



VEPGA

Virginia Energy Purchasing Governmental Association

Elected Official's Guide to
ENSURING FAIR REGULATION FOR ELECTRICITY



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Ensuring Fair Regulation for Electric Utilities

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INTRODUCTION

In 2007, the General Assembly changed course and largely abandoned deregulation, replacing it with a unique form of re-regulation (“Virginia Re-regulation”) that incorporated proposals first advanced by Virginia Power and Appalachian Power. Though vigorously opposed by consumer advocates, environmental interest groups, and the state’s utility regulatory agency, the legislation passed with certain modifications and is now codified, in significant part, at Code of Virginia §§ 56-585.1, 56-585.2, and 56-585.3.

From a consumer’s perspective, this kind of utility regulation is fundamentally flawed. This pamphlet focuses on how Virginia Re-regulation needlessly inflates electricity rates, thereby enriching investor-owned electric utilities at the expense of their customers.

When compared to customary regulation, Virginia Re-regulation grants excessive benefits to utilities and imposes excessive burdens on their customers. Given the complexity of Virginia Re-regulation, these impacts were not clearly understood by policy makers. This pamphlet addresses some of those impacts as well as common misperceptions regarding Virginia Re-regulation.

It is vital that elected officials understand Virginia Re-regulation for two reasons. First, to appreciate what this legislation actually does, as compared to what its supporters claim it does. Second, to understand that any attempt to “improve” the legislation in future General Assembly sessions may further exacerbate how utility shareholders are unduly enriched at the expense of utility customers.

For instance, during the 2009 General Assembly session, HB 2506 gave electric utilities the right to collect a profit on operating costs that the utility pays to third-party contractors for operating an energy efficiency program for the utility. It is unprecedented and unfair for customers to be required to pay a utility company a profit for services performed by a third party, and for making no capital investment at all. Virginia Power has already filed with the State Corporation Commission to collect this type of profit on a project involving no capital investment.

Understanding Virginia Re-regulation will also help in evaluating certain aspects of the Virginia Energy Plan, which was issued in September 2007. For instance, the Virginia Energy Plan stresses the importance of limiting “imports” of electricity by encouraging the construction of electricity facilities in Virginia. From a consumer’s perspective, this “anti-import” stance is misguided. The emphasis should instead be on using generating facilities that keep rates as low as possible. Importing electricity from an existing plant that is outside Virginia, that is dedicated to serving Virginia load, and that has relatively low operating costs may be the best way to achieve this goal.



QUESTION & ANSWER

Why did the General Assembly enact Virginia Re-regulation in 2007?

The proponents claimed this legislation was needed to ensure a sufficient supply of electricity at reasonable prices. Re-regulation was offered as a better alternative than continuing on the path to de-regulation, which in Maryland and Delaware led to rate shock in 2006 when customers were forced to pay the then much higher rates set by a regional energy market. In addition, utilities claimed they needed additional monetary incentives to construct new generation facilities in Virginia.

Will the purpose of the legislation – to allow for sufficient supply of electricity at reasonable prices – likely be accomplished?

No, because the legislation returns Virginia utilities to monopoly rates yet significantly limits – and in some instances eliminates – the State Corporation Commission’s authority to ensure that such rates are reasonable.

Is there any proof that Virginia Re-regulation limits the SCC’s ability to ensure that electricity prices are reasonable?

Yes. In its 2007 rate case, Appalachian Power argued that the SCC should increase its rates based upon rate-making criteria used in Virginia Re-regulation. In its May 15, 2007 Final Order, the SCC rejected Appalachian’s argument because the Virginia Re-regulation legislation was not yet effective; consequently, the SCC calculated Appalachian’s rates under the “just and reasonable” standard as applied in prior SCC cases. According to the SCC, had Virginia Re-regulation been applicable, Appalachian’s rate increase would have been approximately \$ 72 million – an amount three times the level the SCC found reasonable.

Once Virginia Re-regulation did become effective, the SCC was required to approve a \$77.9 million increase in Virginia Power’s rates, effective September 1, 2009, through a separate rate rider for transmission-related costs. The SCC had no authority to consider whether Virginia Power’s rates were excessive during 2008, even though Virginia Power conceded that its rates in 2008 generated a return on its common equity of approximately 17%, greatly in

excess of the rates of return around 10% that the SCC has, in recent times, found to be a reasonable cost of equity for other Virginia utilities.

What are some of the more significant limitations on the SCC's authority?

