Exhibit No.:	_____
Issue(s):	AAO Request
Witness/Type of Exhibit:	Hyneman/Rebuttal
Sponsoring Party:	Public Counsel
Case No.:	WU-2017-0351

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WU-2017-0351

October 13, 2017

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Missouri-American Water Company for an Accounting Authority Order related to Property Taxes in St. Louis County and Platte County	)))))	File No. WU-2017-0351

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) **ss**
COUNTY OF COLE)

Charles R. Hyneman, of lawful age and being first duly sworn, deposes and states:

1. My name is Charles R. Hyneman. I am the Chief Public Utility Accountant for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

CRH

Charles R. Hyneman, C.P.A.
Chief Public Utility Accountant

Subscribed and sworn to me this 13th day of October 2017.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037

Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.

TABLE OF CONTENTS

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN
MISSOURI-AMERICAN WATER COMPANY

CASE NO. WU-2017-0351

Introduction

Q. Please state your name, title and business address.

A. Charles R. Hyneman, Chief Accountant, Office of the Public Counsel (OPC or Public Counsel), P.O. Box 2230, Jefferson City, Missouri 65102.

Q. By whom are you employed and in what capacity?

A. I am employed by the OPC as the Chief Accountant.

Q. What is the role of the Public Counsel?

A. The Public Counsel represents and protects the interests of the public in any proceeding before or on appeal from the Missouri Public Service Commission ("Commission").

Q. Please describe your educational background.

A. I earned Bachelor of Science degrees in Accounting and in Business Administration (dual major) from Indiana State University at Terre Haute. I also earned an MBA from the University of Missouri at Columbia.

Q. Are you a Certified Public Accountant ("CPA") licensed in the state of Missouri?

A. Yes. My Missouri State Board of Accountancy license number is 017550.

Q. Are you a member of any professional Accounting organizations?

A. Yes. I am a member of the American Institute of Certified Public Accountants ("AICPA"). The AICPA represents CPAs and the accounting profession nationally regarding rule-making

and standard-setting. The AICPA established accountancy as a profession and developed its educational requirements, professional standards, code of professional ethics, licensing status, and its commitment to serve the public interest.

Q. Please summarize your professional experience in the field of utility regulation.

A. My professional experience in accounting and auditing began in 1993 when I began my employment with the Staff of the Missouri Public Service Commission ("Staff"). As a Staff regulatory auditor and manager of the Kansas City satellite Auditing office from 1993 to 2015, I participated in many different types of regulatory proceedings involving all major electric, gas, and water utilities operating in the state of Missouri. During this period I participated in and supervised several Accounting Authority Order ("AAO") cases before the Commission. I left the Staff in November 2015 when I joined the OPC.

Since joining the OPC I have participated in and supervised several large utility rate case audits, Infrastructure System Replacement Surcharge ("ISRS") reviews, Fuel Adjustment Clause ("FAC") prudence audits, Affiliate Transaction Rule compliance audits, utility complaint cases and other audits and reviews of Missouri utilities.

Q. Have you participated in and supervised several previous Missouri utility AAO cases?

A. Yes. Some of the cases in which I participated which involved the Commission's practices and policies on AAOs include GR-96-285, GR-98-140, GO-99-258, GR-2004-0209, GO-2002-0175, GU-2005-0095, EU-2010-0194 and WU-2017-0296.

Q. What is the basis of MAWC's AAO request in this case?

A. On June 29, 2017, MAWC filed its *Application and Motion for Waiver* ("AAO Application") concerning the accounting for MAWC's increases in property tax expenses.

Q. Is MAWC requesting a Commission order granting an AAO containing specific language?

A. Yes. In its AAO Application, MAWC requests the Commission include language granting an AAO where MAWC:

> a) is authorized to record on its books a regulatory asset, which represents the increase from 2016 to 2017 in Missouri property taxes for the counties of St. Louis and Platte associated with the counties' change in the calculation of MACRs class lives.
>
> b) may maintain this regulatory asset on its books until the effective date of the Report and Order in MAWC's next general rate proceeding and, thereafter, until all eligible costs are amortized and recovered in rates.

Q. Did MAWC provide witness testimony to support its AAO Application?

A. Yes. MAWC witnesses Brian LaGrand and John Wilde provided direct testimony in support of the AAO Application.

Q. Please summarize MAWC's proposal.

A. In essence, MAWC is seeking specific ratemaking treatment to allow it to adjust future rates to make up for its alleged shortfall in recovery of the amount of property tax expense included in current rates which were set by the Commission in MAWC's last rate case. Specifically, MAWC seeks Commission approval to maintain a property tax "regulatory asset" on its books until the effective date of the Report and Order in MAWC's "next general rate proceeding" and, thereafter, until all eligible costs are amortized and recovered in rates. This is an explicit request to recover in future rates a purported shortfall of an expense recovered in the Company's current rates.

Q. Is MAWC asking the Commission to do something it has declined to do in AAO cases, which is to agree with MAWC that these proposed deferred expenses constitute a regulatory asset with a probability of recovery?

A. Yes. This issue was discussed in detail in testimony and in the hearings in MAWC's current AAO request for lead service line replacements. MAWC is asking the Commission to state with specificity that MAWC is authorized to record on its books a regulatory asset with a probability of rate recovery. As will be discussed later, the Commission has clearly stated in every AAO case that it will not approve any ratemaking treatment in an AAO case.

Q. Is MAWC asking the Commission to make a specific ratemaking determination with respect to these deferred expenses?

A. Yes. MAWC is asking the Commission to allow MAWC to record and maintain this regulatory asset on its books until some future date when "all eligible costs are amortized and recovered in rates."

Q. Should the Commission make this ratemaking determination in MAWC's pending rate case and not in this AAO case?

A. Yes. Since MAWC is asking the Commission for rate treatment of these proposed property-tax-expense deferrals, this request should be addressed in MAWC's pending general rate case and not in this accounting case where the ratemaking treatment of these expenses cannot be addressed and determined.

Q. Please summarize OPC's position on MAWC's AAO Application.

A. As will be described in great detail below, MAWC's AAO Application is unnecessary. The only thing that MAWC can appropriately seek in this case is an approval by the Commission to defer expenses to NARUC USOA account 186, Miscellaneous Deferred Debits ("account 186"). MAWC management has the authority to defer these expenses to account 186 and <u>all</u> parties, OPC, Staff and MAWC recognized this in MAWC's recent hearing in Case No. WU-2017-0351. Since MAWC can record these expenses to Account 186 on its own authority, it does not require any Commission involvement in this decision.

While it is not necessary, there is no prohibition on MAWC asking for something it can already do on its own – defer expenses to Account 186. There is a prohibition, however, against MAWC asking the Commission to classify or even associate the term "regulatory asset" with these deferrals. The Commission does not need to make any decision in order for MAWC to classify these assets as a regulatory asset. The decision to classify these expenses deferred to Account 186 as a "regulatory asset" can only be made by MAWC management.

Summary of OPC's Recommendations

Q. Please state and summarize the five specific reasons why the Commission should not grant the requested AAO in this case.

A. OPC opposes MAWC's requested AAO on five primary grounds:

1. This AAO case is unnecessary. The Commission cannot provide MAWC with any relief when MAWC already has the ability to act for itself.

In this AAO case the Commission can provide no benefit to MAWC. The Commission may allow a deferral of these expenses for accounting purposes, but MAWC already has the power to do that. As the Commission has stated on numerous occasions, it cannot grant any ratemaking treatment in an AAO case. What the Commission is doing by allowing the creation of a regulatory asset, is agreeing recovery of the asset in rates is "probable". In other words, the Commission is agreeing with MAWC that rate recovery of these specific deferred-property-tax expenses is "likely to occur."

Under generally accepted accounting principles ("GAAP") as enforced by the Financial Accounting Standards Board ("FASB") and the Securities and Exchange Commission ("SEC"), the Commission cannot classify these deferred expenses as a regulatory asset in an AAO case. Only MAWC can do that. If MAWC is looking for any degree of rate certainty for these property tax expense increases, it is not possible to obtain any degree of certainly in this AAO case.

The Commission is clear in its AAOs that it provides "no" ratemaking treatment. An order from the Commission to this effect provides no value to MAWC and provides no degree of certainty of rate recovery. It is, however, possible for MAWC to obtain absolute rate "certainty" for these property tax expense deferrals in its pending rate case where the Commission may order the creation of a regulatory asset and confer ratemaking treatment to these deferred expenses.

2. <u>This case is an accounting proceeding. The ratemaking issues MAWC raises in this accounting proceeding can only be addressed in a ratemaking proceeding.</u>

The only two issues MAWC brings forth in this accounting case are: 1) the creation of a regulatory asset and 2) the specific ratemaking treatment of that asset. MAWC seeks ratemaking treatment of property tax expenses that it may incur as a result of changes in property tax rates in two Missouri counties, which became effective on January 1, 2017. This date is included in the test year and true-up period in MAWC's current Missouri rate case No. WR-2017-0285, which extends through December 31, 2017. Any cost increase for MAWC in the area of property tax expense will be reflected in its cost of service in the rate case based on input from the parties and ratemaking decisions of the Commission.

In contrast to an AAO case, in a ratemaking case, the Commission has the ability to order ratemaking treatment for these deferred expenses. In addition, in a rate case, the Commission has absolute authority under GAAP and its own rules to order the creation of a regulatory asset for these deferred expenses. While the Commission cannot order the creation of a regulatory asset in an accounting case, such as this AAO case, it can order the creation of a regulatory asset in a ratemaking case, such as MAWC's pending general rate case.

3. <u>The Commission should not unknowingly create a regulatory asset outside of a rate proceeding.</u>

In AAO cases, the Commission reserves its ratemaking decisions for rate proceedings, in that regard the Commission specifically states that no ratemaking determinations are made in AAO cases. This AAO request conflicts with the Commission's own prohibition on making a ratemaking decision because, as noted above, it requires the Commission to understand and accept that recovery of the expenses in a future rate case is "probable" and that GAAP defines "probable" in this context as "likely to occur."

Conversely, when the Commission acts on a ratemaking issue in a rate case, it either allows or does not allow ratemaking treatment for a specific cost. When the Commission allows ratemaking treatment for costs to be amortized for recovery in future years or to receive other ratemaking treatment, the Commission is effectively stating that these costs are probable of future rate recovery and therefore, the utility may create a regulatory asset. This is the only time a Commission can grant a regulatory asset.

If the Commission expects Missouri utilities to comply with GAAP, which they are required to do, a very significant conflict is inherent in the Commission's current process for granting AAOs and its creation of regulatory assets. Under GAAP standard ASC 980, when this Commission grants an AAO and orders an expense to be deferred as a regulatory asset, the Commission is granting probable future rate recovery of these specific deferred expenses. This is the reason that only the utility's management can create a regulatory asset, and then it can only do so when it can determine recovery in future rates is "probable" (likely to occur). This significant conflict should be resolved by the Commission in this AAO case.

4. <u>If the Commission grants an AAO in this case and MAWC creates a regulatory asset on its books as a result of this AAO, MAWC will likely be in violation of GAAP, which may have serious repercussions.</u>

MAWC is seeking an AAO from the Commission that it says will allow for the creation of a regulatory asset. Under GAAP, a regulatory asset has a special, unique, and mandatory characteristic. That characteristic is that the expenses deferred by a utility are "probable" of

recovery in a rate case. GAAP defines "probable" as "likely to occur." The Commission has always stated that it grants no ratemaking treatment in an AAO and it only allows the deferral of costs. Therefore, MAWC may be unintentionally misleading the Commission by asking it to agree there is probable recovery of this item in rates, when the Commission has a long history in AAO orders of stating specifically that it is not making any ratemaking findings.

Under GAAP, if MAWC defers these property tax expenses or any expenses to Account 186 and MAWC management makes a determination, based on all available evidence, that the deferred costs are probable of rate recovery, then MAWC can classify these deferred debits as a regulatory asset. MAWC's belief in probable recovery of these costs is the only circumstance in which a regulatory asset can be created outside of a ratemaking proceeding. If MAWC creates a regulatory asset other than under these circumstances, it may likely be in violation of GAAP and will be subject to scrutiny and possible sanctions from the Securities and Exchange Commission ("SEC").

5. **Even if it were possible for the Commission to grant an AAO that allows for the creation of a regulatory asset because of the probability of recovery MAWC has not presented evidence these costs are material or unusual.**

OPC witness John Riley's testimony addresses the fact that these expenses are routine and recurring utility operating expenses and are not extraordinary. Mr. Riley also addresses the materiality of these expenses to MAWC's annual net income. OPC does not consider increases in property taxes to be an extraordinary event under GAAP or NARUC USOA standards.

While OPC agrees these potential specific increases in expense were not directly included in MAWC's cost of service in its 2015 rate case, OPC believes MAWC is currently recovering these expenses under a generally accepted ratemaking theory sometimes referred to as "indirect rate recovery." This theory states that rates ordered by the Commission are reasonable until changed.

While it is true that if all other expenses and revenues determined in MAWC's 2015 rate case remain unchanged in 2017 (which is not likely) than one increase in one expense will cause a lower overall profit level. However, it is also probable that increases in revenues and/or decreases in other expenses will cause one specific expense increase to have no impact at all on profit levels. But, even if it did have an impact, the overall profit level earned (after all utility expenses have been recovered) may still be within a range of reasonable profit levels (equity returns) required by utility shareholders.

Finally, as described above, MAWC seeks Commission approval to defer these expenses as a regulatory asset on its balance sheet and let this asset "sit", unchanged, until MAWC has the opportunity to directly include an amortization of this asset in rates. This request is simply 1) a clear request for the Commission to make a ratemaking decision in this case, 2) contrary to Commission policy on regulatory asset amortizations, and 3) just overall bad ratemaking.

Commission discretion in the creation of a regulatory asset

Q. As opposed to an electric and natural gas utility that operate under a FERC USOA, does the National Association of Regulatory Utility Commissioners ("NARUC") USOA include a regulatory asset account?

A. No. I am not aware of any provision in the NARUC USOA for a water company to record a regulatory asset. There is a provision, however, for a water utility to record deferred expenses in Account 186, Miscellaneous Deferred Debits.

In contrast, however, the FERC's USOA includes account 182.3, *Other regulatory assets*, which allows for the utility to create a regulatory asset if the specific GAAP requirements are met. If the electric or natural gas utility management makes an independent determination that certain expenses incurred currently, if deferred, would be probable of rate recovery, the utility should record the deferral as a regulatory asset to Account 182.3.

