

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION
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CASE NO. PUE-2009-00039

APPLICATION OF

APPALACHIAN POWER COMPANY

For recovery of environmental and
reliability costs

ORDER APPROVING SURCHARGE

On May 15, 2009, Appalachian Power Company ("Appalachian" or "Company") filed an application with the State Corporation Commission ("Commission") seeking adjustment of its electric rates pursuant to §§ 56-582 B (vi) and 56-585.1 A 5 of the Code of Virginia ("Code"). Appalachian seeks to revise its surcharge for the recovery of incremental environmental compliance and transmission and distribution system reliability costs ("E&R costs") incurred during calendar year 2008. Appalachian asserted that it incurred qualified incremental E&R costs during the period January 1, 2008 through December 31, 2008, resulting in a total net revenue requirement of \$102.2 million.

The Company represented that the revenue requirement is consistent with the methodologies approved by the Commission in previous E&R cases.¹ The Company also requested a 12.5% rate of return on common equity ("ROE") in this case. Appalachian further stated that its proposed surcharges reflect an allocation of E&R costs among customer rate classes by functional revenues in a manner consistent with its previous E&R cases.

The Commission issued an Order for Notice and Hearing on June 3, 2009, which docketed and required published notice of the application, established a procedural schedule for

¹ See *Applications of Appalachian Power Company for adjustment to capped electric rates pursuant to § 56-582 B (vi) of the Code of Virginia*, Case Nos. PUE-2005-00056, PUE-2007-00069, and PUE-2008-00045.

this case, scheduled a public hearing to commence on October 1, 2009, and assigned a Hearing Examiner to this matter.

On December 18, 2009, Chief Hearing Examiner Deborah V. Ellenberg entered a Report that explained the procedural history of this case, summarized the record, analyzed the evidence and issues in this proceeding, and made certain findings and recommendations ("Chief Hearing Examiner's Report").² The Chief Hearing Examiner noted that Notices of Intent to Participate in this proceeding were timely filed by the Old Dominion Committee for Fair Utility Rates ("Old Dominion Committee"), VML/VACo APCo Steering Committee ("VML/VACo Committee"), Steel Dynamics, Inc. ("Steel Dynamics"), and the Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel"). The Chief Hearing Examiner also discussed the testimony provided by the participants and by the two public witnesses, Senator William Roscoe Reynolds and Delegate Ward Armstrong.

The Chief Hearing Examiner explained that a Stipulation was offered by the Company, Staff, and VML/VACo Committee ("Stipulating Participants"), which recommended a revenue requirement of \$89.5 million for this case. Specifically, the Chief Hearing Examiner stated as follows:

The Stipulating Participants agree that the Company is entitled to a revenue requirement to recover \$89.5 million of incremental costs for E&R costs incurred during the period January 1, 2008 through December 31, 2008. . . .

The recommended revenue requirement was based upon the Staff's December 31, 2008, capital structure, its cost rates as revised on September 15, 2009, and an ROE of 10.6%.³

² An errata to the Chief Hearing Examiner's Report was entered on December 21, 2009.

³ Chief Hearing Examiner's Report at 9 (footnotes omitted).

No party objected to the revenue requirement proposed in the Stipulation.⁴

Next, the Chief Hearing Examiner noted that the principal "issue in controversy was the allocation of the revenue requirement among [customer] classes."⁵ Specifically, the Chief Hearing Examiner stated as follows:

Staff and the Company used the functional revenue approach to allocate the E&R costs among rate classes. That approach was used by the Commission in all prior E&R cases. However, the Commission used that approach because it did not have the benefit of a current [cost-of-service ('COS')] study. The Old Dominion Committee and Steel Dynamics assert that the Commission should approve a cost-based allocation method in this case.⁶

On this issue, the Chief Hearing Examiner found that the revenue requirement should be allocated as proposed by the Company and Staff, explaining as follows:

Staff witness Abbott expressed concern about the risk of a mismatch between cost-causation and recovery due to the assignment of costs using a revenue allocator versus a cost-of-service allocator, but the revenue-based allocator proposed in this case is generally reflective of the results of the COS study.

. . . The Commission continues to move toward cost-causation allocations, and should continue to do so in this case. I am concerned, however, with a rapid and sudden move to that goal as suggested by the Old Dominion Committee and Steel Dynamics. I therefore support and recommend that the Commission continue to allocate costs in this case as proposed by the Company and supported by Staff. I am persuaded by Staff witness Abbott's testimony that use of the functional revenue approach using data from the Company's last case does move most allocations toward cost-based allocation goals. . . .⁷

⁴ *Id.* at 10. The Chief Hearing Examiner further noted that, while "Consumer Counsel did not participate in the Stipulation," Consumer Counsel stated at the hearing that it "does not object to the proposed [S]tipulation" and that it "appears to us that the recovery permitted under the Stipulation is reasonable within the range of likely outcomes." *Id.* at 8 (quoting Tr. 135-136).

