

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

AT RICHMOND, NOVEMBER 26, 2014

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2014 NOV 26 A 11: 15

APPLICATION OF

APPALACHIAN POWER COMPANY

CASE NO. PUE-2014-00026

For a 2014 biennial review of the rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to § 56-585.1 A of the Code of Virginia

FINAL ORDER

On March 31, 2014, Appalachian Power Company ("APCo" or "Company") filed an Application with the State Corporation Commission ("Commission") for a biennial review of the Company's rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to Va. Code § 56-585.1 A and the Commission's Rules Governing Utility Rate Applications and Annual Informational Filings, 20 VAC 5-201-10 *et seq.* ("Rate Case Rules"). Pursuant to Va. Code § 56-585.1 A 8, "[t]he Commission's final order regarding such biennial review shall be entered not more than eight months after the date of filing, and any revisions in rates or credits so ordered shall take effect not more than 60 days after the date of the order."

On April 8, 2014, the Commission issued an Order for Notice and Hearing that, among other things, established a procedural schedule for this case and directed APCo to provide public notice of this matter.

The following parties filed notices of participation: Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel"); Steel Dynamics, Inc. ("SDI"); The Kroger Co. ("Kroger"); VML/VACo APCo Steering Committee ("VML/VACo"); Wal-Mart Stores East, LP, and Sam's East, Inc. (collectively, "Wal-Mart"); Chesapeake Climate Action

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Network, Appalachian Voices, and the Virginia Chapter of the Sierra Club (collectively, "Environmental Respondents"); The Alliance for Solar Choice ("TASC"); and the Old Dominion Committee for Fair Utility Rates ("Committee").

The Commission held a public evidentiary hearing on the following days: September 16, 17, 18, 19, 22, 23, and 24, 2014. The Commission received testimony from witnesses on behalf of the participants and admitted over 130 exhibits. The Commission also received testimony from public witnesses, in addition to written comments from the public in this case.

On or before October 24, 2014, the following participants filed post-hearing briefs: APCo; VML/VACo; Wal-Mart; SDI; Kroger; Environmental Respondents; TASC; Committee; Consumer Counsel; and the Commission's Staff ("Staff").

NOW THE COMMISSION, upon consideration of this matter, is of the opinion and finds as follows.¹

This is APCo's second biennial review under § 56-585.1 A and covers the 2012-2013 historical two-year period. APCo's first biennial review was for 2009-2010. In the first biennial review, the Commission: (1) determined that, during 2009-2010, the Company earned more than 50 basis points below the previously-determined fair rate of return on common equity ("ROE") of 10.53%; (2) as directed by statute, ordered an increase to the Company's rates necessary to provide the opportunity to fully recover the costs of providing the utility's services and to earn not less than a fair combined rate of return,² which resulted in an annual rate increase of \$55,071,025; and (3) approved a new ROE of 10.9%, which was comprised of a market cost of

¹ In reaching the findings in this Final Order, the Commission reviewed and considered the extensive amount of evidence and argument in this proceeding, as well as the pleadings and briefs filed herein that (by themselves) comprise over 500 pages of this record. All amounts reflected in this order are on a Virginia jurisdictional basis unless otherwise noted.

² Va. Code § 56-585.1 A 8 (i).

equity of 10.4%, plus 50 basis points previously required by statute for a renewable energy portfolio standard performance incentive.³

"EARNED" RETURN

The Commission is required to determine whether the Company has, during the test period or periods under review, considered as a whole, "earned more than 50 basis points below [or above] a fair combined rate of return on its generation and distribution services . . . as determined in subdivision 2" ⁴ Based on the ROE determined in APCo's first biennial review, the fair combined rate of return for purposes of the 2012-2013 biennial review period is 10.9%, which results in a ± 50 basis points earnings band of 10.4% - 11.4%.⁵

In order to determine APCo's earned return for 2012-2013, we must rule on contested earnings adjustments related thereto. In 2011, when the requirement to determine earned return under this statute was a matter of first impression, we explained that such determination is not simply a calculation of entries as booked by the utility during the biennial period.⁶ Rather, the earned return under this regulatory statute must represent a utility's reasonable earned return, on

³ *Application of Appalachian Power Company, For a 2011 biennial review of the rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2011-00037, 2011 S.C.C. Ann. Rept. 477, Final Order (Nov. 30, 2011) ("APCo 2011 Biennial Review").

⁴ Va. Code § 56-585.1 A 8 (i), (ii).

⁵ The Commission has previously found that a utility's fair ROE as determined in a biennial review shall be applied to that utility's subsequent biennial review. *Application of Virginia Electric and Power Company, For a 2011 biennial review of the rates, terms, and conditions for the provision of generation, distribution, and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2011-00027, 2011 S.C.C. Ann. Rept. 456, 465, Final Order (Nov. 30, 2011) ("VEPCO 2011 Biennial Review"), *aff'd sub nom. Virginia Elec. and Power Co. v. State Corp. Comm'n*, 284 Va. 726, 744, 735 S.E.2d 684, 693 (2012) ("VEPCO v. SCC"). In 2013, the General Assembly codified this principle into § 56-585.1 A 8 as follows: "The fair combined rate of return on common equity determined pursuant to subdivision 2 in such biennial review shall apply, for purposes of reviewing the utility's earnings on its rates for generation and distribution services, to the entire two successive 12-month test periods ending December 31 immediately preceding the year of the utility's subsequent biennial review filing under subdivision 3." 2013 Va. Acts ch. 2.

⁶ *VEPCO 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 458, *aff'd sub nom. VEPCO v. SCC*, 284 Va. 726, 735 S.E.2d 684.

a regulatory basis, for the biennial period. Thus, to calculate earned return (which is generally net income divided by common equity), the Commission must determine the Company's reasonable revenues, expenses, and rate base for the historical biennium. This, by necessity, requires the Commission to rule on regulatory earnings adjustments proposed by both the utility and other participants in the case. The Commission applied this process for biennial reviews in both 2011 and 2013.⁷ Indeed, as previously explained by the Commission:

This is a first-of-its-kind proceeding before the Commission. The Commission is statutorily directed to determine what the Company earned on a regulatory basis for the direct purpose of possibly impacting customers' bills today by raising rates or issuing rate credits, and of possibly implementing a base rate decrease in the future (during the next biennial review). This also is unlike annual informational filings previously required by the Commission, which analyzed earnings for different purposes and for different potential outcomes. Thus, there is no direct prior precedent for this specific type of proceeding.⁸

APCo, however, now argues that the Commission is prohibited, by its Rate Case Rules or other law, from making certain earnings adjustments in this proceeding. The Rate Case Rules, among other things, set forth filing requirements for this biennial review and for other types of cases; those rules do not and cannot prohibit earnings adjustments required herein to determine the reasonable earned return under the statute.⁹ As noted above, for biennial reviews in 2011 and 2013 the Commission made specific regulatory earnings adjustments in order to determine the

⁷ See also *Application of Virginia Electric and Power Company, For a 2013 biennial review of the rates, terms, and conditions for the provision of generation, distribution, and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2013-00020, 2013 S.C.C. Ann. Rept. 371, Final Order (Nov. 26, 2013) ("*VEPCO 2013 Biennial Review*").

⁸ *VEPCO 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 457, *aff'd sub nom. VEPCO v. SCC*, 284 Va. 726, 735 S.E.2d 684.

⁹ Although the Rate Case Rules cannot supplant statutory requirements or mandate an unreasonable earned return, we find good cause to grant any waivers that might be found necessary to implement the earnings adjustments required herein in order to determine the reasonable earned return under the statute.

utility's reasonable revenues, expenses, and rate base for the historical two-year period. Those biennial reviews included more than 100 such regulatory adjustments – some contested, some not – that were proposed by the utility and by parties to the cases. This is a necessary step in determining earned return under the statute.

Section 56-585.1 in no manner requires the Commission to include unreasonable items in determining the earned return thereunder. The biennial review is not a summation of previously-approved or booked items but, rather, is a review of the utility's actual performance during the prior biennium. As explained by the Supreme Court of Virginia, in order to determine earned return under this statute, the Commission must perform a "retrospective review" of the utility's "performance during the two successive 12-month periods immediately prior to such review[]." ¹⁰ Indeed, the General Assembly amended § 56-585.1 in 2012, 2013, and 2014, but did not amend the process that the Commission has consistently employed for implementing the General Assembly's directive to determine earned return for the historical biennium.

In sum, the Commission must rule on proposed 2012-2013 earnings adjustments for regulatory accounting purposes and to determine earned return under the statute. Accordingly, the Commission makes the findings listed below, which we conclude are reasonable and supported by evidence in the record.

1. *Incentive Compensation.* The Company has not shown that it is reasonable to include incentive plan expenses that exceed a payout ratio of 100% in determining 2012-2013 earned return. The Commission continues to find, as we have in prior biennial reviews, that it is not reasonable for ratepayers to bear incentive plan expenses that exceed a payout ratio of 100%,

¹⁰ *VEPCO v. SCC*, 284 Va. at 730, 736, 735 S.E.2d at 686, 688. The order appealed from and affirmed in this Supreme Court case was the first order under § 56-585.1 in which the Commission made specific earnings adjustments, over the objection of the utility, which were necessary to determine the reasonable earned return for the historical two-year period.

because the Company has not shown that there is a benefit to ratepayers – as opposed to shareholders – warranting such treatment.¹¹ Thus, for regulatory accounting purposes and to determine earned return under the statute, APCo should not include in its cost of service, payable by ratepayers, any incentive plan expenses that exceed the payout ratio of 100%. This finding reduces incentive plan expenses by \$1,540,186 and \$3,245,050 in 2012 and 2013, respectively.¹²

2. *Charitable Contributions.* The Company has not shown that its proposed charitable contribution expense is reasonable for determining 2012-2013 earned return. For regulatory accounting purposes and to determine earned return under the statute, charitable contribution expense should be adjusted to reflect 50% of actual 2012-2013 contributions and, further, to exclude Old White and AEP Foundation.¹³ This finding reduces 2012-2013 charitable contribution expense by \$88,817 and \$167,195 in 2012 and 2013, respectively.

3. *Corporate Aviation.* The Company has not shown that its proposed corporate aviation expense is reasonable for determining 2012-2013 earned return. We do not, however, find that all such incurred costs are unreasonable. Rather we find that it is reasonable to bring this expense in line with commercial flight costs. Thus, for regulatory accounting purposes and to determine earned return under the statute, corporate aviation expense should be adjusted to

¹¹ See, e.g., *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 483; *VEPCO 2013 Biennial Review*, 2013 S.C.C. Ann. Rept. at 373; Ex. 70 (Carr) at 12-17; Ex. 53 (Smith) at 77-85; Ex. 124 (Bosta rebuttal) at 10-11; Staff's Post-Hearing Brief at 14-16; Committee's Post-Hearing Brief at 46; Consumer Counsel's Post-Hearing Brief at 21-22.

¹² For purposes of this calculation, we adopt the methodology proposed by APCo. See, e.g., Ex. 117 (Vaughan rebuttal) at Sched. 1.

¹³ See, e.g., Ex. 57 (Ellis) at 27-29; Ex. 53 (Smith) at 36-38; Staff's Post-Hearing Brief at 23-24; Consumer Counsel's Brief at 28-29.

reflect the cost of equivalent commercial flights.¹⁴ This finding reduces 2012-2013 corporate aviation expense by \$462,833 and \$461,353 in 2012 and 2013, respectively.

