

COMMENTS OF
VIRGINIA INDEPENDENT POWER PRODUCERS, INC.
COMMITTEE ON ELECTRIC UTILITY RESTRUCTURING
RE: STRANDED COSTS, METHODS AND CALCULATIONS
NOVEMBER 24, 2003
August Wallmeyer, Executive Director

Introduction

In these comments, Virginia Independent Power Producers, Inc. (“VIPP”) addresses: (1) Staff’s April 28, 2003 “Accounting Perspective” Proposal; (2) the proposed VCFUR approach distributed at the April 29, 2003 Working Group Meeting; (3) the clarified Virginia Power approach distributed on April 24, 2003; and (4) VIPP’s recommendations for legislative or administrative action, pursuant to paragraph 9 of the January 27, 2003 Resolution of the Legislative Transition Task Force (the “LTTF Resolution”).

VIPP asserts that the **Staff and VCFUR proposals are inconsistent with the basic approach to stranded costs recovery adopted by the Legislature in the Virginia Electric Utility Restructuring Act (the “Act”)** and, if adopted, would add an unnecessary element of complexity to the Work Group’s effort to be responsive to the LTTF. *See* ACT, § 56-595.C(iii).

The appropriate approach to monitoring stranded cost recovery is to compare (i) the cost-based generation component of capped rates to (ii) the generation-related revenues (including wires charge revenues) that would have been received based on competitive market prices throughout the transition period (on the assumption that all customers of the incumbent utility either switched to another supplier or received default service from the incumbent utility at market-based rates).¹ This determination of potential stranded costs would be a useful indicator of whether under- or over-recoveries may occur in the future. Moreover, since actual stranded costs cannot be determined until after 2007, this is the only reasonable methodology to present to the LTTF.

¹ If (i) is greater than (ii) there is an over-recovery; and *vice versa*.

Staff's "Accounting Perspective" Proposal

- Staff's proposed method would "indicate annual recoveries of stranded costs throughout the transition period [using] an accounting approach based on an earnings test mechanism." According to comments made at the April 22 Work Group meeting, Staff would perform the calculation of "excess" earnings on an annual basis between now and 2007 and would include in the calculation excess earnings from the transmission and distribution components of embedded cost rates.
- **Staff's proposal to use "excess earnings" to measure stranded cost recoveries is flatly inconsistent with the LTTF Resolution and the Act.** Paragraph 1 of the LTTF Resolution makes it clear that the definitions, methodology and calculations to be made under Paragraphs 2 and 3 of the Resolution must be "consistent with the Act." The Act is bereft of even an indirect reference to an earnings test as the basis for determining stranded cost recoveries. **Said differently, there is absolutely no linkage whatever, expressed or implied, in the Act between stranded cost recovery and a utility's earnings.** Staff's proposal to forge such a linkage would establish a far-reaching new policy for the Commonwealth. In so doing, Staff would be usurping territory that is the exclusive province of the General Assembly.
- The Staff Proposal would create a scheme of incentives directly at odds with the intent of the General Assembly. In formulating capped rates, the General Assembly intended to provide incumbent utilities with an incentive to reduce future stranded costs by engaging in cost cutting and stranded cost mitigation. Perversely, the Staff Proposal would now penalize utilities for doing exactly that. For example, under the Staff's "earnings test" proposal, an incumbent utility that cut \$10 million in expenses would now be found to have \$10 million more in "excess earnings" and would be penalized for cutting its costs.
- While the Staff Proposal would use the Annual Informational Filing ("AIF") as its starting point for the determination of "excess earnings," it is certain that **AIFs would not be**

acceptable to all parties as properly representing the incumbent utility’s revenue requirement. Experience shows that the AIF is only the first step in a series of discussions, akin to a rate case, about the extent to which book earnings should be adjusted to incorporate “rate making” adjustments. In addition to requiring resolution of these issues, the Staff Proposal would require reaching consensus as to an appropriate rate of return for each year of the transition period. In effect, the Staff Proposal would require the incumbent utility and the Staff to engage in complex annual rate cases—hardly the result anticipated by the General Assembly when it **deregulated** generation.

