Commonwealth of Virginia

Office of the Attorney General

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

Pursuant to Enactment Clause 6 of Chapters 888 and 933 of the 2007 Acts of the General Assembly Concerning Electric Utility Regulation

November 1, 2007

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I. Introduction

In 2007, the General Assembly adopted comprehensive legislation amending the Virginia Electric Utility Restructuring Act, and related provisions of Title 56 of the Code of Virginia, to re-regulate the rates of the Commonwealth's electric utilities and establish goals for the generation of electricity from renewable sources. Enactment clause 6 of Chapters 888 and 933 of the 2007 Acts of the General Assembly (Senate Bill 1416 and House Bill 3068, (hereinafter "the Act")), directs the Office of the Attorney General ("Office"), in consultation with the State Corporation Commission ("SCC" or "Commission"), to submit reports to the Commission on Electric Utility Restructuring on or before November 1, 2007, and again on or before November 1, 2008, that identifies and recommends appropriate corrective legislation to address any issues that may impede the implementation of the provisions of the Act.

The Report reflects this Office's review and analysis of the Act and concerns expressed to the Office by the SCC. Most of the provisions of the Act will be implemented for the first time in future proceedings before the Commission. Indeed, several cases requiring implementation of the Act are

currently pending.[1] The adjudication of these cases, and those that will follow, will offer experience with actual implementation and may identify additional issues in need of legislative correction.

The suggestions herein do not endeavor to foreclose interpretation of the statutory provisions. Accordingly, this Report does not attempt to identify and analyze every provision of the Act susceptible to differing interpretations. Rather it presents modest proposals for clarification and simplifications.[2]

II. Issues that May Impede Implementation of Provisions of the Act

A. § 56-233.1 – Impact on requirements for use of competitive bidding in purchasing and construction practices by public utilities generally.

Section 56-233.1, an existing provision of Chapter 10 of Title 56, required all utilities – not just electric – to use competitive bidding in purchasing and construction practices. In an effort to conform that statutory provision to the new provisions of § 56-585.1, a change was made to the description of utilities subject to the requirement, replacing the word "annual" with the word "biennial" to reflect the adoption of the biennial review process for electric utilities. The change, however, inadvertently eliminates the statutory obligation for natural gas utilities, water utilities, and any electric utility not subject to the new provisions and thus still subject to "annual" reviews. This preexisting statutory requirement can be restored by adoption of the following change:

[1] Application of Virginia Electric and Power Company, For a certificate to construct an electric generation facility in Wise County, Virginia, and for approval of a rate adjustment clause under §§ 56-585.1, 56-580 D, and 56-46.1 of the Code of Virginia, Case No. PUE-2007-00066; Application of Appalachian Power Company, To revise its fuel factor pursuant to § 56-249.6 of the Code of Virginia, Case No. PUE-2007-00067; Application of Appalachian Power Company, For a rate adjustment clause pursuant to § 56-585.1 A 6 of the Code of Virginia, Case No. PUE-2007-00068.

[2] The matters addressed by the Report are set forth generally in the order in which the provisions appear in the Code. Certain Code sections appear more than once, addressed under different topic headings. Suggested amendments to a provision of a Code Section noted under one topic are not also shown in unrelated suggested amendments to the same Code section under another topic.

§ 56-233.1 Public utilities purchasing practices.

Every public utility subject to the ***annual or*** biennial review provisions of Title 56 shall use competitive bidding to the extent practicable in its purchasing and construction practices. In addition, all such public utilities shall file with the Commission and keep current a description of its purchasing and construction practices.

B. § 56-584 - Recovery of stranded costs.

This provision originally stated that stranded costs could be recovered through either capped rates or wires charges. The Act correctly amended this section to strike the clause pertaining to wires charges, but overlooked striking the word "either." This omission can be corrected by adoption of the following amendment:

§ 56-584. Stranded costs.