4. *Cash Working Capital.* The Company has not shown that its proposed cash working capital ("CWC") calculations are reasonable for determining 2012-2013 earned return. Specifically, (a) the Twin Cities liability, which we include as an expense in the earnings review as requested by APCo, should likewise be reflected in CWC, and (b) accounts payable and accrued payroll associated with construction work in progress should be included in the lead/lag study.¹⁵ Thus, for regulatory accounting purposes and to determine earned return under the statute, CWC should be adjusted for (a) and (b), above.¹⁶ This finding reduces rate base by \$4,443,887 and \$3,957,496 in 2012 and 2013, respectively.¹⁷

5. *Putnam Coal Terminal.* The Company has not shown that it is reasonable to include the Putnam Coal Terminal ("Putnam") in rate base and expense for determining 2012-2013 earned return. Putnam was idled in 1998. In March 2013, APCo reclassified Putnam as Plant Held for Future Use ("PHFU"). In response to discovery, APCo also advised that it had not established a timeline for determining whether Putnam will provide utility service during the next four years.¹⁸ APCo excluded certain other PHFU from rate base, but not Putnam. On

¹⁴ See, e.g., Ex. 57, 57-C (Ellis) at 20-22; Staff's Post-Hearing Brief at 27-30.

¹⁵ See, e.g., Ex. 63 (Morgan) at 9-11; Tr. 893-95; Staff's Post-Hearing Brief at 33-35.

¹⁶ See, e.g., Ex. 63 (Morgan) at 8-11, Appendix C.

¹⁷ This amount also reflects (1) Staff's and APCo's correction to use 365 days for the lead/lag study, and (2) CWC adjustments to reflect changes required herein to APCo's proposed earnings review. In addition, each regulatory accounting adjustment to rate base approved herein appropriately includes the resulting interest synchronization effect.

¹⁸ Ex. 59.

rebuttal, APCo asserted that certain Putnam assets are still in use.¹⁹ At the hearing, APCo further testified that part of the March 2013 reclassification to PHFU may have been in error.²⁰ We find that the Company has not, however, reasonably established the specific value of Putnam assets that were in use during 2012-2013, are currently in use, or that will be used in the immediate future, as part of its public service obligation.²¹ Thus, for regulatory accounting purposes and to determine earned return under the statute, Putnam should be removed from rate base and expense.²² This finding reduces rate base by \$2,873,873 and \$2,768,608 in 2012 and 2013, respectively, and reduces expense by \$452,086 and \$431,448 in 2012 and 2013, respectively.

6. *Amos Unit 3.* The Company has not shown that it is reasonable to double-count the remaining two-thirds of Amos Unit 3 ("Amos") by including it in rate base for December 2013 in determining 2012-2013 earned return. On December 31, 2013, APCo acquired from Ohio Power Company ("Ohio Power") the remaining two-thirds interest in Amos. APCo's capacity payments through the American Electric Power Company ("AEP") Pool Interconnection Agreement, however, already reflect payments for Ohio Power's two-thirds ownership of Amos for the entire month of December. We find the remaining two-thirds of Amos for December 2013 are properly reflected in actual capacity payments under the AEP Pool Interconnection Agreement. We further conclude that it is not reasonable also to reflect – again – that same two-thirds of Amos in rate base for the same month. Accordingly, we find that it is not reasonable – for regulatory

¹⁹ See, e.g., Ex. 91 (LaFleur rebuttal) at 7-8.

²⁰ Tr. 1396-97, 1407.

²¹ See, e.g., Ex. 53 (Smith) at 38-46; Ex. 57 (Ellis) at 30-31; Ex. 58, Ex. 59, Ex. 61; Ex. 100 (Allen rebuttal) at 14-22; Ex. 102; Tr. 781-82, 1500-05; Staff's Post-Hearing Brief at 37-38; Committee's Post-Hearing Brief at 45-46; Consumer Counsel's Post-Hearing Brief at 19-20; VML/VACo's Post-Hearing Brief at 14-15.

²² See, e.g., Ex. 53 (Smith) at 45; Ex. 57 (Ellis) at 31; Staff's Post-Hearing Brief at 37-38; Committee's Post-Hearing Brief at 46; Consumer Counsel's Post-Hearing Brief at 20; VML/VACo's Post-Hearing Brief at 16.

accounting purposes and to determine earned return under the statute – to include the remaining two-thirds of Amos in rate base for December 2013.²³ This finding reduces rate base by \$20,063,181 in 2013.

7. *Lobbying and Political Activities and Industry Dues.* The Company has not shown that all of its proposed lobbying and political activities and industry dues expenses are reasonable for determining 2012-2013 earned return. We find, as we have in prior cases, that lobbying expenses should not be included in cost of service. We conclude that for regulatory accounting purposes and to determine earned return under the statute, it is reasonable: (a) to allocate 90% of the Virginia portion of AEP's Washington, D.C. office to lobbying activities; and (b) to remove industry dues attributable to lobbying or political activities.²⁴ This finding reduces expense by \$136,023 and \$109,234 in 2012 and 2013, respectively.

8. *Account 923.* The Company incorrectly booked a 2013 expense to Account 923 – Outside Services. For regulatory accounting purposes and to determine earned return under the statute, such expense should be excluded from cost of service.²⁵ This finding reduces expense by \$138,792 in 2013.

9. *Demand Response Interruptions.* We will not reduce the Company's capacity equalization charges, as requested by Consumer Counsel in determining 2012-2013 earned return, for failing to interrupt loads under its demand response riders in 2011 and 2012. Based on the specific record related to 2011 and 2012, we do not find that APCo's failure to interrupt

²³ See, e.g., Ex. 53 (Smith) at 63; Ex. 57 (Ellis) at 32-34; Tr. 744-48, 782-84; Ex. 104; Staff's Post-Hearing Brief at 7-10; Committee's Post-Hearing Brief at 45; Consumer Counsel's Post-Hearing Brief at 20-21.

²⁴ See, e.g., Ex. 57 (Ellis) at 22-24; Staff's Post-Hearing Brief at 24-25.

²⁵ See, e.g., Ex. 57 (Ellis) at 24; Staff's Post-Hearing Brief at 42.

demand-response customers was unreasonable.²⁶ We further note that Consumer Counsel raises relevant questions regarding the Company's failure to interrupt load under these demand-response tariffs and thus increase costs to customers, which also raises questions as to the efficacy of demand response tariffs if they are not appropriately and effectively implemented.²⁷ Based on facts of this instant case, however, for regulatory accounting purposes and to determine earned return under the statute, we find that it is reasonable not to reduce APCo's capacity charges as requested by Consumer Counsel. Consumer Counsel nonetheless identifies a valid item for continuing review and monitoring, and the result in this case obviously does not preclude the Commission from reaching a different result based on the record in future proceedings.

10. *Payroll Labor.* We find that APCo's proposed payroll labor functional allocation methodology is reasonable for determining 2012-2013 earned return.²⁸ We also conclude that using Federal Energy Regulatory Commission ("FERC") allocation factors, as suggested by Staff, is not *per se* unreasonable. If, however, a FERC allocation factor is used in the future as recommended by Staff, then additional adjustments would need to be made to account for other differences between FERC and Virginia allocation methods.

11. *Accumulated Deferred Virginia State Income Tax.* Accumulated deferred income taxes, including Accumulated Deferred Virginia State Income Tax ("ADVSIT"), are typically treated as reductions to rate base. This is because these accumulated balances are capital supplied by ratepayers, not by shareholders. Indeed, APCo does not dispute that ADVSIT is an

²⁶ See, e.g., Ex. 124 (Bosta rebuttal) at 22-24; Tr. 1752-54, 1778-94; APCo's Post-Hearing Brief at 41-44.

²⁷ See, e.g., Ex. 56 (Norwood) at 6-12; Consumer Counsel's Post-Hearing Brief at 37-43.

²⁸ See, e.g., Ex. 117 (Vaughan rebuttal) at 4-5; Tr. 1681-84; APCo's Post-Hearing Brief at 30-31.

appropriate reduction from rate base.²⁹ The Company, however, argues that ADVSIT should not be removed from rate base in the instant proceeding, because such adjustment was not made in its 2009 and 2011 rate cases. Specifically, APCo states that as part of a stipulation in its 2008 rate case, on-going deferral of ADVSIT was frozen, and the Company has not been recording an amortization of the balance.³⁰

The Commission must determine the reasonable earned return for the historical two-year period. The determination of a reasonable earned return must be based on the facts. Contrary to APCo's assertion, the statute does not require the Commission to include an unreasonable rate base component – whether it be overstated or understated – in determining the actual earned return for purposes of this biennial review. We agree that "shareholders have no claim to a return on capital that is, in fact, free to them."³¹ In other words, if ADVSIT is not deducted, the Company's earned return will be unreasonably decreased by including ratepayer-supplied capital in rate base, to the detriment of ratepayers. Indeed, as noted above, APCo acknowledges that accumulated deferred income taxes are properly deducted from rate base. We find that the Company has not shown that it is reasonable to include ADVSIT in rate base for determining its 2012-2013 earned return. Thus, for regulatory accounting purposes and to determine earned return under the statute, ADVSIT should be deducted from rate base. This finding reduces rate base by \$16,922,454 and \$17,023,461 in 2012 and 2013, respectively.

12. *Asset Retirement Obligations.* Asset Retirement Obligations ("AROs") primarily relate to the Company's legal liabilities for future clean-up of ash ponds and asbestos abatement

²⁹ See, e.g., Tr. 1587.

³⁰ See, e.g., Ex. 14 (Kelly direct) at 15-16; APCo's Post-Hearing Brief at 44-45.

³¹ Staff's Post-Hearing Brief at 26 (emphasis removed).

upon asset retirement. The Company recovers ARO funds from ratepayers during the life of the asset, but any ARO cash expenditures of these funds by the Company do not occur until the asset is retired. Thus, the ARO asset – as it accumulates over time prior to an asset's retirement – benefits APCo but does not represent an investment made by shareholders. Indeed, APCo agrees that rate base should be reduced to recognize the cash benefit to the Company from ARO accounting. APCo, however, reduces rate base for a single year of cash benefit, while Staff reduces rate base for the cumulative cash benefit to APCo. The Company argues that the Commission should reject Staff's adjustment since a single year was apparently used in APCo's 2011 rate case due to an "oversight" by Staff.³² Conversely, Staff notes that its cumulative ARO adjustment was used in APCo's 2009 rate case, and that it is consistent with other rate base deductions (not opposed by APCo in this proceeding) for items presented on a cumulative basis, such as accumulated depreciation and cost of removal.³³

As explained above, the Commission must determine the reasonable earned return for the historical two-year period, and that determination is based on the facts. The statute does not require the Commission to include an unreasonable rate base component in determining the actual earned return for purposes of this biennial review. It is undisputed that the Company receives the cumulative cash benefit from the ARO asset, and APCo has not shown that it is reasonable to include only a single-year benefit in determining the earned return. In other words, the Company's earned return will be unreasonably decreased if only a single-year ARO benefit is deducted from rate base. Accordingly, for regulatory accounting purposes and to determine earned return under the statute, we find that rate base should be reduced by the cumulative ARO

³² See, e.g., Tr. 865; APCo's Post-Hearing Brief at 45.

³³ See, e.g., Ex. 62 (Armstrong) at 42-44; Tr. 863-67; Staff's Post-Hearing Brief at 30-32.

cash benefit to APCo.³⁴ This finding reduces rate base by \$13,783,958 and \$15,252,484 in 2012 and 2013, respectively.

13. *Prepaid Pension Asset.* The prepaid pension asset represents the amount of voluntary additional pension contributions that have been made by APCo. The prepaid pension asset was historically part of rate base, but this asset was not included in rate base in APCo's 2011 rate case. Upon review of the facts of the historical biennium, however, Staff found that it is reasonable to include this asset in rate base because it actually produces a net benefit to customers.³⁵

The Company asserts that if the Commission *reduces* rate base for ADVSIT and AROs to determine the reasonable earned return under the statute based on the facts of this case, then we should likewise *increase* rate base for the prepaid pension asset since it is undisputed that this asset is a reasonable rate base item for the biennium.³⁶ We agree. As repeated above, the statute does not require the Commission to reflect an unreasonable rate base component – whether it be overstated or understated – in determining the actual earned return for purposes of this biennial review. Accordingly, for regulatory accounting purposes and to determine earned return under the statute, we find that rate base should be increased to reflect the prepaid pension asset. This finding increases rate base by \$56,327,634 in each of the 2012 and 2013 earnings test years.