Q. Is the essence of the difference between a regulatory asset and a deferred debit the "probability" of rate recovery?

A. Yes. Under both FERC and NARUC USOA's, deferred debits in account 186 have no association with the probability of rate recovery. However, once a utility management makes a determination that the deferred expenses are probable of future rate recovery, the deferred expenses then are no longer deferred debits, but regulatory assets. Because there is no regulatory asset account in NARUC USOA, this regulatory asset must remain in account 186. However, for electric and gas utilities, the deferred expenses would be transferred from account 186, *Miscellaneous deferred debits* to account 182.3, *Other regulatory assets.*

Q. Is it a discretionary matter for the Commission to issue an AAO granting the creation of a regulatory asset?

A. No. The Commission has great flexibility in AAO cases. It can reject the Application stating that it does not need to rule on the AAO request and it can also issue an AAO stating that it is authorizing the creation of a deferred debit, and not a regulatory asset, on a company's balance sheet. The Commission, when it grants deferral authority as a deferred debit in an AAO case should make it explicitly clear that the burden to determine whether or not the deferred expenses qualify as a regulatory asset is completely on utility management and the Commission is expressing no opinion whatsoever on any likelihood of future rate recovery.

Missouri utilities are required to follow GAAP

Q. What are the only two regulatory bodies, of which you are aware, that have promulgated general rules, standards and requirements for regulatory assets?

A. The only two entities are the FERC and the FASB. The FASB is overseen by the Securities and Exchange Commission. The FASB's requirements for regulatory assets are found primarily in Accounting Standards Codifications ("ASC") 980, *Regulated Operations.* ASC

980-340-25-1 (formerly paragraph 9 of Statement 71, *Accounting for the Effects of Certain Types of Regulation*).

Q. Is MAWC, like all other investor-owned Missouri regulated utilities required to follow and comply with the accounting requirements of GAAP?

A. Yes.

Q. Are there serious consequences for any Missouri regulated utility who does not comply with GAAP?

A. Yes. These consequences we previously explained to the Commission in the May 4, 2012 surrebuttal testimony of Ameren Missouri witness Mr. Stephen M. Ditman in Case No. EO-2012-0142. This testimony was also filed as Staff Exhibit No. 717 in Case No. EO-2015-0055.

At the time of his testimony Mr. Ditman was employed by PricewaterhouseCoopers (PwC") as the PwC engagement partner for the audits of the financial statements of Ameren Corporation and its subsidiary registrants, including Ameren Missouri. Also at the time of his testimony Mr. Ditman had 32 years of accounting and auditing experience with PwC. In his testimony Mr. Ditman defined GAAP as follows:

> GAAP are the set of rules, methods, processes and procedures used by companies across all industries in order to prepare standardized financial statements. Such standards exist to provide accurate and consistent financial information, across companies, to investors, creditors and others who rely on reporting companies' financial statements. GAAP allows the aforementioned parties to make meaningful comparisons.

Mr. Ditman explained to the Commission that the SEC requires all publicly traded companies (like Ameren, MAWC and other Missouri utilities) to adhere to GAAP to insure the comparability and consistency of financial information that is relied on by investors and

creditors. Accounting Standards Codifications, which are issued by the FASB, are the highest form of guidance in the GAAP hierarchy and must be followed. Mr. Ditman testified that PwC's duty as an independent auditor is to issue an opinion on whether the financial statements included within the SEC annual report (10-K) are free from material misstatement and in conformity with GAAP.

Q. What specifically did Mr. Ditman state about the consequences of not following GAAP standards?

A. At page 6 of his surrebuttal testimony, Mr. Ditman addressed the consequences if a company, such as MAWC, does not follow GAAP standards:

> Q. What are the consequences if the Company does not follow the standards?
>
> A. The Company would not obtain an unqualified opinion on its financial statements. An unqualified opinion provides the independent auditor's (such as PwC) judgment that the Company's financial records and statements are fairly and appropriately presented in accordance with GAAP. Without such unqualified opinion there are potential consequences from the SEC, investors, and others who rely on the Company's financial statements.

Q. Do you have another example where a professional accountant provided information to the Commission as the consequences of a utility not complying with GAAP?

A. Yes. On April 7, 2015, Ameren Missouri filed the surrebuttal testimony of Mr. Clifford Hoffman in Case No. EO-2015-0055. Mr. Hoffman retired after 38 years of experience from Deloitte LLP ("Deloitte") as an Audit Partner. Deloitte is a national public accounting, audit and consulting firm with a large public utility audit and accounting practice. In his testimony, Mr. Hoffman described his professional accounting experience as follows:

> I began my career with Deloitte in Minneapolis, Minnesota in July 1974. I was admitted to Partner in the audit practice in June 1985. I was a market leader for the utility industry in the Midwest. I have

> served many utilities as the audit Partner, including Black Hills Corporation, Connexus Energy, Great Plains Energy, Great River Energy, MDU Resources, NorthWestern Corporation and Otter Tail Corporation. As an audit Partner, it was my responsibility to ensure that Deloitte's audit opinions for the utility in question met all United States Securities and Exchange Commission ("SEC") requirements and to ensure that unqualified audit opinions were only issued if the utility's financial statements were prepared in accordance with Generally Accepted Accounting Principles ("GAAP") and SEC requirements. In addition, I served as the audit quality Partner (concurring reviewer) on numerous other utility audits. I retired from Deloitte in October 2012.

Mr. Hoffman described the requirements of GAAP and the consequences to a utility that failed to comply with GAAP:

> A material departure from GAAP could result in an earnings restatement initiated by the utility's Independent Auditors, the SEC or other regulatory groups (e.g., the Federal Energy Regulatory Commission). Failing to follow ASC 980-605-25 would be a material failure to follow GAAP. If the item were material (as here), the Company could also receive a qualified opinion on its internal controls (a "material weakness in internal controls") for its inability to properly apply GAAP.
>
> During my career I have never seen a regulated utility have a qualified opinion related to not conforming with GAAP. Put another way, in my opinion, no regulated utility of which I am aware would ever knowingly fail to follow GAAP, nor should it.
>
> Moreover, since the federal Sarbanes-Oxley Act was adopted (in 2002), it has been well understood that following GAAP is not only necessary to avoid a qualified audit opinion, but is necessary to comply with SEC requirements.
>
> Utility executives are required to provide in writing in their company's SEC Form 10Qs and Form 10Ks certifications as to the appropriateness of their financial statements and disclosures and to certify that they fairly present in all material respects, the operations and financial condition of the Company, which means they are certifying compliance with GAAP.

Regulatory Assets

Q. How does the FASB define regulatory assets under GAAP?

A. In November 2009, Deloitte published its *Energy & Resources 2009 Accounting, Financial Reporting and Tax Update* (See Schedule CRH-R-1). Deloitte prepared this document to assist companies with their financial, regulatory, and compliance reporting requirements.

Section 4 of this document, *An Analysis of the Application of ASC 980, Regulated Operations* ("Section 4") focused on the specialized industry accounting and reporting applied by energy companies. In Section 4, Deloitte defined regulatory assets and the standards and requirements of the FASB as it relates to regulatory assets. Section 4 summarizes the specialized industry reporting requirements for utilities included in the authoritative accounting literature.

> Regulatory Assets
>
> ASC 980-340-25-1 states that the "rate action of a regulator can provide reasonable assurance of the existence of an asset." All or part of an incurred cost that would otherwise be charged to expense should be capitalized as a regulatory asset if:
>
> 1. It is probable that future revenues in an amount approximately equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.
>
> 2. The regulator intends to provide for the recovery of that specific incurred cost rather than to provide for expected levels of similar future costs.
>
> ASC 980-10 requires a rate-regulated utility to capitalize as a regulatory asset an incurred cost that would otherwise be charged to expense if future recovery in rates is probable. Probable is defined in ASC 450-20, *Contingencies: Loss Contingencies* (Statement 5, *Accounting for Contingencies*), as "likely to occur," which is a high test to meet. Thus, ASC 980-340-25-1 has a continuous probability

standard to be met at each balance sheet date in order for a regulatory asset to remain recorded.

Q. What specific evidence should utility management obtain to determine the existence of a regulatory asset?

A. Evidence that a regulatory asset is probable of recovery is a matter of professional judgment of utility management based on the facts and circumstances of each case. Utility management's positive representation is required that each regulatory asset is probable of recovery in future rates.

Q. Has the SEC increasingly scrutinized documentation of the basis for recording regulatory assets?

A. Yes. I have reviewed several documents where SEC Staff has asked utilities to explain their basis for recording regulatory assets on their financial statements. The SEC Staff's focus has been how utility management made the determination that the deferred expenses are probable of future rate recovery. This increased scrutiny is also noted by Deloitte in Schedule CRH-R-1.

Q. Has the SEC staff unofficially suggested certain types of evidence that could support future recovery and corroborate a utility management's representation of the existence of a regulatory asset?

A. Yes. As noted on page 25 of Schedule CRH-R-1 the SEC Staff noted the following sources of potential evidence supporting the existence of a regulatory asset:

*Rate orders from the regulator specifically authorizing recovery of the costs in rates
*Previous rate orders from the regulator allowing recovery for substantially similar costs.
*Written approval from the regulator approving future recovery in rates
*Analysis of recoverability from internal or external legal counsel

Q. Can a Missouri utility obtain any degree of rate recovery assurance from an AAO issued by this Commission?

A. No. Deloitte, in Schedule CRH-R-1 at page 26 describes how in a few jurisdictions, accounting orders signed by the regulator may provide the same degree of assurance as a specific rate order. However, this is atypical and the level of assurance provided by an accounting order must be assessed on a jurisdiction-by-jurisdiction basis. Missouri is a jurisdiction that provides no assurance of recovery in a Commission AAO, therefore a Missouri utility should not obtain any degree of assurance of rate recovery from a Missouri Commission AAO.

Q. Did another accounting firm, PricewaterhouseCoopers' ("PwC") address this issue in its *2013 Guide to Accounting for Utilities and Power Companies*?

A. Yes. PwC provides a comprehensive list of the types of evidence a regulated utility could use to make the determination that certain deferred costs are "probable" of rate recovery and therefore eligible to be recorded as a regulatory asset. PwC concluded that different forms of evidence will provide varying degrees of support for the utility management's assertion that a regulatory asset is probable of recovery and not all forms of evidence will be sufficient in isolation or in combination to make such an assertion. Establishing probability of recovery is more difficult absent a rate order, especially when evaluating unusual or nonrecurring costs.

> Figure 17-4 Potential Sources of Evidence Supporting Cost Deferral as a Regulatory Asset
>
> Examples of forms of evidence to support the recognition of a regulatory asset may include:
> * The regulated utility receives a rate order specifying that the costs will be recovered in the future.
> * The incurred cost has been treated by the regulated utility's regulator as an allowable cost of service item in prior regulatory filings.
> * The incurred cost has been treated as an allowable cost by the same regulator in connection with another entity's filing.

* It is the regulator's general policy to allow recovery of the incurred cost.
* The regulated utility has had discussions with the regulator (as well as its primary intervener groups) with respect to recovery of the specific incurred cost and has received assurances that the incurred cost will be treated as an allowable cost (and not challenged) for regulatory purposes.
* The specific incurred cost (or similar incurred cost) has been treated as an allowable cost by a majority of other regulators and has not been specifically disallowed by the regulated utility's regulator.
* The regulated utility has obtained an opinion from outside legal counsel outlining the basis for the incurred cost being probable of being allowed in future rates.

PwC advised that prior to concluding that recognition of a regulatory asset is appropriate, a regulated utility should also consider other relevant factors, such as:

* The regulatory principles and precedents established by law
* The political and regulatory environment of the jurisdiction (e.g., does further regulation occur in the courts)
* The magnitude of the incurred costs to be deferred and the related impact on ratepayers if such costs are allowed (taking into account the length of the recovery period)
* Whether ratepayers or others may intervene in an attempt to deny recovery

Finally, PwC expressed doubt whether or not an accounting order (much the same as typically issued by the Commission in AAO cases) is sufficient evidence for a utility to record a regulatory asset. PwC suggests that an accounting order is just one type of evidence that can be obtained to record a regulatory asset and that obtaining an accounting order that only provides for deferral and "no assurance of rate recovery" does not provide sufficient evidence that rate recovery is probable.

Q. Please continue

A. At page 17-14 of its 2013 Guide to Accounting for Utilities and Power Companies, PwC noted:

> Question 17-5: Does an accounting order provide sufficient support for recognition of a regulatory asset or liability?
>
> PwC Interpretive Response: It depends. The best evidence for a regulatory asset is a rate order, but the timing of the regulatory process sometimes does not enable the regulated utility to obtain one prior to issuing financial statements. As a result, management and independent accountants may look for an accounting order or related precedent within the regulated utility's jurisdiction, which may indicate that the recovery of such costs in rates is probable.
>
> **Generally, an accounting order alone will not provide sufficient evidence to support the recognition of a regulatory asset. Reporting entities should exercise caution when placing reliance on accounting orders. An accounting order to amortize a regulatory asset or other cost with no impact on revenues does not provide the cause and effect relationship between costs and revenues required to create a regulatory asset.**
> **Similarly, an accounting order that indicates the costs may be deferred for consideration in a future rate case, with no assurance of recovery, does not provide sufficient evidence that future recovery is probable. (emphasis added)**
>
> If a regulated utility obtains an accounting order, it should assess whether a cause and effect relationship is achieved. An accounting order along with supporting evidence, such as historical precedence or an opinion from rate counsel, may provide adequate support for establishment of a regulatory asset if recovery of the specific cost in the future is probable.

Q. Has the Commission asked specific questions about the meaning of the word "probable" as stated in FERC's and FASB's definition of a regulatory asset?

A. Yes. For example on October 31, 2013 in an Oral Argument in Case No. EU-2012-0027, Chairman Hall asked a specific question about the meaning of the word "probable". The response to his question was that if the Commission has issued an AAO, the accounting community will say it's probable that the utility was going to be able to recover these costs in a future period. Chairman Hall was if the Commission issues an AAO, it meets the standards for accountants to recognize the deferred expenses on the books and records as a regulatory asset.

Q. Was the meaning of the word "probable" in the definition of a regulatory asset provided to Chairman Hall accurate?

A. No. Chairman Hall was advised that the Commission's AAO determines probability of future rate recovery and that an AAO determines whether or not a regulatory asset can be created. These statements are wrong and are wholly inconsistent with GAAP ASC 980 and the FERC USOA regulatory asset requirements.

