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November 29, 2006

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HAND DELIVERED

Beth O'Donnell
Executive Director
Public Service Commission of Kentucky
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615

RE: Kentucky Power Company
PSC Case No. 2006-00307

Dear Ms. O'Donnell:

Enclosed please find and accept for filing the original and five (5) copies of Kentucky Power Company's Supplemental Response to the Commission's August 24, 2006 First Set of Data Requests, Item 4(f). By copy of this letter, copies are being served on KIUC and the Attorney General. Copies of the Virginia decision were also provided to counsel for KIUC and the Attorney General at the November 28th hearing.

If you have any questions, please feel free to contact me.

Sincerely,

STITES & HARBISON, PLLC

Michele M. Whittington

Michele M. Whittington

MMW/pjt
Enclosures
cc: Elizabeth E. Blackford
Michael L. Kurtz

KE057:KE113:14671:2:FRANKFORT

COMMONWEALTH OF KENTUCKY

BEFORE THE

PUBLIC SERVICE COMMISSION

RECEIVED
NOV 29 2006
PUBLIC SERVICE COMMISSION

IN THE MATTER OF

THE APPLICATION OF KENTUCKY POWER COMPANY FOR APPROVAL OF AN AMENDED COMPLIANCE PLAN FOR PURPOSES OF RECOVERING ADDITIONAL COSTS OF POLLUTION CONTROL FACILITIES AND TO AMEND ITS ENVIRONMENTAL COST RECOVERY SURCHARGE TARIFF	))))))	CASE NO. 2006-00307

KENTUCKY POWER COMPANY SUPPLEMENTAL RESPONSE TO COMMISSION FIRST SET OF DATA REQUESTS ITEM 4(f)

November 29, 2006

Kentucky Power Company

REQUEST

In addition to the results from the MECO modeling, provide the following information for each of the 44 projects listed in Exhibit JMM-1:

f. Copies of any regulatory commission approvals received for the project.

SUPPLEMENTAL RESPONSE

f. See attached Final Order dated November 20, 2006 in Case No. PUE-2005-00056 before the Commonwealth of Virginia, State Corporation Commission at Richmond, styled "Application of Appalachian Power Company For adjustment to capped electric rates pursuant to § 56-582 B (vi) of the Code of Virginia."

WITNESS: John M. McManus, Errol K. Wagner

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, NOVEMBER 20, 2006

APPLICATION OF

APPALACHIAN POWER COMPANY

CASE NO. PUE-2005-00056

For adjustment to capped electric
rates pursuant to § 56-582 B (vi)
of the Code of Virginia

FINAL ORDER

On July 1, 2005, Appalachian Power Company ("Appalachian" or "Company") filed with the State Corporation Commission ("Commission") an Application seeking adjustment of its capped electric rates pursuant to § 56-582 B (vi) of the Code of Virginia ("Code") and approval of a rate surcharge methodology by which to make adjustments to its capped rates in the future. Appalachian requested that the Commission direct expedited notice to customers and permit the proposed surcharges to be effective, as interim rates subject to refund, for bills rendered on and after August 1, 2005, or as soon thereafter as possible.

The Company stated that § 56-582 B (vi) permits recovery of incremental costs for compliance with state and federal environmental laws and regulations ("environmental costs") and for transmission and distribution system reliability ("reliability costs") after July 1, 2004, and that the cost recovery sought in its Application represents the increment of the Company's environmental and reliability costs above such costs incurred prior to July 1, 2004. The 12-month period ended June 30, 2004, is called the "Base Period" in the Application. Such incremental costs also are identified for two later 12-month periods. The first later period is the 12 months ending June 30, 2005 ("Bridge Period"), and the second later period is the 12 months ending June 30, 2006 ("Projected Period").

Appalachian asserted that at the time of the filing of the Application, it will have incurred incremental costs during the Bridge Period creating an annual revenue requirement of $13.5 million and expects to incur incremental costs during the Projected Period that will create an additional $48.6 million annual revenue requirement. The Company proposed to increase its capped rates during the 12-month period from August 1, 2005, through July 31, 2006, in the amount of $62.1 million, the total revenue requirement for the Bridge Period and Projected Period. The Company proposed to recover this revenue requirement through a 9.18% surcharge factor, called the "E&R Factor," applied to customers' bills during the period August 1, 2005, through July 31, 2006. Appalachian proposed that revenue recovered through the E&R Factor would be trued-up for any over- or under-recovery of incremental environmental and reliability costs actually incurred by the Company. An over-recovery would be deducted from, and an under-recovery would be added to, the next E&R Factor approved by the Commission under § 56-582 B (vi).

The Company stated that Attachment A to its Application sets forth the E&R Factor that it seeks to implement beginning August 1, 2005, which will increase each customer's bill by an equal percentage. Appalachian asserted that this is in accordance with the Commission's practice of considering rate design issues only in general rate cases. In the event, however, that the Commission considers rate design issues in this case, the Company has prepared an exhibit filed with the Application showing the $62.1 million revenue requirement allocated among the Company's rate schedules to recognize variations in the demand and energy usage of customers served on those rate schedules.

