**<u>EXHIBIT 5</u>**

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JULY 15, 2010



APPLICATION OF

APPALACHIAN POWER COMPANY

CASE NO. PUE-2009-00030

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

FINAL ORDER

On July 15, 2009, pursuant to § 56-585.1 A of the Code of Virginia ("Code") and the State Corporation Commission's ("Commission") Rules Governing Utility Rate Applications and Annual Informational Filings (20 VAC 5-201-10 *et seq.*) ("Rate Case Rules"), Appalachian Power Company ("APCo" or "Company") filed an application with the Commission requesting a statutory review of the Company's rates, terms and conditions for the provision of generation, distribution and transmission services ("Application").[1] On July 23, 2009, the Company supplemented and completed its Application by filing a revised Schedule 36 and submitting all of the information required by Schedules 18 and 28 of the Rate Case Rules.[2]

On July 23, 2009, APCo filed a Motion for Leave to File Supplemental Direct Testimony and Schedules in order to calculate the Company's revenue requirement in this proceeding based

[1] On February 24, 2009, pursuant to § 56-585.1 of the Code, the Commission issued an Order Scheduling Rate Proceedings in Case No. PUE-2009-00002 that, among other things, directed APCo to file the instant rate case on July 1, 2009. *Commonwealth of Virginia, At the relation of the State Corporation Commission, Ex Parte: Establishing rate case filing schedule for Virginia's investor-owned electric utilities pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2009-00002, Order Scheduling Rate Proceedings (Feb. 24, 2009). The Commission subsequently issued an Order on June 22, 2009 in Case No. PUE-2009-00030, which extended APCo's filing date to no later than July 15, 2009.

[2] *See* July 22, 2009 Memorandum of Incompleteness (finding that the Company's Application was incomplete as filed and requesting supplementation of Schedules 18, 28, and 36); July 24, 2009 Memorandum of Completeness (finding that APCo completed its Application on July 23, 2009).

on its actual end-of-test year capital structure and cost of capital as of December 31, 2008, instead of the November 30, 2010 projected capital structure proposed in the Company's Application.[3] On July 27, 2009, the Commission entered an Order Granting Motion, which directed the Company to file its supplemental testimony and schedules on or before August 14, 2009. In accordance with the Commission's July 27, 2009 Order, APCo filed its supplemental testimony and schedules on August 14, 2009.

The Application, as amended, requests an increase in base rates of approximately $154 million.[4] The Application, as further supplemented, asserts that a rate increase of approximately $167 million is warranted based on the Company's operations for the test year ended December 31, 2008, as adjusted.[5] The Company requests a return on rate base of 9.027% and a return on common equity of 13.35%.[6] APCo states that the proposed 13.35% return on common equity is based on a traditional cost of equity calculation of 12.50% plus a proposed 0.85% performance incentive for the Company's generating plant performance, customer service, and operating efficiency as authorized by § 56-585.1 A of the Code.[7] The Company represents that the proposed rate increase would raise the monthly bill of a typical residential customer

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[3] The Company's Motion For Leave to File Supplemental Direct Testimony and Schedules was filed in response to the Commission's Order on Commission Staff's Motion *in Limine* entered in Case No. PUE-2009-00019, which held that § 56-585.1 A 10 of the Code requires that an actual end-of-test period capital structure and cost of capital be used in statutory reviews under § 56-585.1 A of the Code. *Application of Virginia Electric and Power Company, For a 2009 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-2009-00019, Order on Commission Staff's Motion *In Limine* (July 14, 2009).

[4] Ex. 14 (Waldo supplemental direct) at 2.

[5] Ex. 27 (Allen additional direct) at 7.

[6] Ex. 26 (Allen supplemental direct) at 2-3; Application at 3.

[7] Application at 3.

using 1,000 kilowatt-hours of electricity from $91.49 per month to $107.14 per month, an increase of $15.65, or 17.1%.[8]

APCo asserts that an increase in base rates is necessary because its current earnings are inadequate to allow the Company to fully recover its costs and earn a fair rate of return on common equity.[9] The Company states that several factors have contributed to its need for rate relief, including: the loss of a large industrial customer in West Virginia in 2009, which causes additional costs to be allocated to the Company's Virginia jurisdictional operations; increases in APCo's capacity equalization charges from affiliated companies; and the rising costs incurred to comply with state and federal environmental requirements.[10]

The Company also proposes several changes to its existing tariffs in order to recover its proposed base rate increase. APCo states that the discrete charges embedded in its rate schedules have been revised to recover the Company's proposed rate increase and to move each customer class closer towards cost of service. In addition, the Company proposes to implement a new rate schedule and rider for its medium and large commercial and industrial customers. The new rate schedule, which the Company designates as Schedule GS (General Service), would combine the Company's current Schedules MGS (Medium General Service) and LGS (Large General Service) into a single rate schedule. The Company states that it developed Schedule GS in order to provide an additional option for the Commission to consider when deciding how best to address customer migration between the Company's medium and large general service rate schedules.[11]

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[8] Ex. 7 (Supplemental Schedules Volume II) at Supplemental Schedule 43, page 1.

[9] Application at 2-3.

[10] Ex. 13 (Waldo direct) at 7-9.

[11] Application at 4; Ex. 78 (Bethel direct) at 12-18.

The Company proposes to place Schedule GS into effect on the date of the Commission's final order in this proceeding.

In addition, APCo proposes to implement a new Economic Development Rider designed to encourage economic development in the Company's service territory. The Company asserts that the Economic Development Rider would offer demand charge reductions to qualifying new and existing large commercial and industrial customers who increase their load by one megawatt or more by investing in new plant and other facilities that help sustain the economy and create jobs.[12]

The Company also proposes certain changes to its terms and conditions of service and its credit and collections program. The proposed changes include, among other things: (i) suspending the Company's current credit and collections program that allows it to require additional deposit amounts if a residential customer exhibits an extended pattern of delinquency or if the deposit on hand is inadequate given the size of a customer's monthly bill; (ii) changing deposits to an amount that is equal to two times the average monthly usage of a customer rather than an amount equal to the customer's estimated bill for the two highest consecutive months of usage; (iii) allowing payments for deposits to be extended up to six months in cases of hardship; and (iv) allowing customers who participate in the Company's budget billing program to spread their settlement payments over the next twelve months of the budget year rather than paying the settlement over three months.[13]

APCo sought to place its proposed rates, terms and conditions of service, with the exception of Schedule GS, into effect on an interim basis beginning December 12, 2009, at

[12] Ex. 13 (Waldo direct) at 17.

[13] *Id.* at 11-12.

which time the Company's proposed transmission rider would also take effect. In this regard, APCo noted that it filed a companion application on July 15, 2009, proposing that certain transmission-related costs charged by PJM Interconnection LLC ("PJM"), be removed from the Company's base rates and recovered through a separate rate adjustment clause, as authorized by § 56-585.1 A 4 of the Code.[14] In order to avoid any duplication of transmission revenues or omission of transmission costs in the Company's rates, the Company proposed that both its requested base rate increase and its approved transmission rider be placed into effect simultaneously on December 12, 2009.

On August 26, 2009, the Commission issued an Order for Notice and Hearing that, among other things: (1) established a procedural schedule for this case; (2) directed APCo to provide public notice of this matter; and (3) as directed by statute, permitted (but did not require) APCo to place its proposed rates into effect on an interim basis, subject to refund, for service rendered on and after December 12, 2009.

The following parties filed notices of intent to participate in this proceeding: VML/VACO APCo Steering Committee ("VML/VACO"); Wal-Mart Stores East, LP & Sam's East, Inc. ("Wal-Mart"); Steel Dynamics, Inc. ("Steel Dynamics"); The Kroger Company ("Kroger"); Old Dominion Committee for Fair Utility Rates ("Committee"); Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel"); and Utility Management Services, Inc.

The Company placed its proposed rates into effect on an interim basis, subject to refund, for service rendered on and after December 12, 2009. On February 24, 2010, APCo filed a letter and tariffs with the Commission explaining that for bills rendered on and after that date it was:

[14] Application at 4. The Commission approved the Company's transmission rate adjustment clause, in Case No. PUE-2009-00031 on October 6, 2009.