14. *Property Tax.* The Company has not shown that its proposed property tax expense is reasonable for determining 2012-2013 earned return in this case. Specifically, APCo's proposed property tax expense does not (a) reflect that portions of its net plant are exempt from

³⁴ See, e.g., Ex. 62 (Armstrong) at 42-44; Tr. 863-67; Staff's Post-Hearing Brief at 30-32.

³⁵ See, e.g., Ex. 57 (Ellis) at 47-48; Staff's Post-Hearing Brief at 99-100.

³⁶ See, e.g., APCo's Post-Hearing Brief at 47, 69 n.77.

property tax, and (b) accurately allocate distribution property taxes to Virginia.³⁷ The Company, however, argues that its proposed allocation must be deemed reasonable for determining earned return since it was used in APCo's 2011 rate case for ratemaking purposes. Contrary to APCo's assertion and as explained above, the statute does not require the Commission to include an unreasonable expense in determining 2012-2013 earned return.

Rather, the Commission must determine the reasonable earned return for the historical two-year period based on the facts of this case. In this instance, the facts show that APCo actually did not, and will not, pay property tax on generation equipment that was included in setting rates. We agree that this property tax adjustment is needed "to recognize that while you may have included one level of expense to set rates, the Company didn't end up paying property taxes on that generation equipment," and, thus, its actual reasonable expense was lower.³⁸ In addition, we agree that the Company's Virginia customers should only be allocated property tax on the distribution plant located in Virginia.³⁹ Accordingly, for regulatory accounting purposes and to determine earned return under the statute, APCo's property tax expense should be adjusted for (a) and (b), above, as proposed by Staff. This finding reduces property tax expense by \$3,969,527 and \$6,435,465 in 2012 and 2013, respectively.⁴⁰

15. *Coal Inventory.* Based on the specific facts of this case, the Company has shown that its actual coal inventory for 2012-2013 was reasonable for determining earned return under

³⁷ See, e.g., Ex. 53 (Smith) at 65-77; Ex. 56 (Norwood) at 11-12; Ex. 57 (Ellis) at 24-27; Staff's Post-Hearing Brief at 19-23; Consumer Counsel's Post-Hearing Brief at 23-25.

³⁸ Tr. 810; Staff's Post-Hearing Brief at 22.

³⁹ See, e.g., Ex. 57 (Ellis) at 26-27; Ex. 56 (Norwood) at 12-13.

⁴⁰ In addition, we find that APCo has not established on this record that its proposed corrections or adjustments (which APCo states would decrease Staff's earnings results by roughly \$6.6 million) must be made, are sufficiently related to the instant adjustment, or are otherwise appropriate based on this record. See, e.g., Ex. 117 (Vaughan rebuttal) at 6-7; Tr. 640-42, 752-53; APCo's Post-Hearing Brief at 33-34; Staff's Post-Hearing Brief at 22-23, 87-88.

the statute. Consistent with the discussion on property taxes, above, we again emphasize that this is not a going-forward rate case where the Commission is projecting a reasonable amount of expenses and rate base to include in rates on a prospective basis. As also noted above, the Supreme Court of Virginia has explained that determination of earned return in a biennial review requires a "retrospective review" of APCo's "performance during the two successive 12-month periods immediately prior to such review[]." ⁴¹ This is the process the Commission has employed in reviewing all of the proposed earnings adjustments herein.

Staff and Consumer Counsel, however, argue that in setting APCo's rates in 2011, the Commission limited the amount of coal inventory in rate base to a thirty-five day supply of coal at average burn rates. This projected amount for ratemaking purposes, however, cannot predetermine the reasonableness of actual expenditures that may be incurred during the historical two-year period. In other words, an amount prospectively included in rates cannot automatically determine the reasonable expenditures that may be reflected in determining earned return. Thus, while an amount approved in rates on a prospective basis is evidence relevant to the question of reasonableness, it is not the end of the inquiry. Indeed, if it were the end of the inquiry, the Commission could not have lowered APCo's property tax expense in the prior section, even though the Company's actual expenditures were less than the amount built into rates.

Further, we agree with Consumer Counsel's explanation that "only a reasonable coal inventory amount should be included in rate base for regulatory purposes." ⁴² Whether or not the coal inventory is reasonable for determining earned return must be based on the reasonableness of the Company's actions, not on the unforeseen vagaries of the market or the weather. In this

⁴¹ *VEPCO v. SCC*, 284 Va. at 730, 736, 735 S.E.2d at 686, 688.

⁴² Consumer Counsel's Post-Hearing Brief at 17. *See also* Tr. 896.

regard, the Company has established that it acted reasonably in managing its coal inventory. Moreover, no party has identified even a single unreasonable action (or lack of action) on the Company's behalf in this matter. For example, no witness showed that any contract entered into by APCo, or that its administration of its contracts, was unreasonable. Indeed, Staff expressly acknowledges that it "has not asserted that the Company's management of coal inventory was imprudent"⁴³ Based on the evidence in this record, we find that the Company's management of its coal inventory was reasonable and, as a result, that its actual 2012-2013 coal inventory amount is reasonable for purposes of determining earned return in this biennial review.

The Company has also shown that its actions were reasonable and necessary to provide reliable service to its customers, which also complies with our explicit directive in the 2011 rate case. Specifically, although the Commission found that APCo had not shown that the thirty-five day coal inventory built into rates would "expose the Company or its customers to risks of plant curtailments or shut downs due to a lack of coal," the Commission further directed that "we expect that the Company shall continue to meet its public service obligations in this regard."⁴⁴ In this instance, the Company showed that it met its public service obligations by reasonably managing its coal procurement based on the information available at the time decisions were made, and that the unprecedented drop in the demand for its coal-fired generation was not reasonably foreseeable and was driven by facts beyond its control.⁴⁵ While not determinative, we also note that due to coal supply and transportation disruptions in early 2014, the Company's coal inventory was needed to such a great extent – in order to meet its public service obligations

⁴³ Staff's Post-Hearing Brief at 19. *See also* APCo's Post-Hearing Brief at 21.

⁴⁴ *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 488.

⁴⁵ *See, e.g.*, Ex. 78 (West rebuttal).

and keep its coal units operating – that its coal inventory was reduced in a period of months by an amount greater than the entire inventory prospectively approved by the Commission in rates.⁴⁶

In addition, the fact that APCo can recover all of its reasonably incurred coal costs through its fuel factor is not relevant to the instant question. The practice of including coal inventory in rate base, and allowing the utility to earn a return thereon, is a long-standing regulatory practice that no party to this case contests. For purposes of this retrospective review of APCo's performance during the prior biennium, the question is whether the Company's actual amount of 2012-2013 coal inventory is reasonable for determining earned return under the statute, and we have found that it is.

Finally, we also emphasize that the approval of APCo's coal inventory in this case does not amount to a "blank check" for a utility to maintain any amount of coal inventory, no matter how excessive. The issue of reasonableness will always be present. In its next biennial review the Company will need to establish that it did not inventory unreasonable amounts of coal in 2014-2015. For example, APCo will need to show that its actions to manage such inventory were reasonable based on the specific factual circumstances relevant to the next biennium. In short, although we find based upon the factual record in this case that APCo's actual 2012-2013 coal inventory is reasonable for determining earned return under the statute, the facts in a future proceeding may be different.

16. *Vegetation Management Pilot.* On February 21, 2013, the Commission approved a Vegetation Management Pilot Program ("Pilot") for APCo. The Commission authorized, at APCo's request, a Pilot for purposes of additional vegetation management that included deferral of Pilot O&M expenses, and the Commission further directed that "recovery of deferred Pilot

⁴⁶ See, e.g., APCo's Post-Hearing Brief at 19-20.

O&M expenses will be dependent upon earnings test results."⁴⁷ The deferral of costs is a unique and unusual action afforded to regulated companies, in this instance, at the discretion and direction of the regulating agency.⁴⁸ In such instance the utility defers an expense, which creates the regulatory asset, and carries that deferred expense (or portions thereof) on its books until the Commission concludes that the utility has earned sufficient revenues to accelerate recovery of such expense.

The Company sought the Commission's approval to institute the Pilot program and to defer the Pilot O&M costs, and the Commission granted such approval. Based on the record produced in such proceeding, the Commission explicitly authorized deferral "until further order of the Commission" and directed that "recovery of deferred Pilot O&M expenses will be dependent upon the results of an earnings test."⁴⁹ The Commission's order did not give APCo the discretion on whether or not to comply with these requirements.⁵⁰ Indeed, this is further demonstrated by the directive in the Pilot order for interested parties to address – in this instant biennial review – specific questions on how to recognize these deferred Pilot O&M costs.

In approving deferral and issuing directives as to its recovery for purposes of the Pilot program, there is no mention in the Pilot order that such deferral was at the "option" of APCo. Rather, APCo sought approval to institute the Pilot and defer these expenses, the Commission's

⁴⁷ *Application of Appalachian Power Company, For approval of a cycle-based vegetation management pilot program*, Case No. PUE-2012-00069, 2013 S.C.C. Ann. Rept. 275, 277, Order on Application (Feb. 21, 2013) ("Pilot Order").

⁴⁸ *See, e.g.*, Tr. 1134-35; Consumer Counsel's Post-Hearing Brief at 51-53; Staff's Post-Hearing Brief at 51-53. *See also* Tr. 1482.

⁴⁹ Pilot Order, 2013 S.C.C. Ann. Rept. at 277.

⁵⁰ Contrary to the Company's assertion, the Commission's implementation of its Pilot order (granting APCo's request) does not violate Generally Accepted Accounting Principles ("GAAP"). GAAP accounting does not dictate treatment of costs for regulatory accounting purposes. *See, e.g.*, Tr. 749-50; Staff's Post-Hearing Brief at 40-41.

order granted such approval (and directed how recovery would be addressed), and the Company shall comply therewith.⁵¹ One of the very purposes of the Pilot, as requested by APCo and approved by the Commission, was to track and defer the Pilot costs. Accordingly, for regulatory accounting purposes and to determine 2012-2013 earned return, 2013 Pilot O&M expenses should be deferred pursuant to the Commission's Pilot order. This finding reduces expenses by \$6,914,157 in 2013.

17. *Cost of Capital.* Finally, to calculate 2012-2013 earned return, we must also determine the Company's cost of capital for this period. In this regard, § 56-585.1 A 10 states in part as follows:

For purposes of this section, the Commission shall regulate the rates, terms and conditions of any utility subject to this section on a stand-alone basis utilizing the *actual end-of-test period capital structure and cost of capital of such utility*, unless the Commission finds that the debt to equity ratio of such capital structure is unreasonable for such utility, in which case the Commission may utilize a debt to equity ratio that it finds to be reasonable for such utility in determining any rate adjustment pursuant to clauses (i) and (iii) of subdivision 8, and without regard to the cost of capital, capital structure, revenues, expenses or investments of any other entity with which such utility may be affiliated. (Emphasis added.)

We find that the Company's actual end-of-test period capital structure – which is calculated by using APCo's *actual* end-of-test period balances of debt and equity – should be used in determining 2012-2013 earned return. This finding complies with the plain language of the above statute, follows Commission precedent in implementing this statute for both APCo and

⁵¹ The Commission's interpretation of its own orders is entitled to deference. See, e.g., *Upper Occoquan Sewage Auth. v. Blake Constr. Co.*, 275 Va. 41, 61, 655 S.E.2d 10, 21 (2008) ("a circuit court's interpretation of its own orders is subject to review, but . . . deference is owed to the court's interpretation" (citation omitted)); *Fredericksburg Constr. Co. v. J.W. Wyne Excavating, Inc.*, 260 Va. 137, 144, 530 S.E.2d 148,152 (2000) ("Furthermore, when construing a lower court's order, a reviewing court should give deference to the interpretation adopted by the lower court." (citation omitted)).