⁵ *Id.* at 10.

⁶ *Id.* at 10-11.

⁷ *Id.* at 11 (footnotes omitted).

In conclusion, the Chief Hearing Examiner made the following findings:

- (1) The Stipulation presents a reasonable resolution to those revenue requirement issues which it addresses, and should be adopted;
- (2) A revenue requirement of \$89.5 million to recover qualified E&R costs incurred during the period January 1, 2008, and December 31, 2008, is justified;
- (3) The revenue requirement should be allocated as proposed by the Company, and supported by Staff, which moves the allocation percentages closer to the cost-based allocation that would be indicated by the current COS study than have been applied in previous E&R cases, but would avoid further rate shock on residential customers that would be experienced with a drastic move to a cost-based methodology; and
- (4) The revised E&R factor should be applied for usage upon issuance of a Final Order herein.⁸

On or before December 29, 2009, the following participants filed comments on the Chief Hearing Examiner's Report: Appalachian; Steel Dynamics; Old Dominion Committee; and Staff.

The Company and Staff support the Chief Hearing Examiner's Report.

Steel Dynamics asserts that: (1) "a COS exists and indisputably shows unwarranted inter- and intra-class subsidies among the customer classes;" (2) "the ultimate recommendation set forth in the [Chief Hearing Examiner's] Report is to continue to use the flawed functional revenue approach to the allocation of E&R costs and to ignore the definitive cost-causation approach;" and (3) "the estimated rate impact on a typical residential customer's monthly bill of moving to cost of service would be *de minimis*."⁹ In addition, Steel Dynamics states that "the

⁸ *Id.* at 12.

⁹ Steel Dynamics' December 29, 2009 Comments at 2-3.

Commission should require that [Appalachian] file a COS-based customer class allocation study with all future rate filings."¹⁰

The Old Dominion Committee asserts as follows: (1) "[t]he [Old Dominion] Committee respectfully objects to the [Chief Hearing Examiner's] Report's recommendation regarding revenue apportionment;" (2) [the functional revenue method] "'improperly classifies too large a percentage of E&R costs as energy-related costs and too small a percentage as demand-related cost;" (3) "continued use of the [functional] revenue method in this case means continuation of the bizarre difference between the approach used to apportion E&R costs among customer classes in base rate cases and the approach used to apportion E&R costs in E&R surcharge cases;" and (4) "the Commission should apply the COS method for apportioning E&R costs in this case."¹¹

NOW THE COMMISSION, having considered this matter, adopts the recommendations in the Chief Hearing Examiner's Report as set forth herein.

Code of Virginia

Appalachian seeks an E&R rate adjustment clause pursuant to §§ 56-582 B (vi) and 56-585.1 A 5 of the Code. Section 56-582 B (vi) provides as follows:

The Commission may adjust such capped rates in connection with the following: . . . (vi) with respect to incumbent electric utilities that were not, as of the effective date of this chapter, bound by a rate case settlement adopted by the Commission that extended in its application beyond January 1, 2002, the Commission shall adjust such utilities' capped rates, not more than once in any 12-month period, for the timely recovery of their incremental costs for transmission or distribution system reliability and compliance with state or federal environmental laws or regulations to the extent such costs are prudently incurred on and after July 1, 2004.

¹⁰ *Id.* at 3 (typeface and case modified).

¹¹ Old Dominion Committee's December 29, 2009 Comments at 2, 5-7 (citation omitted).

Section 56-585.1 A 5 further states as follows:

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;

As required by the plain language of the statutes above, the Commission herein approves a rate adjustment clause for incremental E&R costs prudently incurred between January 1, 2008 and December 31, 2008, which is the historical period chosen by Appalachian for this case.

Revenue Requirement

We adopt the Chief Hearing Examiner's finding "that the revenue requirement recommended by the Stipulating Participants is reasonable."¹² Accordingly, we approve a revenue requirement of \$89.5 million for purposes of the E&R surcharge approved herein.

Class Allocation

As noted above, the Chief Hearing Examiner found that the revenue requirement should be allocated as proposed by the Company and Staff, and Steel Dynamics and the Old Dominion Committee opposed this allocation.

¹² Chief Hearing Examiner's Report at 10.