The Proposed VCFUR Approach

- ❑ Like Staff’s Proposal, the proposed VCFUR method would calculate stranded cost recoveries during the transition period. In so doing, the VCFUR method suffers from the same infirmities as the Staff Proposal. Thus, **the VCFUR method would also be contrary to the Act and would improperly reinstitute annual rate cases to determine so-called excess earnings.**
- ❑ 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 generation assets.
- ❑ Although VCFUR’s written comments attempt to convey the impression that the basic elements of the VCFUR proposal are required by the Act, this is not the case. Section 56-595.C(iii) provides that members of the LTF shall monitor 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. VCFUR’s written comments attempt to stretch and contort this language into a precise mathematical formula, stating that the “LTF *must* determine and compare two amounts: first, the amount that has been, or will be, available for recovery of just and reasonable net stranded costs, and second, the amount

of just and reasonable net stranded costs.” VIPP disagrees. VCFUR’s interpretation is simply not correct or required.

- First, although VCFUR would pretend otherwise,² **nowhere does the Act even mention the term “net” revenues and nowhere does it contemplate the rate case-type calculation that VCFUR says is absolutely “required.”** Second, contrary to VCFUR’s contention, the incredibly complex projection of future stranded costs that constitutes the second component of their proposal is not required either. VIPP believes that Section 56-595.C(iii)’s mandate to the LTTF to report on whether stranded costs are likely to be over- or under-recovered could and should be satisfied by using a far simpler method, such as the one proposed by Virginia Power to calculate potential stranded costs during the transition period.

- As thoroughly discussed in VIPP’s initial comments to the stranded costs working group, **the type of market price and embedded cost projections that VCFUR recommends would be unreliable and subjective in the extreme.**

The Clarified Virginia Power Approach

- The Virginia Power approach 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 cost 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 increase such costs during the transition period. Referring to items (2) and (3) of the Virginia Power approach, one can devise a fairly uncomplicated method of monitoring stranded costs.

- VIPP believes that this refreshingly down-to-earth approach would be acceptable under § 56-595.C(iii). First, unlike the Staff and VCFUR methods, the Virginia Power approach is

² See Fourth Bullet, April 22 VCFUR handout. Following a discussion of *net stranded costs* as set forth in § 56-584 in Bullet Three, VCFUR argues in Bullet Four that it necessarily follows (“Thus”) that the amount that will be available for recovery of net stranded costs is the “*net revenue* collected from wires charges and capped rates.”

consistent with the Act. Second, the Virginia Power method is 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.

VIPP's Recommendations for Appropriate Legislative or Administrative Action

- The stranded cost provisions of the Act were carefully crafted to achieve a balance among competing interests. In that balance lies Virginia's unique solution to the stranded cost issue. The General Assembly recognized the need for rate structures that would create an opportunity for the Commonwealth's incumbent utilities to recover just and reasonable net stranded costs and at the same time would ensure their financial stability as they approached the era of retail competition. **The key concept underlying the Act's stranded cost provisions is that stranded costs are not to be administratively determined and recovered on a dollar-for-dollar basis through discrete rate mechanisms, as in other jurisdictions. Unfortunately, and in direct conflict with the Act, the Staff and VCFUR monitoring proposals veer dangerously in this direction.**
- VIPP is extremely concerned that the **Staff and VCFUR proposals, if adopted by the Work Group and the LTTF, would put the Commonwealth back on a path leading to annual rate cases, intrusive re-regulation of utilities, and a hurried retreat from the Act's restructuring goals. This would be extremely unfortunate.** The implementation of the Act's well-considered framework for competition is in its early stages, and competition has just begun.

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