(1) suspending further collection of its interim rates; and (2) collecting revenue at the level of base rates prior to December 12, 2009 (with the exception of transmission expenses approved as part of the Company's transmission rate adjustment clause in Case No. PUE-2009-00031). The Company explained that it was taking this action pursuant to emergency legislation enacted during the 2010 Session of the Virginia General Assembly.[15] This same legislation further directs the Commission to issue a final order in the instant case "not later than July 15, 2010, for rates to become effective for bills rendered on and after August 1, 2010."[16]

The Commission held public hearings and received testimony from public witnesses in Abingdon (November 18, 2009), Rocky Mount (November 19, 2009), and Richmond (March 16, 2010). The Commission convened the public evidentiary hearing on March 30 and 31, 2010 and April 1 and 2, 2010. In addition, the Commission admitted more than 140 exhibits into the record and received more than 37,000 written and electronic comments in this case.

On or before May 18, 2010, the following participants filed post-hearing briefs: APCo; VML/VACO; Wal-Mart; Steel Dynamics; Kroger; 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.

Cost of Capital

*Capital Structure*

Section 56-585.1 A 10 of the Code requires the Commission to "utiliz[e] the actual end-of-test period capital structure" in this proceeding. We reject APCo's suggestion that using

[15] 2010 Va. Acts of Assembly Chaps. 1 and 2, and Second Enactment Clause.

[16] *Id.*

this statutorily-required capital structure may prevent the Company from having an opportunity to earn a reasonable return on its capital investment.[17] As explained by Staff: (1) APCo's "argument that *some* components of a weighted average cost of capital calculation have increased [after the test year] fails to take into account any decreases in *other* components of that calculation;" (2) "[f]or example, the current cost of short-term debt is lower – indeed, significantly lower – than the 3.906% end-of-test year cost rate, which is also required by law;" (3) "[m]oreover, the costs and relative ratios that determine a weighted average cost of capital are influenced by all issuances, including any future issuances that have not yet occurred;" and (4) "[g]iven these facts, the evidence simply does not show that compliance with the law will not allow [APCo] the opportunity to recover its cost of capital."[18] We find that Staff's proposed use of an actual per books capital structure complies with § 56-585.1 A 10 of the Code, is "consistent with Commission precedent," and is reasonable for purposes of this proceeding.[19]

*Cost of Debt*

Section 56-585.1 A 10 of the Code also requires the Commission to "utiliz[e] the actual end-of-test period . . . cost of capital" in this proceeding, which includes (i) long-term debt, and

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[17] *See, e.g.*, Company's May 18, 2010 Post-hearing Brief at 11-13 (citing Tr. 502 (Avera); Tr. 542 (Gorman); Tr. 596 (Maddox); Tr. 783 (Avera); Ex. 60 (Maddox supplemental direct); Ex. 132 (Waldo rebuttal) at 4-5).

[18] Staff's May 18, 2010 Post-hearing Brief at 55 (emphasis in original) (citing Ex. 96 (Bloomberg Key Rates)).

[19] *Id.* at 54 (citing *Application of Appalachian Power Company, For an increase in electric rates*, Case No. PUE-2006-00065, 2007 S.C.C. Ann. Rept. 321, 326, Final Order (May 15, 2007)). *See also* Ex. 59 (Maddox direct) at 3-7. The test period for this case ended on December 31, 2008. *See, e.g.*, Application at 2. The Company's actual end-of-test period capital structure is as follows:

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|---|---|
| Short-term debt | 3.140% |
| Long-term debt | 54.892% |
| Preferred stock | 0.307% |
| Common equity | 41.525% |
| Investment tax credits | 0.136% |
| *Total Capitalization* | *100%* |

*See* Ex. 59 (Maddox direct) at Schedule 1.

(ii) short-term debt. Accordingly, we approve the actual end-of-test period cost of (i) long-term debt (6.065%), and (ii) short-term debt (3.906%).[20]

*Cost of Equity*

Section 56-585.1 A of the Code 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." We find that a market cost of equity within a range of 9.5% to 10.5% results in a fair and reasonable return on common equity. This return is reasonably supported by the testimony and resulting recommendations of Staff witness Maddox and Committee witness Gorman.[21] Moreover, we find that the methodologies employed by these witnesses are consistent with the public interest and satisfy the standards as stated by Mr. Maddox: "maintenance of financial integrity, the ability to attract capital on reasonable terms, and earnings commensurate with returns on investments of comparable risk."[22]

In addition, we find that the Company's proposed cost of equity of 12.5% does not represent the actual cost of equity in the marketplace and a reasonable return on common equity. In addition to other valid criticisms, Company witness Avera's "cost of equity testimony was never updated with any data beyond March 2009, which was the bottom of a severe drop in the market[, and in] the thirteen months that passed between March 2009 and the conclusion of the evidentiary hearing, the market increased approximately 50%."[23] Indeed, this deficiency in

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[20] *See, e.g.,* Ex. 59 (Maddox direct) at 7; Ex. 2 (Application Volume IV) at Schedule 3, page 3 of 7 and Schedule 4, page 1 of 5; Staff's May 18, 2010 Post-hearing Brief at 53.

[21] *See, e.g.,* Ex. 59 (Maddox direct); Ex. 58 (Gorman direct); Staff's May 18, 2010 Post-hearing Brief at 38-49; Committee's May 18, 2010 Post-hearing Brief at 3-18.

[22] Ex. 59 (Maddox direct) at 9.

[23] Staff's May 18, 2010 Post-hearing Brief at 40 (citing Avera testimony; Ex. 51 (Yahoo! Finance S&P 500 Index Chart); Ex. 52 (Yahoo! Finance Dow Jones Industrial Average chart); *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 693 (1922) (quotation omitted)).

Company witness Avera's recommendation is underscored by more recent testimony that he provided on behalf of other American Electric Power Company ("AEP") operating companies before the Kentucky and Michigan Public Service Commissions – where his use of updated information results in significantly *lower* cost of equity estimates.[24]

Finally, we find that "Staff witness Maddox's proxy group is reasonably constituted both in size and composition" and "has risk comparable to [APCo]."[25] Moreover, Staff notes that: (i) Company witness Avera previously presented a proxy group on behalf of AEP in a recent Federal Energy Regulatory Commission ("FERC") proceeding, wherein he included "three of the same companies that Dr. Avera now criticizes Mr. Maddox for including in his proxy group;" and (ii) although Dr. Avera criticizes Mr. Maddox for including utilities with a Value Line safety rating above AEP's, "Dr. Avera included in testimonies filed on behalf of other AEP operating subsidiaries only a few months before Mr. Maddox's testimony four of the same companies with Value Line safety ratings higher than those of AEP."[26]

*Statutory Peer Group Floor*

Section 56-585.1 A of the Code states as follows:

> [T]he Commission shall determine fair rates of return on common equity applicable to the generation and distribution services of the utility . . . but such return shall not be set lower than the average of

[24] *See, e.g., id.* at 42-49. *Compare* Ex. 49 (Avera direct) *with* Ex. 93 (Avera Michigan DCF Model), Ex. 94 (Avera Kentucky DCF Model), and Ex. 95 (Avera Michigan and Kentucky CAPM Model). Staff also notes that many of "Dr. Avera's updated estimates . . . are *several hundred basis points lower* than his estimates in this case," and that "Dr. Avera's more recent testimony [in other jurisdictions] uses a 7.7% forward-looking market risk premium, which is *200 basis points lower* than what he continues to support in Virginia." Staff's May 18, 2010 Post-hearing Brief at 43, 47 (emphasis in original).

[25] Staff's May 18, 2010 Post-hearing Brief at 38 (typeface and case modified). For example: (1) Staff's proxy group was reasonably "screened based on a number of criteria, including net plant, primary source of income, credit rating, financial strength, and safety rating to ensure the group has risk comparable to [APCo];" and (2) "Staff's peer group has a beta of .69, which is closer to AEP's beta of .70 than [APCo] witness Avera's proxy group with a beta of .73." *Id.* at 38-39 (footnotes omitted).

[26] *Id.* at 39 (footnotes omitted).

> 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, nor shall the Commission set such return more than 300 basis points higher than such average. The peer group of the utility shall be determined in the manner prescribed in subdivision 2 b.