Regulated rates customarily are set to provide utilities with a reasonable profit on their investment. Virginia Re-regulation distorts this basic regulatory principle by requiring the SCC to take specific measures that will guarantee an artificially high profit level. First, the SCC must set the utility's profit level (i.e., its rate of return on equity) using a formula reflecting profits earned by a small group of unusually profitable out-of-state utilities, not a profit level tailored to the specific circumstances of the Virginia utility. Second, in setting rates, the SCC must ignore a utility's earnings from favorable tax treatment: the SCC simply has to pretend these types of earnings never occurred. Third, the SCC must automatically approve rate increases for specific categories of expenses without considering whether cost savings in other areas would offset the need for a rate increase. Fourth, the SCC must approve bonus profits for those utilities building new generation facilities. Each of these measures sets rates at artificially high levels by pre-determining outcomes that are normally left to the discretion of the SCC. This contradicts the long-standing practice of an independent regulatory body fairly balancing the interests of utilities and ratepayers to determine what rates are reasonable.

If Virginia Re-regulation deprives the SCC of its authority to set reasonable electricity prices, what's the solution?

Virginia Re-regulation eliminates the SCC's discretion to set rates that are "just and reasonable" for both the utility and its ratepayers. Virginia Re-regulation eliminates this balanced approach by requiring that the SCC favor utilities over ratepayers. As a result, utilities will earn artificially high profits at the expense of their customers. The solution to this imbalance is to repeal legislative determinations of rate-making issues that have historically been left to the SCC's expert judgment. Restoring the SCC's authority will restore just and reasonable rates.

Won't this hurt the utilities?

No, because “just and reasonable rates” means rates that are fair to both utilities and consumers. The favorable credit ratings of Virginia utilities demonstrate that the SCC has taken this obligation seriously.

Won't this solution jeopardize our electricity supply?

No. As the holders of monopoly franchises, utilities are statutorily required to provide adequate service. The SCC monitors and enforces this duty. It also has a long history of providing incentives and programs to ensure that necessary generating facilities are constructed.

Won't electricity rates go up anyway?

Yes, they may, but the question should be whether those rate increases are reasonable. With its authority so severely constrained by Virginia Re-regulation, the SCC cannot ensure that the utilities' requested rate increases are fully justified and necessary.



What are the consequences to local governments of inflated electricity rates?

Local governments are affected both directly and indirectly by unreasonably high electric rates. Local governments purchase significant amounts of electricity for essential services including schools, courts, and fire and police protection. Virginia Power, for example, sells over \$300 million of electricity a year to local governments. If Virginia Re-regulation were to cause electricity prices to be 10% more expensive, Virginia Power would charge local governments an additional \$30 million per year. The budget impact directly affects local governments and the citizens they

represent. Note: local government rates are set by contract, not by SCC regulation, but changes in jurisdictional rates set by the SCC often influence the contract rates set in bi-lateral negotiations between local governments and utilities.

Inflated rates also affect local governments by weakening their ability to retain or attract business. For a number of years, Virginia localities have enjoyed the economic advantage associated with relatively low electricity prices. The higher electricity prices attributable to Virginia Re-regulation could cause commercial and industrial companies to lose out to competitors in other states and countries. Manufacturing jobs in Virginia have decreased by 20% in recent years, and higher energy costs will only exacerbate this trend.



Didn't Virginia Power estimate that Virginia Re-regulation would not cause its rates to go up by more than the rate of inflation?

Yes, but Virginia Power's estimate excluded its fuel rates, and that is no minor exclusion. As a percentage of total monthly bills, Virginia Power's fuel factor increases caused a 4% rate increase for residential customers and 8% increase for industrial customers on July 1, 2007. Moreover, residential customers were subjected to an 18% increase in their total bills and industrial customers experienced over a 30% increase in their total bills as a result of Virginia Power's July 1, 2008 fuel factor. Actions speak louder than words: Virginia Power's 2007 and 2008 rate increases were significantly higher than the rate of inflation, and these increases occurred well before the full rate impacts of Virginia Re-regulation are felt in later years.

This trend of ever-increasing fuel rates was de-railed by the 2009 recession, and Virginia Power’s fuel factor for 2009 decreased rather than increased. Under customary regulation, having significantly lower fuel costs in 2009 would normally have resulted in overall rate decreases for electricity rates. However, this will not be the result under Virginia Re-regulation.

Why won’t lower fuel costs result in overall lower rates under Virginia Re-regulation?

The downward adjustment in fuel is offset by multiple approved, pending, or expected riders that unnecessarily drive up litigation and administrative costs, complicate Commission cases and regulation, and potentially confuse customers, all to the detriment of the Commission, consumers, and the public.