Q. What should have been the response to Chairman Hall's question?

A. The response should have been that the word "probable" as used by GAAP and the FERC USOA means "likely to occur". The Commission should have been advised that "probable of rate recovery" is the standard that must be met by utility management before a utility is allowed by FASB and FERC (under ASC 980 and FERC USOA Account 182.3 and regulatory asset Definition 31) to create a regulatory asset. The Commission should have been advised that this "probable of rate recovery" language is a standard placed on utility management to meet. It is specifically not a burden for the Commission to meet, as Commission actions in an AAO case should have no impact on whether or not an expense deferral meets the FASB and FERC regulatory asset requirements.

Finally, the Commission should have been advised that a Commission AAO has no impact on whether or not an expense that is deferred as a regulatory asset is probable of rate recovery.

The Commission, if effect, makes this point perfectly clear when it points out in each AAO case that it is making no ratemaking determination.

FERC Requirements for a Regulatory Assets

Q. How does the FERC define regulatory assets and what requirements do the FERC apply to regulatory assets?

A. FERC defines regulatory assets in its USOA Definitions No. 30 and in its USOA account description of Account 182.3, *Other Regulatory Assets*:

> Definition No. 30.
> Regulatory Assets and Liabilities are assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains, or losses that would have been included in net income determination in one period under the general requirements of the Uniform System of Accounts but for it being probable: A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services; or B. in the case of regulatory liabilities, that refunds to customers, not provided for in other accounts, will be required.
>
> Account 182.3 Other regulatory assets.
> A. This account shall include the amounts of regulatory-created assets, not includible in other accounts, resulting from the ratemaking actions of regulatory agencies. (See Definition No. 30.) B. The amounts included in this account are to be established by those charges which would have been included in net income, or accumulated other comprehensive income, determinations in the current period under the general requirements of the Uniform System of Accounts but for it being probable that such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services….. D. The records supporting the entries to this account shall be kept so that the utility can furnish full information as to the nature and amount of each regulatory asset included in this account, including justification for inclusion of such amounts in this account. This conclusion is based on the matching principle, which

assigns costs to the periods in which benefits are expected to be realized.

Q. Is it clear that FERC has developed the accounting for regulatory assets based on GAAP's ASC 980 (formerly FAS 71)?

A. Yes, it is. While MAWC is not subject to the FERC's USOA, the FERC USOA describes from a regulated utility standpoint how to account for regulatory assets created under GAAP rules.

Q. Has FERC issued several orders describing its requirements and standards for regulatory assets, including the requirement that it is the utility's responsibility to determine the existence of a regulatory asset?

A. Yes. For example, in its Order Establishing PJM South, Subject to Conditions, in Docket Nos. ER04-829-000 and 001 at page 20, FERC stated:

> Notwithstanding the general accounting requirements for RTO related costs, the Commission's Uniform System of Accounts also provides that a regulatory asset is to be recognized when amounts otherwise chargeable to expense in the current period are to be recovered in rates in a future period.
>
> To qualify as a regulatory asset, there must be a showing both (i) that the costs at issue are unrecoverable in existing rates and (ii) that it is probable that such costs will be determined to be recoverable in future rates.
>
> Here, Dominion proposes to record costs associated with the start-up of PJM South, the start-up of the Alliance RTO, and certain administrative fees as a regulatory asset in Account 182.3.
>
> At this time, we cannot determine with certainty that all of the costs at issue are, in fact, unrecoverable in Dominion's current retail and wholesale rates or whether all such costs, if deferred, will ultimately be found, in a section 205 proceeding, to be recoverable in future rates.

> Therefore, Dominion must assess all available evidence bearing on the likelihood of rate recovery of these costs in periods other than the period they would otherwise be charged to expense under the general accounting requirements for costs, as discussed above. If based on such assessment, Dominion determines that it is probable that these costs will be recovered in rates in future periods, it should record a regulatory asset for such amounts. (Citations Omitted and Emphasis added)

Q. Is there a prior FERC case which addressed regulatory assets and the very issues with regulatory assets that are present in this MAWC AAO Application?

A. Yes. In its March 9, 2006 Brief For Respondent before the DC Court of Appeals, Nos. 05-1147, *et al. VIRGINIA STATE CORPORATION COMMISSION, et al. PETITIONERS, v. FEDERAL ENERGY REGULATORY COMMISSION* FERC made the following points to the court:

> Under Account 182.3 of the Commission's accounting regulations, "Other regulatory assets," public utilities are instructed that they "shall include the amounts of regulatory-created assets, not includible in other accounts, resulting from the ratemaking actions of regulatory agencies." 18 C.F.R. Part 101, Account 182.3. This accounting instruction refers to the definition, elsewhere in the regulations, of Regulatory Assets and Liabilities as assets and liabilities that result from rate actions of regulatory agencies.
>
> 1. Regulatory assets and liabilities arise from specific revenues, expenses, gains, or losses that would have been included in net income determination in one period under the general requirements of the Uniform System of Accounts but for it being probable: A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services (18 C.F.R. Part 101, Definitions, No. 30) See Uniform System of Accounts, 18 C.F.R. pt. 101, Definition 31A ("Regulatory Asset") (2015).

> 2. Under Definition No. 30 FERC explained that utilities may record certain of their costs as regulatory assets for accounting purposes where they "are both unrecoverable in existing rates and . . . it is probable that such costs will be recoverable in future rates."
>
> 4. FERC has made plain that "[t]he establishment of a regulatory asset account does not determine whether the Commission will permit the recovery of those costs, nor . . . affect in any way parties' rights to raise any argument regarding recovery of those costs"

AAO Cases and Commission Conflict

Q. In past Commission AAO cases has there existed a clear conflict between what utilities requested from the Commission and what relief the Commission was able to provide in an AAO?

A. Yes. As described above, the conflict is that utilities request the Commission order the creation of a regulatory asset. However, the creation of a regulatory asset means that the regulatory asset will be probable of future rate recovery. The Commission cannot both assert that deferred expenses is likely to be recovered in future rates (FASB definition of probable) and also assert that it is making no ratemaking determination in the AAO.

Q. Is the FERC's USOA, especially in the area of accounting for regulatory assets, based on and consistent with GAAP ASC 980 regulatory asset requirements?

A. Yes. Given the fact that MAWC must comply with ASC 980, a review of the FERC decisions on regulatory assets are directly relevant to MAWC.

Q. Does this conflict that exists at the Missouri Commission also exist at the FERC?

A. No. This conflict does not exist at the FERC in either FERC accounting or FERC ratemaking.

Q. Why does this conflict not exist at the FERC?

A. The reason is that, unlike the Missouri Commission, the FERC requires its jurisdictional utilities to make the decision to create a regulatory asset. Therefore, unlike the Missouri Commission, the FERC does not get involved in the decision on whether not the GAAP requirements (probability of rate recovery) of regulatory assets are met.

When the FERC created Account 182.3, *Other regulatory assets* in 1993, it stated that there are only two requirements for a utility to book costs as a regulatory asset. The requirements are that the expenses are 1) not being recovered in current rates and 2) utility management has determined, based on available evidence, such as past Commission rate case orders and/or policies, that this specific expense is probable of being granted rate recovery in the utility's next rate case. That is the basis of FERC account 182.3, Other Regulatory Assets and that is the basis of the requirements of a regulatory asset in ASC 980.

Q. In his direct testimony Mr. LaGrand states the AAO "will allow MAWC to record and defer these expenses on its books as a regulatory asset." Can MAWC use a Commission AAO as the basis to defer expenses as a regulatory asset?

A. No. I believe GAAP prohibits it from doing so. FERC bases its regulatory asset decisions on GAAP and FERC has made it clear on a number of occasions that it, the FERC, does not approve the creation of a regulatory asset in account 182.3. However, FERC states that if the expense deferral meets the requirements of ASC 980 (and its own FERC requirements based on ASC 980) then utility management must make the determination that the requirements are met and create a regulatory asset in account 182.3.

Q. Will FERC provide guidance when asked by a jurisdictional utility to provide input in a case addressing the existence of a regulatory asset?

A. Yes. But the FERC holds firm that it (the FERC) does not decide whether or not it is appropriate to create the regulatory asset. FERC puts that responsibility clearly and directly on the shoulders of utility management. By disassociating itself from the decision to record

the regulatory asset, FERC removes itself from the ratemaking determination that the costs in question are "probable" rate recovery in the next FERC rate case. This is how the process is supposed to work but it is not the process used in Missouri AAO cases.

Q. Have most of the Commission's prior AAOs for Missouri utilities been issued under the FERC's USOA?

A. Yes. While MAWC is required to comply with NARUC's USOA, both NARUC and the FERC's USOA are similar. The differences between the two are likely caused by the fact that FERC's 1993 USOA updates to reflect accounting for regulatory assets is not reflected in the latest NARUC USOA, which is dated 1973 and updated and revised through 1976.

Q. Is it impossible for the Commission to issue an AAO that confers any likelihood of future rate recovery while also making no ratemaking determination?

A. Yes, but the Commission has been and continues to be placed in this contradictory position in every AAO case filed by the Commission and by every AAO recommendation made by Staff and other parties to AAO cases. OPC recommends that the Commission make it very clear to the parties in this case and future AAO cases that the responsibility to create a regulatory asset is solely on utility management and any AAO issued (if it decides to issue an AAO) has no impact of the probability of future rate recovery or the creation of a regulatory asset.

Q. Are you stating that the Commission should dismiss all future AAO applications as unnecessary?

A. No. While the Commission certainly can take this position, and I believe it reasonable to take this position, this is not an OPC recommendation. OPC recognizes the Commission has the right to listen to accounting requests from utilities outside of a rate case and OPC does not suggest any limits on the Commission's discretion in this regard.

Q. Please list and state the titles of the schedules you are attaching to this testimony.

A. I am attaching the following schedules to my rebuttal testimony:

Schedule CRH-R-1
Deloitte Energy & Resources 2009 Accounting, Financial Reporting and Tax Update, Section 4, An Analysis of the Application of ASC 980, Regulated Operations (Statement 71, Accounting for the Effects of Certain Types of Regulation, as Amended and Interpreted) and Other Specialized Industry Accounting, pages 24-26.

Schedule CRH-R-2
PricewaterhouseCoopers LLP Guide to Accounting for Utilities and Power Companies, 2013, pages 17-12 through 17-15.

Schedule CRH-R-3
FERC Order on Rehearing, Dominion, Docket No. ER04-829-002

Schedule CRH-R-4
FERC Brief For Respondent US Court of Appeals for the Fourth Circuit, Nos 09-2052 and 09-2053 (Consolidated) February 9, 2010

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

Deloitte.

Energy & Resources 2009 Accounting, Financial Reporting and Tax Update

Section 4

An Analysis of the Application of ASC 980, *Regulated Operations* (Statement 71, *Accounting for the Effects of Certain Types of Regulation*, as Amended and Interpreted) and Other Specialized Industry Accounting

Introduction

This section summarizes the specialized industry reporting requirements for utilities included in the authoritative accounting literature.

Regulated Operations

ASC 980-10, *Regulated Operations: Overall* (Statement 71) provides guidance in preparing general-purpose financial statements for most utilities. ASC 980-10 (Statement 71) specifies criteria for its applicability by focusing on the nature of regulation rather than on specific industries. In general, the type of regulation covered by ASC 980-10 (Statement 71) permits rates to be set at levels intended to recover the estimated costs of providing regulated services or products, including the cost of capital. The cost of capital consists of interest and a provision for earnings on shareholders' investments.

ASC 980-10 (Statement 71) applies to general-purpose external financial statements of an enterprise that has regulated operations if all of the following criteria are met:

- The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
- The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
- In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

If some of a utility's operations are regulated and meet all of the above criteria, ASC 980-10 (Statement 71) should be applied to only that portion.

General Standards

ASC 980-10 (Statement 71) recognizes that a principal consideration introduced by rate regulation is the cause-and-effect relationship of costs and revenues — an economic dimension that, in some circumstances, should affect accounting for rate-regulated utilities. Thus, a rate-regulated utility should therefore capitalize a cost, as a regulatory asset, or recognize an obligation, as a regulatory liability, if it is probable that through the ratemaking process there will be a corresponding increase or decrease in future revenues.

Regulatory Assets

ASC 980-340-25-1 (paragraph 9 of Statement 71) states that the "rate action of a regulator can provide reasonable assurance of the existence of an asset." All or part of an incurred cost that would otherwise be charged to expense should be capitalized as a regulatory asset if:

- It is probable that future revenues in an amount approximately equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.

- The regulator intends to provide for the recovery of that specific incurred cost rather than to provide for expected levels of similar future costs.

An incurred cost is defined in ASC 980-10 (Statement 71) as "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and must be paid for." Equity return (or an allowance for earnings on shareholders' investment), however, is not an incurred cost that would otherwise be charged to expense.

ASC 980-10 (Statement 71) requires a rate-regulated utility to capitalize as a regulatory asset an incurred cost that would otherwise be charged to expense if future recovery in rates is probable. Probable is defined in ASC 450-20, *Contingencies: Loss Contingencies* (Statement 5, *Accounting for Contingencies*), as "likely to occur," which is a high test to meet. Thus, ASC 980-340-25-1 (paragraph 9 of Statement 71) has a continuous probability standard to be met at each balance sheet date in order for a regulatory asset to remain recorded. Also, see subsequent discussion of ASC 980-20-35, *Regulated Operations: Discontinuation of Rate-Regulated Accounting: Subsequent Measurement* (Emerging Issues Task Force (EITF) Issue 97-4, *Deregulation of the Pricing of Electricity – Issues Related to the Application of FASB Statements No. 71 and 101*), for additional considerations in determining the recoverability of regulatory assets. Additionally, costs that would otherwise be charged to other comprehensive income (OCI), and not to expense in determining net income, also qualify to be capitalized as a regulatory asset under ASC 980-10 (Statement 71) when the other requirements for recording a regulatory asset are met. The basis for this conclusion is primarily that OCI was not well developed when ASC 980-10 (Statement 71) was written. Absent OCI, the cost would be charged to expense for determining net income, and such amounts are charged to "comprehensive" income/expense. The SEC staff has concurred with this conclusion.

If a regulatory asset is recorded, but no longer meets the above criteria, the cost should then be charged below-the-line to other income and expense if the income statement is in a traditional utility format. See subsequent discussion in this Section on income statement presentation.

