that transfers to functionally separate units will be made at book value, a market valuation is unnecessary. Some incumbents and independent power producers opposed a related requirement in proposed 20 VAC 5-202-40 B 6 that would have required incumbent electric utilities to provide year-by-year fair market valuations of long-term power contracts.

The Commission concluded that information about (i) the fair market value of generation assets at the time of their sale or transfer and (ii) the fair market value of long-term power contracts on a year-to-year basis is critical to the Legislative Transition Task Force's assessment of stranded cost recovery. The Task Force is required by § 56-595 to monitor whether the recovery of stranded costs under § 56-584 has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.

While the Commission recognizes that it is required to assist the Task Force in monitoring stranded cost recovery, it has deferred to the Task Force to determine as soon as possible, "by resolution or some other specific directive to the Commission," whether the Task Force will want this information for its use in monitoring utilities' recovery of stranded costs.

The order states, at page 5, that final rule 20 VAC 5-202-40 B 6 c will require the fair market valuation of generation assets and purchase power contracts "if and when the [Task Force] directs the Commission to obtain that information for its use pursuant to the [Task Force's] obligations under § 56-595 of the Act."

The Legislative Transition Task Force formally acted on this issue at today's meeting. The members in attendance unanimously concurred that the Task Force will want information regarding the fair market valuation of generation assets and purchase power contracts for use in monitoring utilities' recovery of stranded costs. The Task Force hereby requests the Commission's assistance with monitoring the recovery of net stranded costs pursuant to subsection C of § 56-595 of the Virginia Electric Utility Restructuring Act.

It should be noted that subsection C of § 56-595 provides, at clause (iii), that the Task Force's duty to monitor whether the recovery of stranded costs has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs begins after the commencement of consumer choice.

Finally, I will observe that final rule 20 VAC 5-202-40 B 6 c provides that the relevant information from the incumbent electric utilities will be provided to the Commission "[i]f the Legislative Transition Task Force adopts a resolution requesting the [C]ommission's assistance with monitoring the recovery of net stranded costs pursuant to § 56-595 C of the Act." This is not consistent with the language on page 5 of your order, which states that the desire of the Legislative Transition Task Force may be conveyed to the Commission "by resolution or some other specific directive." As it would be irregular, and to my knowledge unprecedented, for a legislative commission such as the Legislative Transition Task Force to issue resolutions directing the State Corporation Commission to take certain actions, I trust that this letter will satisfy the request in your order for a "specific directive" stating the desire of the Legislative Transition Task Force. If it does not satisfy such request, please communicate your concerns immediately to me, and provide copies thereof to each member of the Task Force and to its staff.

Very truly yours,

Thomas K. Norment, Jr., Chairman
Legislative Transition Task Force

CLINTON MILLER
CHAIRMAN

THEODORE V. MORRISON, JR.
COMMISSIONER

HULLIHEN WILLIAMS MOORE
COMMISSIONER

COMMONWEALTH OF VIRGINIA

JOEL H. PECK
CLERK OF THE COMMISSION
P.O. BOX 1197
RICHMOND, VIRGINIA 23218-1197

STATE CORPORATION COMMISSION

October 21, 2002

Honorable Thomas K. Norment, Jr.
State Senate of Virginia
P.O. Box 1697
Williamsburg, Virginia 23187-1697

Dear Senator Norment:

Earlier this summer I received correspondence from you dated December 21, 2001 (copy attached). The subject of the letter was electric utilities' recovery of stranded costs under the Virginia Electric Utility Restructuring Act ("Restructuring Act") and the LTTF's monitoring of these costs' recovery under § 56-595 C of the Restructuring Act.[1] I am writing to acknowledge receipt of that letter (which I had not previously received until this summer) and to provide the Commission's view of what this monitoring process might entail—information that I hope will be of assistance to the LTTF as it begins work on this important project.

As a point of beginning, I would also note that this assessment of stranded cost monitoring was summarized in the Commission's second annual report on the status of retail competition, filed with the LTTF and the Governor on August 30, 2002. As we noted in that report, the Restructuring Act provides in § 56-584 that rate caps and wires charges through mid-2007 would reimburse incumbent utilities for their "net just and reasonable stranded costs." Neither this statute nor any other in the Restructuring Act, however, defines stranded costs nor provides any formula or statutory framework for their calculation.