We adopt the Chief Hearing Examiner's recommendation. While a COS study is relevant in allocating costs among customer classes, such allocation need not exactly reflect a COS study in order to be reasonable. Indeed, as explained by this Commission over 15 years ago:

The primary goal of a [COS] study is to allocate and assign costs and revenues to each customer class as reasonably consistent as possible with the incurrence of those costs. However, it must be recognized that there is no scientifically correct method for allocating costs. A certain amount of judgment must be used in any [COS] study. [COS] studies are not precision instruments, but rather tools to facilitate the establishment of a zone of reasonableness.¹³

In this case we find, as posited by the Chief Hearing Examiner and Staff witness Abbott, that using the functional revenue approach proposed herein reasonably moves rates toward the class COS study presented in this matter. Moreover, the rate design approved herein assigns a lower allocation to industrial customers than the allocations utilized in both the Company's prior base rate case and prior E&R case.¹⁴ In sum, we conclude that, in this instance and based on the specific circumstances of this case, using a functional revenue approach results in a reasonable allocation of the revenue requirement approved herein.¹⁵

Finally, we note that the rate increase approved in this Order is lower than that requested in the Company's application. Appalachian sought \$102.2 million, but this amount has been

¹³ *Application of Commonwealth Gas Services, Inc., For a general increase in rates*, Case No. PUE-1992-00037, 1993 SCC Ann. Rept. 262, 264-265 (1993).

¹⁴ *See, e.g.*, Exh. 4 at 5 (Staff witness Abbott). Although not dispositive in our analysis herein, we also note that the cost to residential customers of moving rates completely to the COS in this proceeding – as requested by Steel Dynamics and the Old Dominion Committee – appears greater than that estimated by the Company at the hearing. *See, e.g.*, Exh. 2, Schs. 6 and 8 (Company witness Weis) (indicating that the rate impact on residential customers would be approximately 4.7%, which is greater than that suggested by Company witness Weiss during cross-examination (*see, e.g.*, Tr. 103)).

¹⁵ Finally, we do not herein mandate that the Company file a separate COS-based class allocation study in all future rate applications. This proceeding is limited to Appalachian's E&R surcharge under the terms of §§ 56-582 B (vi) and 56-585.1 A 5 of the Code and does not address other statutorily-permitted rate cases that the Company may file in the future. Accordingly, the need and/or relevancy of COS-based allocations in a future rate case may be subsequently addressed in proceedings related to that case.

reduced to \$89.5 million. Other Appalachian rate cases remain pending before this Commission. The Commission recognizes that many people and businesses in Appalachian's service territory are suffering from economic hardship and any rate increase is burdensome. Under Virginia law, however, the Company is authorized to recover costs reasonably incurred to comply with environmental requirements, which are a significant portion of this rate increase.¹⁶

Accordingly, IT IS HEREBY ORDERED THAT:

(1) The Company's application seeking a rate adjustment clause pursuant to §§ 56-582 B (vi) and 56-585.1 A 5 of the Code of Virginia is granted in part, and denied in part, as set forth herein.

(2) The Findings and Recommendations in the Chief Hearing Examiner's December 18, 2009 Report are adopted as set forth herein.

(3) The Company shall implement a line-item surcharge, designated on customer bills as "Environmental & Reliability Cost Recovery Surcharge," to recover the revenue requirement approved herein for incremental E&R costs prudently incurred from January 1, 2008, through December 31, 2008.

(a) Such surcharge shall be effective for service rendered on and after January 15, 2010, and shall be calculated as recommended in the Chief Hearing Examiner's December 18, 2009 Report.

(b) Such surcharge shall be designed to recover the revenue requirement approved herein for service rendered through December 31, 2010.

(c) Such surcharge shall cease for service rendered after December 31, 2010.

¹⁶ See, e.g., Exh. 20, Sched. 1 (Staff witness Carr); Exh. 11 at 3 (Company witness McManus).

(4) Consistent with the findings made herein, the Company shall forthwith file with the Commission's Division of Energy Regulation revised tariffs, effective for service rendered on and after January 15, 2010.

(5) The Company shall keep track of all base rate and surcharge recoveries of incremental E&R costs on a continuing basis and, beginning September 1, 2010, shall (a) file in this docket monthly reports of the same with the Clerk of the Commission, and (b) serve a copy on all parties to this proceeding.

(6) On or before February 1, 2011, the Company shall file an application with the Commission proposing a methodology by which to address any over- or under-recovery of the revenue requirement approved herein.

(7) This matter is continued.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to all persons on the official Service List in this matter. The Service List is available from the Clerk of the State Corporation Commission, c/o Document Control Center, 1300 East Main Street, First Floor, Tyler Building, Richmond, Virginia 23219. A copy shall also be sent to the Commission's Office of General Counsel and Divisions of Energy Regulation, Public Utility Accounting, and Economics and Finance.

A True Copy
Teste:


Clerk of the
State Corporation Commission