Dominion Virginia Power, and results in a reasonable cost of capital.⁵² Accordingly, we reject the Company's request to remove – from its actual capital structure – actual securitized debt that is included on its books for 2013; taking such action would result in something other than APCo's *actual* end-of-test period capital structure and would be contrary to the plain language of the statute.⁵³

The Company, however, argues that the securitized debt belongs to a wholly-owned subsidiary and is not a liability of APCo or its Virginia customers. This assertion does not dictate a different result. APCo's actual capital structure, in both this and prior proceedings, contains debt and equity from entities that are wholly owned by the Company.⁵⁴ Indeed, the capital structure proposed by APCo in this case still includes undistributed earnings from those same APCo subsidiaries.⁵⁵ Furthermore, APCo also includes this securitized debt, from its wholly-owned subsidiary, as part of its ratemaking capital structure submitted to FERC.

Although APCo asserts that FERC has not explicitly ruled on the question of securitized debt,

⁵² See, e.g., *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 478; *Petition of Appalachian Power Company, For revision of a rate adjustment clause pursuant to § 56-585.1 A 6 of the Code of Virginia with respect to the Dresden Generating Plant*, Case No. PUE-2013-00009, 2013 S.C.C. Ann. Rept. 357, 358, Final Order (Dec. 17, 2013) ("*Dresden Generating Plant*"); *Application of Appalachian Power Company, For a statutory review of the rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2009-00030, 2010 S.C.C. Ann. Rept. 308, 310, Final Order (July 15, 2010) ("*APCo 2009 Rate Case*"); Ex. 64 (Maddox) at 7-14; Tr. 931-32; Tr. 1362; APCo's Post-Hearing Brief at 27; Staff's Post-Hearing Brief at 42-49.

⁵³ Indeed, the only time that the Commission has not utilized an actual capital structure under this section is when we found that the actual equity ratio was unreasonable. *VEPCO 2013 Biennial Review*, 2013 S.C.C. Ann. Rept. at 379. In that instance, we found that an equity ratio of 55.02% was neither reasonable nor prudent. In this instance, we find that APCo's actual capital structure, which reflects an equity ratio of 42.89% for 2013 and 44.28% for 2012, is reasonable. See, e.g., Ex. 64 (Maddox) at 9-10, 37-38, Sched. 3-B, Sched. 3-C, workpapers; Ex. 43 (Woolridge) at JRW-15; Ex. 22 (Avera direct) at Sched. 3.

⁵⁴ For example, most recently in a rate adjustment clause proceeding conducted last year, APCo specifically requested, and was granted, Commission approval of an actual capital structure pursuant to § 56-585.1 A 10 that contains debt and equity from entities that are wholly owned by the Company. See *Dresden Generating Plant*, 2013 S.C.C. Ann. Rept. at 358.

⁵⁵ See, e.g., Tr. 1360-62; Staff's Post-Hearing Brief at 45.

the Company does not claim that this issue is pending at FERC. Nor does APCo contest the fact that it has identified this securitized debt at FERC as "long term debt" of APCo, that this securitized debt of its wholly-owned subsidiary is included in its ratemaking capital structure at FERC, or that FERC's transmission cost determinations ultimately flow through to Virginia customers.⁵⁶

While not determinative of the legal issue, we also note that the record includes evidence on the impact of the securitized debt. For example, the securitized debt was the culmination of many years of under-recoveries in West Virginia jurisdictional costs, which resulted in a negative impact to the credit metrics of all of APCo.⁵⁷ A Moody's Investor Service report states that West Virginia's efforts to find a solution to this matter was "a credit positive," but that the securitization is also "a credit negative" to the Company since it will limit rate flexibility for other types of cost increases in the future.⁵⁸ We need not, however, rule on the benefits or detriments of this type of arrangement for Virginia ratepayers. Rather, for purposes of this proceeding, we use APCo's actual booked capital structure as required by the plain meaning of the statute, which includes the debt and equity from its wholly-owned subsidiaries and, also, results in a reasonable cost of capital.

Next, we find that the effective cost rate of long-term debt should be used as recommended by Staff. This complies with the statute, follows Commission precedent thereunder, and results in a reasonable cost of capital.⁵⁹

⁵⁶ See, e.g., Ex. 65; Ex. 66; Tr. 937-41; Staff's Post-Hearing Brief at 46-47.

⁵⁷ See, e.g., Ex. 64 (Maddox) at 10-11; Tr. 934.

⁵⁸ See, e.g., Ex. 64 (Maddox) at 13-14, Appendix E.

⁵⁹ See, e.g., Ex. 64 (Maddox) at 14-15, 17-18; Ex. 88 (Hawkins rebuttal) at 11; Tr. 1357-58; Staff's Post-Hearing Brief at 49.

In sum, for regulatory accounting purposes and to determine earned return under the statute, the Company's 2012-2013 cost of capital should reflect: (a) APCo's actual end-of-test period capital structure as booked by the utility, which includes the debt and equity balances of wholly-owned subsidiaries; and (b) the effective cost rate of long-term debt. This finding increases the Company's combined 2012-2013 earned return by reducing net income by approximately \$5,948,622.

TEST PERIOD EARNINGS

Based on our findings in this case, APCo earned, on average, an ROE of approximately 11.86% during the 2012-2013 biennial review period. As noted above, the fair rate of return for purposes of this proceeding is 10.9%, which results in overearnings of \$24,366,969 over the two-year period on a revenue basis. Pursuant to § 56-585.1 A 8 (ii) of the Code, 60% of earnings above an ROE of 11.4% must be credited to customers' bills. In this instance, 60% of earnings above 11.4% equates to \$5,825,380 on a revenue basis, which shall be credited to customers' bills as required by statute.

CREDITS TO CUSTOMERS' BILLS

Section 56-585.1 A 8 of the Code directs in part as follows:

(ii) ... Any such credits shall be amortized over a period of six to 12 months, as determined at the discretion of the Commission, following the effective date of the Commission's order, and shall be allocated among customer classes such that the relationship between the specific customer class rates of return to the overall target rate of return will have the same relationship as the last approved allocation of revenues used to design base rates;

...

[A]ny revisions in rates or credits so ordered shall take effect not more than 60 days after the date of the order.

We find that such credits to customers' bills, which must total not less than \$5,825,380, shall:

(1) be amortized over a period of six (6) months; (2) be based on each customer's usage during

calendar years 2012 and 2013; and (3) begin to take effect within sixty (60) days after the date of this Final Order.

These rate credits "shall be allocated among customer classes such that the relationship between the specific customer class rates of return to the overall target rate of return will have the same relationship as the last approved allocation of revenues used to design base rates."⁶⁰ In this regard, the rate credits shall be allocated among customer classes based on the percentages approved in APCo's 2011 Biennial Review.⁶¹

SECTION 56-585.1 A 3 OF THE CODE

Since the Commission has determined that there shall be credits to customers' bills as a result of this biennial review, the statute requires the Commission to take specific action regarding previously-approved rate adjustment clauses ("RACs"). Specifically, § 56-585.1 A 7 states that "[a]ny petition [for a RAC] filed pursuant to subdivision 4, 5, or 6 shall be considered by the Commission on a stand-alone basis without regard to the other costs, revenues, investments, or earnings of the utility." After a RAC is approved and implemented, however, § 56-585.1 A 3 directs in part as follows:

If the Commission determines that rates should be revised or credits be applied to customers' bills pursuant to subdivision 8 or 9, any rate adjustment clauses previously implemented pursuant to subdivision 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 after such

⁶⁰ Va. Code § 56-585.1 A 8 (ii).

⁶¹ See, e.g., Va. Code § 56-585.1 A 8 (ii); Ex. 68 (Abbott) at 42-43; *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 489, n.101; Staff's Post-Hearing Brief at 50-51.

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.

APCo has two previously implemented RACs that fall within the above statute.⁶² These two RACs provide for the recovery of certain renewable power costs ("RPS-RAC") and certain environmental compliance costs ("E-RAC").

Thus, the above statute: (1) requires the Commission to "combine" these RACs with the utility's costs, revenues, and investments "until the amounts that are the subject of such [RACs] are fully recovered;" and (2) directs that after these RACs are combined, they "shall thereafter be considered part of the utility's costs, revenues, and investments for the purposes of future biennial reviews."

In this proceeding, Staff has identified concerns associated with combining, for any extended period, into base rates either the E-RAC, for which the Company has ceased deferred accounting because base rates alone are adequate for recovery of the subject costs, or the RPS-RAC.⁶³ For this reason, Staff proposes that the Commission limit any combination of the \$37.6 million and \$7.3 million levels of costs currently recovered through these two RACs to the duration when those costs are expected to be "fully recovered."

Based on the specific facts and circumstances of the E-RAC, combination of this RAC should be implemented at the currently approved cost level for the period December 1, 2014, until February 11, 2015, as recommended by Staff. The record indicates that including in base rates the level of costs currently recovered through the E-RAC would, if extended beyond February 11, 2015, require customers to continue paying costs that APCo would have already

⁶² See, e.g., Ex. 70 (Carr) at 56; APCo's Post-Hearing Brief at 92-95; Staff's Post-Hearing Brief at 56.

⁶³ See, e.g., Ex. 70 (Carr) at 56-62; Tr. 1092-1093; Staff's Post-Hearing Brief at 57-58.

fully recovered.⁶⁴ Although APCo proposes addressing any over- or under-recovery of environmental costs in a subsequent RAC filing,⁶⁵ our approval to extend the combined recovery identified herein through February 11, 2015, is intended to provide the Company with recovery of all E-RAC costs identified in the record.⁶⁶ Furthermore, APCo acknowledges that the Company has "since 2013 . . . been generally recovering its environmental costs through current base rates" and that the Company "ceased recording E-RAC over/under-recovery deferrals and tracking its environmental compliance costs effective January 2014."⁶⁷

Based on the statute and the unique circumstances of the RPS-RAC, combination of this RAC shall be implemented at the currently approved cost level for the period December 1, 2014, until January 31, 2015, as recommended by Staff.⁶⁸ The record indicates that including in base rates the level of costs currently recovered through the RPS-RAC would, if extended beyond January 31, 2015, require customers to continue paying costs that APCo would have already fully recovered.⁶⁹ Additionally, the framework for potentially considering RPS-RAC costs, revenues, and investments in future biennial reviews is not addressed by the statute as it is for the

⁶⁴ Ex. 70 (Carr) at 57-58.

⁶⁵ See, e.g., Ex. 124 (Bosta rebuttal) at 29; APCo's Post Hearing Brief at 93.

⁶⁶ Ex. 100 (Allen rebuttal) at 29-30; Tr. 1092-93. The intervening requirements of § 56-585.1 A 3 supersede the prior directive for the Company to file, on or before May 1, 2015, an E-RAC petition. See *Petition of Appalachian Power Company, For approval of a rate adjustment clause, E-RAC, to recover costs incurred in complying with state and federal environmental laws and regulations, pursuant to Va. Code § 56-585.1 A 5 e*, Case No. PUE-2013-00010, 2013 S.C.C. Ann. Rept. 361, Order Nunc Pro Tunc (Dec. 9, 2013). However, should APCo, in the future, seek the recovery of environmental costs through a RAC, the Company shall provide, as part of any such filing, sufficient information for the Commission to fully evaluate and determine whether any such request "should be offset by any over-recoveries the Company has experienced but not yet credited to customers." Ex. 70 (Carr) at 59.

⁶⁷ APCo's Post-Hearing Brief at 93. See also Ex. 100 (Allen rebuttal) at 28-29.

⁶⁸ See, e.g., Ex. 70 (Carr) at 58-60; Staff's Post-Hearing Brief at 58-59.

⁶⁹ See, e.g., Ex. 70 (Carr) at 60.

E-RAC. APCo's RPS-RAC was established pursuant to § 56-585.1 A 5 for the purpose of recovering purchased power costs, which the statute generally considers as fuel costs reviewed and recoverable under § 56-249.6.⁷⁰

Accordingly, given the facts and circumstances in this case, we adopt the above recommendations for combining the E-RAC and RPS-RAC, which we find complies with the statute and protects customers from paying rates in excess of costs, while at the same time allowing the Company to fully recover its costs.