Next, in selecting the majority of the peer group utilities to calculate the statutory floor for rate of return on common equity, § 56-585.1 A 2 b of the Code 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.

No party contested the composition of the peer group – which in this case is comprised of seven utilities after removing the companies with the two highest, and the two lowest, reported returns as required by the above statute.[27] The participants, however, differ on which utilities should comprise the "majority" to be selected by the Commission to determine the statutory floor.

In this regard, the statute clearly leaves this selection to the Commission's discretion. A statutory floor comprised of *any* four of the seven-member peer group satisfies the statute. Indeed, APCo acknowledged during the hearing that the statute gives the Commission this discretion.[28] We select a majority consisting of four peer group utilities that, on average, had a return on average equity of 10.53%.[29] Thus, we approve a fair rate of return on common equity for APCo of 10.53%, which results in an overall rate of return on rate base of approximately

[27] *See, e.g., id.* at 49 n.172.

[28] *See* Tr. 1183-1185 (Waldo).

[29] *See, e.g.,* Ex. 60 (Maddox supplemental direct) at Schedule 15 – Updated. We find that, on the facts before us in this case, it is reasonable to utilize returns on average equity for this purpose.

7.85%. We find that the cost of equity and overall rate of return approved herein are fair and reasonable, permit the attraction of capital on reasonable terms, fairly compensate investors for the risks assumed, and enable the Company to maintain its financial integrity. This finding reduces the Company's requested rate increase by approximately $28.0 million.[30]

*Rate of Return Adder*

Section 56-585.1 A of the Code states as follows:

> The Commission may increase or decrease such combined rate of return by up to 100 basis points based on the generating plant performance, customer service, and operating efficiency of a utility, as compared to nationally recognized standards determined by the Commission to be appropriate for such purposes.

We reject APCo's request to increase its fair rate of return on equity by 0.85%. This statute does not require the Commission to approve *any* increase to APCo's fair rate of return as determined above. Based on the record in this case, we find that the Company's generating plant performance, customer service, and operating efficiency do not warrant any adder above APCo's fair rate of return at this time.[31] This finding reduces the Company's requested rate increase by approximately $13.0 million.[32]

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[30] In addition, any comparison by APCo to cost of equity, rate of return floor, rate of return adder, or any other issue in the Commission's prior rate case for Dominion Virginia Power ("Dominion") (Case No. PUE-2009-00019) is inapposite to the instant proceeding. *See, e.g.*, Ex. 132 (Waldo rebuttal) at 5-6. The facts and circumstances of the two cases are simply not comparable. For example, the settlement approved by the Commission in the Dominion rate case encompassed a number of items not present in the instant proceeding, including: (1) refunds or credits of fuel, base rate, and rate adjustment clause recoveries that totaled approximately $726 million; and (2) the Dominion stipulation also provided for no change in base rates until December 2013, at the earliest. *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 37-38 (citing Tr. 1191-92 (Waldo); *Application of Virginia Electric and Power Company, For a 2009 statutory review of 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-2009-00019 *et al.*, Order Approving Stipulation and Addendum (Mar. 11, 2010)).

[31] *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 56-72; Consumer Counsel's May 18, 2010 Post-hearing Brief at 30-34; Committee's Post-hearing Brief at 18-23; VML/VACO's May 18, 2010 Post-hearing Brief at 12.

[32] *See* Company's May 18, 2010 Post-hearing Brief, Attach. 2.

Capacity Equalization Expense

The Company "is a member of the AEP-East Power Pool which is governed by an interconnection agreement [('Interconnection Agreement')]."[33] Staff and Consumer Counsel present extensive evidence and argument regarding the capacity equalization charges that APCo is required by the Interconnection Agreement to pay to certain other AEP operating affiliates. Under the Interconnection Agreement, "[a] generating capacity obligation is calculated for each AEP-East company, and those companies that do not own enough capacity to satisfy their calculated obligation must make payments to those with surplus capacity."[34] Further, "[s]ince 2007, [APCo] has been the most deficient company in the AEP-East pool by a substantial margin."[35] Staff also contends that "AEP has maintained [APCo] as a capacity-deficient company notwithstanding the fact that AEP's capacity equalization charges to [APCo] have tripled – from $138 million to $394 million – since 2006,"[36] and that "AEP has also maintained [APCo] as a capacity-deficient company as it has taken aggressive steps to move another AEP-East operating company from a deficiency comparable to that of [APCo] to a surplus position."[37]

In fact, Consumer Counsel argues that "APCo's capacity deficit position is the most troubling driver of the requested rate increase" – although the Interconnection Agreement "calls for each AEP-East company to have sufficient capacity resources to serve its native load . . .

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[33] Consumer Counsel's May 18, 2010 Post-hearing Brief at 2.

[34] Staff's May 18, 2010 Post-hearing Brief at 21.

[35] *Id.* (citing Ex. 100 (Carr direct) at 37).

[36] *Id.* (citing Ex. 33 (Company response to request OAG 6-126)).

[37] *Id.* (citing Ex. 34 (Company response to request OAG 9-181); Ex. 124 (Company response to request OAG 7-142); Ex. 140 (Company response to request OAG 9-175); Ex. 137-C; Ex. 138-C; Ex. 139-C).

APCo's deficit has increased as new generation capacity has been repeatedly assigned by AEP to other members of the pool."[38] Some of the limited capacity additions proposed for APCo have reflected some of AEP's highest cost generation, while lower cost generation has been assigned to an affiliated company, Columbus Southern Power Company ("Columbus Southern"). For example, Consumer Counsel asserts that AEP assigned new capacity to Columbus Southern when AEP could foresee that such action would increase Columbus Southern's earned return on investment and leave APCo to pay increasing capacity charges, which would put pressure on APCo's earned returns and upward pressure on rates.[39] While APCo now states that it has earned low returns over the past several years, this should be viewed in connection with the fact that Columbus Southern – another AEP-owned subsidiary – "is earning returns of up to 22%" according to evidence presented in this case.[40]

Indeed, it can be reasonably argued, as Consumer Counsel has done, that over the past several years AEP has repeatedly taken actions in assigning capacity that have harmed APCo and its customers while benefitting other AEP subsidiaries.[41] As noted above, the Company's capacity deficit position "has increased as new generation capacity has been repeatedly assigned by AEP to other members of the pool," and this "new capacity for other AEP-East companies consists of relatively low cost gas-fired generating units which were acquired by AEP . . . at costs below a new build."[42] Based on a variety of factors, including this capacity deficit, "APCo

[38] Consumer Counsel's May 18, 2010 Post-hearing Brief at 4 (citing Ex. 100 (Carr direct), App. B, at 1, 3; Ex. 109 (Nelson chart)).

[39] *See, e.g., id.* at 4-16.

[40] *See, e.g., id.* at 5-16 (citations omitted).

[41] *See, e.g., id.* at 3-19 (citations omitted).

[42] *Id.* at 4-5.

is paying nearly $258 million . . . more annually to its sister companies for capacity equalization than it did in 2006."[43]

APCo acknowledges that it did not necessarily act in its own best interests regarding the assignment of capacity within the AEP-East Pool. That is, in this instance, APCo indicated that it supported what was deemed best for the AEP system – not what was necessarily best for APCo:

> [T]his is a zero sum construct, so I'm viewing that in terms of the total AEP system. I weigh in with the considerations of the specific impact on APCo, but my vote is a reflection of what I believe is best for the AEP System.[44]

Indeed, as summed up by Consumer Counsel, "[i]f the pooling arrangement is a zero sum construct as APCo insists, then it becomes even clearer that by assigning so much capacity to [Columbus Southern], AEP has intentionally benefitted other pool parties at APCo's expense."[45] The Commission, however, is limited in its jurisdiction regarding APCo's capacity equalization expense under the Interconnection Agreement, which is a wholesale power pooling agreement that has been approved by FERC, and cannot "reallocate" capacity responsibility among the AEP operating companies as dictated by the terms of the Interconnection Agreement.