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. To the extent not preempted by federal law, the establishment by the Commission of wires charges for any distribution cooperative shall be conditioned upon such cooperative entering into binding commitments by which it will pay to any power supply cooperative of which such distribution cooperative is or was a member, as compensation for such power supply cooperative's stranded costs, all or part of the proceeds of such wires charges, as determined by the Commission.

C. § 56-585 - Elimination of default service obligation upon the expiration or termination of capped rates.

The Act amended § 56-585 concerning default service to provide that default service shall expire upon the expiration or termination of capped rates. This provision was added to § 56-585 because, with the re-regulation of

generation, there will be regulated rates, and thus availability of default service will no longer be necessary. However, the elimination of default service obligations for all Virginia utilities has consequences contrary to another express provision of the Act.

Allegheny Power and Delmarva Power and Light were permitted to divest their generation assets subject to Orders of the SCC ensuring protection of consumers from the risks of the utilities' decision to divest. The Orders incorporated agreements by the companies to price their generation in accordance with prescribed formulae that would insulate customers from potentially higher unregulated market rates *during such time as the utilities had default service obligations*. Thus, without a default service obligation an argument could be made that the divestiture agreements – and the related SCC Orders - are inoperative.[3] However, the fifth enactment clause of the Act explicitly provides that nothing in the Act shall be deemed to modify or impair the terms, unless otherwise modified by an order of the SCC, of any order of the Commission approving the divestiture of a utility's generation assets that was entered pursuant to § 56-590.

Thus, the intent of the General Assembly, as expressed in the subsequent enactment clause, should be clear. The technical conflict can be eliminated in a manner that reconciles the Act's provision to the stated intent of the enactment clause with the following amendment:

> § 56-585. Default service.
>
> A. The Commission shall, after notice and opportunity for hearing, (i) determine the components of default service and (ii) establish one or more programs making such services available to retail customers requiring them during the availability throughout the Commonwealth of customer choice for all retail customers as established pursuant to § 56-577. For purposes of this chapter, "default service" means service made available under this section to retail customers who (i) do not affirmatively select a

[3] In July 2007, Delmarva entered an agreement to transfer its Virginia service territory to A&N Electric Cooperative. The SCC approved the transfer on October 19, 2007, in Case Nos. PUE-2007-00061, et al. It therefore appears this issue is now moot as to Delmarva.

supplier, (ii) are unable to obtain service from an alternative supplier, or (iii) have contracted with an alternative supplier who fails to perform. Availability of default service shall expire upon the expiration or termination of capped rates *except as to any incumbent electric utility that divested its generation assets with approval of the Commission pursuant to §56-590 prior to January 1, 2002.*

D. § 56-585.1 A.2, A.8, and A.9 – Combined rates of return on both generation and distribution services.

There are provisions of § 56-585.1 in subdivisions A.2.g., A.8(i), (ii), and (iii), and A.9 that speak of a "combined rate of return on both its generation and distribution services . . . ." These provisions are preceded in subdivisions A.8 and A.9 by the clause "considered as a whole." It is unclear what, if anything, "on both" requires. It is fair to conclude that "considered as a whole" and "combined rate of return" mean that the earnings at issue should be considered on a bundled basis, regardless of the unbundled earnings for generation and distribution considered separately. There is no reason to believe that "on both" was intended to change that logical result. However, the language could be used to support an argument that a determination of the requisite earnings be made separately for generation and distribution, and that rate increases (or credits, or decreases) are ordered *only* if earnings from both generation and distribution – considered separately – are *each* below (or above) the authorized rate of return. At the very least, the "on both" language is surplusage that creates uncertainty. For clarity, "both" should be stricken from these provisions.

The following amendments to subdivisions 2, 8 and 9 of § 56-585.1 A would accomplish this clarification:

§ 56-585.1. Generation, distribution, and transmission rates after capped rates terminate or expire.

. . . .