FAIR RATE OF RETURN ON COMMON EQUITY

The final action that the statute requires the Commission to take in this biennial review proceeding involves ROE. Specifically, § 56-585.1 A 2 requires the Commission to determine a fair ROE in each biennial review. We follow a similar process in determining a fair ROE herein as we have in prior biennial reviews. First, we determine the market cost of equity under § 56-585.1 A 2. Next, we apply the statutory peer group ROE floor pursuant to § 56-585.1 A 2. Finally, the Commission may increase or decrease ROE based on consideration of the Company's performance under certain circumstances as provided in § 56-585.1 A 2 c.

Market Cost of Equity

Section 56-585.1 A 2 states that the Commission shall determine fair rates of return on common equity and "may use any methodology to determine such return it finds consistent with the public interest"⁷¹ Staff calculated APCo's cost of equity to be between 8.80% and

⁷⁰ For the wind purchase power costs currently recovered through the RPS-RAC, the Commission has previously identified the "costs from these agreements – whether incremental or non-incremental – . . . as 'fuel costs' consistent with APCo's Definitional Framework for Fuel Expenses." *Petition of Appalachian Power Company, For approval of a rate adjustment clause, RPS-RAC, to recover the incremental costs of participation in the Virginia renewable energy portfolio standard program, pursuant to Va. Code §§ 56-585.1 A 5 d and 56-585.2 E*, Case No. PUE-2011-00034, 2011 S.C.C. Ann. Rept. 471, 473, Order Approving Rate Adjustment Clause (Nov. 3, 2011).

⁷¹ Va. Code § 56-585.1 A 2 a.

9.80%.⁷² The Committee examined the testimony presented by APCo witness Dr. Avera, Staff witness Maddox, and Consumer Counsel witness Woolridge and recommended that the Company's return on equity should be set no higher than 9.3%.⁷³ Based, in part, on Consumer Counsel witness Woolridge's finding that APCo's cost of equity is 8.75%, Consumer Counsel asserts that APCo's market cost of equity does not exceed 9.3%.⁷⁴ VML/VACo contends that the credible evidence on ROE comes from Staff witness Maddox and Consumer Counsel witness Woolridge, which "respectively support a ROE of 9.3% and 8.75%."⁷⁵ Wal-Mart witness Chriss recommended that the Commission "should closely examine APCo's proposed forward-looking ROE in light of the ROE recently approved for Dominion Virginia Power, ROEs approved by Commissions nationwide, and the potential impact of ROE on customer rates."⁷⁶ APCo, based on the testimony of Dr. Avera, and on a comparison of risks between APCo and Dominion Virginia Power, recommended that its cost of equity be set at 10.52%.⁷⁷

We find that a market cost of equity within a range of 8.80% to 9.80% fairly represents the actual cost of equity in capital markets for companies comparable in risk to APCo seeking to attract equity capital. Furthermore, under the circumstances of this case and for purposes of implementing the statute, we find that using a cost of equity of 9.70% – which is near the top of the range – is fair and reasonable for these purposes. We conclude that this return is supported

⁷² Ex. 64 (Maddox) at Sched. 18; Staff's Post-Hearing Brief at 62.

⁷³ Committee's Post-Hearing Brief at 33.

⁷⁴ Ex. 43 (Woolridge) at 2; Consumer Counsel's Post-Hearing Brief at 4.

⁷⁵ VML/VACo's Post-Hearing Brief at 3.

⁷⁶ Ex. 44 (Chriss) at 13-14. On brief, Wal-Mart recommended that the cost of equity be set at no more than 10.0%. Wal-Mart's Post-Hearing Brief at 5.

⁷⁷ Ex. 22 (Avera direct); Ex. 73 (Avera rebuttal); Ex. 47; APCo Post-Hearing Brief at 61-64.

by evidence in the record and results in a fair and reasonable return on common equity.⁷⁸

Conversely, we find that APCo's proposed cost of equity of 10.52% represents neither the actual cost of equity in the marketplace for comparable electric utility companies nor a reasonable return on common equity for the Company.

We conclude that a market cost of equity of 9.70% is supported by reasonable proxy groups, growth rates, discounted cash flow methods, and risk premium analyses. We also find that approving an ROE of 9.70%, which is at the high end of the range found reasonable herein, is supported by the concept of gradualism in ROE determinations, and by the Company's current debt-to-equity ratio as represented in its actual end-of-test period capital structure discussed above. In addition, we find that Dr. Avera's DCF, CAPM and ECAPM analyses use unreasonably high growth rates that upwardly skew his results.⁷⁹ We also find that Dr. Avera's analyses were further inflated by his asymmetric exclusion of approximately one-third of his DCF results, and that his "size adjustments" were unsupported by the evidence.⁸⁰ In addition, we agree with Consumer Counsel that APCo's comparisons to Dominion Virginia Power fail to consider the continued reduction in capital costs and interest rates that have occurred since the

⁷⁸ See, e.g., Staff's Post-Hearing Brief at 62; Wal-Mart's Post-Hearing Brief at 5; Committee's Post-Hearing Brief at 33; Consumer Counsel's Post-Hearing Brief at 4; APCo's Post-Hearing Brief at 61-64; Ex. 22 (Avera direct); Ex. 43 (Woolridge); Ex. 64 (Maddox); Ex. 73 (Avera rebuttal). We also included in our analysis a broad range of economic factors addressed in the evidence.

⁷⁹ See, e.g., Ex. 64 (Maddox) at 49-53; Ex. 43 (Woolridge) at 55-56, 59-63; Tr. 449-50, 941-44; Staff's Post-Hearing Brief at 63-68.

⁸⁰ See, e.g., Ex. 43 (Woolridge) at 54-55; Ex. 64 (Maddox) at 50; Tr. 947-48; Ex. 26; Staff's Post-Hearing Brief at 68-71.

2013 biennial review.⁸¹ In sum, we conclude that a market cost of equity of 9.70% is supported by the record and satisfies all applicable constitutional standards.⁸²

Statutory Peer Group Floor

Virginia law next requires that the Commission calculate a statutory floor below which the authorized ROE cannot be set. Section 56-585.1 A 2 provides as follows:

a. The Commission may use any methodology to determine such return it finds consistent with the public interest, but such return shall not be set lower than the average of the returns on common equity reported to the Securities and Exchange Commission for the three most recent annual periods for which such data are available by not less than a majority, selected by the Commission as specified in subdivision 2 b, of other investor-owned electric utilities in the peer group of the utility subject to such biennial review, nor shall the Commission set such return more than 300 basis points higher than such average.

b. . . . In its final order regarding such biennial review, the Commission shall identify the utilities in such peer group it selected for the calculation of such limitation. For purposes of this subdivision, an investor-owned electric utility shall be deemed part of such peer group if (i) its principal operations are conducted in the southeastern United States east of the Mississippi River in either the states of West Virginia or Kentucky or in those states south of Virginia, excluding the state of Tennessee, (ii) it is a vertically-integrated electric utility providing generation, transmission and distribution services whose facilities and operations are subject to state public utility regulation in the state where its principal operations are conducted, (iii) it had a long-term bond rating assigned by Moody's Investors Service of at least Baa at the end of the most recent test period subject to such biennial review, and (iv) it is not an affiliate of the utility subject to such biennial review.

⁸¹ See, e.g., Tr. 1164-71; Ex. 77; Consumer Counsel's Post-Hearing Brief at 9-10.

⁸² See, e.g., Ex. 64 (Maddox) at 20. We also note that the 50 basis-point RPS "adder" that was automatically added to the market ROE set in APCo's most recent biennial review has been repealed by the General Assembly and, thus, will not be added to the market ROE determined herein.

No party contested the composition of the peer group as required by statute, which in this case comprises nine utilities after removing the companies with the two highest, and the two lowest, reported returns as required by § 56-585.1 A 2 b.⁸³

In selecting the majority of the peer group utilities that will be used to calculate the statutory ROE floor, § 56-585.1 A 2 b directs as follows:

In selecting such majority of peer group investor-owned electric utilities, the Commission shall first remove from such group the two utilities within such group that have the lowest reported returns of the group, as well as the two utilities within such group that have the highest reported returns of the group, and the Commission shall then select a majority of the utilities remaining in such peer group.

The participants differ on which utilities should comprise the "majority" to be selected by the Commission to determine the statutory floor. The majority that we select had, on average, a return on average equity close to the mid-point of the ROE range found fair and reasonable herein.⁸⁴ This results in a statutory floor of 9.34%, which is close to the 9.3% mid-point of the ROE range determined above.⁸⁵

As we discussed in prior biennial reviews, the above statute clearly leaves the selection of this "majority" to the Commission's discretion. There is no ambiguity in the statute; thus, we do not reach questions of legislative construction or intent.⁸⁶ If the General Assembly wanted the

⁸³ See, e.g., Ex. 2 at Sched. 45; APCo's Post-Hearing Brief at 62 n.62; Staff's Post-Hearing Brief at 73; Ex. 64 (Maddox) at 41-43; Schedules 20 and 21.

⁸⁴ We find, based on the facts before us in this case, that it is reasonable to utilize returns on average equity for this purpose.

⁸⁵ Specifically, the statutory floor is comprised of the following six companies: Duke Energy Progress Inc.; South Carolina Electric and Gas Company; Entergy Mississippi, Inc.; Duke Energy Carolinas LLC; Gulf Power Company; and Tampa Electric Company. (For a list of utilities, see, e.g., Ex. 64 (Maddox) at Sched. 21.)

⁸⁶ See, e.g., *Brown v. Lukhard*, 229 Va. 316, 321, 330 S.E.2d 84, 87 (1985) ("If language is clear and unambiguous, there is no need for construction by the court; the plain meaning and intent of the enactment will be given it. . . . Therefore, when the language of an enactment is free from ambiguity, resort to legislative history and extrinsic facts is not permitted because we take the words as written to determine their meaning.") (citations omitted); *School Bd.*

Commission to apply a particular approach or evaluation methodology in selecting a majority, it could have directed as such; it did not.⁸⁷ We continue to find – as we have in prior biennial reviews – that it is reasonable in this proceeding to select a majority that has a reported return that is close to a market cost of equity capital found fair and consistent with the public interest herein. The plain language of the statute giving the Commission the discretion to select a majority in no manner precludes such a result. Moreover, we do not, and need not, find that this is the only majority that is reasonable.⁸⁸ We conclude that the specific majority chosen herein is reasonable and does not violate any constitutional or statutory provision.

Performance Adjustment

Section 56-585.1 A 2 c states as follows:

The Commission may, consistent with its precedent for incumbent electric utilities prior to the enactment of Chapters 888 and 933 of the Acts of Assembly of 2007, increase or decrease the utility's combined rate of return based on the Commission's consideration of the utility's performance.

This provision is discretionary. No participant, including the Company, has requested a performance adjustment under this statute. We likewise decline to issue a performance adjustment under § 56-585.1 A 2 c – either positive or negative – based on the record in the current proceeding.

of Chesterfield County v. School Bd. of the City of Richmond, 219 Va. 244, 250, 247 S.E.2d 380, 384 (1978) ("Where a statute is plain and unambiguous there is no room for construction by the court and the plain meaning and intent of the statute will be given to it." (citation omitted)); *Almond v. Gilmer*, 188 Va. 1, 14, 49 S.E.2d 431, 439 (1948) ("The province of construction lies wholly within the domain of ambiguity." (citation omitted)).

⁸⁷ Moreover, the lack of a particular evaluation methodology for selecting a "majority" directly contrasts with the very specific criteria prescribed by the General Assembly in other parts of § 56-585.1 A 2. *See also VEPCO v. SCC*, 284 Va. at 741, 735 S.E.2d at 691 ("[W]e presume that where the General Assembly has not placed an express limitation in a statutory grant of authority, it intended for the Commission, as an expert body, to exercise sound discretion.").