A number of key factors affect APCo's overall capacity costs, and Staff and Consumer Counsel are correct that decisions by APCo and AEP regarding capacity additions, and which

[43] *Id.* at 3. While this discussion focuses on APCo's capacity equalization payments, we recognize that the Company's generation costs are not limited to such payments; that is, if APCo possessed more of its own generation, it obviously would be incurring the costs associated therewith. We further note, however, that when AEP did propose new capacity for APCo, its major project – a new coal-fired facility known as an Integrated Gasification Combined Cycle plant – (i) was originally projected to cost far more than other coal-fired options, and (ii) was further burdened with such significant and unquantifiable cost and technological uncertainties that the Commission found it must be rejected. *See, e.g., 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).

[44] Tr. 326 (Waldo).

[45] Consumer Counsel's May 18, 2010 Post-hearing Brief at 16. *See also* Tr. 626 (Norwood).

affiliated operating companies undertake those additions, can and do have significant impacts on APCo. We are concerned that the decision making over recent years regarding capacity changes has had a significant adverse effect on APCo and its ratepayers. Accordingly, we direct APCo and AEP to submit a written report to Staff (beyond what has been presented in this record), on or before January 4, 2011, on the reasons for their past actions regarding capacity, as well as the steps that can be taken to ameliorate the negative effects of high capacity charges on APCo and its customers.

In determining a reasonable level of capacity equalization expense to be included in APCo's going-forward rates for purposes of this proceeding, the participants have litigated two issues that must be considered for rate setting purposes in this case: (1) Member Load Ratio ("MLR"); and (2) Capacity Equalization Rate. We address both of these issues below. In sum, based on our findings below, we approve a Virginia jurisdictional capacity equalization expense of approximately $154.6 million.

*Member Load Ratio*

APCo's MLR is used to determine its generating capacity obligation to the AEP-East Power Pool.[46] The Company proposes to utilize a forecasted average MLR for the rate year of approximately 33.165%.[47] Staff asserts that the MLR "is not reasonably predictable," and that

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[46] The Company's "MLR is the relationship between its peak demand and the total non-coincident peak demand of the AEP-East system, all measured over the preceding twelve months," and "[e]ach member's capacity obligation is determined on a monthly basis by multiplying the total AEP-East capacity by its MLR." Staff's May 18, 2010 Post-hearing Brief at 23 (citations omitted). In addition, "Pool members that do not own enough generating capacity to satisfy their obligations purchase capacity from the surplus members of the Pool," and the "amount of payments/receipts (capacity settlements) is based on the relative deficits/surpluses and the generation costs of the surplus members." Company's May 18, 2010 Post-hearing Brief at 29 (citing Ex. 100 (Carr direct) at 31).

[47] *See, e.g.,* Company's May 18, 2010 Post-hearing Brief at 33 (citations omitted); Staff's May 18, 2010 Post-hearing Brief at 24; Consumer Counsel's May 18, 2010 Post-hearing Brief at 20 n.80.

"rates should instead be based on the five-year average [MLR] of 31.98%."[48] Consumer Counsel similarly proposes a five-year average MLR.[49] Both Staff and Consumer Counsel note that the Commission has previously used a five-year average MLR to calculate a reasonable rate year level of capacity equalization expense for APCo.[50]

We continue to find that it is reasonable to establish APCo's MLR based on a five-year average. While we do not preclude consideration of other approaches in the future, as we previously found in a prior APCo rate case, "[u]se of a five-year average MLR at this time should moderate the volatility of the MLR in general and avoids setting rates solely on the basis of an extremely high or low MLR."[51] Such use of a five-year average reasonably addresses the unpredictable nature of the MLRs throughout the AEP-East system.[52] Over the past ten years, APCo has seen MLRs ranging from approximately 28% to over 35%.[53] Staff also notes that "[d]uring the last ten years, the Company's MLR has experienced several rapid increases and decreases alike."[54] Moreover, it is understandable that MLRs could be significantly volatile. For example, APCo's specific MLR is influenced not only by its load, but by load variations of the

[48] Staff's May 18, 2010 Post-hearing Brief at 24.

[49] Consumer Counsel's May 18, 2010 Post-hearing Brief at 20 (citing Ex. 64 (Norwood direct) at 19).

[50] Staff's May 18, 2010 Post-hearing Brief at 23 (citing *Application of Appalachian Power Company, For an expedited increase in base rates*, Case No. PUE-1994-00063, 1996 S.C.C. Ann. Rept. 255, 256, Final Order (May 24, 1996)); Consumer Counsel's May 18, 2010 Post-hearing Brief at 20.

[51] *Application of Appalachian Power Company, For an expedited increase in base rates*, Case No. PUE-1994-00063, 1996 S.C.C. Ann. Rept. 255, 256, Final Order (May 24, 1996).

[52] We also note that Indiana Michigan Power Company ("I&M") – an affiliate of APCo that also operates under the Interconnection Agreement – recently agreed to use a five-year average MLR as approved by the Indiana Utilities Regulatory Commission. *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 24 n.76 (citing *Petition of Indiana Michigan Power Company, an Indiana Corporation, For Authority to Increase its Rates and Charges*, Cause No. 43306, 2009 Ind. PUC LEXIS 107 at *172-73, 273 P.U.R.4th 310, Opinion (Mar. 4, 2009)).

[53] *See, e.g.*, Ex. 64 (Norwood direct) at Ex. SN-3; Ex. 100 (Carr direct) at 41, Graph.

[54] Staff's May 18, 2010 Post-hearing Brief at 23-24.

other AEP-East companies. That is, APCo's MLR is impacted by diverse factors stretching across the *entire* AEP-East footprint, including economic cycles, weather patterns, usage patterns, and customer migration.[55]

Staff's proposed five-year average MLR utilizes actual data through October 2009.[56] Subsequent to the filing of Staff's testimony, however, the record in this case was expanded by the Company to include actual MLR data through February 2010, which results in a higher five-year average MLR and a larger revenue requirement as compared to using October 2009 data. We find that it is reasonable, based on the record in this case, to use the most recent five-year average in the record – *i.e.*, through February 2010 – to establish the Company's MLR. This finding results in an MLR for APCo of 32.44% and reduces the Company's requested rate increase by approximately $15.0 million.[57]

*Capacity Equalization Rate*

The Capacity Equalization Rate "is the *price* charged" for APCo's capacity deficiency, and it consists of: (1) "the Capacity Investment Rate ('Investment Rate'), which is based on the gross installed cost of the surplus members' generating units and a FERC-approved annual carrying charge of 16.49%;" and (2) "the Fixed Operating Rate ('Operating Rate'), which is based on the operating costs and one-half of the maintenance costs of the surplus members' units."[58]

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[55] *See, e.g.*, Ex. 100 (Carr direct) at 31-41. We find that, based on the record in this case, the Company's proposed MLR is not reasonably predictable.

[56] Staff's proposed five-year average also adjusts for the loss of Century Aluminum, a former 300 megawatt customer in APCo's West Virginia jurisdiction. APCo did not oppose specific recognition of Century Aluminum in this case. Moreover, both APCo and Staff supported accounting adjustments to recognize the loss of Century Aluminum in the instant case. *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 81.

[57] This MLR is determined by (1) using actual MLRs as shown by Consumer Counsel witness Norwood, which were updated through February 2010 by Company witness Nelson (resulting in a five-year average of 33.04%), and (2) adjusting for the loss of Century Aluminum (reducing the five-year average MLR by 0.6%). *See, e.g.*, Ex. 64 (Norwood direct) at Ex. SN-3; Ex. 108 (Nelson rebuttal) at 16; Ex. 100 (Carr direct) at Appendix B, pages 5-6.

[58] Staff's May 18, 2010 Post-hearing Brief at 22, 25 (emphasis in original) (citing Ex. 100 (Carr direct) at 32-33).