Nevertheless, § 56-595 C of the Restructuring Act provides that the Legislative Transition Task Force ("LTTF") shall:

> after the commencement of customer choice, monitor, with the assistance of the Commission, the Office of the Attorney General,

[1] Your letter states that the LTTF will want information regarding the fair market valuation of incumbent utilities' generation assets and purchase power contracts for use in monitoring utilities' recovery of stranded costs. This was in response to this Commission's request (in its October 19, 2000, Order adopting functional separation rules) that the LTTF advise the Commission whether such information was desired for the LTTF's use in monitoring stranded cost recovery under § 56-595 C of the Restructuring Act. More importantly, the letter also states that the LTTF requests this Commission's assistance in carrying out the LTTF's charge to monitor these costs under that provision of the Restructuring Act.

> incumbent electric utilities, suppliers, and retail customers, whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.

Since there was no determination of reasonable net stranded costs going into the transition (nor any statutory structure for their calculation, thereafter), this may be a challenging task for the LTTF. However, the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers are all required by this statute to assist the LTTF in this endeavor.

The Commission would note that since measuring the "underrecovery" or "overrecovery" of stranded costs under § 56-595 C requires their quantification, it will be necessary to establish a method for their calculation. Moreover, and with respect to monitoring the levels of their recovery, it will also be necessary to determine what part of the utilities' capped rates and wires charges should be allocated to stranded cost recovery. Simply put, two things must be done in order to monitor the progress Virginia's utilities are making toward recovery of their stranded costs. First, determine the amount of stranded costs; second, allocate some part of wires charges and capped rates to their recovery.

We look forward to working with you and the members of the LTTF with respect to this important undertaking. Please call me if you have any questions in the meantime.

Sincerely,

Clinton Miller

CM/nl
Attachment

cc: Franklin G. Munyan, Esquire

Attachment 3

LTTF Staff November 19, 2002 Report

Quantifying Electric Utilities' Standard Costs

QUANTIFYING INCUMBENT ELECTRIC UTILIITIES' STRANDED COSTS

Legislative Transition Task Force
November 19, 2002

Subsection C of § 56-595 of the Restructuring Act provides that members of the Legislative Transition Task Force shall:

> "[A]fter the commencement of customer choice, monitor, with the assistance of the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs . . .
>
> § 56-584 of the Restructuring Act provides:
>
> Just and reasonable net stranded costs, to the extent that they exceed zero value in total for the incumbent electric utility, shall be recoverable by each incumbent electric utility provided each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates as provided in § 56-582 or wires charges as provided in § 56-583.

The Restructuring Act provides that shopping customers choosing to purchase generation from a nonincumbent must pay a nonbypassable wires charge as a surrogate for the stranded cost recovery that an incumbent would recover from nonshopping customers. The recovery mechanism will be in effect until mid-2007.

EXAMINATION OF STRANDED COSTS BY JOINT SUBCOMMITTEE

The Joint Subcommittee Studying Electric Utility Restructuring under SJR 91 convened a Stranded Costs Task Force. Members included Senators Watkins and Holland and Delegates Parrish, Plum and Kilgore.

1. Rationale for Stranded Cost Recovery

Stranded cost recovery was one of the most critical policy hurdles the joint subcommittee had to clear as it developed Virginia's restructuring bill.

Arguments for allowing recovery of stranded costs term are based on the "regulatory compact," implicit in the relationship between regulated utilities and their regulators, which provides that in exchange for fulfilling their obligation to serve all customers within certificated service territories, costs prudently incurred by regulated utilities in furtherance of providing such service will be recovered in regulated rates.

Under this theory, any departure from a regulated, cost-of-service environment must make allowance for utility recovery of costs (prudently incurred while fully regulated) rendered uneconomic because of restructuring.

If generation is deregulated, then market price for generation could drop below the rate a given utility is receiving in the current, regulated market. Consequently, the utility's generation assets -- constructed and financed at a time when cost-of-service regulation was in place -- could lose substantial portions of their pre-restructuring book value. Similarly, power purchased from nonutility generators by investor-owned utilities may be at above-market prices in a deregulated market for generation. Additionally, "regulatory assets" (previously deferred, generation-related costs or obligations incurred by a regulated electric utility in providing electricity prior to generation deregulation) were also identified as costs potentially stranded in connection with generation deregulation.