⁸⁸ Indeed, the statutory floor selected in this case is not necessarily the lowest (*i.e.*, 8.04%), or the highest (*i.e.*, 9.88%), that could be selected consistent with the statute. *See* Ex. 64 (Maddox) at Sched. 21.

Fair ROE

In sum, we conclude that the fair ROE for APCo under § 56-585.1 A 2 is 9.70%. We find that this ROE is fair and reasonable to the Company within the meaning of the statute and based on the Company's current debt-to-equity ratio as represented in its actual end-of-test period capital structure, permits the attraction of capital on reasonable terms, fairly compensates investors for the risks assumed, enables the Company to maintain its financial integrity, and supports the concept of gradualism in ROE determinations.⁸⁹ This ROE will, among other things, serve as the fair combined rate of return against which APCo's earned return will be compared in its next biennial review proceeding, which will cover the 2014-2015 two-year period.⁹⁰

TARIFFS, RATE DESIGN, AND REVENUE APPORTIONMENT

The Company and various parties to this case have proposed changes related to tariffs, rate design, and revenue apportionment pursuant to the Commission's regulatory authority under Chapter 10 of Title 56 of the Code of Virginia. Even though such proposals would result in changing rates for certain customers, none of the parties assert that the Commission is prohibited from making such changes as part of this biennial review proceeding, as long as the Commission does not change the Company's aggregate revenue requirement.

⁸⁹ As required by statute, in setting ROE we have also considered and applied the requirements of Va. Code § 56-585.1 A 2 e, which mandates as follows:

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 retail electric energy that are cost competitive with costs of retail electric energy provided by the other peer group investor-owned electric utilities.

In this regard, Staff witness Lough presented comparisons of APCo's relevant performance to statutory peer group utilities, among others. *See, e.g.*, Ex. 83 (Lough).

⁹⁰ The fair ROE approved herein shall also apply to the Company's applicable RACs under Va. Code §§ 56-585.1 A 5 and 6, effective November 30, 2014.

Although § 56-585.1 does not require the Commission to address these matters within a biennial review proceeding, we have considered the parties' proposals and find that the tariff, rate design, and revenue apportionment findings below are reasonable and supported by evidence in the record. In addition, many of the rejected proposals below would have *raised* rates to certain customers in the circumstance where, although APCo is found to be earning more than cost of service and a reasonable return, those customers' rates cannot be reduced accordingly at this time.

1. *Customer Charges.* We reject APCo's proposed increases to the customer charges for Residential Service ("RS"), Small General Service ("SGS"), and Sanctuary Worship Service ("SWS"). We agree with Consumer Counsel and Staff that APCo has not established that it is reasonable to increase such costs to these customers at this time and in the manner proposed by the Company.

2. *General Service and Medium General Service Rate Schedules.* We reject the Company's proposal to merge the General Service ("GS") and Medium General Service ("MGS") rate schedules into a new MGS schedule. Under this proposal, approximately 90% of current GS customers would receive a rate increase, and approximately 78% of current MGS customers would receive a rate increase.⁹¹ We agree with Staff that the Company has not established that it is reasonable to increase such costs to these customers at this time and in the manner proposed by the Company.

3. *Advanced Time-of-Day and Critical Peak Pricing Rate Schedules.* We reject APCo's proposal to eliminate its Advanced Time-of-Day ("ATOD") tariff and to replace it with a new Critical Peak Pricing tariff. Currently, only one customer – SDI – is on ATOD, and we do

⁹¹ See, e.g., Ex. 68 (Abbott) at 34; Staff's Post-Hearing Brief at 117.

not find that it is reasonable to change this tariff at this time. In addition, based on the record in this case, we agree with Staff that the Company did not establish that SDI is receiving a subsidy from other Large Power Service customers, and that inclusion of SDI did not cause APCo to under-earn on this subclass. We also agree with Staff that it may have been appropriate to replace ATOD with a pricing structure that no longer reflects the AEP Pool Interconnection Agreement, as long as "the affected customer does not experience a rate increase based on calendar year 2013 usage patterns, if the customer avoids the highest-priced" hours.⁹² The Company, however, did not include and support such a proposal in this proceeding.

4. *Large General Service.* Kroger and Wal-Mart propose changes to the Large General Service ("LGS") rate schedule, which would shift certain costs currently recovered through the energy charge to the customer charge and the demand charge. The Company, however, asserts that such proposals "fail to strike a balance between higher and lower load factor LGS customers, and would only benefit higher load factor LGS customers."⁹³ We agree with APCo and Staff that it has not been established herein that it is reasonable to increase the customer and demand charges to lower load factor LGS customers at this time and in the manner proposed by either Kroger or Wal-Mart.

5. *General Service Time-of-Day and Large General Service Time-of-Day Rate Schedules.* Based on the specific facts set forth in this proceeding, we approve the Company's proposal to revise the existing General Service Time-of-Day rate schedule and create a new Large General Service Time-of-Day rate schedule.

⁹² Staff's Post-Hearing Brief at 115. *See also* Ex. 68 (Abbott) at 28-31.

⁹³ APCo's Post-Hearing Brief at 107. *See also* Ex. 117 (Vaughan rebuttal) at 26.

6. *Cogeneration and Small Power Production Rate Schedule.* Based on the specific facts set forth in this proceeding, we approve the Company's proposal to modify its Cogeneration and Small Power Production ("Cogen/SPP") rate schedule to be applicable to customers with qualifying cogeneration or small power production facilities that have a net capacity of 5 MW or less (up from 100 kW or less). In addition, we note that "[b]ecause there are currently no customers served by the existing Cogen/SPP rate schedule, the proposed modified Cogen/SPP rate schedule will not have any effect on the Company's revenues in the near term."⁹⁴

7. *Vegetation Management Pilot.* We reject APCo's request to extend its Vegetation Management Pilot. We agree with Consumer Counsel that this Pilot should conclude in 2015 as currently approved by Commission order.⁹⁵ Consumer Counsel also raises a relevant concern as to whether the Pilot is negatively impacting non-Pilot vegetation management. The Commission's Pilot order addressed this matter and expressly directed that the Pilot "shall not in any way negatively impact non-Pilot vegetation management spending on the Company's Virginia distribution system during the Pilot program."⁹⁶ In this regard, APCo's annual reports on the Pilot should address how this program has impacted vegetation management of non-Pilot circuits.

8. *Demand-Side Management Programs.* The Company proposed a three-year Residential Low Income Program, which will provide weatherization and energy efficiency services to customers with annual household income at or below 60% of the state median income level and who live in electrically-heated, single-family homes. The Company also proposed an

⁹⁴ Staff's Post-Hearing Brief at 117-18. *See also* Ex. 68 (Abbott) at 35-36.

⁹⁵ *See, e.g.*, Tr. 80, 1578-81; Consumer Counsel's Post-Hearing Brief at 45-50.

⁹⁶ Pilot Order, 2013 S.C.C. Ann. Rept. at 277.

ongoing Residential Direct Load Control Program, which is designed to reduce residential peak demand by the use of direct load controllers attached to the air conditioning systems and heat pumps of participating residential customers. As recommended by Staff, we find that both programs should be approved and that the Residential Direct Load Control Program should be limited to three years (like the Residential Low Income Program).⁹⁷

9. *Standby Charge.* We approve the Company's proposed Standby Charge as modified below. Having considered the evidence and arguments, we conclude that the Standby Charge approved herein is reasonable based on the specific components contained therein, is consistent with the previous Standby Charge approved by the Commission,⁹⁸ and complies with the statute. In this regard, § 56-594 F states as follows:

F. Any residential eligible customer-generator or eligible agricultural customer-generator who owns and operates, or contracts with other persons to own, operate, or both, an electrical generating facility with a capacity that exceeds 10 kilowatts shall pay to its supplier, in addition to any other charges authorized by law, a monthly standby charge. The amount of the standby charge and the terms and conditions under which it is assessed shall be in accordance with a methodology developed by the supplier and approved by the Commission. The Commission shall approve a supplier's proposed standby charge methodology if it finds that the standby charges collected from all such eligible customer-generators and eligible agricultural customer-generators allow the supplier to recover only the portion of the supplier's infrastructure costs that are properly associated with serving such eligible customer-generators or eligible agricultural customer-generators. Such an eligible customer-generator or eligible agricultural customer-generator shall not be liable for a standby charge until the date specified in an order of the Commission approving its supplier's methodology.

⁹⁷ See, e.g., Ex. 84 (Carsley) at 10; Staff's Post-Hearing Brief at 132-33.

⁹⁸ *Application of Virginia Electric and Power Company, For approval of a standby charge and methodology and revisions to its tariff and terms and conditions of service pursuant to § 56-594 F of the Code of Virginia*, Case No. PUE-2011-00088, 2011 S.C.C. Ann. Rept. 530, Final Order (Nov. 23, 2011).

We find that APCo's proposed Standby Charge, as modified herein, "collected from all such eligible customer-generators and eligible agricultural customer-generators allow the supplier to recover only the portion of the supplier's infrastructure costs that are properly associated with serving such eligible customer-generators or eligible agricultural customer-generators" as set forth in the above statute.⁹⁹ The distribution component of the Standby Charge is based on APCo's class cost of service study. The transmission component is based on APCo's approved transmission costs and is discounted by 3.5% to recognize that "net metering customers might not necessarily contribute to all of APCo's transmission peaks."¹⁰⁰ We conclude, however, that such discount should be increased to 8%, which is within the increased discount range proposed in Staff's testimony and is consistent with the discount approved for Dominion Virginia Power's Standby Charge.¹⁰¹

We also conclude that it is reasonable, based on the record in this proceeding, not to incorporate a generation component or to reflect alleged benefits accruing to APCo. The record supports a finding that, at this time, no such generation or benefit component is needed in order for the Standby Charge to be reasonable or for it to satisfy the above statute. This finding is also consistent with our prior approval of Dominion Virginia Power's Standby Charge.¹⁰²

⁹⁹ Although we find that the proposed Standby Charge meets this standard, we note that the statute does not state that this is the *only* standard upon which a Standby Charge may be found reasonable by the Commission. *Compare, e.g.,* § 56-585.1 A 5 c ("The Commission shall *only* approve such a petition if The Commission shall *only* allow such recovery to the extent that") (emphasis added).

¹⁰⁰ APCo's Post-Hearing Brief at 116. *See also* Ex. 37 (Sebastian direct) at 5.

¹⁰¹ *See, e.g.,* Ex. 85 (Grant) at 7-9; Tr. 1298; Staff's Post-Hearing Brief at 123-24; *Application of Virginia Electric and Power Company, For approval of a standby charge and methodology and revisions to its tariff and terms and conditions of service pursuant to § 56-594 F of the Code of Virginia*, Case No. PUE-2011-00088, 2011 S.C.C. Ann. Rept. 530, Final Order (Nov. 23, 2011).

¹⁰² *See, e.g.,* Ex. 85 (Grant) at 4; Ex. 112 (Sebastian rebuttal) at 2; APCo's Post-Hearing Brief at 116-118. In addition, similar to the requirement placed on Dominion Virginia Power when we approved its Standby Charge, the Company shall undertake the studies discussed by Staff and APCo related to the load characteristics of net metering customers and the generation-related impacts of customer-generators. *See, e.g.,* Ex. 85 (Grant) at 11; Ex. 112

In sum, we find that APCo's proposed Standby Charge, as modified and approved herein, is reasonable, complies with the statute, and will become effective the date of this order.

10. *Economic Development Rider.* We approve the Company's proposed Economic Development Rider, which was not opposed in this proceeding.