Evidence that a regulatory asset is probable of recovery is a matter of professional judgment based on the facts and circumstances of each case. Utility management's positive representation is required that each regulatory asset is probable of recovery in future rates. The SEC has increasingly scrutinized documentation of the basis for recording regulatory assets. The SEC staff has unofficially suggested that evidence that could support future recovery and corroborates utility management's representation includes:

- Rate orders from the regulator specifically authorizing recovery of the costs in rates

- Previous rate orders from the regulator allowing recovery for substantially similar costs.

- Written approval from the regulator approving future recovery in rates

- Analysis of recoverability from internal or external legal counsel

The best evidence of a regulatory asset is a rate order. However, the scheduling and length of the regulatory process sometimes does not enable an entity to obtain a rate order on a timely basis. As a result, a utility might obtain an "accounting order" or comparable form of communications from its regulator or the regulator's staff agreeing with the entity's proposed accounting for an incurred cost; even though such orders often include a qualifier that the letter guidance is not authoritative for ratemaking purposes. In a few jurisdictions, accounting orders signed by the regulator may provide the same degree of assurance as a specific rate order. However, this is atypical and the level of assurance provided by an accounting order must be assessed on a jurisdiction-by-jurisdiction basis, with particular focus on legal authority, who signs the accounting order, and historical regulatory precedents and practices.

Under guidance included in ASC 980-340-25-1 (EITF Issue 93-4, *Accounting for Regulatory Assets*), an incurred cost that does not meet the asset recognition criteria in ASC 980-340-25-1 (paragraph 9 of Statement 71) at the date the cost is incurred should be recognized as a regulatory asset when it meets those criteria at a later date. Under ASC 980-340-35-1 (paragraph 10 of Statement 71), as amended by ASC 360-10-35, *Property Plant and Equipment: Overall: Subsequent Measurement* (Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*), previously disallowed costs that are subsequently allowed by a regulator to be recovered, should be recorded as an asset, consistent with the classification that would have resulted had the cost initially been included in allowable costs. This provision applies to plant costs and regulatory assets created by actions of a regulator.

ASC 980-340-35-1 (paragraph 10 of Statement 71), as amended by ASC 360-10-35 (Statement 144), also concludes that a regulator can reduce or eliminate the value of an asset. If a regulator disallows recovery of part of a regulatory asset, that part of the asset is to be written off. Although special rules apply to disallowances of a recently completed utility plant, any write downs in the value of other assets are limited to the amount appropriate under U.S. GAAP.

Regulatory assets should be amortized over future periods consistent with the related increase in customer revenues.

Regulatory Liabilities

ASC 980-405-25-1 (paragraph 11 of Statement 71) also recognizes that the rate actions of a regulator can impose a liability on a rate-regulated utility, usually to its customers. The following are examples of ways in which regulatory liabilities can be imposed.

- A regulator may require refunds to customers.
- A regulator can provide provisions in rates for costs not yet incurred.
- A regulator can require that a gain be given to customers by amortizing amounts to reduce future rates.

ASC 980-405-40-1 (paragraph 12 of Statement 71) expands this idea that "actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator." Thus, a rate-regulated enterprise's balance sheet should include all liabilities and obligations that an enterprise in general would record under U.S. GAAP, such as for capital leases, pension plans, compensated absences, and income taxes. The SEC staff, in SAB 10F, *Utility Companies-Presentation of Liabilities for Environmental Costs*, clarified that such liabilities should not be offset with corresponding regulatory assets.

Regulatory liabilities should be amortized over future periods consistent with the related decrease in customer revenues.

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Guide to Accounting for Utilities and Power Companies

2013

Dear Clients and Friends:

PwC is pleased to offer this Guide to Accounting for Utilities and Power Companies. This guide provides accounting guidance for reporting entities in the utility and power industry to consider when preparing financial statements in accordance with accounting principles generally accepted in the United States of America.

We have organized this guide by topical area into 20 chapters. The chapters address a variety of accounting issues relevant for utilities and power companies and should be used as a supplement to U.S. GAAP and to the general accounting guidance provided by other PwC Guides. The chapters include accounting and financial reporting considerations in the following areas:

- Commodity contract accounting, including leasing and derivatives. Chapters relating to natural gas, emission allowances, and renewable energy credits are also included.

- Accounting for power-related investments including business combinations, investments in power plant entities, and consolidation of variable interest entities.

- Accounting for nonfinancial assets and liabilities including inventory, property, plant, and equipment, asset retirement obligations, and nuclear power plants. The accounting for government grants is also included.

- Accounting for regulated operations, including considerations relating to utility plant, income taxes, and business combinations.

Each chapter discusses the relevant accounting literature and includes specific questions and examples to illustrate application.

This guide has been prepared to support you as you consider the accounting for transactions and address the accounting, financial reporting, and related regulatory relevant to the industry. It should be used in combination with a thorough analysis of the relevant facts and circumstances and the authoritative accounting literature. We hope you find the information and insights in this guide useful. We will continue to share with you additional perspectives and interpretations as they develop.

PricewaterhouseCoopers LLP

entity arising from past events. The classification of these expenses as part of other comprehensive income instead of net income does not change their underlying nature.

Consistent with this conclusion, the SEC staff previously expressed the view that mark-to-market accounting for securities classified as available-for-sale should not render results on the balance sheet for unrealized gains or losses that are different from the impact of realized gains or losses. If future regulatory rates will be adjusted to reflect investment experience, then the impact of applying ASC 320 should have a corresponding impact to an associated regulatory asset or liability rather than adjusting earnings or other comprehensive income. We believe that this premise is also applicable to other types of amounts deferred in other comprehensive income.

Question 17-4: Are unrealized losses on derivative contracts considered incurred costs?

PwC Interpretive Response

Yes. We believe unrealized losses qualify as incurred costs because the losses are recognized within the carrying value of the derivative recorded on the balance sheet, and would be sustained by the reporting entity if the contract were to be terminated at the measurement date. Furthermore, we believe unrealized gains may represent a liability that should be returned to the ratepayer. The evaluation of unrealized gains and losses on derivatives should follow the conclusion reached for realized gains and losses on the related contracts. If a reporting entity concludes that commodity costs qualify for deferral under a regulatory mechanism, it should also defer unrealized gains and losses instead of immediately recognizing such amounts in income.

17.3.1.2 Recovery of the Incurred Cost Is Probable

In evaluating whether an incurred cost is eligible for deferral as a regulatory asset, a regulated utility should determine whether the cost is probable of being recovered through future revenue from rates that the regulator allows to be charged to customers.

> ASC 980-340-25-1(a)
>
> It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

Determining whether rate recovery of an incurred cost is probable is a matter of judgment. Management should carefully evaluate the preponderance and quality of all evidence available in reaching a probable conclusion. A specific rate order specifying the nature of the cost, as well as the timing and manner of recovery, generally provides the best evidence that recovery is probable. However, the nature of the regulatory process does not always allow a reporting entity to obtain a rate order prior to issuing financial statements. As a result, management should consider all relevant forms of evidence when assessing the appropriateness of recognition of a regulatory asset. Potential sources of evidence are summarized in Figure 17-4.

Figure 17-4
Potential Sources of Evidence Supporting Cost Deferral as a Regulatory Asset

Examples of forms of evidence to support the recognition of a regulatory asset may include:

- The regulated utility receives a rate order specifying that the costs will be recovered in the future.
- The incurred cost has been treated by the regulated utility's regulator as an allowable cost of service item in prior regulatory filings.
- The incurred cost has been treated as an allowable cost by the same regulator in connection with another entity's filing.
- It is the regulator's general policy to allow recovery of the incurred cost.
- The regulated utility has had discussions with the regulator (as well as its primary intervener groups) with respect to recovery of the specific incurred cost and has received assurances that the incurred cost will be treated as an allowable cost (and not challenged) for regulatory purposes.
- The specific incurred cost (or similar incurred cost) has been treated as an allowable cost by a majority of other regulators and has not been specifically disallowed by the regulated utility's regulator.
- The regulated utility has obtained an opinion from outside legal counsel outlining the basis for the incurred cost being probable of being allowed in future rates.

Different forms of evidence will provide varying degrees of support for management's assertion that a regulatory asset is probable of recovery; not all forms of evidence will be sufficient in isolation or in combination to make such an assertion.

Establishing probability of recovery is more difficult absent a rate order, especially when evaluating unusual or nonrecurring costs.

Prior to concluding that recognition of a regulatory asset is appropriate, a regulated utility should also consider other relevant factors, such as:

- The regulatory principles and precedents established by law
- The political and regulatory environment of the jurisdiction (e.g., does further regulation occur in the courts)
- The magnitude of the incurred costs to be deferred and the related impact on ratepayers if such costs are allowed (taking into account the length of the recovery period)
- Whether ratepayers or others may intervene in an attempt to deny recovery

Some regulated utilities have costs that may benefit customers in several jurisdictions. Because recovery is based on a regulator's action, separate consideration should be made as to the probability of recovery in each regulatory jurisdiction. If regulatory recovery cannot be supported across all jurisdictions

due to different rate structures or differing fact patterns, the regulated utility should establish a regulatory asset only for those amounts attributable to jurisdictions that meet the criteria for deferral.

Question 17-5: Does an accounting order provide sufficient support for recognition of a regulatory asset or liability?

PwC Interpretive Response

It depends. The best evidence for a regulatory asset is a rate order, but the timing of the regulatory process sometimes does not enable the regulated utility to obtain one prior to issuing financial statements. As a result, management and independent accountants may look for an accounting order or related precedent within the regulated utility's jurisdiction, which may indicate that the recovery of such costs in rates is probable. Generally, an accounting order alone will not provide sufficient evidence to support the recognition of a regulatory asset.

Reporting entities should exercise caution when placing reliance on accounting orders. An accounting order to amortize a regulatory asset or other cost with no impact on revenues does not provide the cause and effect relationship between costs and revenues required to create a regulatory asset. Similarly, an accounting order that indicates the costs may be deferred for consideration in a future rate case, with no assurance of recovery, does not provide sufficient evidence that future recovery is probable.

If a regulated utility obtains an accounting order, it should assess whether a cause and effect relationship is achieved. An accounting order along with supporting evidence, such as historical precedence or an opinion from rate counsel, may provide adequate support for establishment of a regulatory asset if recovery of the specific cost in the future is probable.

17.3.1.3 Recovery of Previously Incurred Costs

> ASC 980-340-25-1(b)
>
> Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

In evaluating deferral of an incurred cost, one of the key considerations is whether future revenue will be permitted to recover the past costs. A rate increase intended to recover future costs would not support deferral. Determining whether future revenue will be provided for recovery of previously incurred costs may require significant judgment. Factors to consider in assessing whether this criterion is met include:

- State regulatory history—What is the history of recovery of regulatory assets in the state? Have amounts been disallowed in the past? Is the regulator approving current rates at a level to recover current costs? If not, what

evidence supports that the regulator will authorize recovery within a reasonable time period?

- Projected costs—Are the regulated utility's costs expected to continue to increase? If costs continue to increase, is it probable that the regulator will be willing to approve sufficient rate increases to recover these past costs as well as current costs?

In particular, the regulated utility should consider whether there is a pattern of increasing costs and deferral of recovery to future periods. This may suggest that it will be difficult to recover the previously incurred costs through future rates, absent a rate order that specifies recovery.

17.3.2 Subsequent Measurement

Subsequent actions of a regulator can either reduce or eliminate the value of a previously recognized regulatory asset or, alternatively, may provide sufficient support for recognition of amounts previously expensed. Regulated utilities should reassess the probability of a recovery each reporting period, considering the impact of any changes or events during the period.

17.3.2.1 Subsequently Allowed Recovery

An incurred cost that does not meet the recognition criteria in ASC 980-340-25-1 at the date the cost is incurred should be recognized as a regulatory asset if and when it meets those criteria at a later date.

> ASC 980-340-35-2
>
> If a regulator allows recovery through rates of costs previously excluded from allowable costs, that action shall result in recognition of a new asset. The classification of that asset shall be consistent with the classification that would have resulted had those costs been initially included in allowable costs.

ASC 980-340-35-2 requires that a new asset be recorded for the amount that becomes allowed. Prior to the Codification, FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, paragraph B61 provided further guidance on the classification of the new asset, in part, as follows:

> The Board decided that previously disallowed costs that are subsequently allowed by a regulator should be recorded as an asset, consistent with the classification that would have resulted had those costs initially been included in allowable costs. Thus, plant costs subsequently allowed should be classified as plant assets, whereas other costs (expenses) subsequently allowed should be classified as regulatory assets. . . . The Board decided to restore the original classification because there is no economic change to the asset—it is as if the regulator never had disallowed the cost. The Board determined that restoration of cost is allowed for rate-regulated enterprises in this situation, in contrast to other impairment situations, because the event requiring recognition of the impairment resulted from actions of an

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

PJM Interconnection, L.L.C. and
Virginia Electric and Power Company

Docket Nos. ER04-829-002

ORDER ON REHEARING

(Issued March 4, 2005)

1. In this order, the Commission grants, in part, and denies, in part, rehearing of its October 5, 2004 Order,[1] in which we accepted, subject to condition, a joint proposal to establish PJM Interconnection, L.L.C. (PJM) as the Regional Transmission Organization (RTO) for Virginia Electric and Power Company (Dominion).[2]

Background

2. On May 11, 2004, as amended on July 16, 2004, PJM and Dominion (collectively the Filing Parties) submitted for filing an expansion proposal known as PJM South, which was generally modeled after PJM's prior expansions.[3] The Filing Parties' submission included, among other things, a joint proposal to allocate their respective

[1] *PJM Interconnection, L.L.C. and Virginia Electric and Power Company*, 109 FERC ¶ 61,012 (2004) (October 5 Order).

[2] Rehearing and/or clarification of the October 5 Order is sought by Dominion; Southeastern Federal Power Customers, Inc. (SEFPC); Virginia State Corporation Commission (Virginia Commission); Direct Energy Marketing, Inc. and Strategic Energy, L.L.C. (Direct Energy, *et al*.); Virginia Committee for Fair Utility Rates (Virginia Committee); the Division of Consumer Counsel of the Office of the Attorney General of Virginia (Virginia Consumer Counsel); and MeadWestvaco Corp. (MeadWestvaco).