Since Virginia's prevailing electricity prices are low to moderate, some suggested that utilities may realize measurable increases in generation prices above their current, regulated levels following generation's deregulation. This could increase the value of a utility's generation assets above their pre-restructuring book value, resulting in a windfall of "stranded benefits."

Neither stranded costs nor stranded benefits could be calculated in advance of restructuring. The market prices for generation, which is a key variable, is unknown until a competitive market for such generation exists.

2. Elements of Stranded Costs

The report of the Stranded Costs Task Force illustrates the difficulty in agreeing upon a definition of "stranded costs." Task force members distinguished stranded costs and its elements from "transition costs," or costs which utilities may incur in transitioning from a regulated to deregulated market for generation. Illustrative of transition costs are utilities' costs in (i) establishing or joining an independent system operator or regional power exchange and (ii) funding mandatory consumer education programs concerning restructuring.

Primary sources of potential stranded costs were identified as (i) generation asset devaluation, (ii) potential losses associated with above-market purchased power contracts (including cooperatives' wholesale power purchase contracts), and (iii) regulatory assets. Perspectives were provided to the task force by:

> **Virginia Power:** Stranded costs are losses in the economic value of an electric utility's investments and obligations related to the supply of electric generation that result from the implementation of competition in the purchase and sale of electric energy. Virginia Power proposed permitting utilities to recover net losses associated with the onset of retail competition, including the costs of increased consumer and employee benefits, mandated obligations (NUG contracts, nuclear decommissioning, and other governmental requirements imposed prior to competition), transition costs (including the formation of an ISO/RTE), and the net losses in the economic value of generation investments (stranded costs).

SCC: Stranded costs will occur if there is a net loss in economic value of existing generation-related utility assets and contracts from a restructured industry. The change in economic value will be based upon the difference between embedded-cost electricity rates calculated under regulation and competitive market-based electricity prices.

AOBA: Stranded costs represent costs that are recoverable by a utility under existing regulatory policies that are not recoverable under competitive market pricing of services if current regulated rates are above competitive market prices. Stranded value represents profits in excess of a regulated fair rate of return that the owners of regulated generation resources would derive if they are permitted to price energy and capacity services on the basis of market values that are in excess of current cost-based ratemaking levels. The most consistent approach to measurement of the future value of a utility's generation assets is obtained when the utility sells its generation resources through an open competitive bidding process.

Virginia Citizen's Consumer Council: Stranded costs are the difference between the value of generation-related assets currently in rates that have a net book value equal to or above their market value and the value of generation-related assets that have a net book value below their market value, after mitigation efforts, and excluding costs that are avoidable in the future. Stranded costs should be recoverable only when management had no discretion over incurring the costs or when failure to recover these costs would drive the utility into bankruptcy.

Consumer Counsel, Office of Attorney General: Stranded costs in a competitive market are a utility's lost revenues associated with prudently incurred and unrecoverable costs related to utility investments in power production assets. Stranded benefits in a competitive market are a utility's net profits over and above earnings that would result under the continuation of traditional cost-based regulation.

The Division of Consumer Counsel's comments to the SJR 91 subcommittee on stranded costs, a copy of which is attached, illustrates the complexity of the issue. The Division notes that unless and until there is effective competition in the retail electric generation market and customers leave their current provider in favor of a competitor, no stranded costs or benefits can exist.

3. Determining Stranded Costs and Benefits Generally

Senate Bill 1269 as introduced was silent on the issue of who would determine stranded costs. Section 56-595 was amended in committee to direct the Task Force to monitor the issue. Prior to its introduction, the report of the SJR 91 stranded costs task force notes that stakeholders agreed that the State Corporation Commission should play a significant role in addressing stranded costs and stranded benefits. Several proposals specifically enumerated factors that the SCC would use in calculating and determining stranded costs and stranded benefits.

SCC COLLECTION OF STRANDED COST RECOVERY INFORMATION

On October 19, 2000, the SCC entered its final order in the matter of the functional separation of the generation, distribution, and transmission services of incumbent electric utilities. The order discussed requirements for the reporting of information relating to ascertaining to incumbent electric utilities' recovery of stranded costs.