A.2.g. If the combined rate of return on common equity earned by ~~*both*~~ the generation, and distribution services is no more than 50

basis points above or below the return as so determined, such combined return shall not be considered either excessive or insufficient, respectively.

. . . .

A.8. If the Commission determines as a result of such biennial review that:

(i) The utility has, during the test period or periods under review, considered as a whole, earned more than 50 basis points below a fair combined rate of return on ~~*both*~~ its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, the Commission shall order increases to the utility's rates necessary to provide the opportunity to fully recover the costs of providing the utility's services and to earn not less than such fair combined rate of return, using the most recently ended 12-month test period as the basis for determining the amount of the rate increase necessary. . . . ;

(ii) The utility has, during the test period or test periods under review, considered as a whole, earned more than 50 basis points above a fair combined rate of return on ~~*both*~~ its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, the Commission shall, subject to the provisions of subdivision 9, direct that 60 percent of the amount of such earnings that were more than 50 basis points above such fair combined rate of return for the test period or periods under review, considered as a whole, shall be credited to customers' bills. . . . ; or

(iii) Such biennial review is the second consecutive biennial review in which the utility has, during the test period or test periods under review, considered as a whole, earned more than 50 basis points above a fair combined rate of return on ~~*both*~~ its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matter determined with respect to facilities described in subdivision 6, the Commission shall, subject to the provisions of subdivision 9 and in addition to the actions authorized in clause (ii) of this subdivision, also order reductions to the utility's rates it finds appropriate. However, the Commission may not order such rate reduction unless it finds that the resulting rates will provide the utility with the opportunity to fully recover its costs of providing its services and to earn not less than

a fair combined rate of return on ~~*both*~~ its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, using the most recently ended 12-month test period as the basis for determining the permissibility of any rate reduction under the standards of this sentence, and the amount thereof.

. . . .

A.9. If, as a result of a biennial review required under this subsection and conducted with respect to any test period or periods under review ending later than December 31, 2010 (or, if the Commission has elected to stagger its biennial reviews of utilities as provided in subdivision 1, under review ending later than December 31, 2010, for a Phase I Utility, or December 31, 2011, for a Phase II Utility), the Commission finds, with respect to such test period or periods considered as a whole, that (i) any utility has, during the test period or periods under review, considered as a whole, earned more than 50 basis points above a fair combined rate of return on ~~*both*~~ its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, . . .

E. § 56-585.1 A.2.e - In setting the return on equity within the peer group range, the SCC shall strive to maintain costs of retail electric energy that are cost competitive with costs of retail electric energy provided by the other peer group investor-owned electric utilities.

This provision gives the SCC an additional tool to help ensure that the retail cost of electricity charged to consumers by Virginia's utilities does not become excessive as compared to the rates charged by other utilities in the region.[4] However, instead of referring to "rates" -- which the Commission sets -- it refers to "costs." The reference to the "costs of retail electric energy" is intended to refer to the amount paid by consumers. In the utility ratemaking context, those "costs" properly are referred to as rates. The use of the term costs

[4] The laws governing utility ratemaking typically prevent a regulatory agency from considering factors external to the subject utility's own costs. Section 56-585.1 A.2.e appears to be a legally permissible variation of the usual ratemaking approach, provided the Commission does not employ it to set rates so low as to result in an unconstitutional regulatory taking.

instead invites confusion and impossibility of performance. The Commission has no practical means of ascertaining the "costs" of utilities outside its jurisdiction. The following amendment would correct the problem:

> § 56-585.1 A.2.e. In addition to other considerations, in setting the return on equity within the range allowed by this section, the Commission shall strive to maintain ~~*costs of*~~ *rates for* retail electric energy that are ~~*cost*~~ competitive with ~~*costs of*~~ *rates for* retail electric energy provided by the other peer group investor-owned electric utilities.

