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February 15, 2011

BY HAND & E-MAIL

The Honorable Thomas K. Norment, Jr.(district03@senate.virginia.gov)
The Honorable Robert Tata (DelBTata@house.virginia.gov)
The Honorable John C. Watkins (district10@senate.virginia.gov)
The Honorable Timothy D. Hugo (DelTHugo@house.virginia.gov)
The Honorable Richard L. Saslaw (district35@senate.virginia.gov)
The Honorable William R. Janis (DelBJanis@house.virginia.gov)
The Honorable L. Louise Lucas (district18@senate.virginia.gov)
The Honorable Kenneth R. Plum (DelKPlum@house.virginia.gov)
The Honorable Terry G. Kilgore (DelTKilgore@house.virginia.gov)
The Honorable James M. Scott (DelJScott@house.virginia.gov)

Re: **Comments on Issues for Meeting of the Commission on Electric Utility Regulation, February 17, 2011**

Dear Senator Norment and other members of the Commission on Electric Utility Regulation:

We represent the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (collectively, "Committees"), which have for decades represented the interests of large industrial customers of Dominion Virginia Power ("DVP") and Appalachian Power Company ("APCo") in State Corporation Commission ("SCC") electricity rate cases. On behalf of the Committees, we wish to comment on issues of critical importance to such cases that are scheduled for consideration by the Commission on Electric Utility Regulation ("CEUR") during its meeting on February 17, 2011.

1st CEUR Issue: **Determination of a rate of return, including the utilization of peer groups and the rate of return floor**

Overall Response: The statutory floor applied to returns on common equity should be repealed.

2nd CEUR Issue: **Transmission rates and the role of regional transmission organizations ("RTOs")**

Overall Response: DVP's emphasis on Virginia being the second largest importer of electricity is misguided and disingenuous.

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3rd CEUR Issue: **Policy impacts and concerns related to the provision of basis point incentives**

Overall Response These incentives are not needed, increase rates unnecessarily, and should be repealed. The rationale often cited for such incentives is that Virginia is the second largest importer of electricity. This is misleading.

Attachment A to this letter provides greater detail concerning each response.

The 2007 statutory provisions for a rate of return floor and basis point incentives have driven up electric rates. Unnecessarily high electric rates can cause the loss of manufacturing jobs in Virginia. The General Assembly should not pick winners and losers in Virginia's economy by favoring more expensive in-state generation over manufacturing jobs.

We appreciate the opportunity to provide these comments to the Commission.

Sincerely,

Louis R. Monacell

Louis R. Monacell

Edward L. Petrini

cc Ms. Ellen Porter
Mr. Frank Munyan
Ms. Patty Lung

ATTACHMENT A

to Letter of February 15, 2011, to
Commission on Electric Utility Restructuring

1st CEUR Issue: Determination of a rate of return, including the utilization of peer groups and the rate of return floor

Overall Response: The statutory floor applied to returns on common equity should be repealed.

- **<u>The statutory floor diverges from a cost-based approach</u>**. Instead of determining the utility's return on equity on the basis of its "cost" of equity capital -- *i.e.*, the amount needed to attract equity investors -- the legislation places an artificial, non-cost-related "floor" on that return.
    - Utility rates customarily are set based on a utility's cost of providing utility service. An important element of a utility's cost is its return on common equity capital. The SCC determines the cost of equity based on the amount needed to attract equity investors to the utility. That is derived from analysis of financial market data.

- **<u>The "peer utilities" are arbitrarily defined by statute</u>**. The SCC must use an ROE that is no lower than the average of earned returns on equity reported by no less than a majority of a so-called "peer group" of utilities to the Securities and Exchange Commission for the three most recent annual periods for which such data are available. (The reported returns for the utilities with the two highest and the two lowest returns are not used in determining a majority.) The location of the utilities in the "peer group" are arbitrarily defined by the statute, to include certain utilities in the Southeast (*e.g.*, Kentucky is included but not Tennessee) despite the fact that Virginia utilities raise their equity capital in national and international markets.

- **<u>No other jurisdiction in the U.S. uses this approach</u>**. We are not aware of a single jurisdiction in the U.S. that uses the approach in the Virginia statute. Moreover, as a witness for the Navy testified in DVP's most recent base rate case, the approach in the statute reflects a method discarded years ago, called the "comparable earnings" method, which used historical accounting returns for a select group of companies. Following the advent of market-based methods, he testified, the comparable earnings approach was "effectively discarded" in favor of those market-based methods, which more accurately assess a utility's required return. (Direct Testimony of Stephen G. Hill, SCC Case No. PUE-2009-00019, at 13) The Virginia law, he testified, "resurrect[s] that more inaccurate methodology—comparable earnings …" (Id.)

- **<u>The statutory "floor" has resulted in customers paying higher rates than necessary to compensate the utility for its costs</u>**. In the recent Appalachian Power ("APCo") rate case, the SCC found that APCo's cost of equity capital was between 9.5% and 10.5%.

Absent the statute, this finding typically would produce an ROE for ratemaking purposes of 10.0%, the mid-point of the range. However, due to the statutory "floor," the SCC was required to set rates based on 10.53%. The result was an increase of $1.5 million in APCo's rates above the level that would have prevailed but for the statute.