11. *Reconnection Policy.* We approve the Company's proposed reconnection fees, which were not opposed by any participant in the case.¹⁰³ We reject, however, APCo's proposal to change its tariff so that reconnections are not made after dark. We are not unmindful of the potential safety concerns raised by the Company, concerns that are not limited to APCo but may apply to other utilities as well. The Company, however, did not cite any other Virginia utility that has explicitly sought or received such an exception as part of its filed tariff. This does not mean that APCo, or any utility, must endanger the safety of its employees in order to perform a reconnection. To the contrary, it means that a restrictive tariff change is not required in this regard for utilities to protect employee safety. If APCo or any utility reasonably believes that a specific after-dark reconnection will endanger the safety of its employees, it should document the situation and perform the reconnection upon sunrise or when conditions reasonably permit.

12. *Residential Underground Installation.* We approve the Company's proposed residential underground installation fees, which were not opposed by any participant in the case.¹⁰⁴

(Sebastian rebuttal) at 3-4; APCo's Post-Hearing Brief at 116-17; Staff's Post-Hearing Brief at 122. The results of such studies shall be filed with the Commission as part of APCo's next biennial review application.

¹⁰³ See, e.g., Ex. 85 (Grant) at 12-13; APCo's Post-Hearing Brief at 111.

¹⁰⁴ See, e.g., Ex. 85 (Grant) at 12.

13. *Customer Investigative Charge.* We do not find that the proposed Customer Investigative Charge – in both amount and description – is sufficiently supported or required by the facts in this case, and it is therefore rejected.

14. *Commercial and Industrial Customer Deposits.* We do not find that the proposed changes to Commercial and Industrial Customer Deposits are sufficiently supported or required by the facts in this case, and they are therefore rejected.

15. *Miscellaneous Terms and Conditions.* We approve the Company's proposal to change the time on which full payment is due from "prior to receipt of the next bill" to "on or before the scheduled due date" for residential, commercial, and industrial customers, which was not opposed in this case.

16. *Metering and Billing Terms and Conditions.* We approve the Company's proposal to change tariff language addressing metering equipment, as clarified by the definition of "telemetering equipment" recommended by Staff, which was not opposed in this case.¹⁰⁵

17. *Use of Energy by Customer Terms and Conditions.* We do not find that the proposed changes to this section of the Company's terms and conditions are sufficiently supported or required by the facts in this case, and they are therefore rejected.¹⁰⁶

18. *Revenue Apportionment Among Rate Classes.* We agree with Consumer Counsel and Staff that revenue should not be reapportioned among rate classes, as requested by the Committee and SDI, as part of this proceeding. We do not find that such reapportionment is sufficiently supported or required by the facts in this case, and it is therefore rejected. Such reapportionment will necessarily increase rates to the RS, SWS, and MGS classes at a time when

¹⁰⁵ As recommended by Staff, our approval herein shall have no ratemaking implications. Ex. 81 (Joshipura) at 7.

¹⁰⁶ See, e.g., Ex. 81 (Joshipura) at 8-9; Ex. 110 (Simmons rebuttal) at 2-3.

APCo's own cost of service study already shows that its rates are producing revenues in excess of its costs plus a fair rate of return.¹⁰⁷ As further stated by Consumer Counsel: "When rates are designed in a fashion that they are producing such excess revenues, it is possible that a class could be paying its full cost of service 'but that class would still be shown to be below parity because another class was paying even more than its allocated revenue requirement.'"¹⁰⁸

ACCOUNTING ADJUSTMENTS

The Company and various participants in this case have proposed additional accounting adjustments pursuant to the Commission's regulatory authority under Chapter 10 of Title 56 of the Code of Virginia. The proponent of each adjustment, in general, asserts that its proposal is not prohibited by the statute and may be made as part of this biennial review proceeding.

Although § 56-585.1 does not require the Commission to address these matters in this biennial review proceeding, we have considered specific proposals and conclude that the findings below are reasonable and supported by evidence in the record.

1. *Depreciation.* While proposing new depreciation rates, the Company and Staff both acknowledge that unique circumstances and uncertainty exists related to this matter, especially involving the potential impacts associated with the Environmental Protection Agency's ("EPA") Clean Power Plan and the uncertainty regarding estimated retirement dates for many of APCo's coal facilities.¹⁰⁹ The EPA's proposed 111(d) regulations will likely affect the useful lives of all coal-fired plants in ways that cannot be fully understood at this time. We find that these are significant circumstances and uncertainties that could substantially impact the reasonableness of

¹⁰⁷ See, e.g., Ex. 2 at Sched. 21; Consumer Counsel's Post-Hearing Brief at 61-62; Staff's Post-Hearing Brief at 118-19.

¹⁰⁸ Consumer Counsel's Post-Hearing Brief at 62 (citation omitted). See also Tr. 1038.

¹⁰⁹ See, e.g., Ex. 62 (Armstrong) at 19-21; Staff's Post-Hearing Brief at 76; APCo's Post-Hearing Brief at 66.

the depreciation studies and the resulting depreciation rates in this case. As a result, we find that depreciation rates should not be changed at this time. Rather, the Commission will revisit this issue as part of APCo's next biennial review, which will occur after the EPA's expected issuance of final rules under 111(d). We conclude that it is reasonable to review depreciation rates at that time, when the potential impacts of the EPA's proposed regulations on coal-fired plants should be further known.

2. *Coal Inventory.* We find that APCo has not shown that its proposed changes to its future, or going-forward, coal inventory targets are necessary or reasonable.¹¹⁰ Rather, we continue to find – as we did for projecting a reasonable going-forward amount in APCo's 2011 case – that the Company's coal inventory targets should reflect average burn rates and a thirty-five day supply of coal.¹¹¹

3. *Amos Unit 3.* APCo established that for Virginia jurisdictional ratemaking purposes, the Company's accounting for the transfer of the remaining two-thirds of Amos results in the rate level required by the Commission's approval of such transaction.¹¹² Thus, we conclude that APCo does not need to seek a return of a portion of the purchase price for the remaining two-thirds of Amos as requested by Staff.¹¹³

4. *Major Storm Damage Expense.* The Company includes an estimate of major storm damage expense for the prospective rate year. We agree with Consumer Counsel and Staff that under the current statutory framework for biennial reviews, it is no longer appropriate to include

¹¹⁰ See, e.g., Ex. 78 (West rebuttal) at 3-5, 12-14; Tr. 1196; APCo's Post-Hearing Brief at 21-23.

¹¹¹ See, e.g., Tr. 896-99; Consumer Counsel's Post-Hearing Brief at 18; Staff's Post-Hearing Brief at 89.

¹¹² See, e.g., Tr. 1451-52; APCo's Post-Hearing Brief at 91.

¹¹³ We note that Staff corrected the transfer's impact on accumulated deferred income taxes in this proceeding, as well as the impact on the Company's depreciation study filed with its Application. In future cases, the Company should properly reflect the transferred portion of Amos for regulatory accounting purposes.

an estimated cost for future major storm damage in operating expenses for prospective ratemaking.¹¹⁴ Section 56-585.1 A 8 allows APCo to defer and recover costs associated with "severe weather events" under certain circumstances. This statute provides APCo the opportunity to recover these costs. Thus, we find that major storm damage expense should not be included as a normalized expense for ratemaking and should be removed from the prospective rate year. We further note, as referenced by Consumer Counsel, that we required the same treatment by Dominion Virginia Power in its most recent biennial review.¹¹⁵

5. *Ohio Valley Electric Corporation.* The demand costs associated with APCo's purchase of power from Ohio Valley Electric Corporation should be recognized as a base rate component effective January 1, 2014, as proposed by the Company and accepted by Staff and Consumer Counsel.¹¹⁶

6. *Integrated Gasification Combined Cycle Study Costs.* APCo seeks authority to amortize and recover \$9.2 million, in 2014 and 2015, for certain deferred costs associated with the Company's 2007 proposal to construct an Integrated Gasification Combined Cycle ("IGCC") facility. The Company has not established that the \$9.2 million in expenditures was reasonable. We agree that the "vast majority of the IGCC study costs were related to detailed engineering studies and construction schedule and costs development for the IGCC project."¹¹⁷ The Commission previously found that this project was unreasonable and imprudent, and the Company has not established otherwise in this instant case regarding its detailed engineering

¹¹⁴ Ex. 53 (Smith) at 86-87; *VEPCO 2013 Biennial Review*, 2013 S.C.C. Ann. Rept. at 377; Consumer Counsel's Post-Hearing Brief at 31; Ex. 70 (Carr) at 38-39.

¹¹⁵ Consumer Counsel's Post-Hearing Brief at 31.

¹¹⁶ See, e.g., Ex. 16 (Bosta direct) at 8; Ex. 70 (Carr) at 34; APCo's Post-Hearing Brief at 82-83.

¹¹⁷ Consumer Counsel's Post-Hearing Brief at 35. See also Ex. 92; Tr. 713-14; VML/VACo's Post-Hearing Brief at 8-12.

studies and development costs attendant thereto.¹¹⁸ We also recognize, as did Consumer Counsel, that a limited amount of costs for normal analysis as to the feasibility of various generation alternatives may be reasonable. The Company, however, has not established what, if any, portion of its requested \$9.2 million recovery of deferred costs may fall into this category. We reject APCo's request to amortize and recover \$9.2 million for IGCC study costs.

7. *Joint-Use Assets.* The Joint-Use Assets herein reflect certain information technology assets that are jointly utilized by multiple affiliated companies. For the reasons set forth by Staff, we find that these Joint-Use Assets should be on AEP Service Company's books, and that APCo should pay an appropriate facilities charge to AEP Service Company. Furthermore, due to APCo's practical inability to track these costs retroactively, we adopt Staff's alternative recommendation "that all *future* Joint-Use Assets be required to remain on AEP Service Company's books and that APCo pay an appropriate facilities charge to AEP Service Company."¹¹⁹ We find that the Company has failed to show, on this record, that such implementation is impractical on a *prospective* basis.

8. *Production O&M Expense.* APCo proposes to use 2013 O&M expense levels as the basis for its ongoing level of certain production O&M expense. Consumer Counsel asserts that "[u]sing the 2013 O&M level of expense is unreasonable because 2013 includes the costs associated with operating seven coal units that are scheduled to be retired during the first half of 2015 ('Disposition Units')."¹²⁰ We agree. The Company's ongoing production O&M expense should be adjusted as recommended by Consumer Counsel witness Norwood to reflect "the

¹¹⁸ *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, 2008 S.C.C. Ann. Rept. 405, 406, 408, Final Order (Apr. 14, 2008), 2008 S.C.C. Ann. Rept. 411, 413, Order on Reconsideration (May 29, 2008).

¹¹⁹ Staff's Post-Hearing Brief at 98 (emphasis added). See also Ex. 57 (Ellis) at 18-19.

¹²⁰ Consumer Counsel's Post-Hearing Brief at 43. See also Ex. 56 (Norwood) at 23-24.

Company's budgeted O&M expense at the Disposition Units in 2014 and 2015."¹²¹ In addition, we recognize, as did Staff, that this going-forward adjustment does not pre-determine prudently-incurred O&M expense for 2014-2015;¹²² the reasonableness of APCo's actual production O&M expense for 2014-2015 is an issue that may be addressed in determining earned return in the Company's next biennial review.

9. *Projected Merit Wage Increase.* We find that, based on the facts of this case, the Company's proposed merit wage increase serves as a reasonable projection on a going-forward basis.¹²³

10. *Virginia Sales and Use Tax.* We adopt Staff's proposal that, "[e]ffective January 1, 2014, the surcharge mechanism and the related deferral should be limited to [Virginia Sales and Use Tax] associated with 'the repeal of the exemption' in House Bill 5018."¹²⁴

11. *Vegetation Management Pilot.* Consistent with our findings above regarding APCo's Vegetation Management Pilot, the Company shall defer the costs of this program in 2014 and 2015 as previously required by Commission order. As noted above, the Commission previously required such treatment as part of the approved Pilot, and we find that the Company has not established that it is necessary or appropriate to modify the directives of that order as part of this biennial review proceeding.

12. *Regulatory Assets.* As noted above, the concept of a "regulatory asset" is unique to regulated companies. A utility may, at the Commission's discretion, defer actual costs beyond

¹²¹ Consumer Counsel's Post-Hearing Brief at 45. See also Ex. 56 (Norwood) at 23-24; Ex. 56-C (Norwood) at SN-9.