First, we find that Staff's proposed Investment Rate is reasonable for this purpose: (1) "[p]ursuant to the terms of the Interconnection Agreement, the Investment Rate to be used for an entire calendar year is fixed at the affiliates' plant investments as of December 31 of the previous year;" (2) "[t]hus, the Investment Rate for 2010 will be based on those investments as of December 31, 2009;" and (3) "Staff calculated its Investment Rate based on investment data as of that date, which was provided by the Company."[59] Second, we do not find the Company's proposed Operating Rate, which is based on forecasts, to be reliable for setting rates herein. Rather, we find that Staff's proposed actual October 2009 Operating Rate, which is the most recent actual Staff-audited Operating Rate and uses actual October 2009 data, is reasonable and shall be used to calculate the Capacity Equalization Rate for purposes of this proceeding.[60] These findings result in a Capacity Equalization Rate of $12.73 per kW and reduce the Company's requested rate increase by approximately $12.8 million.[61]

Cook Accidental Outage Insurance Proceeds

As explained by the Company, "[b]oth units of the Cook Nuclear Plant ("Cook") are owned by I&M, another AEP-East Zone operating company," and "Cook Unit 1 experienced an accident on September 20, 2008 and remained out of service until December 18, 2009."[62] Although Cook Unit 1 has resumed production, it "is not expected to return to full power until the fall of 2011."[63] I&M "maintains accidental outage insurance on the Cook facility . . . in addition to property insurance [and has] received $184.4 million in accidental outage policy

[59] *Id.* at 25-26 (citing Ex. 100 (Carr direct) at 40).

[60] *See, e.g., id.* at 25.

[61] Ex. 100 (Carr direct) at 42.

[62] Company's May 18, 2010 Post-hearing Brief at 48 (citing Ex. 100 (Carr direct) at 22-23, 28).

[63] Staff's May 18, 2010 Post-hearing Brief at 32 (citing Ex. 100 (Carr direct) at 22-23).

proceeds through December 2009 and an additional $72.1 million of property insurance proceeds through September 2009."[64] Conversely, AEP has "continued to charge [APCo] 'full price' for Cook's installed capacity cost and certain operating and maintenance expense through the AEP-East pool capacity equalization mechanism."[65]

Staff asserts that the Commission should reduce APCo's "proposed revenue requirement [in this proceeding] by $14.7 million, which is half of [APCo's] Virginia jurisdictional MLR share of the [Cook insurance] proceeds."[66] We conclude that it is not appropriate at this time to deem insurance proceeds received by I&M to be allocable for rate setting purposes in Virginia, which does not preclude consideration of such matters in future proceedings.

Mountaineer Carbon Capture and Sequestration Demonstration Project

As described by Consumer Counsel, the Company is undertaking the Mountaineer Carbon Capture and Sequestration Demonstration Project at its "Mountaineer coal-fired plant in West Virginia in an effort to test and prove whether carbon capture and sequestration [('CCS')] is a viable commercial technology for coal-fired electric generation plants in the event carbon emissions are regulated," and this "is the first CCS project being undertaken at an in-service coal plant."[67] Specifically, this is a "validation project" intended to test CCS technology at a level that is not commercial in scale.[68] The Company asserts that "[c]ustomers of utilities in the U.S. and abroad will benefit from the work we are doing at our Mountaineer plant," but that the "first

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[64] *Id.* at 31-32 (citing Ex. 100 (Carr direct) at 25-26).

[65] *Id.* at 32 (citing Ex. 100 (Carr direct) at 23-24).

[66] *See id.* at 31-33 (citing Ex. 100 (Carr direct) at 24-25, 27).

[67] Consumer Counsel's May 18, 2010 Post-hearing Brief at 24-25 (citing Tr. 465 (LaFleur)).

[68] Ex. 123 (AEP Selected to Receive DOE Funds); Staff's May 18, 2010 Post-hearing Brief at 14.

use of any technology comes at a higher cost than subsequent uses."[69] The Company concludes that "it is most prudent to gain knowledge now that will allow compliance with [greenhouse gas ('GHG')] controls, whether in the form of state or federal legislation or via regulatory action."[70] APCo seeks to include approximately $74 million in rate base, and requests both a return on rate base and recovery of expenses, for this project.[71]

It is reasonable for AEP to evaluate and explore options regarding potential federal legislation or regulation regarding GHG emissions. We do not find, however, that it was reasonable for APCo to incur the Mountaineer CCS project costs and then seek recovery from Virginia ratepayers. For example: (i) although AEP asserts that this demonstration project will benefit customers of all of AEP's operating companies and of all utilities in the United States, APCo's ratepayers (and not shareholders) are being asked to pay for all of the costs incurred by AEP for this project; and (ii) as stated by Consumer Counsel, "AEP is undertaking no other [CCS] initiatives at any of its other subsidiaries' plants," and "APCo and its customers are being asked to shoulder the entire financial burden and risk associated with AEP's [CCS] research and development."[72] Accordingly, we deny the Company's request for cost recovery of the

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[69] *Id.*

[70] Company's May 18, 2010 Post-hearing Brief at 65 (citing Ex. 121 (LaFleur rebuttal) at 7).

[71] *See, e.g.*, Consumer Counsel's May 18, 2010 Post-hearing Brief at 25 (citing Tr. 373); Staff's May 18, 2010 Post-hearing Brief at 14.

[72] *See, e.g.*, Consumer Counsel's May 18, 2010 Post-hearing Brief at 24-29; Staff's May 18, 2010 Post-hearing Brief at 13-15. VML/VACO also asserts that the Commission should deny the costs associated herewith. VML/VACO's May 18, 2010 Post-hearing Brief at 9. Furthermore: (1) this project significantly increases operation and maintenance expenses at the Mountaineer plant; (2) this project decreases the efficiency of the Mountaineer facility, which results in increased fuel costs; (3) the CCS technology decreases the Mountaineer plant's operating capacity, which further increases APCo's capacity deficit position within the AEP-East pool and, thus, increases APCo's capacity equalization charges; and (4) the potential benefits to Virginia ratepayers currently are speculative at best. *See, e.g.*, Consumer Counsel's May 18, 2010 Post-hearing Brief at 24-29; Staff's May 18, 2010 Post-hearing Brief at 13-15.

Mountaineer CCS demonstration project under the facts presented herein.[73] This finding reduces the Company's requested rate increase by approximately $9.8 million.

December 2009 Storm Costs

The Company stated that it "incurred substantial costs from storms in December 2009 that totaled approximately $26.8 million in incremental distribution operations and maintenance costs."[74] We will allow the Company to "defer on its books this incremental distribution storm restoration expense, until such time as a request for recovery is made and subsequently ruled upon by the Commission."[75] This finding does not constitute approval or rejection of all or part of these costs.

PJM Ancillary Fees

We reject APCo's projection of PJM ancillary fees. These fees are based on variables (such as the amount of hours that AEP's generating plants run and market prices) that have proven to be volatile in the past.[76] We do not find that the Company's projection of future PJM ancillary fees "reasonably can be predicted to occur during the rate year."[77] Rather, we find that it is reasonable for the revenue requirement established herein to reflect actual PJM ancillary fees as occurred during the twelve months ended October 31, 2009, and that such level of fees

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[73] In addition, although there was evidence that this CCS project could also *increase* APCo's fuel and capacity equalization charges, we do not address in this case whether an approved level of such charges should be reduced to remove the impact of the Mountaineer CCS project. *See, e.g.*, Consumer Counsel's May 18, 2010 Post-hearing Brief at 25; Ex. 100 (Carr direct) at 63-64.

[74] Company's May 18, 2010 Post-hearing Brief at 67.

[75] *Id.*

[76] *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 19-21 (citing Ex. 41 (Schedule of Actual v. Projected December 2009 Results); Ex. 112 (Rate Year Forecast Compared to Available Actual to Date Total Company); Ex. 100 (Carr direct) at 47; Ex. 108 (Nelson rebuttal) at 19).

[77] Va. Code § 56-235.2 A.

provides the Company with a reasonable opportunity to recover its costs. This finding reduces the rate increase requested in the Company's Application by approximately $7.4 million.

Employee Incentive Plans

AEP has an Annual Incentive Plan ("AIP") and a Long-Term Incentive Plan (collectively, "Incentive Plans"). As explained by Staff: (1) "[a]ward calculations for the Incentive Plans are based in large part on AEP earnings and shareholder return;" (2) "[i]ndeed, AEP earnings performance ultimately determines the AIP payouts in any given year;" (3) "[t]he primary goals of the Incentive Plans are to increase shareholder value;" (4) "[t]he benefits of incentivizing [earnings per share] and stock price growth accrue primarily to AEP's shareholder[s];" and (5) "because these incentives are driven by *AEP* earnings and stock prices, they may actually provide incentives to take certain actions that are not necessarily in the best interests of [*APCo*] or its ratepayers."[78] The Company seeks to collect 100% of the costs of the Incentive Plans from ratepayers.