As originally proposed, 20 VAC 5-202-40 B 6 would have required that incumbent electric utilities provide the fair market value of generation assets, even if they intend to transfer these assets at book value. Incumbent utilities opposed the requirement on grounds that, to the extent that transfers to functionally separate units will be made at book value, a market valuation is unnecessary. Some incumbents and independent power producers opposed a related requirement in proposed 20 VAC 5-202-40 B 6 that would have required incumbent electric utilities to provide a year-by-year fair market valuation of long-term power contracts.

The Commission concluded that information about (i) the fair market value of generation assets at the time of their sale or transfer and (ii) the fair market value of long-term power contracts on a year-to-year basis is critical to the Task Force's assessment of stranded cost recovery. However, the SCC added that while it is required to assist the Task Force in monitoring stranded cost recovery, it "will defer to the Task Force to determine as soon as possible, by resolution or some other specific directive to the Commission, whether it will want this information for its use in monitoring utilities' recovery of stranded costs." The SCC's final version of the rule provides that the fair market valuation of generation assets and purchase power contracts will be required "if and when the Task Force directs the Commission to obtain that information for its use pursuant to the Task Force's obligations under § 56-595 of the Act."

The Task Force agreed during its meeting in December 2000 that it would want information regarding the fair market valuation of generation assets and power contracts for use in monitoring utilities' recovery of stranded costs. However, the Task Force was subsequently asked to reconsider this issue. The Task Force revisited the issue at its December 21, 2001, meeting, and unanimously agreed to inform the Commission that it would want the information for use in monitoring utilities' recovery of stranded costs. By letter dated October 21, 2002, SCC Commissioner Clinton Miller observed that the Restructuring Act neither defines stranded costs nor provides any formula or statutory framework for their calculation. In order to monitor the progress incumbent utilities are making toward their recovery of stranded costs, the amount of stranded costs will need to be determined, and some part of the wires charges and capped rates will need to be allocated to their recovery.

STRANDED COSTS METHODOLOGY IN MICHIGAN

The SCC's 2002 report on the status of competition pursuant to section 56-506 of the Restructuring Act discusses the methodology for determining net stranded costs that was adopted by the Michigan Public Service Commission (Part II, p. 53). Net stranded costs are defined as the difference between (i) the revenue requirements associated with fixed generation assets, generation-related regulatory assets, and capacity payments associated with purchase power agreements and (ii) the revenues available to cover those costs.

STAKEHOLDER PROPOSALS ADDRESSING STRANDED COSTS

Proposal 5 in Part III of the SCC's 2002 report on the status of competition pursuant to section 56-506 of the Restructuring Act states that the SCC or General Assembly should calculate recoverable stranded costs for each utility and the pricing of standard offer service should reflect an amortization of those costs over a fixed period of time.

In its response, the SCC notes that the Restructuring Act neither defines stranded costs nor provides any formula or statutory framework for their calculation. "Since there was no determination of reasonable net stranded costs going into the transition (nor any statutory structure for their calculation, thereafter), this may be a challenging task for the LTTF." (Part III, p. 18) The SCC's report further notes:

> [S]ince measuring the 'underrecovery' or 'overrecovery' of stranded costs under § 56-595 C requires their quantification, it will be necessary to adopt a formula or method for their calculation. Moreover, and with respect to monitoring their levels of recovery, it will also be necessary to determine what part of the utilities' capped rates (together with wires charges) should be allocated to stranded cost recovery. Simply put, two things must be done in order to monitor the progress Virginia's utilities are making toward recovery of their stranded costs. First, determine the amount of stranded costs; second, allocate wires charges and some part of capped rates to their recovery. Undertaking any of the foregoing presupposes, however, that authority exists within the Restructuring Act's current statutory framework for doing so.

Attachment 4

Order Establishing Proceeding Dated March 3, 2003

Case No. PUC-2003-0062

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, MARCH 3, 2003

COMMONWEALTH OF VIRGINIA, ex rel.