¹²² Tr. 1115-17.

¹²³ See, e.g., Ex. 100 (Allen rebuttal) at 24; APCo's Post-Hearing Brief at 96-97.

¹²⁴ Staff's Post-Hearing Brief at 102. See also Ex. 63 (Morgan) at 6-8.

the period within which they are incurred. This is an unusual and extraordinary action – *i.e.*, being permitted to recognize expenses outside of the period incurred – that benefits the public utility by allowing it to defer expensing costs to future periods.¹²⁵ Accordingly, when the Commission permits regulatory asset treatment for deferred costs, it must subsequently determine whether the utility has received sufficient revenues to accelerate recovery of those costs.

The Commission has previously recognized regulatory assets for APCo, including: Vegetation Management Pilot costs; 2009 storm damage costs; Other Post Employment Benefit ("OPEB") transition obligation costs; and environmental and reliability ("E&R") surcharge costs. The exercise of the Commission's discretion cannot end with the creation of these regulatory assets. The Commission must determine when these deferred costs have been recovered, because no cost that has been actually recovered should continue to be deferred on the Company's books.¹²⁶ Staff recommends that the Commission perform this analysis now. The Company, however, contends that such action would be "illegal."¹²⁷

We find that this matter raises important questions that should be reviewed in a separate proceeding in which the participants can further develop the record and legal arguments on, for example, how and when the Commission can address sufficiency of earnings related to the regulatory treatment of deferred costs that have been permitted to be carried on APCo's books at

¹²⁵ See, e.g., Consumer Counsel's Post-Hearing Brief at 51-53; Staff's Post-Hearing Brief at 51-53.

¹²⁶ See, e.g., Staff's Post-Hearing Brief at 53.

¹²⁷ See, e.g., APCo's Post-Hearing Brief at 13, 16.

the discretion of the Commission. We anticipate initiating such a proceeding for APCo forthwith.¹²⁸

13. *Additional Adjustments.* The Commission's findings above on the following items (in determining 2012-2013 earned return) likewise should apply on a going-forward basis for regulatory accounting purposes: Incentive Compensation; Charitable Contributions; Corporate Aviation; CWC; Putnam; Lobbying Expense; Payroll Labor; ADVSIT¹²⁹; AROs; Prepaid Pension Asset; and Property Tax Expense.¹³⁰ We again note, however, that while going-forward approval of any particular item may be relevant to the question of reasonableness in the next biennial review, it is not the end of the inquiry. That is, as emphasized repeatedly in this order, rate case or other findings that are made on a *prospective* basis do not predetermine the reasonableness of actual items that may be incurred in the next biennium for purposes of reviewing the utility's performance – and determining the just and reasonable earned return – in the next *retrospective* biennial review.

Accordingly, IT IS ORDERED THAT:

- (1) The Company's Application is granted in part and denied in part as set forth in this Final Order.
- (2) The Company shall comply with the directives set forth in this Final Order.

¹²⁸ In doing so, we do not foreclose any arguments or options for addressing such matters, including but not limited to the proposals set forth in the instant case.

¹²⁹ Additionally, the Commission finds to be reasonable and hereby approves the Company's proposal to amortize these deferred credits over the 20-year period beginning February 1, 2015. *See, e.g.*, Ex. 14 (Kelly direct) at 6-7, 15-16; Ex. 70 (Carr) at 21-22.

¹³⁰ We also adopt Staff's rate year revenue adjustments and resulting billing determinants. We note that the Company will realize modest revenue increases from the standby charge, reconnection charge, and residential underground charge approved herein. Such charges shall be designed with offsetting revenue decreases to the affected rate classes based on Staff's billing determinants in order to maintain revenue neutrality.

(3) The Company shall forthwith file revised tariffs and terms and conditions of service and supporting workpapers with the Clerk of the Commission and with the Commission's Divisions of Energy Regulation and Utility Accounting and Finance, as necessary to comply with the directives set forth in this Final Order. The Clerk of the Commission shall retain such filing for public inspection in person and on the Commission's website:

<http://www.scc.virginia.gov/case>.

(4) This case is dismissed.

JAGDMANN, Commissioner, Dissenting in Part:

I dissent to the parts of this Final Order that require APCo to defer its Vegetation Management Pilot program costs. The plain language of the Commission's Pilot order "authorized" the Company to defer Pilot expenses. There is no language in the Pilot order that directed, mandated, or otherwise required the Company to defer such costs in all circumstances. In my view, it would be unusual and inappropriate for the Commission to force the creation of a regulatory asset for a period in which the Company has sufficient earnings to book such expenses and still earn its authorized rate of return. Accordingly, I would find, as requested by APCo, that it was appropriate to expense the Pilot program costs for purposes of determining earned return in this biennial review. Similarly, I would also find that APCo has the discretion to expense Pilot costs in future periods, as well.

DIMITRI, Commissioner, Dissenting in Part:

I strongly disagree with the majority's ruling on the issue of a rate base return on APCo's coal inventories in 2012 and 2013. This ruling costs customers – residential, commercial and large business – \$6.9 million in what should be refunds to them.

While APCo is reimbursed dollar-for-dollar through the fuel factor for *all* coal it burns, the level of inventory it is allowed to earn a return on (*i.e.*, the carrying costs) is subject to a standard of reasonableness because it affects rates to customers and company earnings. This Commission, in the last two APCo biennial review/rate cases,¹³¹ ruled on the reasonable level of coal inventory to be built into rates, both times determining that a volume reflecting a 35-day average burn rate was appropriate.¹³² In fact, in 2009, APCo proposed the 35-day average burn rate as the reasonable level for the Commission to approve for ratemaking purposes.¹³³ And in 2011, the Commission specifically ruled that the 35-day average burn level remained appropriate.¹³⁴

In this case where significant revenues are at stake, the majority abandons the 35-day level found reasonable for setting rates in past cases and finds that APCo's actual coal inventory levels for 2012 and 2013 were (a) reasonable because some level of the excessive amount was used in 2014; and (b) Staff and other parties apparently had the burden to prove imprudence, a standard not applied in the order to any other determination of reasonableness for adjustments to earnings in 2012-2013. The record, however, shows APCo's coal inventory levels throughout the 2012-2013 earnings test period were extremely excessive and anything but reasonable. For this period, APCo's actual average coal inventory was *more than triple* the 35-day average daily burn rate this Commission found reasonable in APCo's 2011 biennial review and *more than triple* the same 35-day average daily burn rate level this Commission finds reasonable going

¹³¹ *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 487-88; *APCo 2009 Rate Case*, 2010 S.C.C. Ann. Rept. 308; Ex. 63 (Morgan) at 2.

¹³² Too high a level of inventory in rate base inflates rates (or reduces refunds) to customers because they must pay a return, or profit, to the utility based upon the size of the inventory.

¹³³ Ex. 63 (Morgan) at 2.

¹³⁴ *APCo 2011 Biennial Review*, 2011 S.C.C. Ann. Rept. at 487-88.

forward in this proceeding.¹³⁵ Stated in tons of coal inventory, for 2012 a 35-day average burn for APCo (what the Commission in 2011 had found reasonable) came to 820,085 tons. APCo's *actual* average inventory in 2012 was 2,476,048 tons.¹³⁶ In 2013 the 35-day allowance was 701,260 tons, while the *actual* level was 2,385,747 tons.¹³⁷ Even the Company's witness acknowledged that "we had too much" when testifying about APCo's earnings test coal inventory.¹³⁸ And APCo's *current* target, even with the addition of its recently acquired interest in Amos Unit 3, is only 1,299,720 tons,¹³⁹ approaching half of the inflated level that the majority finds reasonable for the earnings test period. The Commission set a 35-day standard in 2011 and sets a 35-day level going forward for 2015. The majority ruling ignores the overwhelming evidence of abnormal levels in 2012 and 2013 and requires customers to pay a return on these excessive amounts and simply declares it "reasonable."

The record shows that APCo's excessive earnings test period coal inventory was a direct result of actions or decisions made by the Company.¹⁴⁰ Specifically, APCo failed to forecast demand for coal-fired generation accurately, and executed coal purchase contracts that required APCo to take coal shipments regardless of APCo's need or its existing inventory level.¹⁴¹ These

¹³⁵ For the thirteen average monthly balances for 2012, APCo's actual coal inventory amounted to over a 105-day average daily burn inventory, and for 2013 APCo's actual coal inventory amounted to over a 119-day average daily burn inventory. *See* Ex. 63 (Morgan), Appendix A at 3-4 (13 Month Average (Tons) divided by Average daily burn (Tons)).

¹³⁶ Ex. 63 (Morgan), Appendix A at 4.

¹³⁷ Ex. 63 (Morgan), Appendix A at 3.

¹³⁸ Tr. 1220.

¹³⁹ Ex. 78 (West rebuttal) at 13; Tr. 1205.

¹⁴⁰ As Company witness West testified concerning what he deemed "a large inventory:" "If you look at – we were above inventory on our coal plants for '12 and '13 and it was almost exclusively low-sulfur barge coal that was the high inventory. Again, that was because of that decision we made in 2011." Tr. 1221.

¹⁴¹ Tr. 1220-21; APCo's Post-Hearing Brief at 18-19.

were analyses and decisions within the Company's control that turned out to be wrong. Moreover, the monthly balances in 2012 and 2013 show no significant progress in reducing the excessive levels.¹⁴² Based on the record in this case, APCo should not be rewarded with additional earnings through an inflated rate base for such decisions.

While the majority makes much of the ultimate use of some of the high inventory levels during the cold weather of the winter of 2014 as a result of the Polar Vortex, those circumstances actually demonstrate the opposite – that APCo's earnings test period coal inventories were in fact excessive.¹⁴³ Even after the unusually high winter coal burn rates, coupled with only limited coal deliveries from January through March 2014, APCo's coal inventory only then approached a level near the Company's own target and a level near what the Commission had found to be reasonable in APCo's 2011 biennial review and on a going-forward basis in this proceeding. On March 23, 2014, APCo had 1.1 million tons in inventory.¹⁴⁴ In other words, it took an extreme occurrence, after 24 months of greatly excessive inventory levels, to bring the Company's coal inventory down to a level approaching reasonable, well after the end of the biennial review period.

APCo asserted that during the winter of 2014, its coal inventory was reduced by more than the entire inventory found to be reasonable in the 2011 biennial review. Through this assertion the Company attempts to imply that excessive average inventories for 2012 and 2013 are now justified by an extreme occurrence and drawdown subsequent to the earnings test period. This assertion ignores that the 35-day average burn inventory is an average inventory. Actual

¹⁴² Ex. 63 (Morgan), Appendix A at 3-4.

¹⁴³ The drawdown of coal inventory during the cold 2014 supply disruptions occurred after the end of the earnings test period and, generally, is outside the earnings test study period.

¹⁴⁴ Tr. 1206-07.

inventories are expected to be built higher during the fall and the spring, and drawn down during the winter and the summer.¹⁴⁵ Focusing on the drawdown during the winter of 2014, at best, may provide some insight concerning the inventory balances for the fall of 2013, but provides no meaningful information concerning earlier inventory balances. Thus, APCo's comparison of the winter of 2014 drawdown to the 13-month average balance provides little, if any, probative evidence. The majority's reliance on an extreme weather event in 2014 to deem reasonable the inventory levels in 2012 and 2013 (far in excess of Commission standards and APCo's own targets) defies logic, and the order's claim that this is not a "blank check" for the future must ring hollow for customers who are today presented with just such a check for payment in this case. When levels that are multiples of those previously deemed and prospectively declared reasonable by the Commission are allowed, the clear precedent from this ruling is that there is no standard of reasonableness applied in such matters, sending precisely the wrong signal to the utility and penalizing customers.

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 and Utility Accounting and Finance.

¹⁴⁵ Tr. 1213, 1215.