[3] *See, e.g., PJM Interconnection, L.L.C. and Allegheny Power*, 96 FERC ¶ 61,060 (2001).

filing rights under section 205 of the Federal Power Act (FPA).[4] In addition, Dominion proposed to further condition its agreement to join PJM South on the Commission's approval of certain rate requirements. First, Dominion proposed that a license plate rate structure be approved for PJM South, consistent with PJM's existing rate design. Second, Dominion proposed to recalculate PJM's existing Border Rate (a rate frozen pursuant to a Commission-approved settlement) by incorporating Dominion's revenue requirement into PJM's existing weighted average rates and thus recalculating the Border Rate on a region-wide basis. Third, Dominion proposed that lost revenues not be recovered in connection with the establishment of PJM South – whether to compensate Dominion for its lost revenue attributable to its integration into PJM, or any other PJM transmission owner seeking to collect their own lost revenues within the Dominion Zone relating to their integration into PJM.

3. Dominion also sought approval to recognize as a regulatory asset certain costs related to the establishment and operation of PJM South, as well as the costs previously incurred by Dominion regarding its participation in the proposed Alliance RTO.[5] Dominion proposed to defer recovery of these costs until Virginia's retail rate cap expires in December 2010, at which time Dominion indicated that it would make a section 205 filing with the Commission. Dominion also identified as a condition to its agreement to join PJM South, acceptance of its market-based rates application in Docket No. ER04-834-000.[6] Finally, Dominion clarified that its proposed initial rates applicable to the PJM South zone would be the subject of a separate Phase II Filing, to be made prior to the implementation date of PJM South.[7]

4. In the October 5 Order, we accepted the Filing Parties' proposal to establish PJM South, subject to conditions. First, we accepted Dominion's proposal to utilize its current rate design with respect to the establishment of its initial rates, subject to PJM's revision

[4] 16 U.S.C. § 824d (2000).

[5] *See Alliance Companies, et al*., 97 FERC ¶ 61,327 (2001) (finding that the Alliance RTO, as proposed, lacked sufficient scope to exist as a stand-alone RTO).

[6] In an order issued September 16, 2004, we granted Dominion market-based rate authority. *See Virginia Electric Power Company*, 108 FERC ¶ 61,242 (2004).

[7] Dominion made its Phase II filing on October 28, 2004 in Docket No. ER05-87-000. Dominion's filing was subsequently accepted by the Commission subject to conditions. *See PJM Interconnection, L.L.C. and Virginia Electric and Power Company*, 109 FERC ¶ 61,302 (2004).

of its system-wide rate design in Docket No. EL02-111-004, *et al*.[8] We also addressed Dominion's request to recognize as a regulatory asset certain costs related to the establishment and operation of PJM South, as well as the costs previously incurred by Dominion regarding its participation in the proposed Alliance RTO.

5. However, we rejected Dominion's proposal to unilaterally alter PJM's Border Rate, given the fact that PJM's Border Rate is a jointly-filed rate applicable to any transaction that goes through or exits the PJM region. We also rejected the Filing Parties' proposed allocation of their future section 205 filing rights, specifically, the Filing Parties' proposal to vest, in Dominion, unilateral filing rights authority over rate design matters. We noted that PJM is a single integrated transmission system with system-wide rates and a single rate design. We further found that the PJM Transmission Owners recognized this fact in accepting the collective action requirements set forth in the PJM Transmission Owners Agreement at section 6.5.1.[9] We found that Dominion cannot both join PJM and yet retain its own independent authority to seek rate design changes. As such, we required Dominion to be bound by the terms of section 6.5.1.

6. Finally, we rejected Dominion's proposed exemption from PJM's lost revenue charges, but did so without prejudice. We found that Dominion's integration into PJM must be subject to the resolution of related issues in the Going Forward Principles and

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[8] *See Midwest Independent Transmission System Operator, Inc*., *et al*., 106 FERC ¶ 61,262 at P 1 (2004) (Order on Going Forward Principles and Procedures). Under the Going Forward Principles and Procedures, the PJM Transmission Owners agreed to develop and propose a long-term transmission pricing structure to apply throughout the combined PJM and Midwest Independent System Operator (Midwest ISO) regions, to be implemented on December 1, 2004.

[9] Section 6.5.1 provides as follows:

> The following actions of the [PJM Transmission Owners] shall require the concurrence of (i) representatives whose combined Individual Votes equal or exceed two-thirds of the total Individual Votes cast at a meeting, and (ii) representatives whose combined Weighted Votes equal or exceed two-thirds of the total Weighted Votes cast at a meeting . . . (e) Approval of changes in or relating to the establishment and recovery of the Transmission Owners' transmission revenue requirements, transmission rate design under the PJM [OATT], or any provisions governing the recovery of transmission-related costs incurred by the Transmission Owners in accordance with section 5.1.

Procedures proceedings, just as the rest of PJM will be. Accordingly, we found that Dominion, if it so chooses, may make or participate in a filing in the context of that proceeding.

Requests for Rehearing and Clarification

7. Dominion asserts as error our requirement, in the October 5 Order, that Dominion, as a condition to its membership in PJM, bind itself to the joint transmission owner filing requirements set forth at section 6.5.1 of the PJM Transmission Owners Agreement. Dominion argues that the Commission's finding ignores the fundamental holding in *Atlantic City Electric Co., et al v. FERC*.[10] Specifically, Dominion asserts that the Commission's requirement that Dominion waive its individual section 205 filing rights as a condition to its membership in PJM is neither compelled by, nor supported by, *Atlantic City*. Dominion argues that *Atlantic City* stands for the proposition that neither the Commission nor any third-party transmission owner or group of transmission owners can force a utility to cede its section 205 filing rights.

8. Dominion further argues that in relying on Dominion's proposed PJM-wide, joint Border Rate as a rationale for rejecting Dominion's filing rights proposal, the Commission ignored the fact that Dominion's proposal was primarily based on its interest in retaining its existing transmission rate over its own facilities. Dominion argues that these rates would not be joint rates.

9. Dominion also asserts as error the Commission's rejection of Dominion's requested conditions related to lost revenue recovery and its requirement that Dominion be subject to the long-term pricing structure currently pending in the Going Forward Principles and Procedures proceeding. Dominion argues that the Commission is not precluded from approving Dominion's proposed rate treatment for PJM South, as requested, and then separately dealing with the issues raised in the Going Forward Principles and Procedures proceeding as to the remainder of PJM. Dominion asserts that, by contrast, requiring Dominion to participate in the Going Forward Principles and Procedures proceeding at the eleventh hour, as part of the combined region, would be unfair to Dominion.

[10] 295 F.3d 1 (D.C. Cir. 2002) (*Atlantic City*).

10. A number of parties also assert as error the Commission's guidance regarding Dominion's proposed regulatory asset treatment covering its RTO start-up expenses and related costs.[11] These requests for rehearing and/or clarification are discussed in greater detail below.[12] Finally, SEFPC asserts as error the Commission's determination not to grandfather the rates it currently pays in conjunction with a long-term third party agreement with the Southeastern Power Administration (SEPA) for transactions that exit PJM South for subsequent delivery in the CP&L control area. SEFPC argues that the transmission service at issue is relatively small (76 MW) and otherwise analogous to the grandfathered treatment accorded in the October 5 Order to certain of Dominion's pre-Order No. 888, wholesale bundled contracts

Discussion

11. For the reasons discussed below, we will grant rehearing, in part, and deny rehearing, in part, of the October 5 Order. We will also require Dominion to make a compliance filing, within 30 days of the date of this order, addressing certain matters, as identified below.

A. Dominion's Proposed Division of its Section 205 Filing Rights

1. Filing Rights with Respect to Rate Design

12. We will grant rehearing, in part, regarding Dominion's filing rights allocation proposal as it relates to rate design matters. As noted above, Dominion asserts that the Commission erred in rejecting its proposal to reserve section 205 filing rights regarding Dominion's proposed license plate rate design. Dominion further asserts as error our requirement that Dominion adopt the rate design filing rights allocation provisions set forth at section 6.5.1 of the PJM Transmission Owners Agreement. Dominion maintains that it is not requesting authority to modify joint rates, but simply to retain section 205 filing rights with respect to the rates and rate design used to collect revenues from its own facilities. Dominion argues that the Commission's order rejecting that proposal violates

[11] *See* rehearing requests of the Virginia Commission, Direct Energy, *et al*.; the Virginia Committee; MeadWestvaco; and the Virginia Consumer Counsel.

[12] On November 19, 2004, Dominion filed an answer further addressing these issues. Rule 213(a) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 213(a)(2), prohibits an answer to a rehearing request, unless otherwise permitted by the decisional authority. We are not persuaded to accept Dominion's answer and therefore will reject it.

Atlantic City, because in *Atlantic City*, the court did not authorize the Commission, or a group of transmission owners, to limit the section 205 filing rights of a new member of the RTO relative to the rate design applicable to service regarding its assets.

13. We will grant rehearing, in part. In section 2.2.1 of the PJM South Transmission Owner's Agreement, Dominion reserved the right to file unilaterally under section 205 to change the rates and charges for transmission and ancillary services for delivery to the Virginia Power Zone. The PJM South Transmission Owner's Agreement also provides, however, that Dominion "shall not unilaterally file rates that do not preserve the revenues or payments due to other PJM Transmission Owners and shall not implement rates that result in a customer paying PJM more than one transmission access charge."

14. The Commission has accepted filing rights allocations by the PJM East and PJM West Transmission Owners that have allocated the filing rights among their members. As the Commission made clear in its September 28, 2004 Order accepting the PJM West's Transmission Owners Agreement, the transmission owners, pursuant to their agreement, cannot affect the rates or terms and conditions of the PJM East transmission owners without their consent.[13] The Commission, in fact, required that with respect to the transmission rate design for the PJM region, such changes will have to be approved by both sets of transmission owners. In addition, Dominion has recognized that the Commission retains its authority to revise Dominion's rate design, or a proposed change to Dominion's rate design, under the Commission's section 206 authority.

15. The PJM South Transmission Owner's Agreement also provides that any section 205 filings made by Dominion will be limited to rates for its own facilities and cannot affect the revenues or payments to the other transmission owners, or rate design of the other transmission owners. Therefore, the Commission finds this provision generally acceptable.

16. Dominion's filing rights allocation provision, however, is unclear as to whether Dominion may file to change rate designs applicable to the PJM region as a whole. Accordingly, consistent with the *PJM West Order*, we direct Dominion to make a compliance filing within 30 days of the date of this order making clear that it does not have a unilateral right to file for transmission or ancillary service rate design changes that would affect the overall PJM rate design without receiving the consent of the PJM transmission owners to whom this rate design would apply.

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[13] *PJM Interconnection, L.L.C.*, 108 FERC ¶ 61,318 at P. 69-70 (2004) (*PJM West Order*).

2. Border Rate

17. We will deny Dominion's request for rehearing as it relates to Dominion' Border Rate proposal. Dominion contends that its proposal with respect to the Border Rate was not to change the design of that rate, but only to include its data in the calculation of the rate. Dominion maintains that its proposal to include its data in the Border Rate did not require approval by the other PJM transmission owners. Dominion refers, without citation, to statements by the other transmission owners that a new transmission owner could file, without receiving approval from the other transmission owners, to revise the Border Rate schedules (Schedules 1A, 7, and Attachment H).

18. Dominion does not provide a citation to the purported statement that the PJM transmission owners approved of a filing to change the Border Rate, without their approval pursuant to the provisions of the transmission owner's agreement and PJM's tariff. Unlike other new transmission owners,[14] Dominion did not seek specific approval of the PJM transmission owners before filing its proposed change to the Border Rate, and, in fact, the other transmission owners have not supported it.

19. As we noted in the October 5 Order, the PJM tariff reflects only a single Border Rate, and does not contain a formula into which Dominion's data could be inserted to calculate a new Border Rate. In the absence of such a formula in the tariff specifying how a new transmission owner's data should be incorporated, Dominion has failed to show that either under *Atlantic City* or the FPA, it has the right to file unilaterally to modify a rate charged jointly with another utility. We will deny rehearing with respect to this issue.

20. In the underlying orders addressed in *Atlantic City*, the transmission owners within PJM initially agreed on a procedure for changing rate design and other tariff terms for transmission service, which the Commission rejected. In its place, the Commission substituted a provision that would have required that all changes in transmission rates and rate design would have to be approved by the independent PJM Board. The Court ruled that the Commission did not have statutory authority under either sections 205 or 206 to require that the transmission owners relinquish their section 205 filing rights. In that regard, the court emphasized that utilities can file to initiate rate changes with respect to services provided with their own assets.

[14] *See* PJM Interconnection, L.L.C. and Commonwealth Edison Co. Filing to Integrate with PJM, Docket No. ER04-367-000, n.1 (Dec. 31, 2003) (PJM transmission owners approved the revision to the Border Rate).

21. The court's analysis and discussion, however, were limited to the Commission action before it, *i.e.*, the Commission's initial determination to overturn a filing rights allocation proposal to which the transmission owners had agreed. The court in *Atlantic City* recognized that "utilities may choose to voluntarily give up, by contract, some of their filing freedom under section 205."[15] The court did not address the situation we are presented with here in which transmission owners have not agreed to an allocation of filing rights and one utility seeks to file under section 205 to revise the rate for services provided by another utility using its own assets.

22. However, in this case, the other utilities comprising PJM (whose rates Dominion is seeking to change) have not authorized Dominion to make a section 205 filing to change their Border Rate. Under these circumstances, Dominion cannot cite to any provision under the FPA which would permit one utility to use section 205 to change the rate of another utility. Under the FPA, attempts by one utility to change the rate of another utility must be made pursuant to section 206, together with a showing that the existing rate of the other utility is unjust or unreasonable.

23. Moreover, Dominion's own tariff filing would not permit a filing to change the PJM Border Rate, absent approval of the other PJM transmission owners. Section 2.2.1 of the PJM South Transmission Owner Agreement states that Dominion does not have authority to file rates that do not preserve the revenues or payments due to other PJM transmission owners. A filing that would change the single Border Rate within PJM could have just such an effect, even if it is limited to a filing seeking only to add Dominion's costs to the rate. For instance, if such a filing increased the rate, and so reduced the volume of such border transactions, Dominion's filing could reduce the revenues to other transmission owners. Dominion could of course file under section 206 claiming that the existing PJM Border Rate is unjust and unreasonable without the inclusion of its costs, but it simply cannot reserve the right under section 205 to make a rate filing that revises other transmission owners' rates.