STATE CORPORATION COMMISSION

In the Matter of Developing Consensus Recommendations on Stranded Costs

CASE NO. PUE-2003-00062

ORDER ESTABLISHING PROCEEDING

By resolution adopted on January 27, 2003, the General Assembly's Legislative Transition Task Force (LTTF)[1] requested the Virginia State Corporation Commission ("Commission") to convene a work group composed of representatives of the Commission Staff, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers to develop consensus recommendations on stranded costs.[2] By July 1, 2003, the Commission will submit to the LTTF the work group's consensus recommendations on:

> (a) Definitions of "stranded costs" and "just and reasonable net stranded costs."
> (b) A methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or

[1] The LTTF was established by § 56-595 of the Code of Virginia "to work collaboratively with the Commission in conjunction with the phase-in of retail competition," and it is comprised of ten legislators.

[2] A copy of the LTTF's Resolution provided by the staff of the LTTF to the Commission Staff is attached to this Order.

> underrecovery of just and reasonable net stranded costs . . . .

Requested Actions paragraph 2, LTTF Resolution of Jan. 27, 2003 (hereinafter LTTF Resolution), at 1.

The Commission is to report by November 1, 2003, the work group's consensus recommendations on:

> (a) The amount of each incumbent electric utility's just and reasonable net stranded costs.
> (b) The amount that each incumbent electric utility has received, and is expected to receive over the balance of the capped rate period, to offset just and reasonable net stranded costs from capped rates and from wires charges.

Requested Actions paragraph 3, LTTF Resolution at 1.

The LTTF also directed the Commission to:

> Include in its reports to the Legislative Transition Task Force any recommendations for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any overrecovery or underrecovery of just and reasonable net stranded costs.

Requested Actions paragraph 9, LTTF Resolution at 2.

The LTTF resolution does not require the Commission to promulgate rules governing any aspect of stranded costs or to make any ruling or finding in either its judicial or legislative capacity. The Commission will not enter a final order in this proceeding. While the Commission will docket this matter, our Rules of Practice and Procedure will not apply. Rather, we will establish procedures in this Order guided by the LTTF's resolution.

Our first task is to convene a work group. Requested Actions paragraph 1 of the LTTF Resolution, at 1, provides that the work group should consist of "such persons as the Commission deems appropriate to represent" various identified groups. While the resolution provides for Commission oversight of the representatives, we find that self-nomination is appropriate for formation of the work group. Based on our experience in related proceedings involving retail competition, the Commission is confident that a variety of individuals representing the groups listed in Requested Actions paragraph 1 will express an interest in the work group. We are also confident that these persons will work in good faith as requested by the LTTF in Requested Actions paragraph 7.

The Commission will not limit the size of the work group or require some proportional representation of the groups identified in Requested Actions paragraph 1. If, at any point, it appears that incumbent electric utilities, suppliers, or retail customers are not adequately represented, the Commission will use its best efforts to recruit additional persons to assure representation of all interests. We will establish procedures for providing notice of the convening of the work group.

The LTTF has identified one other issue, which the Commission will address. The Commission must determine whether the work group has access to necessary information, and we must also take measures to bar unauthorized disclosure of stranded cost information provided by incumbent utilities.[3] Requested Actions paragraphs 5, 6, LTTF Resolution at 1. As noted, the LTTF has requested that all participants in the work group act in good faith. The Commission expects this good faith to extend to the representatives' providing and using confidential information. We will delegate to our Office of General Counsel responsibility for developing, in consultation with the work group, procedures for the request and dissemination of information, including information deemed confidential. These

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[3] The Commission's Regulations Governing the Functional Separation of Incumbent Electric Utilities Under the Virginia Electric Utility Restructuring Act provide that:

> If the Legislative Transition Task Force adopts a resolution requesting the commission's assistance with monitoring the recovery of net stranded costs pursuant to §56-595 C of the Act, then the following information shall be provided to the commission: (I) fair market value of each generation and transmission asset functionally unbundled, transferred or sold to a third party or affiliate and (ii) a list of all long-term power contracts functionally unbundled, transferred or sold to a third party or affiliate. Information furnished shall include the length and anticipated expiration date of each contract, annual cash payments for power, and the market value of each power contract for each year of its remaining life.

20 VAC 5-202-40 B 6 c.

The LTTF Resolution requests the Commission to form a workgroup to develop consensus recommendations on the definition of stranded costs, a methodology for their calculation, calculation of these costs, and calculation of offsetting amounts received for rates and wire charges. At this time, the Commission will not require the filing of the information listed in our regulation. Rather, we will reassess the need for the requested information after the work group submits its first report.

procedures shall be considered at the work group's first meeting. If agreement on procedures cannot be reached, the Office of General Counsel will request guidance from the Commission. We note again that our Rules of Practice and Procedure do not apply in this proceeding, and representatives in the work group are not parties.