F. §§ 56-585.1 A.3, 56-585.1 A.4, 56-585.1 A.5 and 56-585.1 A.7 - Stand-Alone Rate Adjustment Clauses.

These provisions establish, and set forth procedures for the recovery of certain costs through, annual "rate adjustment clauses." Utilities may not petition for approval of such clauses more than once in any 12-month period. The SCC must consider these petitions on a "stand-alone basis without regard to other costs, revenues, investments, or earnings of the utility." Section 56-585.1 A.3 directs that, once implemented, any rate adjustment clauses pursuant to subdivision 4 or 5, or those related to facilities utilizing simple-cycle combustion turbines described in subdivision 6, are to be combined with the utility's costs, revenues, and investments in the next biennial review *only if* the SCC *first* determines in the biennial review that rates should be revised or credits be applied to customers' bills.

The primary intent of these clauses is to provide utilities with the opportunity for more timely recovery of costs between biennial reviews of their base rates. Accomplishing that purpose does not require that, once implemented, consideration of the costs and revenues captured by rate adjustment clauses in biennial reviews be conditioned on the limited circumstances currently provided by the Act. As a practical matter, implementation would be simplified if they are included with the utility's other costs and revenues and considered in the utility's subsequent biennial review

from the outset of that process. We have been unable to identify any meaningful advantage to the current "two-step" process. That result can be accomplished with the following amendment:

> § 56-585.1 A.3. Each such utility shall make a biennial filing by March 31 of every other year, beginning in 2011, consisting of the schedules contained in the Commission's rules governing utility rate increase applications (20 VAC 5-200-30); however, if the Commission elects to stagger the dates of the biennial reviews of utilities as provided in subdivision 1, then Phase I utilities shall commence biennial filings in 2011 and Phase II utilities shall commence biennial filings in 2012. Such filing shall encompass the two successive 12-month test periods ending December 31 immediately preceding the year in which such proceeding is conducted, and in every such case the filing for each year shall be identified separately and shall be segregated from any other year encompassed by the filing. ~~*If the Commission determines that rates should be revised or credits be applied to customers' bills pursuant to subdivision 8 or 9, a*~~*Any* rate adjustment clauses previously implemented pursuant to subdivision 4 or 5, or those related to facilities utilizing simple-cycle combustion turbines described in subdivision 6, shall be combined with the utility's costs, revenues and investments until the amounts that are the subject of such rate adjustment clauses are fully recovered. ~~*The Commission shall combine such clauses with the utility's costs, revenues and investments only after it makes its initial determination with regard to necessary rate revisions or credits to customers' bills, and the amounts thereof, but a*~~*After* such clauses are combined as herein specified, they shall thereafter be considered part of the utility's costs, revenues, and investments for the purposes of future biennial review proceedings. By the same date, each such utility shall also file its plan for its projected generation and transmission requirements to serve its native load for the next 10 years, including how the utility will obtain such resources, the capital requirements for providing such resources, and the anticipated sources of funding for such resources.

G. § 56-585.1 A.5.b - Recovery of costs for demand-side management, conservation, energy efficiency and load management programs.

Section 56-585.1 A.5.b provides a rate adjustment clause for costs associated with conservation efforts. The existing language "Projected and actual costs of providing incentives for the utility to design and operate . . ." is confusing. The language appears to authorize recovery of only the costs of providing incentives and not the actual costs of the programs themselves. Assuming the intent was to authorize recovery of the costs of the program, the amendment suggested below would make that clear. It would also change the phrase "demand-management" to the term of art used in the industry, "demand-*side* management," to be clear that no other reference is intended.

> § 56-585.1 A.5.b. Projected and actual costs ~~*of providing incentives*~~ for the utility to design and operate fair and effective demand-*side* management, conservation, energy efficiency, and load management programs, *including incentives to undertake such programs*. The Commission shall approve such a petition if it finds that the program is in the public interest and that the need for the incentives is demonstrated with reasonable certainty; provided that the Commission shall allow the recovery of such costs as it finds are reasonable;

H. § 56-585.1 A.5.a., b., c., and d. - Commission authority to determine the duration or amortization period for rate adjustment clauses.