The Company has not shown that 100% of the Incentive Plan expenses serve to benefit ratepayers. We will not, however, reject all of these costs; rather, as recommended by Staff, we find that 50% of such expenses are just and reasonable for ratemaking purposes in this case.[79] This finding reduces APCo's requested rate increase by approximately $4.2 million.

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[78] Staff's May 18, 2010 Post-hearing Brief at 26-27 (emphasis in original) (citations omitted). Indeed, Consumer Counsel asserts that AEP has been incented to take actions that it knew would hurt APCo and would benefit AEP. *See, e.g.*, Consumer Counsel's May 18, 2010 Post-hearing Brief at 10-13 (Confidential) (citations omitted).

[79] *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 26-27; Tr. 883 (Carr). In addition, we find that APCo failed to make an appropriate adjustment to remove the portion of American Electric Power Service Corporation ("AEPSC") employees' incentive compensation expense that was attributable to AEP exceeding its earnings per share targets. *See, e.g.*, Ex. 100 (Carr direct) at 55. This additional adjustment is reflected in Staff's Other Operating Expense Adjustments referenced below.

Environmental Expenses

We reject APCo's projection of environmental expenses. As explained by Staff:

> [The Company] incurs expense to operate its environmental control equipment. These expenses include the handling and disposal of gypsum and the consumption of urea, limestone, trona, polymer, and lime hydrate. The Company incurs additional expense to consume emission allowances, which are used to offset emissions of regulated pollutants.[80]

We find that the Company's forecasts of these environmental expenses have proven to be unreliable and inaccurate.[81] We do not find that the Company's projections of future environmental expenses "reasonably can be predicted to occur during the rate year."[82] Rather, we adopt Staff's proposed expense level for this purpose, which uses actual data and limited forecasts that we find reasonably can be predicted to occur during the rate year.[83] Staff evaluated and audited individual components of this expense and made reasonable recommendations on each.[84] The difference between the Company's and Staff's proposals "results primarily from the Company's forecasts for urea, limestone, and polymer."[85] We further find that Staff's recommended level of environmental expenses provides the Company with a reasonable opportunity to recover its costs. This finding reduces the rate increase requested in the Company's Application by approximately $5.3 million.

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[80] Staff's May 18, 2010 Post-hearing Brief at 16 (citing Ex. 100 (Carr direct) at 43).

[81] *See, e.g., id.* at 16-19 (citing Tr. 1215 (Waldo); Ex. 41 (Schedule of Actual v. Projected December 2009 Results); Ex. 100 (Carr direct) at 43-46; Ex. 108 (Nelson rebuttal) at 20).

[82] Va. Code § 56-235.2 A.

[83] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 16-19 (citing Tr. 1215 (Waldo); Ex. 41 (Schedule of Actual v. Projected December 2009 Results); Ex. 100 (Carr direct) at 43-46; Ex. 108 (Nelson rebuttal) at 20).

[84] *See id.*

[85] *Id.* at 17 (citing Ex. 100 (Carr direct) at 46).

Rate Base

We reject the Company's proposed rate year average adjustments to rate base, which include projected future costs for items such as plant in service, construction work in progress ("CWIP"), accumulated depreciation, and accumulated deferred income taxes. We agree with Staff that APCo's predictions of these significant rate base components are "based on unreliable and inaccurate assumptions."[86] We do not find that the Company's projected "future costs . . . reasonably can be predicted to occur during the rate year."[87] Rather, we find that it is reasonable for the rate base established herein to reflect Staff's proposed rate base, which contains "[r]ecent, actual information, normalized or annualized when necessary and adjusted for reasonably predictable future changes."[88]

We also find, contrary to APCo's assertions, that the rate base approved herein provides the Company with a reasonable opportunity to recover its costs. The approved rate base includes known costs, plus future costs (such as CWIP related to distribution projects) that we conclude reasonably can be predicted to occur during the rate year. In addition, APCo's contention that the approved rate base will not permit recovery of costs associated with capital investment in scrubbers for its Amos coal plant is misplaced.[89] First, the rate base that *APCo* proposed does not include these scrubbers.[90] Second, the Amos scrubbers provide further example of how the

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[86] *Id.* at 9.

[87] Va. Code § 56-235.2 A. *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 8-13 (citing Ex. 100 (Carr direct) at 74-76).

[88] Staff's May 18, 2010 Post-hearing Brief at 8.

[89] Company's May 18, 2010 Post-hearing Brief at 74-75. In addition, in a footnote on Attachment 2 of its post-hearing brief, the Company "requests recognition of the Amos 2 scrubber and its expenses." *Id.* at Attach. 2 n.3. We recognize that the Company may seek to include Amos 2 scrubbers in subsequent rate cases if appropriate, but such recognition does not modify our rate base findings for purposes of the instant proceeding.

[90] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 10 (citing Tr. 1160 (Allen)).

Company's projected future costs of such rate base components are not reasonably predictable. Specifically, "[i]n the space of just ten months, a $530 million construction project had its in-service dates moved from: (a) March 2010 and December 2010 to (b) 2012, and (c) back to the first quarters of 2010 and 2011."[91] Finally, the rate base and associated revenue growth adjustment that we approve herein does not decrease -- but, rather, *increases* -- the Company's proposed revenue requirement.[92]

The rate base and associated revenue adjustment approved herein increases the Company's rate request by approximately $3.5 million.[93]

Deferred Fuel Balance

Consumer Counsel "recommended an adjustment to the deferred fuel balance to reflect an updated estimated fuel balance," and the Company agreed with the recommended adjustment.[94] We find that Consumer Counsel's proposed adjustment, which uses APCo's "revised forecast of rate year fuel cost deferrals . . . for determining the 13-month average deferral fuel balance to be included in working capital in this case," is reasonable and shall be

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[91] Ex. 100 (Carr direct) at 11.

[92] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 10. In addition, our approval reflects consistent treatment of rate base and customer growth, which the Company and Staff agree is needed to avoid a mismatch between revenue and rate base. *See, e.g., id.* at 12 (citing Ex. 100 (Carr direct) at 15-21); Company's May 18, 2010 Post-hearing Brief at 75.

[93] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 12, 16 (citing Ex. 100 (Carr direct) at 15-21; Ex. 103 (Carr revised statements) at Revised Statement VII-A). This amount does not include changes to the deferred fuel balance, which are discussed below.

[94] *See, e.g.,* Consumer Counsel's May 18, 2010 Post-hearing Brief at 35-36 (citing Ex. 64 (Norwood direct) at 33-34); Company's May 18, 2010 Post-hearing Brief at 75-76 (citing Tr. 384 (Nelson); Ex. 64 (Norwood direct) at 33-34).

approved.[95] This finding reduces the Company's requested rate increase by approximately $2.4 million.

Next, the Committee asserts that the "Commission should exclude from revenue requirement the costs of APCo's wind purchased power costs associated with the Camp Grove and Fowler Ridge Projects," which are part of the Company's renewable energy portfolio standard ("RPS") program under § 56-585.2 B of the Code.[96] The Committee states, among other things, that "APCo has not shown that its proposed inclusion of [these] costs in the deferred fuel component of rate base complies with Va. Code § 56-585.2 E."[97] The Company opposes such adjustment,[98] which would reduce its requested rate increase by approximately $1.2 million.[99] We find that APCo has not satisfied – nor even attempted to satisfy – the statutory standards under § 56-585.2 E of the Code for recovery of these costs. Specifically, and as we similarly found in APCo's prior fuel factor proceeding:

> [T]he Company has not met its burden under [the plain language of § 56-585.2 E of the Code] (a) to establish what portion – if any – of the Camp Grove and Fowler Ridge costs represent 'incremental costs of the RPS program,' and (b) to allocate and recover such costs based on demand and excluding large industrial rate classes. Accordingly, we reject the Company's request to include ... the RPS program costs attendant to Camp Grove and Fowler Ridge.[100]

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[95] Consumer Counsel's May 18, 2010 Post-hearing Brief at 36 (citing Ex. 64 (Norwood direct) at 33-34). This reduces APCo's deferred fuel adjustment from $31.9 million to $13.8 million. *Id.*

[96] Committee's May 18, 2010 Post-hearing Brief at 31 (typeface modified).