Next, Appalachian requested approval to continue the revenue requirement methodology proposed in its Application for 12-month Projected Periods beginning after June 30, 2006, in

order to determine incremental E&R costs for purposes of future applications under § 56-582 B (vi). The Company contended that such methodology is appropriate to maintain timely recovery of such costs as required by the statute, and that with appropriate adjustments for over- or under-recoveries, the proposed methodology accomplishes the statutory direction for timely recovery while protecting customers from over-recovery of such costs.

The Company further asserted that the significant amounts and upward trend of these costs are just beginning and require that recovery of such costs through rates commence as soon as possible. For example, Appalachian stated that incremental environmental compliance costs alone in the Projected Period ending July 1, 2006, are expected to create an additional revenue requirement of at least $31 million, which is more than double the $13.5 million revenue requirement created by incremental costs for both environmental compliance and transmission and distribution reliability in the immediately preceding Bridge Period ending June 30, 2005.

In addition, the Company requested that in the event the Commission determines to make effective only a portion of its revenue request prior to consideration on the merits, such portion should be made effective for bills rendered on and after August 1, 2005, or as soon thereafter as possible. Appalachian stated that to the extent costs whose recovery is authorized by § 56-582 B (vi) are not recovered on a current basis under the E&R Factor as the Commission may authorize, the Company would defer such unrecovered costs. Then, when the Commission has completed its consideration of the Application and to the extent the Commission determines that such costs are eligible for recovery under § 56-582 B (vi), the Company in its next Application would seek their recovery beginning immediately after the end of the E&R Factor authorized by the Commission in this proceeding.

On July 14, 2005, the Commission issued an Order for Notice and Hearing that, among other things, docketed this proceeding, required Appalachian to give notice of its Application, established a procedural schedule, and assigned this case to a Hearing Examiner. In addition, the Order for Notice and Hearing prohibited the Company from implementing any portion of the Application until further order of the Commission. The Order for Notice and Hearing allowed the Company, each respondent, and the Commission's Staff ("Staff") to file legal memoranda on whether, and under what circumstances, the Commission has the authority to make effective, on an interim basis subject to refund, any portion of the rates proposed in the Application.

On October 14, 2005, the Commission issued an Order finding, among other things, that: (1) § 56-582 B (vi) of the Code does not permit the Commission to implement the Company's proposed rates herein on an interim basis subject to refund; and (2) the Company may not seek to adjust capped rates in this proceeding for costs that have yet to be incurred.

On February 7 and 27, 2006, public hearings were convened, with the Chief Hearing Examiner presiding, to receive testimony and evidence from public witnesses and the participants in this case. Post-hearing briefs were filed on April 11, 2006.

On May 4, 2006, Appalachian filed a separate application with the Commission requesting a net increase in base rates, pursuant to § 56-582 C of the Code, of approximately $198.5 million. Such application is separate from the instant proceeding and was docketed by the Commission as Case No. PUE-2006-00065.[1] In that application the Company requests, among other things, recovery of certain E&R costs; however, Appalachian asserts that the E&R costs requested therein are not duplicative of the E&R costs sought in the instant proceeding for the period July 1, 2004, through September 30, 2005.

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[1] *Application of Appalachian Power Company For an increase in electric rates*, Case No. PUE-2006-00065, Order for Notice and Hearing and Suspending Rates (May 30, 2006).

On September 22, 2006, Chief Hearing Examiner Deborah V. Ellenberg entered a Report in the instant Case No. PUE-2005-00056, which summarized the record, analyzed the evidence and issues in the proceeding, and made certain findings and recommendations. Specifically, the Chief Hearing Examiner's Report included the following findings:

(1) dollar-for-dollar recovery is not provided for in § 56-582 B (vi) of the Code;

(2) a going-forward adjustment to Appalachian's rates is necessary for it to recover incremental E&R costs that were prudently incurred as of September 30, 2005, pursuant to § 56-582 B (vi) of the Code, and should be used in subsequent E&R adjustment cases;

(3) a return on common equity of 9.8% and an overall cost of capital using the Staff's updated capital structure of 7.306% to 7.760% are reasonable;

(4) the Company's capped rates would be adjusted to collect an additional revenue requirement of $29.481 million if interim rates in the pending general rate case did not supersede an increase in this case; and

(5) Staff's proposed revenue allocation methodology, exclusive of fuel revenue, is just and reasonable.[2]

On October 13, 2006, the following participants filed comments on the Chief Hearing Examiner's September 22, 2006 Report: Appalachian; Old Dominion Committee for Fair Utility Rates ("Old Dominion Committee"); Virginia Municipal League and the Virginia Association of Counties APCo Steering Committee ("VML/VACo Committee"); Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel"); and Staff.

NOW THE COMMISSION, having considered the Chief Hearing Examiner's Report, the record, the pleadings, and the applicable law, is of the opinion and finds as follows.

[2] Chief Hearing Examiner's September 22, 2006 Report at 46.