By July 1, 2003, the Commission must present to the LTTF a report on either the work group's consensus on definitions and methodology, Requested Actions paragraph 1, LTTF Resolution at 1, or, in the absence of consensus, a report on the representative's recommendations on the definitions and methodology and a Commission Staff analysis of these recommendations. Requested Actions paragraph 8, LTTF Resolution at 2. The Commission must report on these same issues to the LTTF's Subcommittee on Stranded Costs prior to submission of the report to the LTTF. Requested Actions paragraph 4, LTTF Resolution at 1.

To meet the LTTF's requirements, the Commission will establish a schedule for work group activities. We will set the first meeting of the work group for April 1, 2003. The work group will set additional meeting dates in April. A draft report shall be submitted to the Commission by May 30, 2003. The Commission will then submit a draft of the report to the Stranded Cost Subcommittee by June 16, 2003.

To focus consideration on the issues, the Commission requests that prospective representatives and other interested persons respond to any or all of the following questions.

1. Define "stranded costs." Include in the definition a detailed listing of each stranded cost component. Is this definition applicable to all electric utilities operating in Virginia? If not, to which utility or utilities does it apply and why?

2. Define "just and reasonable net stranded costs." Provide a detailed explanation of how and why it differs from "stranded costs." Is this definition applicable to all electric utilities operating in Virginia? If not, to which utility or utilities does it apply and why?

3. Provide a methodology for calculating "just and reasonable net stranded costs." Be specific in providing the necessary steps, beginning with each component comprising gross stranded costs and each component offsetting this amount to reach a net amount.

4. Describe how stranded costs are recovered. Provide a methodology for calculating such recovery. Describe the recovery period.

5. Do the calculation and recovery methodologies described in responses to questions 3 and 4 produce (or are they likely to produce) over-recovery or under-recovery of just and reasonable net stranded costs? How should such over- or under-recovery be dealt with?

6. Requested Actions paragraph 1 of the LTTF Resolution requests that the work group develop consensus recommendations "consistent with the provisions of the Act." Explain how that phrase guides or possibly constrains the actions of the work group. Identify each section of the Virginia Electric Utility Restructuring Act, §§ 56-576 to -596 of the Code of Virginia, pertinent to such guidance or constraint. Additionally, explain each such section's significance in the context of definitions offered in response to questions 1 and 2 as well as in the methodologies proffered for calculating and recovering just and reasonable net stranded costs in response to questions 3 and 4.

7. Provide copies of any study or studies undertaken to define and/or calculate stranded costs for any Virginia electric utility.

8. Provide any additional comments on the issues raised by Requested Actions paragraphs 2 and 3 of the LTTF Resolution.

To allow broad dissemination of information, we will request the filing of responses to these questions, if possible, in electronic form. The responses will be posted on the Commission's Division of Economics and Finance Web site. We will establish procedures for responding to these questions.

The Commission recognizes that responses to questions 5 and 7 may include material, which the authors deem confidential. Any portion of a paper response to questions 5 and 7 provided to the Staff as required by the procedures we establish and deemed confidential should be prominently marked as confidential. If possible, a complete electronic response to questions 5 and 7, including any material deemed confidential, should be provided to the designated Staff members. Distribution or access to portions of the paper or electronic responses to questions 5 and 7 deemed confidential will be restricted until the work group agrees on confidentiality procedures. The Commission encourages transmission of versions of the responses to questions 5 and 7, which omit material deemed confidential, to the electronic address in ordering paragraph (9).

With regard to the report on the amount of stranded costs, Requested Actions paragraph 3 of the LTTF Resolution, the LTTF again requested that the Commission first submit the report to its Subcommittee on Stranded Costs. Accordingly, a draft report prepared pursuant to Requested Actions paragraph 3 shall be submitted to the Commission by September 30, 2003. The Commission will submit a draft of the report to the Stranded Cost Subcommittee by October 15, 2003. The work group may schedule necessary meetings, but approximately 30 days should be allowed for drafting the report.