[97] *Id.* at 39.

[98] Company's May 18, 2010 Post-hearing Brief at 76-77.

[99] *See, e.g.,* Ex. 100 (Carr direct) at 79.

[100] *Application of Appalachian Power Company, To revise its fuel factor pursuant to Va. Code § 56-249.6*, Case No. PUE-2009-00038, 2009 S.C.C. Ann. Rept. 462, 466, Order Establishing Fuel Factor (Aug. 3, 2009) (footnote omitted). The Company may defer these carrying costs on its books pending a subsequent request for recovery of the same.

In sum, the two findings above, which decrease the deferred fuel component of rate base, collectively reduce the Company's requested rate increase by approximately $3.6 million.

Accumulated Deferred Income Taxes and Accumulated Deferred Investment Tax Credits

Accumulated Deferred Income Taxes ("ADIT") and Accumulated Deferred Investment Tax Credits ("ADITC") are components of rate base and are related to separate operating expenses that the Commission has permitted APCo to recover herein.[101] The Company proposes to functionalize the rate base impact of ADIT/ADITC based on APCo's functional ledgers.[102] Staff, however, proposes to functionalize the rate base impact of these items in a manner that is similar to the method by which the related operating expenses are functionalized.[103] We adopt Staff's recommendation and find that it is reasonable to functionalize the rate base impact of ADIT/ADITC based on the same functionalization of related expenses. This treatment also avoids a ratemaking mismatch and permits recovery of appropriate expenses and return on rate base. This finding reduces the Company's requested rate increase by approximately $3.6 million.

Overtime Pay

We find that the Company's proposed overtime pay expense is reasonable.

Capitalization of Executive Compensation

We find that the Company's proposed expensing of executive compensation is reasonable.

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[101] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 15.

[102] *See, e.g., id.* (citing Tr. 879-880 (Carr)); Company's May 18, 2010 Post-hearing Brief at 78-79 (citing Ex. 24 (Kelly rebuttal) at 3-5).

[103] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 15; Tr. 879-880 (Carr).

Umbrella Trust Plan

The Umbrella Trust Plan funds payments for certain executive employee benefits administered by AEPSC and was established to dedicate funds for these benefits in the event of a bankruptcy or change in control of AEP.[104] In addition: (1) "[t]ypically, the gains on the plan assets offset all or a portion of the cost of those benefits;" (2) "from 2004 through the 2008 test year, [APCo] experienced a loss only in the test year;" and (3) "[t]his aberration in 2008 was due primarily to losses in the stock market."[105] Accordingly, we find that the Company's request to include one-half of the abnormal test year loss as a rate year expense is unreasonable. Rather, we conclude that it is reasonable to reflect a normalized level of Umbrella Trust Plan results. Specifically, we find that it is reasonable to use a five-year average of such results – which reflects both (i) gains from 2004 through 2007, and (ii) losses from 2008.[106] This finding reduces the Company's requested rate increase by approximately $1.3 million.

Other Operating Expense Adjustments

Staff proposed a series of additional operating expense adjustments – some of which increased, and some of which decreased, the Company's revenue requirement.[107] We find that these adjustments are reasonable and shall be approved. This finding reduces the Company's requested rate increase by approximately $5.1 million.

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[104] *See, e.g.*, Staff's May 18, 2010 Post-hearing Brief at 29.

[105] *Id.* at 29-30 (citing Tr. 1031-32 (Hoersdig); Ex. 100 (Carr direct) at 58).

[106] *Id.* at 30.

[107] *See, e.g., id.* at 34-36 (citing Ex. 100 (Carr direct) at 48-49; Ex. 103 (Carr revised statements) at Revised Statement VII-A).

Jurisdictional and Class Cost of Service Studies

We find that APCo's proposed jurisdictional cost of service study, as subsequently updated by the Company, is reasonable.[108] The Company's jurisdictional cost of service study "was uncontested by the other parties in this proceeding and was consistent with the study filed and approved by the Commission in the Company's 2008 base rate case" (Case No. PUE-2008-00046).[109]

Next, we find that the Company's proposed class cost of service study reasonably allocates Virginia jurisdictional costs among APCo's retail customers. The Company appropriately "determined the Virginia retail class cost of service through the standard three-step approach of functionalization, classification and allocation."[110] Moreover, "the Company's jurisdictional, functional, and recommended functionalized class cost of service studies are generally consistent with comparable studies conducted by [APCo] and Staff in the Company's last base rate case, Case No. PUE-2008-00046" – which were adopted by the Commission.[111]

Revenue Allocation

We herein approve an annual revenue requirement increase for APCo of approximately $61.5 million. For purposes of allocating this increase among customer classes, the Company notes that "each party [in this case] argues for different changes" to revenue allocation among

[108] *See, e.g.,* Company's May 18, 2010 Post-hearing Brief at 87.

[109] *Id.*

[110] *Id.*

[111] Staff's May 18, 2010 Post-hearing Brief at 73 (citing Ex. 104 (Roberts direct) at 6-10). In addition, we decline to adopt at this time the "minimum system" approach for allocating certain distribution costs. *See, e.g.,* Kroger's May 18, 2010 Post-hearing Brief at 2-4; Committee's May 18, 2010 Post-hearing Brief at 39-42; Staff's May 18, 2010 Post-hearing Brief at 73-74; Company's May 18, 2010 Post-hearing Brief at 92-93. Rather, we have found that APCo's traditional class cost of service methodology, as previously approved by this Commission, remains reasonable for purposes of this proceeding.

customer classes, and that "[a]ll recommend a smaller share of the [rate increase in this case] be allocated to the rate schedule(s) under which they take most or all of their service."[112] We conclude that Staff's proposed "Alternative 2" revenue apportionment, modified such that all customer classes move toward rate of return parity, is reasonable for establishing rates in this proceeding.[113] We find that this result, among other things, avoids unnecessary rate shock and reasonably promotes (i) gradualism in rates, (ii) rate stability and predictability, and (iii) historic continuity.[114]

Schedule GS (General Service)

The Company proposes to implement a new rate schedule, Schedule GS, which would replace Schedules MGS (Medium General Service) and LGS (Large General Service). Schedules MGS and LGS "are both generally applicable to customers with demands greater than 25 kilowatts but less than 1,000 kilowatts, with low load customers benefiting from service under

[112] Company's May 18, 2010 Post-hearing Brief at 88. *See also* Kroger's May 18, 2010 Post-hearing Brief at 3-4; Committee's May 18, 2010 Post-hearing Brief at 46-51; Wal-Mart's May 18, 2010 Post-hearing Brief at 3-5; Steel Dynamic's May 18, 2010 Post-hearing Brief at 5-7.

[113] *See, e.g.,* Staff's May 18, 2010 Post-hearing Brief at 74-77. This results in a specific revenue increase for each customer class as follows:

| Customer Class | Revenue Increase |
|---|---|
| Residential | $ 39,000,043 |
| Small General Service (SGS) | $ 2,020,218 |
| Medium General Service (MGS) | $ 3,025,244 |
| Large General Service (LGS) | $ 5,166,130 |
| Large Power Service (LPS) | $ 11,182,233 |
| Sanctuary Worship Service (SWS) | $ 656,477 |
| Outdoor Lighting (OL) | $ 422,377 |
| Total | $ 61,472,722 |

[114] The rate design within each class shall be implemented consistent with APCo's proposals in this case – except where modified herein by the Commission – and reduced to reflect the decreased revenue requirements as also approved herein. In addition, for the residential class, the reduced revenue requirement shall be applied to the proposed rates for energy consumption.