Section 56-582 B (vi) of the Code

Appalachian seeks an adjustment to its capped rates pursuant to § 56-582 B (vi) of the Code, which provides as follows:

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

As required by the plain language of the statute, the Commission will adjust the Company's capped rates for incremental E&R costs prudently incurred between July 1, 2004, and September 30, 2005, which is the historical period applicable to this case.

Section 56-582 B (vi) requires the Commission to identify, and to adjust capped rates for the timely recovery of, prudently incurred incremental E&R costs. The Commission has further explained that "the statute does not permit the Commission to adjust capped rates for costs that are *expected* to be incurred."[3] As a result, in this proceeding we must determine, and permit recovery of, the actual incremental E&R costs prudently incurred between July 1, 2004, and September 30, 2005. This necessarily requires the Company to defer such costs on its books to allow timely recovery according to the statute.[4]

We therefore reject the Chief Hearing Examiner's recommendations that the Company expense all incremental E&R costs as incurred, that the Company write-off specific incremental

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[3] October 14, 2005 Order at 8 (emphasis in original).

[4] The utility, however, may not defer such costs for an unreasonable amount of time. Rather, in order to receive timely recovery of its prudently incurred incremental E&R costs under the statute, a utility has an obligation to file timely requests for recovery thereunder.

E&R costs prudently incurred after July 1, 2004, and that Appalachian's general rate case supersede any rate increase resulting from the instant proceeding.[5] We recognize that the Chief Hearing Examiner's recommendations are consistent with fundamental ratemaking and accounting principles. For example, for purposes of setting just and reasonable rates under traditional ratemaking statutes, the Company would typically – consistent with the Chief Hearing Examiner's recommendations – expense and capitalize incremental E&R costs as incurred pursuant to the Uniform System of Accounts. Section 56-582 B (vi), however, does not reflect traditional principles of ratemaking.

The Chief Hearing Examiner, supported by Staff testimony, attempts to reconcile the dichotomy of (i) the unique limited-issue ratemaking required in § 56-582 B (vi), and (ii) the general rate case increases also permitted to the Company pursuant to § 56-582 C. The Chief Hearing Examiner establishes an annualized E&R revenue requirement designed to collect costs on a going-forward basis. This result, however, violates the directives in § 56-582 B (vi). Recovery of annualized costs is not the same as dollar-for-dollar recovery of costs actually incurred during a specific time period and may result in disallowance of costs otherwise recoverable under § 56-582 B (vi). As explained by Consumer Counsel, the Chief Hearing Examiner in effect "recommend[s] that Appalachian not recover any E&R costs as a result of this case."[6]

Indeed, Consumer Counsel highlights the fact that the Chief Hearing Examiner's proposed treatment of incremental E&R costs would undoubtedly "benefit consumers."[7]

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[5] Chief Hearing Examiner's September 22, 2006 Report at 30.

[6] Consumer Counsel's October 13, 2006 Comments at 3 n.2.

[7] *Id.* at 7.

Section 56-582 B (vi), however, is an atypical, limited-issue ratemaking statute that requires the Commission to permit recovery of certain E&R costs without analyzing, for example, whether such costs are offset by other decreased costs or increased revenues. Accordingly, even though consumers would benefit, Consumer Counsel acknowledges that the Chief Hearing Examiner's result goes beyond that permitted by § 56-582 B (vi) and does not request the Commission to adopt such result.[8] We agree with Consumer Counsel's conclusion. Although the Chief Hearing Examiner's treatment of incremental E&R costs is consistent with established ratemaking principles and would benefit consumers, we are bound to follow the statute.

Finally in this regard, the distinctly different ratemaking paradigms encompassed in §§ 56-582 B (vi) and 56-582 C in no manner permit double-recovery of incremental E&R costs. Any measures needed to ensure that there is no double-recovery may be addressed in Appalachian's general rate cases under § 56-582 C, and in any subsequent limited-issue E&R case under § 56-582 B (vi). Furthermore, although we have determined herein that the Company may defer certain incremental E&R costs on its books to permit recovery under § 56-582 B (vi), we have not concluded that such deferral is appropriate for incremental E&R costs that are otherwise reflected in capped rates. Indeed, under the heading Revenue Apportionment and Rate Design, below, we explain in more detail the deferred accounting and the method of cost recovery approved herein under § 56-582 B (vi).

Incremental E&R Costs

The Company's requested "E&R revenue requirement, based on actual costs incurred July 1, 2004 through September 30, 2005, is $21,138,000."[9] The Chief Hearing Examiner

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[8] *Id.*

[9] Chief Hearing Examiner's September 22, 2006 Report at 26 (citation omitted).

explained that the "Company presented extensive testimony detailing its incremental E&R costs," and that most of the factual differences among the participants in this regard were resolved during the proceeding for the purposes of this case.[10] The Report, however, identifies the following costs for which there remains disagreement among one or more of the participants: depreciation expense; emission allowances; employee labor costs; Wyoming-Jackson's Ferry transmission line costs; and carrying costs. Based on the Chief Hearing Examiner's Report and our findings below, we approve a revenue requirement of $21.337 million for recovery of incremental E&R costs prudently incurred from July 1, 2004, through September 30, 2005.