Virginia Power already has four approved riders encompassing fuel, sales and use tax, FERC transmission costs, and costs associated with the Wise County coal plant. Approval for three other riders is pending, one for the Bear Garden generating facility, a second for costs of a peak-shaving program, and a third for costs of multiple energy efficiency programs. If approved, these would increase the total number of riders to seven. Virginia Power has the right to obtain a rider for collecting the cost of renewable portfolio standard (“RPS”) program costs and another rider for collecting costs of certain environmental facilities. Such riders, if requested and approved, would increase the number of riders to nine. If the Commission were to approve a rider for a future North Anna nuclear unit, Virginia Power could have ten separate riders within the next couple of years. If the Commission were to approve a separate rider for each new combined cycle (“CC”) and combustion turbine (“CT”) unit described in Virginia Power’s 2009 Integrated Resource Plan, there could be an additional nine to thirteen new separate riders just for CC and CT units by 2025.

All of these riders are in addition to biennial base rate cases, which are required every two years to allow for “timely and current” recovery of costs. All these riders, in addition to the frequent base rate cases, carry the obvious potential for a greater number of rate increases for customers during a given year -- each potentially

occurring at different times -- leading to a greater likelihood of customer confusion and heightened customer concern.

Who are the winners and losers under Virginia Re-regulation?

Utility shareholders win and utility ratepayers lose. Some would argue that environmentalists also win, but the same goals could be achieved without imposing an undue burden on ratepayers. For example, providing equal incentives for building new generation and for implementing conservation measures could have been accomplished by removing bonus payments for building new generation: this approach would achieve the same environmental goals and would help ratepayers.

What action should elected officials take?

Local elected officials should educate their General Assembly delegation of the significance of this issue to local governments, their citizens, and the Commonwealth.

Is a more detailed analysis available concerning the impact of Virginia Re-regulation on local governments?

Yes: the Virginia Energy Governmental Purchasing Association ("VEPGA") is a joint powers association of local governments within Virginia Power's service territory. VEPGA has prepared a White Paper on Virginia Re-regulation that is available on VEPGA's website, www.vepga.org

Common Misperceptions About 2007 Legislation

	Virginia Power's assessment	What the legislation really does
#1 Abandons Electricity Experiments	The legislation "end[s] Virginia's 10-year experiment with deregulation and electricity restructuring" and replaces it with a new experiment – unlike regulation in any other state – using rigid statutory formulas that re-define what are "reasonable" rates and profits.
#2 Embraces Cost of Service Regulation	The legislation "restore[s] Virginia to full cost-of-service regulation by the State Corporation Commission."	The legislation significantly inflates a utility's rates. As a result, rates will be higher than those that have been deemed reasonable under customary cost-of-service regulation.
#3 No Increases without SCC Approval	"Not one cent can be added to customer bills without approval from the State Corporation Commission."	Certain costs, including fuel, transmission and environmental compliance, must be flowed through to customers. In these and other areas, "approval" is little more than a rubber-stamp.
#4 Retains SCC Oversight	"With a few modifications, the SCC will have the powers it historically exercised before Virginia's deregulation process began."	Those modifications include the duty to approve a profit level that is "excessive" when evaluated by the standards of customary regulation, and so will ensure higher rates.
#5 Provides Needed Incentives for New Generation	The legislation "provide[s] incentives for utilities to build new generation to meet growing demand and add environmental equipment at their power stations."	Construction incentives and bonuses aren't needed. The SCC has never denied a request to build a power plant and has always allowed utilities to recoup their investment.
#6 Helps Virginia's Economy	These incentives will "make sure Virginia's economy has the power it needs for decades to come."	More costly electricity service is likely to act as a brake on economic growth. High rates risk the loss of manufacturing jobs and energy-intensive industries, and discourage new businesses from locating in Virginia.
#7 Increases Consumer Protection	The legislation "add[s] important new consumer protections that place certain restrictions on a utility's ability to raise its rates."	Consumers are ill-served by provisions that strip the SCC of its power to initiate rate-cases for rate reductions and that impose unreasonably short time limits on SCC review of a utility's costs and earnings.
#8 Provides significant incentives for renewable energy	The legislation "provide[s] incentives for utilities to invest in renewable forms of energy and demand-side management and conservation programs."	Because participation is only voluntary, the legislation is a missed opportunity to promote environmental gains in Virginia. Meaningful energy-efficiency provisions can help delay or avoid the need for new power plants.

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Virginia Energy Purchasing Governmental Association
an association of over 175 local governmental entities
that assists its members in matters
affecting the provision of electricity service

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