B. Dominion's Requested Conditions Regarding Lost Revenues

24. We will deny rehearing of the October 5 Order regarding our determination not to consider, in this proceeding, Dominion's proposed exemption from PJM's lost revenue charges. PJM's lost revenue charges are the transitional charges recovered by PJM's transmission owners in connection with their elimination of through-and-out rates.

[15] 295 F.2d at 10.

Absent these transitional mechanisms, the revenue requirement of each transmission owner would be borne solely by the customers within each transmission owner's zone under PJM's existing license plate rate design and thus result in cost shifts.

25. In the October 5 Order, we noted that issues relating to PJM's existing lost revenues recovery mechanisms are currently pending in another proceeding, *i.e.*, in Docket No. EL02-111-004, *et al*. (PJM's Going Forward Principles and Procedures proceeding).[16] We also noted that if Dominion so chooses, it may make or participate in a filing in the context of that proceeding.

26. Subsequently, in an order issued November 18, 2004, in Docket Nos. ER05-6-000, *et al*., we found, under section 206, that a region-wide license plate rate design coupled with an appropriate transition mechanism to recover lost revenues represented a reasonable approach to pricing transmission service within PJM's expanded markets.[17] Dominion is a party to that proceeding and has, in fact, sought clarification and/or rehearing of that determination, as it would apply to the Dominion Zone, on much the same grounds it has raised here. Dominion's only request in this proceeding is to be exempt from having to pay the lost revenue recovery charge established in Docket Nos. ER05-6-000, *et al*.[18] That issue must be litigated in the proceeding in which the terms for payment of the rate was established, rather than in this collateral proceeding.

27. We also reject Dominion's assertion that it is being denied due process by being subjected to the lost revenue recovery mechanism approved in another proceeding, *i.e.*, in Docket No. ER05-6-000, *et al.*, Dominion claims that it did not have an opportunity to participate in that proceeding prior to the issuance of the November 18 Order. In fact, however, Dominion was aware of these proceedings and could have participated as an active party to the extent necessary to protect its interests. Indeed, the Chief Administrative Law Judge (ALJ) assigned to that proceeding specifically invited

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[16] *See Midwest Independent Transmission System Operator, Inc*., 106 FERC ¶ 61,262 (2004).

[17] *See* Midwest Independent Transmission System Operator, Inc., 109 FERC ¶ 61,168 (November 18 Order), *order granting clarification*, 109 FERC ¶ 61,243 (2004), *reh'g pending.*

[18] Such a filing is in the nature of a request for a declaratory order that a rate imposed by the Commission under section 206 should not be applied to Dominion. Such a determination should be made in the still-open docket addressing this issue, rather than in another docket with different parties.

Dominion to participate and Dominion declined.[19] Dominion's rights have been preserved since it is a party to the ER05-6-000 proceeding, and has sought rehearing of that order on precisely the grounds asserted here.

C. Dominion's Proposed Regulatory Asset Treatment For Its RTO Start Up Costs and Related Expenses

1. The October 5 Order

28. In the October 5 Order, we addressed Dominion's request to record, as a regulatory asset, and defer recovery of $279.4 million, plus carrying costs, in RTO start-up costs and PJM administrative fees (collectively, RTO Costs) until the expiration of Virginia's capped retail rates. First, we noted that the Commission's Uniform System of Accounts provides that a regulatory asset should be recognized when amounts otherwise chargeable to expense in the current period are to be recovered in rates in a future period. We explained that to qualify as a regulatory asset, a two-pronged showing was required: (i) that the costs at issue are unrecoverable in existing rates; and (ii) that it is probable that such costs will be determined to be recoverable in future rates.

29. We found, however, that we could not determine with certainty that all of the costs that Dominion seeks to defer are, in fact, unrecoverable in Dominion's current retail and wholesale rates or whether all such costs, if deferred, will ultimately be found, in a section 205 proceeding, to be recoverable in future rates. Accordingly, we found that Dominion must assess all available evidence bearing on the likelihood of rate recovery of

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[19] In an order issued June 4, 2004, the ALJ stated as follows:

> The [ALJ] was . . . advised that pursuant to the Joint Application, Dominion proposed to transfer operational control over [its] transmission system to PJM on November 1, 2004, and come under the PJM Tariff. As a result of the PJM South filing, it appears to the [ALJ] that it would be in the direct interest of Dominion to begin immediate participation with the other Transmission Owners in the Combined Region in their efforts to develop a permanent long-term solution to the elimination of seams, since Dominion's transmission system will become part of the Combined Region upon [its] integration into PJM.

See "Order of Chief Judge Inviting Dominion Virginia Power to Participate in Settlement Proceedings," Midwest Independent Transmission System Operator, Inc., Docket Nos. EL02-111-004, *et al*. (June 4, 2004).

these costs in periods other than the period they would otherwise be charged to expense under the general accounting requirements for costs. We noted that if, based on such assessment, Dominion determines that it is probable that these costs will be recovered in rates in future periods, it should record a regulatory asset for such amounts.

2. Requests for Rehearing and Clarification

30. On rehearing, the Virginia Consumer Counsel argues that in permitting Dominion to book its RTO costs as regulatory assets (without even a threshold determination by the Commission regarding the eligibility of these costs as regulatory assets), the October 5 Order violated the Commission's own regulations. Specifically, the Virginia Consumer Counsel argues that Part 101 of the Commission's regulations define "Regulatory Assets and Liabilities" as "assets and liabilities that result from the *rate actions* of regulatory agencies."[20] The Virginia Consumer Counsel argues that contrary to this express requirement, the October 5 Order allows Dominion to make its own unilateral determination regarding both the category and the amount of costs (including carrying costs) it may record on its books as a regulatory asset.

31. The Virginia Consumer Counsel also notes that while the October 5 Order correctly identifies the two-pronged standard applicable to the recovery of a regulatory asset, the Commission nonetheless erred in its determination that it would not (and could not) assess whether this test has been satisfied by Dominion. The Virginia Consumer Counsel argues that this holding represents a clear divergence from Commission precedent, citing *Midwest Independent Transmission System Operator, Inc*.[21] The Virginia Consumer Counsel submits that in the *Midwest ISO Orders*, the Commission states that its two-prong test must be satisfied in the form of a section 205 filing made by the transmission owner as a prerequisite to the recordation of the regulatory asset that is requested.

32. MeadWestvaco asserts that the cases relied upon by Dominion in support of its regulatory asset request do not support that request. MeadWestvaco asserts that in *Florida Power Corp.*[22] and *American Electric Power Service Corp.*,[23] for example, the

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[20] *See* 18 C.F.R. Part 101 at def. 30 (2004) (emphasis added).

[21] 103 FERC ¶ 61,205 (2003). *See also Midwest Independent Transmission System Operator, Inc*., 102 FERC ¶ 61,279, *order on reh'g*, 106 FERC ¶ 61,337 (2004) (collectively, *Midwest ISO Orders*).

[22] Unpublished Letter Order, Docket No. AC01-10-000 (December 14, 2004).

deferral period at issue corresponded to the integration date and/or start-up of the RTO, consistent with the Commission's "matching principle."[24] Direct Energy, *et al*. make a similar argument, pointing out that under the October 5 Order, the Commission violates the matching principle.

33. The Virginia Committee also seeks rehearing with respect to these determinations. The Virginia Committee points out, among other things, that Dominion should not be permitted to have its cake and eat it too – to both support "capped rates" intended to recover all of its costs before the Virginia Commission and then claim to this Commission that these very same costs now require regulatory asset treatment. The Virginia Committee asserts that this request is particularly inappropriate where, as here, Dominion has not even attempted to show that these costs are in fact unrecoverable in its capped rates.

34. Direct Energy, *et al*. submit that in examining the just and reasonableness of Dominion's RTO costs, cost decreases as well as cost increases should be considered over the relevant period. The Virginia Commission makes the same argument, pointing out that an examination of Dominion's overall earnings suggests that Dominion is currently over recovering its costs. Direct Energy, *et al*. further argue that to the extent Dominion seeks to recover any costs, it must first make a rate filing and seek approval of these rates. Direct Energy, *et al*. point out that should the recovery of those rates be threatened by the inability to recover these costs at the retail level, Dominion's recourse should not be the establishment of a regulatory asset. Rather, Direct Energy, *et al*. submit that any such dispute should be brought before an appropriate court on federal preemption grounds.

35. The Virginia Commission questions Dominion's ability to satisfy the first prong of the Commission's two-prong regulatory asset test, *i.e.*, whether Dominion can show that its RTO related costs cannot be recovered in its existing rates. The Virginia Commission asserts that were the Commission to accept Dominion's costs in the form of a rate revision, there is a mechanism in place for these costs to be reflected in the transmission component of Dominion's unbundled retail rates. Specifically, the Virginia Commission asserts that under Dominion's retail rate cap, the transmission component of Dominion's rate is permitted to rise or fall during the rate cap period, subject to a corresponding adjustment in the wires charge or distribution rate.

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[23] 104 FERC ¶ 61,013 (2003).

[24] Under the Commission's matching principle, costs are to be assigned to the periods in which the related benefits are expected to be realized.

36. The Virginia Commission also argues that Dominion initially expensed all of its Alliance RTO start-up costs in its retail rates and recovered these costs under its capped rates. The Virginia Commission adds that notwithstanding Dominion's subsequent reversal of these entries at the time it declared its proposed regulatory asset treatment, these costs were clearly "recoverable."

37. Finally, the Virginia Commission asserts that the October 5 Order erred in not finding that Dominion's Alliance RTO start-up costs incurred after the Commission directed the Alliance Companies to implement an independent board were not prudently incurred because the Alliance Companies never complied with that requirement. The Virginia Commission concludes that the Commission erred in not denying Dominion recovery of these costs.

3. Commission Ruling

38. We deny rehearing of the October 5 Order regarding Dominion's proposed regulatory asset treatment of its RTO Costs. In acknowledging Dominion's request to record its claimed RTO Costs as a regulatory asset, the October 5 Order made no finding regarding the ultimate justness or reasonableness of these costs. Such findings can only be made at the time that Dominion makes its section 205 filing seeking to recover such costs in its rates.

39. The guidance provided in the October 5 Order regarding the proper accounting and recordation of a regulatory asset was procedural in nature and thus without prejudice to any party seeking to challenge the subsequent recoverability of these costs in a future rate case. In providing this guidance, the Commission did not violate Part 101 of its regulations. Those regulations provide for the booking of certain costs as a regulatory asset where it is "probable that such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services."[25]

40. These regulations require that Dominion, not the Commission, make the determination based on generally accepted accounting principles. This means that Dominion must support its determination with relevant, reliable evidence demonstrating that it indeed meets the criteria for recognition of a regulatory asset discussed *supra* at the time it makes the initial determination, each accounting period thereafter, and when it makes its section 205 filing.

[25] *See* 18 C.F.R. § Part 101 at section 182.3 (2004).

41. Moreover, our ruling on the regulatory asset treatment is consistent with our rulings in the *Midwest ISO Orders*. In the *Midwest ISO Orders*, we made no finding regarding the recoverability of a regulatory asset because there was no such rate proposal before us. Instead, we provided guidance applicable to any transmission owner seeking to recover a regulatory asset in its rates. We stated, for example, that our accounting rules require "a utility to recognize a regulatory asset where it [the utility] determines it is probable that a cost that would otherwise be charged to expense in one period will be recovered in rates in another."[26] We also stated that "any party desiring to recover [its claimed costs] in rates other than the period in which they would ordinarily be charged to expense must submit a filing demonstrating that their retail rates in effect applicable to that period and a rate plan for recovery of them in a different period."[27] For all these reasons, we will deny rehearing of the October 5 Order as to this issue.

D. SEFPC's Request for Grandfather Rates

42. As noted above, SEFPC requests that the rates it currently pays Dominion for transactions that exit the Dominion Zone, for subsequent delivery in the CP&L control area, be frozen at their current level and thus not be required to pay a through-and-out rate (PJM's Border Rate) until such time as a seams agreement can be developed between CP&L and Dominion. SEFPC argues that the transmission service at issue is relatively small (76 MW) and otherwise analogous to the grandfathered treatment accorded in the October 5 Order to certain of Dominion's pre-Order No. 888, wholesale bundled contracts.

43. We will deny SEFPC's request for rehearing. SEFPC requests, in effect, that it be granted a preferential rate for its transactions that exit PJM, based on the needs and circumstances relating to its third-party contractual obligations. However, as we held in the October 5 Order and reiterate here, SEFPC has not demonstrated that PJM's region-wide Border Rate is unjust or unreasonable, nor is the instant proceeding the appropriate forum in which to consider a region-wide rate issue.

44. We also cannot agree that the rate exemption SEFPC seeks is warranted or otherwise lawful. First, this proposed exemption cannot be justified based on the grandfathered rate treatment accorded to certain of Dominion's wholesale bundled contracts. As we have held in the past, a public utility seeking to join an RTO is not

[26] *See* 106 FERC ¶ 61,337 at P 13.

[27] Id. at P 15.

required to terminate or abrogate its pre-existing contracts.[28] Similarly, with respect to SEFPC's contract, Dominion is not seeking to abrogate its contractual rights. Finally, SEFPC cannot claim a right to amend its agreement, based on the express right given to Dominion to seek a rate revision. Dominion's right is within the scope of the business risk SEFPC assumed when in entered into the agreement, but does not implicate or otherwise justify SEFPC's request.

The Commission orders:

(A) Rehearing of the October 5 Order is hereby granted, in part, and denied, in part, as discussed in the body of this order.

(B) Dominion is hereby required to make a compliance filing within 30 days of the date of this order, as discussed in the body of this order.

By the Commission.

(S E A L)

Linda Mitry,
Deputy Secretary.

[28] *PJM Interconnection, L.L.C.,* 109 FERC ¶ 61299 (2004).

Nos. 09-2052 and 09-2053 (Consolidated)

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In the United States Court of Appeals for the Fourth Circuit

OFFICE OF THE ATTORNEY GENERAL OF VIRGINIA, DIVISION OF CORPORATION COUNSEL, *et al*.
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL ENERGY REGULATORY COMMISSION

BRIEF FOR RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

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FEBRUARY 9, 2010

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TABLE OF CONTENTS

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

ADMINISTRATIVE CASES:

TABLE OF AUTHORITIES

ADMINISTRATIVE CASES: **PAGE**

STATUTES:

REGULATIONS:

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OFFICE OF THE ATTORNEY GENERAL OF VIRGINIA, DIVISION OF CONSUMER COUNSEL, *et al*., PETITIONERS,

v.