Depreciation Expense

We agree with the Chief Hearing Examiner's conclusion that the Company may not recover, as part of this case, depreciation associated with capital costs incurred prior to July 1, 2004. As explained in the Report, the "Staff and the Company . . . disagree on the allowed ratemaking treatment of depreciation expenditures associated with additions to plant in service recorded prior to July 1, 2004, and depreciation associated with construction work in progress ('CWIP') prior to July 1, 2004. Staff excluded depreciation expense booked after July 1, 2004, but incurred on actual E&R plant recorded in service prior to July 1, 2004. Staff witness Pate contends that the incremental costs recoverable under Virginia Code § 56-582 B (vi) must be related to investments made on or after July 1, 2004."[11]

The Chief Hearing Examiner agreed with Staff and found "that depreciation is the allocation of a facility's costs over the useful life of the plant. . . . The depreciation associated with those capital costs incurred prior to July 1, 2004, therefore should not be included in the

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[10] *Id.* at 30.

[11] Chief Hearing Examiner's September 22, 2006 Report at 30-31 (citations omitted).

adjusted capped rates in this proceeding."[12] Appalachian objects and argues that such a conclusion "of course, is contrary to fundamental accounting and ratemaking principles."[13] As explained above regarding cost deferrals, however, implementation of § 56-582 B (vi) necessarily requires results that may be contrary to fundamental accounting and ratemaking principles. The statute only permits limited-issue recovery of incremental E&R costs incurred on and after July 1, 2004. E&R costs incurred prior to July 1, 2004, may be allocated, via depreciation expense, in subsequent periods; the actual cost, however, was incurred prior to July 1, 2004. Thus, under § 56-582 B (vi) the Commission only will recognize depreciation expense booked on actual E&R investments incurred on or after July 1, 2004.

Emission Allowances

The Chief Hearing Examiner finds, as requested by the Company, that if the depreciation expense on E&R investment incurred prior to July 1, 2004, is disallowed in this case, then incremental E&R costs likewise should not be *credited* to include gains on the disposition of emission allowances related to pollution control facilities in service prior to July 1, 2004.[14] We agree. As explained by the Chief Hearing Examiner, "the Company will be entitled to address depreciation costs and gains from the disposition of emission allowances associated with plants in service prior to July 1, 2004, without the 'bright line' limitation established in the E&R statute, in its pending base rate case, but recovery in this case should be limited in accordance with the line drawn in the statute."[15]

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[12] *Id.* at 31.

[13] Appalachian's October 13, 2006 Comments at 29.

[14] Chief Hearing Examiner's September 22, 2006 Report at 31.

[15] *Id.* at 31-32.

Employee Labor Costs

We agree with the Chief Hearing Examiner's finding that the Company's own employee labor costs are properly included as incremental E&R costs to the extent the cost is capitalized and associated with plant booked in service after June 30, 2004.[16]

Wyoming-Jackson's Ferry Transmission Line Costs

The Chief Hearing Examiner concluded that all high voltage transmission lines are not by definition proposed and built solely for reliability purposes.[17] The Chief Hearing Examiner found, however, that the Wyoming-Jackson's Ferry high voltage transmission line "is primarily reliability-related" and, thus, incremental costs associated with the line should be included in the incremental E&R revenue requirement.[18] We agree.

The Chief Hearing Examiner also stated that "any E&R rate adjustment should disallow such costs in the future if the Company receives FERC approval to recover costs through rates designed to recover costs for regional transmission facilities including the Wyoming-Jackson's Ferry line, from all who benefit from use of the facilities on an equitable, region-wide basis."[19] We agree that the Company should not be permitted to recover costs through retail rates that it is also recovering through wholesale rates. Any decision to reject E&R costs on this basis in a future proceeding must be based on the record in that proceeding.

Carrying Costs

We find that the E&R revenue requirement should include carrying costs as requested by Appalachian for the period July 1, 2005, through September 30, 2005. The Chief Hearing

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[16] *Id.* at 32.

[17] *Id.* at 39.

[18] *Id.*

Examiner, Staff, Consumer Counsel, Old Dominion Committee, and VML/VACo Committee, however, conclude that no such carrying costs should be included in this case. The Chief Hearing Examiner acknowledged that "this case has taken some time to resolve," but found that "this case will establish the process for adjusting capped rates for timely recovery of E&R costs" and suggested that future E&R cases would proceed more expeditiously.[20] The Chief Hearing Examiner also noted, as asserted by Staff, that "the Commission generally does not authorize a return on regulatory assets resulting from deferred accounting even when dollar-for-dollar recovery is allowed."[21]

As explained above, the implementation of § 56-582 B (vi) requires us to look beyond traditional and fundamental ratemaking principles found just and reasonable in the context of other cases, and this statute neither mandates nor prohibits recovery of the carrying costs requested herein. Based on the plain language of the statute and the length of this proceeding, we grant the Company's request that the incremental E&R revenue requirement include three months of carrying costs.[22] This finding is based on the particular circumstances of this proceeding and does not permit the Company to accrue such carrying costs on a going-forward basis.