The Commission Staff has developed lists of individuals, organizations, and companies interested in the implementation of retail competition. The Commission will direct the Staff to provide copies of this Order by electronic transmission or, when electronic transmission is not possible, by mail to individuals, organizations, and companies on these lists.

Accordingly, IT IS ORDERED THAT:

(1) This matter be docketed as Case No. PUE-2003-00062 and all associated papers be filed herein.

(2) Within three business days of the filing of this Order with the Clerk, the Commission Staff shall mail a copy of this Order to each member of the LTTF, to its staff, and to the Attorney General.

(3) Within five business days of the filing of this Order with the Clerk, the Commission Staff shall transmit electronically or mail copies of this Order to interested persons and organizations as discussed in this Order.

(4) The Commission Staff shall promptly submit a copy of this Order for publication in the *Virginia Register*.

(5) On or before March 7, 2003, the Commission Staff shall file with the Clerk a certificate of the mailing required by paragraph (2).

(6) On or before March 14, 2003, the Commission Staff shall file with the Clerk a certificate of the transmission or mailing required by paragraph (3) and include a list of the names and addresses of persons to whom the Order was transmitted or mailed.

(7) On or before March 14, 2003, any person shall file with the Clerk of the Commission, c/o Document Control Center, P.O. Box 2118, Richmond, Virginia 23218-2118, a letter expressing the intention to represent a group in this matter. The letter shall include a complete mailing address, voice telephone number, facsimile telephone number (if available), and electronic mail address (if available). If several interested persons are members of the same organization or employees of the same entity, they shall designate in the letters one contact person. Interested persons are encouraged to transmit a copy of the letter filed with the Clerk, or the requested information, to econfin@scc.state.va.us.

(8) On or before March 21, 2003, one paper copy of any responses to the questions set out in this Order, and, if possible, an electronic copy of the complete response to

questions 5 and 7, if any portion of the response is deemed confidential, shall be mailed or delivered to the following Commission Staff:

Ronald A. Gibson, Director
Division of Public Utility Accounting
State Corporation Commission
P.O. Box 1197
Richmond, VA 23218-1197

Lawrence T. Oliver, Assistant Director
Division of Economics and Finance
State Corporation Commission
P.O. Box 1197
Richmond, VA 23218-1197

William F. Stephens, Director
Division of Energy Regulation
State Corporation Commission
P.O. Box 1197
Richmond, VA 23218-1197

Wayne N. Smith
Office of General Counsel
State Corporation Commission
P.O. Box 1197
Richmond, VA 23218-1197

If possible, complete copies of responses to the questions, including spreadsheets, attachments, and the like, should be transmitted electronically to econfin@scc.state.va.us. Any portion of the responses to questions 5 and 7 deemed confidential should be deleted from responses transmitted to this electronic address.

(9) Until the work group reaches agreement on access and dissemination, or until otherwise ordered by the Commission, Staff members receiving written and electronic copies of responses to questions 5 and 7 shall treat as confidential any

material clearly marked as confidential and shall limit access to other Staff members participating in the work group.

(10) The Commission Staff shall post promptly upon receipt all materials received by electronic transmission to econfin@scc.state.va.us on the Division of Economics and Finance Web site, http://www.state.va.us/scc/division/eaf/comments.htm. The Commission Staff shall not be responsible for editing any posted document to remove information deemed confidential.

(11) The Commission Staff shall convene the work group on April 1, 2003, in the Tyler Building, 1300 East Main Street, Richmond, Virginia, at 9:00 A.M. If necessary, the Staff may convene the meeting on the same date at the same time at a nearby-location. The Staff shall make a reasonable effort to inform interested persons of the new location.

(12) Individuals with disabilities who require an accommodation to participate in the work group meetings should contact the Commission at least seven (7) days before the scheduled meeting date at 1-800-552-7945 (voice) or 1-804-371-9206 (TDD).

(13) On or before May 30, 2003, the work group shall forward to the Commission a draft of the report called for in Requested Actions paragraph 2 of the LTTF Resolution, or advise the Commission that it was unable to develop consensus recommendations so that the Commission may implement the

provisions of Requested Actions paragraph 8 of the LTTF Resolution.