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ON PETITIONS FOR REVIEW OF ORDERS OF THE FEDERAL ENERGY REGULATORY COMMISSION

BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

STATEMENT OF THE ISSUE

Whether the Federal Energy Regulatory Commission (FERC or Commission) reasonably approved the recovery of costs of Virginia Electric and Power Company, doing business as Dominion Virginia Power (Dominion), related to Dominion's joining and participating in a FERC-approved Regional Transmission Organization (RTO), where such costs were prudently-incurred

wholesale costs which under Commission policy were fully recoverable in Dominion's wholesale rates.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

COUNTER-STATEMENT OF JURISDICTION

Petitioners, the Office of the Attorney General of Virginia, Division of Consumer Counsel, and the Virginia State Corporation Commission (collectively the Virginia Parties) invoke this Court's jurisdiction under Federal Power Act (FPA) § 313, 16 U.S.C. § 825*l*(b). However, as discussed in Argument Section II (B)(2) below, the Court lacks jurisdiction to hear the Virginia Parties' arguments that the Commission improperly failed to distinguish between RTO start-up costs and RTO administrative costs for purposes of Dominion's rate recovery (Br. 26-27, 29-30), as the Virginia Parties did not make these arguments on rehearing before the Commission, as 16 U.S.C. § 825*l*(b) requires.

On rehearing (*see* Virginia Parties' Rehearing Requests at JA 197-241), the Virginia Parties argued that the Commission should disapprove recovery of *all* of Dominion's deferred RTO costs -- which included both RTO start-up costs and RTO administrative costs -- without distinguishing in any manner between the two categories. The Virginia Parties made no argument whatsoever to the

Commission, as they do now to this Court, that RTO administrative costs could or should be treated any differently than are RTO start-up costs.

Having failed to argue on rehearing that RTO start-up costs and RTO administrative costs could or should be treated differently, the Virginia Parties cannot now be heard to argue that FERC erred in failing to make such a distinction. As this Court has recognized, its review of FERC orders "is limited by 16 U.S.C. § 825*l*, which provides, 'No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure to do so.'" *Mt. Lookout-Mt. Nebo Property Protection Ass'n v. FERC*, 143 F.3d 165, 173 (4th Cir. 1998). Therefore, the Virginia Parties' claims based upon the distinction between RTO administrative and RTO start-up costs are jurisdictionally barred.

STATEMENT OF THE CASE

On September 12, 2008, Dominion filed under FPA § 205, 16 U.S.C. 824d, to recover certain categories of Regional Transmission Organization costs, including costs incurred in the (unsuccessful) development of the Alliance RTO, costs incurred to join the PJM Interconnection, L.L.C. (PJM) RTO, and PJM RTO administrative fees. Dominion had deferred collection of these costs pending

expiration of a retail rate freeze that precluded passing on to retail ratepayers their share of the RTO costs incurred.

In the challenged Orders, the Commission permitted Dominion's requested cost recovery, finding that the costs Dominion sought to recover were wholesale costs, subject to FERC jurisdiction, that were fundamentally related to Dominion's efforts to participate in an RTO. *Virginia Electric and Power Co*., 125 FERC ¶ 61,391 (2008) (Tariff Order), *on reh'g*, 128 FERC ¶ 61,026 (2009) (Rehearing Order). Under Commission policy, recognizing the role that RTOs play in the development of competitive electricity markets, the Commission permits transmission owners such as Dominion to recover through special surcharges their costs in seeking to join an RTO, as well as their ongoing administrative fees related to their participation in the RTO.

On rehearing, the Virginia Parties argued that the Commission's approval of the deferred cost recovery constituted retroactive ratemaking as it adjusted prospective rates to make up for an alleged shortfall in prior rates. The Virginia Parties also asserted that, prior to approving recovery of these deferred costs, the Commission was required: (1) to find that Dominion had not already received sufficient retail revenues during the retail rate freeze to cover the RTO costs; and (2) to find that Dominion was legally unable to pass through the RTO costs to retail ratepayers at the time they were incurred.

The Commission rejected these contentions. Recovery of the deferred costs did not constitute retroactive ratemaking because the costs were not incurred for past service; rather, the costs were being charged to customers at the time they were enjoying the benefits of RTO participation, and ample notice had been provided to ratepayers that these deferred costs may be subject to recovery in the future. The Virginia Parties proffered no evidence that Dominion had already recovered these costs in its retail rates, which were frozen under state law prior to the time that the RTO costs were incurred. In any event, the question of whether Dominion had already received sufficient revenues under its retail rates to cover these costs, or whether state law permitted Dominion to pass through these costs to retail ratepayers during the retail rate freeze, were state law questions of retail rate recovery beyond the Commission's statutory authority.

STATEMENT OF FACTS

I. ORDER NO. 2000

In its Order No. 2000,[1] the Commission encouraged the voluntary interconnection and coordination of transmission facilities into regional districts by utilities "for the purpose of assuring an abundant supply of electric energy through the United States with the greatest possible economy." Order No. 2000 at 31,039.

[1] *Regional Transmission Organizations*, Order No. 2000, FERC Stats. & Regs. ¶ 31,089 (1999), *on reh'g*, Order No. 2000-A, FERC Stats. & Regs. ¶ 31,092 (2000), *petitions for review dismissed*, *Public Util. Dist. No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

The Commission explained the benefits RTOs provide for consumers:

> Regional institutions can address the operational and reliability issues now confronting the industry, and eliminate any residual discrimination in transmission services that can occur when the operation of the transmission system remains in control of a vertically integrated utility. Appropriate regional transmission institutions could: (1) improve efficiencies in transmission grid management; (2) improve grid reliability; (3) remove remaining opportunities for discriminatory transmission practices; (4) improve market performance; and (5) facilitate lighter handed regulation. Thus we believe that appropriate RTOs could successfully address the existing impediments to efficient grid operation and competition and could consequently benefit consumers through lower electricity rates resulting from a wider choice of services and service providers. In addition, substantial cost savings are likely to result from the formation of RTOs.

Id. at 30, 993. As the Supreme Court recently explained, the Commission has undertaken various initiatives in recent years "to break down regulatory and economic barriers" and "to reduce technical inefficiencies caused when different utilities operate different portions of the grid independently," most notably by "encourage[ing] transmission providers to establish 'Regional Transmission Organizations' – entities to which transmission providers would transfer operational control of their facilities for the purpose of efficient coordination." *Morgan Stanley Capital Group v. Pub. Util. Dist. of Snohomish County*, 128 S. Ct. 2733, 2740-41 (2008).

To encourage RTO development and participation, Order No. 2000 directed transmission-owning utilities (like Dominion) either to participate in an RTO or to

explain their refusal to do so. *Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1365 (D.C. Cir. 2004). Also to encourage participation, Order No. 2000 "assure[d] utilities that they will not be penalized for RTO participation," Order No. 2000 at 31,172, and clarified that "the reasonable costs of developing an RTO may be included in transmission rates." *Id*. at 31,196.

II. DOMINION'S EFFORTS TO JOIN AN RTO

In furtherance of the Commission's initiatives in Order No. 2000, Dominion attempted, with several other utilities, to develop the Alliance RTO. Ultimately, however, FERC found that the proposed Alliance RTO lacked sufficient geographic scope. *See Alliance Cos*., 97 FERC ¶ 61,327 at 62,529-30 (2001). Nevertheless, consistent with Commission policy, the Commission would "allow recovery of all costs prudently incurred by any Alliance GridCo participant to establish an RTO once it is a member of an RTO." *Alliance Cos*., 99 FERC ¶ 61,105 at 61,442 (2002) (Alliance RTO Order).

Dominion then turned its attention to the already-formed PJM RTO, the operator of the transmission grid in various Mid-Atlantic and Midwestern states. In May 2004, Dominion and PJM filed a joint proposal with the Commission to establish PJM as the RTO for Dominion, under an expansion arrangement to be known as PJM South (the 2004 Filing). *See* JA 5-28. Consistent with Order No.

2000, Dominion would transfer control of its transmission facilities to PJM and PJM would provide service on Dominion's facilities under the PJM tariff. JA 7.

Because Dominion was subject to a Virginia retail rate cap, Dominion would be unable initially to pass through to its Virginia retail customers their allocable share of Dominion's RTO-related costs. JA 12. Dominion requested regulatory asset treatment for these costs, pursuant to which the costs would be recorded as a regulatory asset and amortized once the Virginia retail cap terminated. *Id*. Specifically, Dominion sought FERC approval of its plan to record as a regulatory asset: (1) costs associated with the development of the Alliance RTO; (2) costs associated with integrating with PJM; and (3) PJM administrative fees. JA 22.

III. THE INTEGRATION ORDERS

In *PJM Interconnection, LLC*, 109 FERC ¶ 61,012 (2004) (Integration Order), *on reh'g*, 110 FERC ¶ 61,234 (2005) (Integration Rehearing), the Commission conditionally approved creation of PJM South. The Commission also "approve[d] Dominion's request" for regulatory asset treatment for its RTO-related costs, "subject to the discussion below." Integration Order P 50. As the Commission explained, applicants such as Dominion must incur start-up costs prior to receiving the commercial benefits of being integrated with an RTO. *Id.* When such costs are incurred in periods other than the anticipated benefit period, the costs should be allocated to the periods when the related benefits are expected

to be realized. *Id*. This conclusion is based on the matching principle, which assigns costs to the periods in which benefits are expected to be realized. *Id*. P 50 n.50. The conclusion is not based upon the contention that the costs, if not deferred, would be trapped under retail rate caps. *Id*. Thus, the costs should be initially recorded as an asset, deferred, and then amortized to expense over the anticipated benefit period. *Id*. P 50.

The Commission concluded that Dominion's proposed deferral of its PJM South start-up costs was consistent with this principle. *Id.* P 51. The Commission's Uniform System of Accounts, 18 C.F.R. Part 101, Account 182.3, provides for the booking of costs as a regulatory asset where it is "probable that such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services." Integration Rehearing P 39. Thus, a utility may recognize a regulatory asset where the utility determines it is probable that a cost that would otherwise be charged to expense in one period will be recovered in rates in another. *Id*. P 41.

The Commission found that Dominion must in the first instance determine whether the costs it proposed to defer met the standard for regulatory assets. Integration Order P 54. If, "based on such assessment, Dominion determines that it is probable that these costs will be recovered in rates in future periods, it should record a regulatory asset for such amounts." *Id*. The Commission made no

findings regarding the ultimate recovery of the deferred costs in Dominion's wholesale rates. Integration Rehearing P 38.

The Virginia Parties petitioned for appellate review of the Integration Orders, but the D.C. Circuit dismissed the petitions for review for lack of aggrievement. *Virginia State Corp. Comm'n v. FERC*, 468 F.3d 845 (D.C. Cir. 2006). The Integration Orders addressed only the proposed accounting treatment of Dominion's RTO-related costs, and did not address or decide the issue of whether the costs ultimately would be recoverable in Dominion's wholesale rates. *Id*. at 847. Because accounting practices are not controlling for ratemaking purposes, there was no rate impact on the Virginia Parties that could constitute the requisite injury-in-fact for standing. *Id*.

In October 2004, PJM and Dominion submitted proposed rates and related revisions to the PJM operating agreements for the purpose of integrating Dominion into PJM. *PJM Interconnection L.L.C. and Virginia Electric and Power Co*., 109 FERC ¶ 61,302 P 1 (2004). Among the proposals was a crediting mechanism designed to facilitate Dominion's deferral of its RTO-related administrative fees. *Id*. P 5. The Commission denied protests regarding the credit mechanism, affirming that the Commission had accepted Dominion's regulatory asset treatment for PJM administrative costs in the Integration Order. *Id*. P 24 (citing Integration Order PP 47-54). However, "[t]he [Integration] Order, although accepting

regulatory asset treatment for these costs, did not determine whether these costs are recoverable in a future rate case." *Id*. (citing Integration Order P 54).

IV. THE ORDERS UNDER REVIEW

A. The Tariff Order

In anticipation of the expiration of the Virginia retail rate cap, in September 2008, Dominion submitted a proposed Deferral Recovery Charge (the 2008 Filing) to recover the RTO costs Dominion had previously deferred pursuant to the Integration Orders. Tariff Order P 1, JA 181. These deferred RTO costs represented the share of Dominion's total RTO-related costs allocable to Dominion's Virginia retail customers. 2008 Filing Exh. DVP-1 at 4, 12, JA 49, 57. The costs were incurred in connection with: (i) efforts to establish the Alliance RTO ($17.8 million); (ii) efforts to join the PJM RTO ($32.9 million); and (iii) deferred PJM administrative fee costs, dating from Dominion's entry into the PJM RTO in May 2005 through August 31, 2009 ($102.5 million). *Id*. P 2, JA 181-82.

The Commission accepted the proposed Deferral Recovery Charge. *Id*. P 27, JA 190. The costs Dominion sought to recover were fully-supported wholesale costs subject to Commission jurisdiction that were fundamentally related to Dominion's efforts to join and participate in an RTO. *Id*. PP 27-28, JA 190-91. In Order No. 2000, recognizing the role that RTOs can play in the development of fully competitive electricity markets, the Commission sought to encourage RTO

formation and participation. *Id*. Because efforts to create RTOs are in furtherance of Commission policies, the Commission permits transmission owners to recover through special surcharges their costs in seeking to form and join an RTO, as well as their ongoing RTO administrative fee costs. *Id*. Here, Dominion sufficiently demonstrated both the nature of the costs and how they were incurred in furtherance of its RTO commitments. *Id*. P 28, JA 191. The prudence of the costs was not challenged. *Id*. Thus, recovery of the costs on an amortized basis through the proposed Deferral Recovery Charge was appropriate. *Id*. PP 28, 30, JA 191.

The Commission rejected arguments that Dominion must be denied recovery because it failed to seek recovery earlier. *Id*. P 29, JA 191. Commission policy at the time Dominion incurred its Alliance RTO formation costs, and at the time that Dominion joined PJM, required deferral of RTO formation costs until Dominion joined an RTO. *Id*. Dominion was not required to file to recover its RTO formation costs at any particular time thereafter. *Id*. No harm had been shown to wholesale customers as a result of the delay. *Id*. P 30, JA 192.

The Commission found no need to address arguments regarding the effect of the Virginia retail rate freeze on retail rate recovery of these costs. *Id*. P 32, JA 193. The Commission found only that Dominion's costs, as filed, were properly recoverable wholesale costs. *Id*. The Commission left for Virginia state regulators

the issue of whether or under which circumstances these costs may be recovered in Dominion's retail rates. *Id*.