Capital Structure and Return on Common Equity

Appalachian asserted that "[a]n independent reanalysis of the Company's authorized ROE is not within the plain meaning of § 56-582 B (vi) and is not properly at issue in this proceeding

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[19] *Id.*

[20] *Id.* at 40.

[21] *Id.* at 39.

[22] This results in a one-time carrying cost of $335,000, which is based on the return on equity approved below.

based on any other authority cited by any party or the Staff."[23] The Chief Hearing Examiner, however, found that "ROE is properly at issue as a necessary element of determining incremental E&R costs in a § 56-582 B rate proceeding."[24]

As explained by the Chief Hearing Examiner, the Company includes a return component as part of the incremental E&R costs for which it seeks recovery herein. Specifically, Appalachian "proposes to use a current capital structure and cost of debt in the calculation of that return, yet it argues that the cost of equity should be determined based on an ROE that resulted from a settlement approved by the Commission in the Company's last base rate case almost seven years ago."[25] As recognized by the Company's proposal herein, the Commission must use *some* return component in determining incremental E&R cost recovery. We agree with the Chief Hearing Examiner that, like the Company's capital structure and cost of debt, such "ROE should also be determined based on current conditions."[26]

The Chief Hearing Examiner further states that the "Company complains that the Commission has traditionally applied one rate of return for a utility's entire rate base and it should continue to do so . . ."[27] The Chief Hearing Examiner, however, correctly explains that "the General Assembly has directed the Commission to engage in incremental ratemaking in this

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[23] Appalachian's January 20, 2006 Reply to Responses to Appalachian Power Company's Motion *In Limine* and to Strike Prepared Testimony at 3.

[24] Chief Hearing Examiner's January 27, 2006 Ruling at 3.

[25] *Id.*

[26] *Id.*

[27] *Id.*

instance. [T]he statute clearly requires this incremental approach which may well result in a different rate of return on the incremental rate base, including ROE."[28] We agree.

In this regard, the Chief Hearing Examiner found that: (1) "Staff's updated capital structure [is] reasonable and consistent with Commission practice;" and (2) "the more convincing studies offered in this case by Messrs. Oliver and Gorman support a cost of equity range of 9.3% to 10.3%, and that a midpoint of 9.8% is reasonable to calculate the incremental revenue requirement."[29] We have considered the evidence and pleadings presented on this matter and agree with the Chief Hearing Examiner's conclusion that a "return on common equity of 9.8% and an overall cost of capital using Staff's updated capital structure of 7.306% to 7.760% are reasonable."[30]

Finally, this conclusion is applicable to the determination of the revenue requirement in the instant proceeding. We do not intend that our findings herein be taken as a capital structure or a cost of equity range that must be applied in future cases. For example, we note that Staff's proposed ROE, which we approve herein, did not assume dollar-for-dollar recovery of E&R costs and, thus, subsequent cases may address the impact of such recovery on ROE. We also do not intend that our findings herein be taken as a capital structure or a cost of equity range that must be applied in Appalachian's pending rate case, Case No. PUE-2006-00065. Such findings in that case will be based on the evidence and argument adduced in that proceeding.

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[28] *Id.*

[29] Chief Hearing Examiner's September 22, 2006 Report at 40, 42.

[30] *Id.* at 46.

Revenue Apportionment and Rate Design

Inter-Class Revenue Apportionment

As explained by the Chief Hearing Examiner, the Company contends that the Commission should not consider rate design changes in this limited-issue proceeding and, thus, should "spread[] its incremental E&R revenue requirement on an equal percentage of revenue basis among all customers."[31] The Chief Hearing Examiner, however, rejects the Company's assertion that rate design changes should not be addressed in this proceeding.[32] Rather, the Chief Hearing Examiner explains that "[o]ne of the most significant issues in this proceeding is to establish, not change, an incremental E&R revenue recovery method."[33] We agree. The Chief Hearing Examiner also concludes that it is reasonable to apply Staff's proposed revenue apportionment method, which "maintains the relative relationships between customer classes that were established by the Commission upon its last consideration of a complete class cost of service study."[34] We also agree.

Staff's proposal "divide[s] the class functional revenues by the overall functional revenues to calculate the ratio of functional revenues that each class contributes to the entire revenue requirement. The ratios were then applied to the incremental E&R revenue requirement to apportion those costs 'to the various classes and functions, thus maintaining the relative relationships that exist between the customer classes in the current Commission approved rate design.'"[35] For example, the Chief Hearing Examiner notes that since "residential customers are

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[31] *Id.* at 43-44.

[32] *Id.* at 44.