MGS and high load customers benefiting from service under LGS."[115] As explained by Staff, "if a MGS customer's usage characteristics change over time, it may benefit from migrating to LGS, and vice versa," and, according to APCo, "if all identified customers that could benefit by switching schedules were to do so, the Company 'would lose about $770,000 based on present rates.'"[116]

Staff asserts that "[a]s proposed, Schedule GS will adversely affect low load factor customers currently receiving service under Schedules MGS and LGS."[117] Wal-Mart opposes this new schedule, asserting that it (i) is unjustified, (ii) inappropriately collects only 21% of demand-related costs through demand charges, and (iii) creates new revenue instability.[118] VML/VACO also opposes this schedule, stating that "elimination of Schedules MGS and LGS will adversely affect the Public Authorities and governmental customers."[119] Wal-Mart and Kroger further contend that the class rates of return for Schedules MGS and LGS must be equalized prior to replacing such schedules with GS; since LGS has a higher relative rate of return than MGS, these parties assert that the new blended GS rate will permanently disadvantage LGS customers if rates of return are not equalized.[120]

Finally, Staff recommends that Schedule GS "be offered on a voluntary basis, in conjunction with" Schedules MGS and LGS, which "will give the Company an appropriate

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[115] Staff's May 18, 2010 Post-hearing Brief at 78.

[116] *Id.* at 78-79 (citing Ex. 78 (Bethel direct) at 14).

[117] *Id.* at 79.

[118] *See, e.g.,* Wal-Mart's May 18, 2010 Post-hearing Brief at 7-9.

[119] VML/VACO's May 18, 2010 Post-hearing Brief at 13.

[120] *See, e.g.,* Kroger's May 18, 2010 Post-hearing Brief at 10-12; Wal-Mart's May 18, 2010 Post-hearing Brief at 5.

amount of time to examine the effects of Schedule GS on customers."[121] We adopt Staff's recommendation and approve Schedule GS on a voluntary basis. APCo has not established that it is reasonable at this time to eliminate Schedules MGS and LGS as proposed in this case.[122]

Schedule LGS (Large General Service)

The Company's proposed rate design for Schedule LGS (i) "would recover approximately 65% of demand-related costs through $/kW demand charges,"[123] and (ii) includes a new energy charge designed to recover certain demand-related costs.[124] Kroger asserts that demand charges should recover at least 80% – not 65% – of demand-related costs.[125] Wal-Mart and Kroger further oppose APCo's new energy charge as an improper means through which to collect demand-related costs.[126] Staff recommends that this schedule be modified to collect 70% of demand-related costs through demand charges, which was required by the Commission as part of the approved settlement in APCo's prior rate case (Case No. PUE-2008-00046).[127] We adopt Staff's recommendation and find that it is reasonable to "retain[] the level of demand costs that the Company recovers through $/kW demand charges at 70%."[128] This finding also eliminates the need for APCo's new LGS energy charge, which we therefore reject.

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[121] Staff's May 18, 2010 Post-hearing Brief at 79.

[122] In addition, as requested by Kroger and APCo, we clarify that the two-tier energy charge in Schedule GS does not constitute a declining block rate. *See, e.g.,* Kroger's May 18, 2010 Post-hearing Brief at 12-14; Company's May 18, 2010 Post-hearing Brief at 90.

[123] Staff's May 18, 2010 Post-hearing Brief at 78.

[124] *See, e.g.,* Kroger's May 18, 2010 Post-hearing Brief at 7-8; Wal-Mart's May 18, 2010 Post-hearing Brief at 5.

[125] *See, e.g.,* Kroger's May 18, 2010 Post-hearing Brief at 5-7.

[126] *See, e.g., id.* at 7-10; Wal-Mart's May 18, 2010 Post-hearing Brief at 5-7.

[127] Staff's May 18, 2010 Post-hearing Brief at 78.

[128] *Id.* (footnote omitted).

Schedule LPS (Large Power Service)

The Committee asserts that: (1) "APCo is proposing a 'cost shift' from demand to energy charges in its LPS rate design;" (2) "[t]here is no basis . . . for the Company's proposed rate design for LPS;" (3) "Staff neither concurs with or opposes APCo's proposed rate design;" and (4) "APCo . . . offered no rebuttal to [the Committee's testimony on this issue]."[129] We find that APCo has not established that its proposed cost shift from the LPS demand charges is just and reasonable. These demand and energy charges shall be designed consistent with the cost allocations reflected in the Company's previously approved Schedule LPS.

Schedule GS-TOD (General Service Time-of-Day)

We adopt Staff's proposals (i) to increase the maximum normal demand for General Service Time-of-Day rates from 500 kW to 1,000 kW, and (ii) to remove this schedule's current limitation of 500 customers.[130]

Experimental – ATOD (Advanced Time-of-Day) Schedule

The Commission approved APCo's Advanced Time-of-Day Schedule on an experimental basis in 1997. We adopt Staff's proposal that, given the passage of time, this schedule should no longer be deemed experimental and that all references to such as "experimental" should be removed from the tariff.[131]

Schedule NMS (Net Metering Service Rider)

We approve APCo's proposed revisions to its Net Metering Service Rider, which are designed to reflect recent statutory amendments.[132]

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[129] Committee's May 18, 2010 Post-hearing Brief at 51-53.

[130] *See* Staff's May 18, 2010 Post-hearing Brief at 79.

[131] *See id.* at 80.

[132] *See id.*

Schedule EDR (Economic Development Rider)

We approve APCo's proposed addition of an Economic Development Rider, which is designed to encourage economic development in the Company's service area.[133]

Credit and Collections

We approve the Company's proposed changes to its credit and collections program, which include, among other things: (i) suspending APCo's current credit and collections program that allows it to require additional deposit amounts if a residential customer exhibits an extended pattern of delinquency or if the deposit on hand is inadequate given the size of a customer's monthly bill; (ii) changing deposits to an amount that is equal to two times the average monthly usage of a customer rather than an amount equal to the customer's estimated bill for the two highest consecutive months of usage; (iii) allowing payments for deposits to be extended up to six months in cases of hardship; and (iv) allowing customers who participate in the Company's budget billing program to spread their settlement payments over the next twelve months of the budget year rather than paying the settlement over three months.[134]

Other Rate Schedules

The Commission approves the Company's proposed rate designs for residential service (Schedules RS, RS-E, RS-TOD), sanctuary worship (Schedule SWS), small general service (Schedules SGS and SGS-TOD), medium general service (Schedule MGS), large power service time-of-day (Schedule LPS-TOD), standby service (Schedule SBS), and outdoor lighting (Schedule OL).[135]

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[133] *See id.* (citing Ex. 104 (Roberts direct) at 33-34).

[134] Ex. 13 (Waldo direct) at 11-12.

[135] *See* Staff's May 18, 2010 Post-hearing Brief at 77-78, 80.

Accordingly, IT IS HEREBY 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 forthwith file revised tariffs and terms and conditions of service with the Commission's Division of Energy Regulation, in accordance with this Final Order, effective for bills rendered on and after August 1, 2010.

(3) The Company shall determine, using the methodology prescribed by the General Assembly (2010 Va. Acts of Assembly Chaps. 1 and 2), whether customer refunds are due. For each customer where application of this methodology results in a refund, the Company shall provide such refund within sixty (60) days of the issuance of this Final Order.

(4) Interest upon the ordered refunds shall be computed from the date payments of monthly bills were due to the date each refund is made at the average prime rate for each calendar quarter, compounded quarterly. The average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the *Federal Reserve Bulletin* or in the Federal Reserve's Selected Interest Rates (Statistical Release H.15) for the three (3) months of the preceding calendar quarter.

(5) The refunds ordered herein may be credited to current customers' accounts. Refunds to former customers shall be made by check mailed to the last known address of such customers when the refund amount is $1 or more. The Company may offset the credit or refund to the extent of any undisputed outstanding balance for the current or former customer. No offset shall be permitted against any disputed portion of an outstanding balance. The Company may retain refunds to former customers when such refund is less than $1. The Company shall maintain a record of former customers for which the refund is less than $1, and such refunds shall be

promptly made upon request. All unclaimed refunds shall be subject to § 55-210.6:2 of the Code.

(6) The Company shall deliver to the Commission's Divisions of Public Utility Accounting and Energy Regulation a report showing either that refunds are not required or that all refunds have been made pursuant to this Final Order, detailing the costs of the refunds and the accounts charged.

(7) The Company shall bear all costs incurred in effecting the refunds ordered herein.

(8) This case is dismissed.

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

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