These provisions establish and set forth procedures for the recovery of certain costs through annual "rate adjustment clauses." Beneath § 56-585.1 A.5.d, it states "[t]he Commission shall have the authority to determine the duration or amortization period for any adjustment clause approved under this subdivision." While it is logical that this should apply to each of the clauses of A.5, it could be interpreted to apply to only A.5.d. For clarity and to ensure proper implementation by the SCC, we believe it should be explicit that the Commission's authority to determine the duration and amortization periods applies to each clause under subdivision A.5. The amendment suggested below would make that clear.

§ 56-585.1 A.5. A utility may at any time, after the expiration or termination of capped rates, but not more than once in any 12-month period, petition the Commission for approval of one or more rate adjustment clauses for the timely and current recovery from customers of the following costs:

a. Incremental costs described in clause (vi) of subsection B of § 56-582 incurred between July 1, 2004, and the expiration or termination of capped rates, if such utility is, as of July 1, 2007, deferring such costs consistent with an order of the Commission entered under clause (vi) of subsection B of § 56-582. The Commission shall approve such a petition allowing the recovery of such costs that comply with the requirements of clause (vi) of subsection B of § 56-582;

b. Projected and actual costs of providing incentives for the utility to design and operate fair and effective demand-management, conservation, energy efficiency, and load management programs. The Commission shall approve such a petition if it finds that the program is in the public interest and that the need for the incentives is demonstrated with reasonable certainty; provided that the Commission shall allow the recovery of such costs as it finds are reasonable;

c. Projected and actual costs of participation in a renewable energy portfolio standard program pursuant to § 56-585.2 that are not recoverable under subdivision 6. The Commission shall approve such a petition allowing the recovery of such costs as are provided for in a program approved pursuant to § 56-585.2; and

d. Projected and actual costs of projects that the Commission finds to be necessary to comply with state or federal environmental laws or regulations applicable to generation facilities used to serve the utility's native load obligations. The Commission shall approve such a petition if it finds that such costs are necessary to comply with such environmental laws or regulations. If the Commission determines it would be just, reasonable, and in the public interest, the Commission may include the enhanced rate of return on common equity prescribed in subdivision 6 in a rate adjustment clause approved hereunder for a project whose purpose is to reduce the need for construction of new generation facilities by enabling the continued operation of existing generation facilities. In the event the Commission includes such enhanced return in such rate adjustment clause, the project that is the subject of such clause shall be treated as a facility described in subdivision 6 for the purposes of this section.

> The Commission shall have the authority to determine the duration or amortization period for any adjustment clause approved under ~~*this*~~ subdivision*s 5 a through 5 d*.

I. § 56-585.1 A.7 and A.8 - Deadlines for SCC final orders.

Section 56-585.1 A.7 prescribes deadlines of three months, eight months, and nine months from filing, respectively, for the Commission to enter final orders on petitions for rate adjustment clauses filed pursuant to subdivisions A.4 (certain transmission related costs), A.5 (costs for environmental compliance, conservation and energy efficiency programs, or renewable energy portfolio standard programs), and A.6 (costs for new generation facilities or major unit modifications). In addition, § 56-585.1 A.8 requires a final order within nine months from the end of the test period, in a biennial rate review, which is six months after filing.

As a practical matter, these statutory deadlines may limit the level of participation that can be afforded to the parties involved in these proceedings. The SCC typically provides for public notice of rate filings and allows time for case participants to retain consultants, conduct discovery, and pre-file testimony before a public hearing. Following a hearing, legal briefs are often required after a transcript of the hearing becomes available. The statutory deadlines likely will require curtailing the time allotted for some of this traditional practice, or revision of the practice altogether. However, given the Commission's authority to adopt its own rules of practice, it would be premature to assume a need for a legislative remedy at this time.