[33] *Id.*

[34] *Id.*

[35] *Id.* at 42-43 (citation omitted).

responsible for 64.88% of all of the Company's current distribution revenue, [Staff] allocated 64.88% of the incremental E&R distribution-related revenue requirement to those residential customers."[36]

The Chief Hearing Examiner states that "[i]n support of its allocation, Staff explained, the Company has unbundled rates for its services under Virginia law. In the Company's function[al] separation case, the Commission approved rates designed by the Company 'to recover its revenue requirements in a manner reflective of the functionalized (generation, transmission, and distribution) costs incurred to provide service for each customer class. As a result, the Company's overall revenues can be identified by the customer class and function from which each dollar comes."[37] This, in turn, allows the Commission to apportion incremental E&R revenues consistent with the revenue relationships in the Company's currently approved rate design.

In addition, we also adopt Staff's proposal not to include *generation* revenues produced through the fuel factor, and which are recovered via a different methodology than base rates, as part of total generation revenues in calculating the ratios to be applied to the incremental E&R *generation*-related revenue requirement. As explained by the Chief Hearing Examiner, Staff testified that "excluding fuel factor revenues from the calculation that determines the ratios for apportioning the incremental revenue requirement to the various customer classes allows the recovery of the incremental revenue requirement to be indifferent to changes in the fuel factor."[38]

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[36] *Id.* at 43.

[37] *Id.* at 42 (citations omitted).

[38] *Id.* at 43 (citation omitted).

The Chief Hearing Examiner further notes that "Consumer Counsel supports Staff's cost allocation proposal as consistent with the Company's functional separation and the limited nature of this proceeding. VML/VACo [Committee] also supports removing fuel from the allocation, but takes no position on the revenue allocation among the rate classes as its members are billed according to various rate classifications and individual members may have differing views."[39] The Old Dominion Committee, however, strongly opposes Staff's revenue allocation. The Old Dominion Committee "disagrees with the [Chief Hearing Examiner's] recommended adoption of Staff's proposed revenue apportionment and rate design methodologies, which reflect novel departures from the Commission's traditional methodologies and impose unfair burdens on high load factor customers."[40]

Specifically, the Old Dominion Committee asserts that the Commission should reject "Staff's method for apportioning revenues among Appalachian's rates classes because (1) contrary to Staff's claim, it does not 'maintain existing rate relationships;' (2) contrary to Staff's claim, it is not supported by high load factor customers' disproportionately higher generation use in terms of kWh; (3) it does not properly account for differences between high and low load factor customers; (4) it apportions E&R revenue responsibility among jurisdictional rate classes in a way that is inconsistent with the use of cost-based allocators to apportion the E&R revenue requirement among jurisdictional and non-jurisdictional customers; (5) it apportions E&R revenue responsibility on the basis of current functional revenue, which is

[39] *Id.*

[40] Old Dominion Committee's October 13, 2006 Comments at 3.

unrelated to the incremental, demand-related E&R costs; and (6) it produces results that are unfair to high load factor customers."[41]

Although the Old Dominion Committee complains that Staff's proposal "reflect[s] novel departures from the Commission's traditional methodologies," as repeatedly observed herein § 56-582 B (vi) is, in and of itself, a novel departure from traditional ratemaking methodologies. The Old Dominion Committee asserts that this case is "dominated by *demand*-related costs."[42] Consumer Counsel, on the other hand, argues that "[w]ere it proper to conduct a fully-allocated cost of service study in this case, however, we believe it would likely be found that most of the environmental costs at issue in this proceeding – the largest category of costs at issue – are *energy*, rather than demand, costs."[43] Neither the Old Dominion Committee's nor Consumer Counsel's assertions of cost causation (*i.e.*, demand v. energy) are supported by a fully-allocated cost of service study. Indeed, as recognized by the Chief Hearing Examiner, "[n]one of the cost-allocation alternatives proposed in this case are based on a fully-allocated cost of service study, nor is one contemplated or necessary for purposes of this limited-issue proceeding."[44] Thus, in the absence of a new cost of service study, Staff's proposed revenue apportionment is based on the ratio of functional revenue that each customer class contributes to the entire functional revenue requirement as a result of the Company's most recently approved rate design and revenue allocation. We find that Staff's proposal is reasonable for purposes of implementing this limited-issue ratemaking statute.

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[41] *Id.* at 10.

[42] *Id.* at 16 (emphasis added).

[43] Consumer Counsel's October 13, 2006 Comments at 10 (citation omitted) (emphasis added).

[44] Chief Hearing Examiner's September 22, 2006 Report at 44.