- Similarly, in DVP's 2008 case for a rate rider for its Wise County coal plant, the SCC found that DVP's cost of equity was between 9.5% and 10.5%; however, because of the statutory "floor," the SCC set the ROE at 11.12%. The result, again, was unnecessarily higher rates for DVP's customers as a result of the statutory ROE floor.

- A settlement among the parties to DVP's most recent base rate case was approved by the SCC in March of 2010, so the SCC did not determine a cost of common equity capital in that case. All four of the non-DVP financial witnesses testified that DVP's cost of common equity was approximately 10% or less (one testified that it was 9.5%). The ROE included in the settlement was 11.9%. The November 2010 issue of *Public Utilities Fortnightly*, a widely read trade magazine, contains recently authorized utility ROEs. DVP's 11.9% ROE is higher than any of the other U.S. electric utility ROEs on the list.

- **Because of the statutory floor, the utility has a greater incentive to increase its rate base and the common equity component of its capital structure**. Unnecessarily inflating a utility's ROE increases the utility's normal incentive to increase its rate base and the common equity component of its capital structure. The percentage of common equity in DVP's capital structure has increased. In DVP's most recent base rate case, it projected that the percentage of common equity in its capital structure would increase from 47.71% at year-end 2008 to 52.85% at year-end 2010. This results in higher rates as the utility substitutes equity capital for debt at three times the cost.

- **This statutory floor unnecessarily restricts the expert determinations of the SCC**. The SCC's determination of ROE under the "just and reasonable" standard has resulted in authorized returns that are fully in line with those in other states.

- **The "earned returns reported to the SEC" of southeast utilities are not reflective of the ROE of DVP and APCo for many reasons**:

  - Earned returns of southeast utilities include earnings unrelated to state-regulated retail electric service, such as earnings from natural gas sales, wholesale sales at market prices, etc.

  - Returns reported to the SEC are not adjusted for factors considered by the SCC and other regulators in determining a utility's authorized cost of equity, such as the utility's financial risks (represented by differing capital structures, for example) and regulatory risks (such as the extent to which the utility benefits from mechanisms intended to ensure recovery of costs).

2nd CEUR Issue: Transmission rates and the role of regional transmission organizations (RTOs)

Overall Response: DVP's emphasis on Virginia being the second largest importer of electricity is misguided and disingenuous.

- **This "anti-import" stance is misguided**. The emphasis should instead be on generating facilities that keep Virginia's rates as low as possible. Importing electricity from existing plants outside Virginia that have lower costs than those within Virginia may be the best way to achieve this goal.

- **The claim that Virginia is the second largest importer ignores important facts**. First, it ignores that over 80% of APCo's generation is located in West Virginia and that APCo is part of a seven-state tight power pool, *i.e.*, a pooling arrangement within the AEP affiliated system, that provides lower cost electricity to APCo's Virginia customers than APCo could procure on its own. Moreover, it ignores that DVP's own Mt. Storm coal unit is located just over the border in West Virginia.

- **DVP takes inconsistent positions regarding "imports."** DVP attempts *both*: (i) to emphasize the hundreds of millions of dollars that it saves by buying electricity from the PJM market, as opposed to running its more expensive units, *and* (ii) to emphasize the amount of electricity that it "imports" as a reason for its need to build expensive new power plants in Virginia.

3rd CEUR Issue: Policy impacts and concerns related to the provision of basis point incentives

Overall Response These incentives are not needed, increase rates unnecessarily, and should be repealed. The rationale often cited for such incentives is that Virginia is the second largest importer of electricity. This is misleading.

- **They are excessive and unneeded for adequate generation and service**. A utility should not receive a "bonus," at its customers' expense, for fulfilling its duty to serve its customers, a duty that arises from its state-regulated monopoly status. Moreover, a utility already has a powerful incentive to increase its rate base because its authorized return on equity – its profit level built into its rates -- is calculated, in part, based on the size of its rate base. Indeed, the entire, *existing* generation fleets of both DVP and APCo have been built *without* the basis point incentives included in the 2007 law. Other utilities, such as Duke Energy, are considering construction of new nuclear and other generating units without statutory "bonuses" in their ROE.

- **They will increase rates significantly**. If a Virginia utility were to construct a $10 billion nuclear plant, the 200 bonus points for building it could cost ratepayers over $125 million per year when the plant goes into service.

- **They are one-sided, slanted toward the utility**. DVP can claim the 50 basis point renewable portfolio standard ("RPS") bonus for achieving its RPS targets at little additional cost to DVP. It already owns renewable energy sources. According to the SCC Staff, DVP forecasts spending only $7.9 million (net present value) through 2025 for the purchase of certain renewable energy credits in order to meet its RPS goals. (SCC Staff Report, SCC Case No. PUE-2009-00082, at 7). Thus, at relatively little additional cost to DVP, ratepayers would pay 50 additional basis points for the RPS bonus, costing them approximately $33 million *per year* as a result of the statute. Moreover, the statute requires that a 100 bonus point negative adjustment for poor generation performance, customer service, and operating efficiency be erased by a 50 basis point bonus for achieving RPS goals.

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