Several proceedings are currently pending at the Commission under § 56-585.1 A.5.a and A.6. These cases will provide practical experience with the new statutory deadlines. Also, pursuant to § 56-585.1 E, the Commission is directed to promulgate rules and regulations as may be necessary to implement the provisions of § 56-585.1. This rulemaking opportunity will allow the SCC to adopt procedures for adjudication of the filings subject to statutory deadlines in a

manner that optimizes the time allotted to the case participants and to the Commission. There will be an opportunity to revisit this issue in the 2008 report, if necessary, with some experience to form the basis of any recommendation.

J. § 56-585.1 A.8 - Actions taken in biennial review.

The term "such biennial review" in the opening clause of § 56-585.1 A.8 was the result of that text originally following the biennial review section of the Act (subdivision A.3 of § 56-585.1). Because subdivision A.8 is now separated from the biennial review provisions of the § 56-585.1 by five subdivisions, the language is no longer helpful. A corrective amendment follows:

> § 56-585.1 A.8. If the Commission determines as a result of ~~*such biennial review*~~ *reviews conducted under subdivision A.3* that: . . . .

K. § 56-585.1 A.8(i) - Biennial review rate increases.

Section 56-585.1 A.8 sets forth the provisions for increasing rates (clause (i)), crediting customer bills (clause (ii)), and decreasing rates (clause (iii)) in the biennial review process. Under 8(iii), when there have been over-earnings for two consecutive biennial reviews, in addition to credits pursuant to 8(ii), the SCC shall order rate reductions. However, there is conditional language in 8(iii) instructing that the Commission may not order rate reductions "unless it finds that the resulting rates will provide the utility with the opportunity to fully recover its costs of providing its services and to earn not less than a fair combined rate of return . . . ." It is possible a utility would have over-earned in the past, but due to rising costs or other factors a prospective rate reduction would not provide it with the opportunity to continue to recover its costs and earn a fair return.

The identical conditional language appears in Subdivision 8(i) pertaining to rate increases. However, because the inquiry engaged in for determining the appropriateness of a rate increase following a period of under-earnings is

different than that for a rate decrease, the conditional language should be adjusted slightly to have an equivalent beneficial effect. For a rate increase following a period of under-earnings the relevant inquiry is not simply whether a prospective rate increase *will* provide the utility with the opportunity to continue to recover its costs and earn a fair return, but whether, due to the possibility of falling costs or other factors, the increase is *necessary* to do so. This point is illustrated by the existing language in the first sentence of 8(i) that "the Commission shall order increases to the utility's rates necessary to provide the opportunity to fully recover the costs . . . ."

The following amendment would resolve this issue:

> § 56-585.1 A.8. If the Commission determines as a result of such biennial review that:
>
> (i) The utility has, during the test period or periods under review, considered as a whole, earned more than 50 basis points below a fair combined rate of return on both its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, the Commission shall order increases to the utility's rates necessary to provide the opportunity to fully recover the costs of providing the utility's services and to earn not less than such fair combined rate of return, using the most recently ended 12-month test period as the basis for determining the amount of the rate increase necessary. However, the Commission may not order such rate increase unless it finds that the resulting rates ~~will~~ *are necessary to* provide the utility with the opportunity to fully recover its costs of providing its services and to earn not less than a fair combined rate of return on both its generation and distribution services, as determined in subdivision 2, without regard to any return on common equity or other matters determined with respect to facilities described in subdivision 6, using the most recently ended 12-month test period as the basis for determining the permissibility of any rate increase under the standards of this sentence, and the amount thereof; . . . .

III. Conclusion

The Act represents a new approach to rate making for regulated electric utilities. This Office will report next year on implementation difficulties and proposed legislative correction that become apparent in the course of actual implementation of this new approach over the coming year. The attorneys and staff of the Office of the Attorney General are ready to assist in any way requested with regard to the issues and suggestions included herein.