Intra-Class Revenue Apportionment

Staff also asserts that its "approach to apportionment among classes 'may be applied on an intra-class basis to maintain the relative relationships that exist between billing tiers of multi-tiered rate designs.'"[45] The Chief Hearing Examiner agrees with Staff and finds that "[i]t is also consistent and reasonable to apply Staff's allocation method within each class."[46] The Old Dominion Committee, however, claims that the Chief Hearing Examiner's "recommendation *must* be rejected," asserting that "[i]t does not reflect cost causation, and it would cross-subsidize low load factor customers at the expense of high load factor customers."[47]

The Old Dominion Committee argues that: (1) Staff's "approach would increase all demand-related, energy-related, and customer rate elements for the specific function (distribution, transmission, or generation) by the same percentage determined for that function" even though "[a]lmost all of the incremental E&R costs are demand-related, none are customer-related, and all energy-related items are credits to costs, not a cost itself;" and (2) since the "incremental E&R costs are overwhelmingly demand-related," Staff's approach again "means that high load factor customers cross-subsidize low load factor customers."[48] The Old Dominion Committee concludes that "this case is overwhelmingly dominated by demand-related costs," that demand-related costs should be recovered "in the same way that demand-related costs are incurred and *traditionally* recovered," and that "demand-related E&R costs should be recovered,

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[45] *Id.* at 45 (citation omitted).

[46] *Id.* at 45.

[47] Old Dominion Committee's October 13, 2006 Comments at 22 (emphasis added).

[48] *Id.* at 23-24.

wherever possible, by adjusting demand charges, and energy credits should be returned to customers through adjustments to energy charges."[49]

We disagree with the Old Dominion Committee's assertion that the Commission *must* reject Staff's methodology. As explained below, § 56-582 B (vi) does not prescribe any particular method of cost recovery. Again, this is not a traditional rate case, and there is no fully-allocated cost study herein for purposes of allocating specific costs as demand or energy. We agree with the Chief Hearing Examiner that under the circumstances of this proceeding, it is appropriate to apply the same functional revenue ratio to all billing components within a rate schedule. Thus, we find that Staff's proposal is reasonable for purposes of implementing this limited-issue ratemaking statute.

Surcharge and True-Up

Finally, we find that it is reasonable to collect the incremental E&R revenue requirement – as apportioned herein – through a surcharge that is listed as a separate line item on customers' bills and designated as "Environmental & Reliability Cost Surcharge." We also find that it is reasonable to apply a true-up mechanism to ensure that there is not an over- or under-recovery of prudently incurred incremental E&R costs under this limited-issue ratemaking statute. We conclude that this represents a just and reasonable implementation of our discretion under the statute.

We therefore reject arguments that § 56-582 B (vi) prohibits a dollar-for-dollar recovery of incremental E&R costs. In our October 14, 2005 Order, we explained that, "[f]or example, § 56-582 B (i) permits changes to capped rates for recovery of fuel costs pursuant to § 56-249.6, which expressly contemplates adjustments for over- or under-recovery of costs previously

[49] *Id.* at 24-25 (citation omitted) (emphasis added).

incurred. There are no analogous provisions in § 56-582 B (vi)."[50] Indeed, § 56-582 B (vi) does not mandate true-ups for over- or under-recovery; it also does not prohibit such. Furthermore, the directive in § 56-582 B (vi) to adjust "capped rates" does not mandate that the Commission adjust capped rates via any particular mechanism. As noted by Appalachian, "the 'capped rates' established in § 56-582 'include rates, tariffs, electric service contracts, and rate programs. . .', not just unit rates."[51]

As stated by the Company, the plain language of this statute "neither prescribes nor prohibits any specific method of cost recovery."[52] Appalachian explains that the Commission, for example, could require a surcharge with a true-up, a surcharge without a true-up, or revisions to tariff rates.[53] Having concluded that the Company may defer incremental E&R costs as prescribed above, we find that it is reasonable to adjust capped rates via a surcharge that assures no under- or over-recovery of prudently incurred incremental E&R costs under § 56-582 B (vi). The surcharge shall be calculated in accordance with Staff's proposed revenue apportionment methodology as approved above.

Accordingly, the line-item surcharge approved herein will recover incremental E&R costs prudently incurred from July 1, 2004, through September 30, 2005. As found herein, the revenue requirement for such recovery is $21.337 million.[54] The surcharge shall be effective for service rendered on and after December 1, 2006. This surcharge shall be designed to recover the

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[50] October 14, 2005 Order at 8.

[51] Appalachian's October 13, 2006 Comments at 8 n.2 (citation omitted).

[52] *Id.* at 20.

[53] *Id.* at 21.

[54] This results from: (1) the Company's proposed revenue requirement of $21.138 million; minus (2) $5.185 million for the depreciation expense disallowed above; plus (3) $5.879 million for the emission allowance credit disallowed above; minus (4) $0.495 million to reflect the return on equity of 9.80% approved herein.

above revenue requirement for service rendered during the 12 months ending November 30, 2007. The surcharge we are approving in this proceeding shall cease after that date. Any future E&R surcharge may address incremental E&R costs prudently incurred after September 30, 2005, and not otherwise recovered in rates.

As a result, in this and future cases under § 56-582 B (vi), the *cumulative incremental costs* incurred between July 1, 2004, and the date through which Appalachian seeks recovery of costs incurred[55] are compared to the *cumulative recoveries* over the same period. The difference is the under- or over-recovery position that should be deferred by the Company on its books. The surcharge is then designed to include a recovery, or a return, of this amount over 12 months. The *cumulative incremental costs* are defined as the sum of: (1) costs related to E&R plant added after June 30, 2004; plus (2) incremental E&R-related operation and maintenance ("O&M") expense incurred after June 30, 2004. Moreover, O&M expense during any 12-month period is considered incremental to the extent it exceeds E&R-related O&M expense that was incurred during the 12 months ended June 30, 2004.