(14) On or before September 30, 2003, the work group shall forward to the Commission a draft of the report called for in Requested Actions paragraph 3 of the LTTF Resolution adopted, or advise the Commission that it was unable to develop consensus recommendations so that the Commission may implement the provisions of Requested Actions paragraph 8 of the LTTF Resolution.

Parties Filing Letters of Intent

Attachment 5

PARTIES FILING LETTERS OF INTEREST
CASE NO. PUE-2003-00062

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Division of Consumer Counsel
Office of Attorney General
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Virginia Committee For Fair Utility Rates
Old Dominion Committee for Fair Utility Rates
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VML/VACo APCo Steering Committee
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Virginia Electric and Power Company

Earnings Available for Stranded Cost Recovery

Attachment 6

VIRGINIA ELECTRIC AND POWER COMPANY
EARNINGS AVAILABLE FOR STRANDED COST RECOVERY
VIRGINIA JURISDICTIONAL AFTER REGULATORY ACCOUNTING ADJUSTMENTS
FOR THE YEARS 1999 - 2002
IN THOUSANDS

		(1)	(2)	(3)	(4)	(5)
NO.		1999	2000	2001	2002	Total
1	**OPERATING REVENUE**	3,608,416	3,762,524	3,865,197	4,050,144	
2	**OPERATING REVENUE DEDUCTIONS**					
3	OPERATION & MAINTENANCE EXPENSE	2,116,389	2,164,417	2,498,319	2,176,594	
4	DEPRECIATION & AMORTIZATION	424,575	427,530	396,227	383,881	
5	FEDERAL INCOME TAXES	222,102	251,272	236,820	393,973	
6	TAXES OTHER THAN INCOME TAXES	203,742	206,106	118,798	109,506	
7	(GAIN)/LOSS ON DISPOSITION OF PROPERTY	(1,694)	(2,711)	909	(3,894)	
8	**TOTAL OPERATING REVENUE DEDUCTIONS**	2,965,114	3,046,614	3,251,073	3,060,060	
9	**OPERATING INCOME**	643,302	715,910	614,124	990,084	
10	PLUS: AFUDC	0	0	0	0	
11	LESS: CHARITABLE DONATIONS	2,495	2,429	878	1,699	
12	OTHER INTEREST EXPENSE/(INCOME)	8,258	7,070	7,035	3,933	
13	**ADJUSTED OPERATING INCOME**	**632,549**	**706,411**	**606,211**	**984,452**	
14	PLUS: OTHER INCOME/(EXPENSE)	0	0	0	0	
15	LESS: INTEREST EXPENSE-BOOKED	215,329	226,524	233,233	220,174	
16	PREFERRED DIVIDENDS	37,445	35,899	27,956	23,273	
17	JDC CAPITAL EXPENSE	14,504	13,283	11,545	9,827	
18	**INCOME AVAILABLE FOR COMMON EQUITY**	**365,270**	**430,705**	**333,477**	**731,178**	
19	ALLOWANCE FOR WORKING CAPITAL	298,988	341,363	352,754	437,068	
20	PLUS: NET UTILITY PLANT	7,634,626	7,725,123	7,893,609	7,996,417	
21	LESS: OTHER RATE BASE DEDUCTIONS	960,527	886,656	985,070	1,045,092	
22	**TOTAL AVERAGE RATE BASE**	**6,973,087**	**7,179,830**	**7,261,293**	**7,388,393**	
23	TOTAL AVERAGE CAPITAL	6,973,087	7,179,830	7,261,293	7,388,393	
24	AVERAGE COMMON EQUITY CAPITAL	3,180,285	3,283,552	3,250,082	3,265,522	
25	% RATE OF RETURN EARNED ON AVG. RATE BASE	9.07%	9.84%	8.35%	13.32%	
26	% RATE OF RETURN EARNED ON AVG. COMMON EQ.	11.49%	13.12%	10.26%	22.39%	
27	**EARNINGS AVAILABLE FOR STRANDED COSTS**	**40,388**	**142,155**	**23,893**	**679,916**	**886,352**

Note: 2001 included $155 million of Virginia Jurisdictional NUG contract write-offs in O&M Expense.
Capital structure reflects index method prescribed in the Stipulation in Case No. PUE-1996-00296.
Stranded cost recovery is reflected at 100% of excess earnings for all years.
Depreciation expense reflects amounts recorded on the financial statements.