The Company may recover its incremental E&R costs through a surcharge under § 56-582 B (vi), and through its base rates. As a result, the *cumulative recoveries* are defined as the sum of: (1) cumulative surcharge revenues collected; plus (2) cumulative amounts of incremental costs that have been built into and recovered through base rates. There have been no surcharge revenues collected to date; such recovery will commence for service rendered on and after December 1, 2006, per this Final Order. As noted above, the Company filed a base rate application, in Case No. PUE-2006-00065, on May 4, 2006. An interim base rate increase was implemented in Case No. PUE-2006-00065 on October 2, 2006; thus, there was no base rate

[55] The cumulative costs through September 30, 2005, are at issue in the instant case.

recovery of incremental E&R costs prior to October 2, 2006. To the extent the final base rates we approve in Case No. PUE-2006-00065 include any recovery of incremental E&R costs, there will be an amount of base rate recovery after that date in addition to the surcharge recovery beginning December 1, 2006. Accordingly, that base rate recovery must be quantified in order to take it into consideration in any future case involving E&R costs, and the Company shall be required to keep track of all base rate and surcharge recoveries on a continuing basis.

Jurisdiction over Retail Transmission

The Chief Hearing Examiner found that the Federal Energy Regulatory Commission ("FERC") has not exercised jurisdiction over the Company's retail transmission services, which are unbundled by law in a functional separation plan but are still being offered to customers as a bundled package.[56] The Chief Hearing Examiner also found no evidence that the Company's FERC Open Access Transmission Tariff includes retail transmission, or that the Company has a separate retail transmission tariff on file with FERC.[57] We agree.

Accordingly, IT IS HEREBY ORDERED THAT:

(1) The Company's Application seeking adjustment of its capped electric rates pursuant to § 56-582 B (vi) of the Code of Virginia is granted in part, and denied in part, as set forth herein.

(2) The Chief Hearing Examiner's September 22, 2006 Report is adopted in part, and rejected in part, as set forth herein.

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[56] Chief Hearing Examiner's September 22, 2006 Report at 35.

[57] *Id.* at 36.

(3) Section 56-582 B (vi) of the Code requires the Commission to adjust the Company's capped rates for the timely recovery of Appalachian's incremental E&R costs prudently incurred on and after July 1, 2004.

(4) The Company shall implement a line-item surcharge, designated on customer bills as "Environmental & Reliability Cost Surcharge," to recover the $21.337 million revenue requirement approved herein for incremental E&R costs prudently incurred from July 1, 2004, through September 30, 2005.

(a) Such surcharge shall be effective for service rendered on and after December 1, 2006, and shall be calculated in accordance with Staff's proposed revenue apportionment methodology as approved above.

(b) Such surcharge shall be designed to recover the $21.337 million revenue requirement approved herein for service rendered during the 12 months ending November 30, 2007.

(c) Such surcharge shall cease for service rendered after November 30, 2007.

(d) Any future E&R surcharge shall address any under- or over-recovery of the revenue requirement approved herein.

(5) Consistent with the findings made herein, the Company shall forthwith file with the Commission's Division of Energy Regulation revised tariffs, effective for service rendered on and after December 1, 2006.

(6) The Company shall keep track of all base rate and surcharge recoveries of incremental E&R costs on a continuing basis and shall provide reports of same to Staff as may be reasonably requested.

(7) This case is dismissed.

Commissioner Jagdmann did not participate in this matter.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to: Anthony J. Gambardella, Jr., Esquire, Woods Rogers PLC, 823 East Main Street, Suite 1200, Richmond, Virginia 23219; James Bacha, Esquire, American Electric Power Service Corporation, 1 Riverside Plaza, Columbus, Ohio 43215; Louis R. Monacell, Esquire, and Edward L. Petrini, Esquire, Christian & Barton, L.L.P., 909 East Main Street, Suite 1200, Richmond, Virginia 23219-3095; Guy T. Tripp, III, Esquire, Hunton & Williams LLP, Riverfront Plaza, East Tower, 951 East Byrd Street, Richmond, Virginia 23219-4074; Howard W. Dobbins, Esquire, and Robert D. Perrow, Esquire, Williams Mullen, P.O. Box 1320, Richmond, Virginia 23210-1320; D.M. Roussy, Jr., Office of the Attorney General, Insurance and Utilities Regulatory Section, 900 East Main Street, Second Floor, Richmond, Virginia 23219; C. Meade Browder, Jr., Senior Assistant Attorney General, Office of the Attorney General, Division of Consumer Counsel, 900 East Main Street, Second Floor, Richmond, Virginia 23219; and the Commission's Office of General Counsel and Divisions of Energy Regulation and Public Utility Accounting.

A True Copy
Teste:

Joel H. Peck
Clerk of the
State Corporation Commission