B. The Virginia Parties' Requests for Rehearing

On rehearing, the Virginia Consumer Counsel argued, as relevant here, that the Commission erred in approving the Deferral Recovery Charge by: (1) failing to analyze whether Dominion received revenues sufficient to cover these costs during the retail rate freeze, Request for Rehearing and Clarification of the Attorney General of Virginia, Division of Consumer Counsel (Virginia Consumer Counsel Rehearing) at 7, JA 203; and (2) engaging in retroactive ratemaking, because the Tariff Order adjusts prospective rates to make up for an alleged shortfall in prior rates. *Id*. at 11-12, JA 207-08. The Virginia Consumer Counsel also argued accounting error in the Commission's failure to require that Dominion show a regulatory barrier precluded recovery of the RTO costs at the time they were incurred, in order to satisfy the regulatory asset standard. *Id*. at 15-18, JA 211-14.

For its part, the Virginia State Corporation Commission separately argued that the Commission should have required evidence that Dominion's costs were unrecoverable when incurred, Request for Rehearing of the Virginia State Corporation Commission at 3-7, JA 235-39, and that Dominion could not make such a showing. *Id.* at 7-8, JA 239-40.

C. The Rehearing Order

The Commission denied rehearing. Rehearing Order P 1, JA 243. The Commission's long-standing policy is to promote RTO formation and, consistent with this policy, to permit utilities to recover their prudently-incurred RTO formation costs. *Id*. PP 19, 38, JA 249, 258. These costs are an investment in a more efficient method of buying and selling electricity with benefits that accrue to wholesale ratepayers into the future. *Id*. PP 19, 23-24, JA 249, 251-52. Because this investment has future benefits, the Commission amortizes this investment over a number of years (over a 10-year period in the case of Dominion). *Id*. PP 19, 23-24, JA 249, 251-52. *See also id*. P 21, JA 250 (quoting Integration Order P 50). Dominion's costs were wholesale costs subject to FERC jurisdiction that were prudently incurred, attributable to Dominion's commitment to join an RTO (the policy warranting deferred cost treatment), and appropriately allocated to the ratepayers responsible for these costs under the amortization schedule Dominion proposed in its filing. *Id*. P 27, JA 253 (citing Tariff Order PP 28, 30).

The Virginia Parties' rehearing arguments reflect a fundamental misunderstanding of the meaning and function of regulatory assets under the Commission's accounting regulations and the relationship between these regulatory assets and the Commission's ratemaking rules. *Id*. P 20, JA 249. Regulatory assets are defined in the Commission's regulations as "specific

revenues, expenses, gains, or losses that would have been included in net income determination in one period under the general requirements of the Uniform System of Accounts but for it being probable: A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services." *Id.*, JA 250 (quoting 18 C.F.R. Part 101).

Regulatory asset costs therefore include non-recurring costs that a utility determines are probable of recovery in periods other than the period in which they are incurred. *Id*. P 22, JA 251. Under Commission policy, RTO-related costs are deferred at least until the utility joins an RTO. *Id*. PP 19, 29, JA 249, 254. Commission regulations do not require that deferred costs must be recovered within any specific time period after a utility joins an RTO. *Id*. PP 22, 26, 29, JA 251, 252, 254. Permitting recovery to begin within a few years of Dominion joining the RTO appropriately matched costs with benefits and did not cause harm to wholesale customers. *Id*. PP 26, 29, JA 252-53.

The Commission rejected, as a misinterpretation of Commission policy, arguments that Dominion must show that a regulatory barrier prevented the costs from being recovered in Dominion's retail rates to satisfy the Commission's regulatory asset accounting standard. *Id*. PP 25, 30, JA 252, 254. Rather, a cost incurred to benefit future periods that has not been included in determining the utility's currently effective rates -- *i.e*. the cost is not being recovered in current

rates -- should be amortized over the period in which the benefits are realized. *Id*. Cost recovery at wholesale should not depend on cost recovery at retail. *Id*. PP 30-31, JA 254-55. Dominion was not therefore required to demonstrate that a regulatory barrier barred recovery of these costs in its retail rates. *Id*. P 49, JA 261.

The Commission also rejected the argument that Dominion is being permitted to double-recover costs. *Id*. P 36, JA 257. The Virginia Consumer Counsel provides no evidence that Dominion will recover these costs twice. *Id*. The costs have been accumulated in the regulatory asset account and will be recovered at wholesale through rates on an amortized basis. *Id*. In any event, any issue of double recovery at the retail level is for the state regulator to determine, as the Commission does not regulate retail rates. *Id*.

The Commission further rejected arguments that it had engaged in retroactive ratemaking. *Id*. P 41, JA 258. The rule against retroactive ratemaking prevents a utility from recovering in current rates costs incurred in providing service in prior periods. *Id*. The RTO costs for which the Commission permitted recovery were not costs incurred in providing a past service, but rather were costs incurred to improve the efficiency of service through joining an RTO. *Id*., JA 259. Dominion's RTO investments therefore were properly allocated to the current and future wholesale customers of Dominion. *Id*. P 41, JA 259.

Further, Order No. 2000 put all parties on notice at the outset that RTO start-up costs would be recoverable in transmission rates, and the Alliance RTO Order (*Alliance Cos.*, 99 FERC ¶ 61,105 at 61,442 (2002)) and Dominion's May 11, 2004 filing later provided notice that these costs would be deferred for later recovery. *Id*. P 42, JA 259. Retroactive ratemaking does not apply when customers are on notice that rates may be increased. *Id*. (citing *Columbia Gas Transmission Corp. v. FERC*, 895 F.2d 791, 797 (D.C. Cir. 1990)).

SUMMARY OF ARGUMENT

In the challenged orders, the Commission accepted Dominion's proposed Deferral Recovery Charge, designed to recover Dominion's costs of joining and participating in a Regional Transmission Organization. The costs at issue were wholesale costs, subject to FERC jurisdiction, that were fundamentally related to Dominion's efforts to participate in an RTO. Under Commission policy, recognizing the role that RTOs play in the development of competitive, regional electricity markets, the Commission permits transmission owners such as Dominion to recover through special surcharges their costs in seeking to join an RTO, as well as their ongoing administrative fees related to their participation in the RTO. Further, deferred recovery of Dominion's costs was appropriate, as the costs will be recovered during the period that consumers are receiving the benefits of Dominion's joining an RTO.

Before the Commission, the Virginia Parties asserted that granting recovery of *all* of Dominion's RTO costs constituted retroactive ratemaking. Before this Court, the Virginia Parties now agree with the Commission that RTO start-up costs benefit current and future ratepayers, and therefore approval of those costs does not constitute retroactive ratemaking. Now, the Virginia Parties contend only that approval of Dominion's RTO administrative costs constitute retroactive ratemaking, as those costs provide only past benefits. This argument is

jurisdictionally barred as the Virginia Parties failed to argue before the Commission on rehearing any distinction between RTO start-up costs and RTO administrative costs. In any event, the Commission reasonably concluded that all of Dominion's RTO costs provided current and future ratepayer benefits, and were properly allocated to Dominion's current and future ratepayers.

The Virginia Parties also recognize that no issue of retroactive ratemaking arises if ratepayers are on notice that they may be assessed a surcharge. As the Commission found, Order No. 2000, the Alliance RTO Order, and Dominion's 2004 Filing sufficed to provide notice to ratepayers that Dominion was deferring its RTO costs in expectation of future collection, and that the Commission had a policy of permitting recovery of such costs. While the Virginia Parties assert that no notice was provided of RTO administrative costs, as distinct from start-up costs, this argument is barred because no purported distinction between RTO start-up and administrative costs was presented to the Commission on rehearing. In any event, Dominion's 2004 Filing requesting regulatory asset treatment expressly included RTO administrative costs, which, coupled with the Commission's approval of the accounting treatment in the Integration Orders, and policy of permitting recovery of RTO costs, provided ample notice to ratepayers.

The Virginia Parties also argue that Dominion should have been required to provide evidence that it did not and could not have recovered these RTO costs in

its retail rates when the costs were incurred. The Commission, however, lacks jurisdiction over issues of retail rate recovery under state law. Issues of retail rate recovery are not germane to a determination of whether these costs properly were recoverable in Dominion's FERC-jurisdictional wholesale rates. Dominion amply fulfilled the FPA burden of proof to recover these costs at wholesale. Also, the Virginia Parties provided no evidence of any double recovery under Dominion's retail rates, which were frozen under a retail rate cap prior to any RTO costs being incurred and thus did not include any of the RTO costs in the rate design.

Arguments that the Commission's regulatory asset accounting standard required evidence of Dominion's retail rate recovery fare no better. Accounting practices are not controlling for ratemaking purposes. Further, the Virginia Parties misinterpreted the Commission's standard, which does not require consideration of retail rate recovery to permit deferral of wholesale costs as regulatory assets.

ARGUMENT

I. STANDARD OF REVIEW

Judicial review of FERC orders is governed by FPA § 313(b), 16 U.S.C. § 825*l*(b), which provides that "the findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." *Sugarloaf Citizens Ass'n v. FERC*, 959 F.2d 508, 512 (4th Cir. 1992). Thus, the scope of the Court's review of FERC action is narrow. *Appomattox River Water Authority v. FERC*, 736 F.2d 1000, 1002 (4th Cir. 1984); *Consolidated Gas Supply Corp. v. FERC*, 653 F.2d 129, 133 (4th Cir. 1981). "This Court may set aside the FERC's order only if we find it to be arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law, or unsupported by substantial evidence." *Appomattox River*, 736 F.2d at 1002 (citations omitted). In addition, the Court "must defer to the Commission's regulatory expertise." *Consolidated Gas*, 653 F.2d at 133. Where Congress has entrusted regulation to the Commission, "[a] presumption of validity . . . attaches to each exercise of the Commission's expertise." *Atlantic Seaboard Corp. v. FPC*, 397 F.2d 753, 755 (4th Cir. 1968). *See also Central Electric Power Coop., Inc. v. Southeastern Power Administration*, 338 F.3d 333, 337 (4th Cir. 2003) ("Given the expertise of agencies in the fields they regulate, a presumption of regularity attaches to administrative actions.").

"'Statutory reasonableness is an abstract quality represented by an area rather than a pinpoint.'" *Consolidated Gas*, 653 F.2d at 134 (quoting *Montana-Dakota Utils. Co. v. Northwestern Public Serv. Co*., 341 U.S. 246, 251 (1951)). "The statutory requirement that rates be 'just and reasonable' is obviously incapable of precise judicial definition, and [the Court] afford[s] great deference to the Commission in its rate decisions." *Morgan Stanley*, 128 S. Ct. at 2738. "Because [i]ssues of rate design are fairly technical, and, insofar as they are not technical, involve policy judgments that lie at the core of the regulatory mission, [the court's] review of whether a particular rate design is just and reasonable is highly deferential." *Northern States Power Co. v. FERC*, 30 F.3d 177, 180 (D.C. Cir. 1994) (internal quotation marks and citations omitted).

II. THE COMMISSION REASONABLY APPROVED DOMINION'S DEFERRAL RECOVERY CHARGE.

A. Commission Policy Permits Recovery Of RTO-Related Costs In FERC-Jurisdictional Wholesale Rates.

In its Order No. 2000 rulemaking, the Commission held that RTOs could successfully address the existing impediments to efficient and competitive grid operation and that substantial cost savings were likely to result from the formation of RTOs. Rehearing Order P 38, JA 257-58 (citing Order No. 2000 at 30,993). *See also* Tariff Order P 27, JA 190. The Commission's long-standing policy is to promote the formation of Regional Transmission Organizations, and, consistent

with this policy, to permit utilities to recover their prudently-incurred RTO formation costs. Rehearing Order PP 19, 38, JA 249, 258. Order No. 2000 "assure[d] utilities that they will not be penalized for RTO participation," Order No. 2000 at 31,172, and clarified that "the reasonable costs of developing an RTO may be included in transmission rates." *Id*. at 31,196.

Because efforts to create RTOs further Commission policies, the Commission permits transmission owners to recover their costs in seeking to form and join an RTO, as well as their ongoing administrative fee costs related to their participation in the RTO. Rehearing Order P 23, JA 251; Tariff Order P 27, JA 190. These costs are an investment in a more efficient method of buying and selling electricity, with benefits that accrue to wholesale ratepayers into the future, in periods after the costs are incurred. Rehearing Order PP 19, 23, JA 249, 251. Because this investment has future benefits to the wholesale ratepayers who participate in the RTO, the Commission amortizes this investment over a number of years. Rehearing Order P 19, JA 249. *See also id*. P 21, JA 250 (quoting Integration Order P 50).

In the 2008 Filing, Dominion sought to recover RTO costs incurred in connection with: (i) early unsuccessful efforts to establish the Alliance RTO; (ii) later successful efforts to join the PJM RTO; and (iii) PJM administrative fees,

dating from Dominion's entry into the PJM RTO in May 2005 through August 31, 2009. Tariff Order P 2, JA 181-82; 2008 Filing Exh. DVP-1 at 17, JA 62.

The Commission found that Dominion's costs, including its ongoing administrative costs, were fully-supported costs related to Dominion's initially-failed but ultimately successful effort to join an RTO. Tariff Order P 28, JA 191. These costs were appropriately recovered as they were prudently incurred, attributable to Dominion's commitment to join an RTO (the policy warranting deferred cost treatment), and appropriately allocated to the ratepayers responsible for (and benefitting from) these costs under the amortization schedule Dominion proposed in its filing. Rehearing Order PP 24, 27, JA 252-53 (citing Tariff Order PP 28, 30, JA 191).

B. The Commission's Approval Of The Deferral Recovery Charge Did Not Constitute Retroactive Ratemaking.

1. The Deferral Recovery Charge Appropriately Matches The Costs And Benefits Of RTO Participation.

The Virginia Parties generally suggest that, because "the RTO costs Dominion seeks to recover were incurred in the past," allowing recovery of these costs constitutes retroactive ratemaking. Br. 3, 24-25. However, the rule against retroactive ratemaking prevents a utility from recovering in current rates costs incurred in providing service in prior periods. Rehearing Order P 41, JA 259. Here, the subject RTO costs were not incurred in providing a past service, but

rather were costs incurred to improve the efficiency of service through joining an RTO, with benefits accruing to wholesale ratepayers into the future. *Id*. at PP 19, 23, 41, JA 249, 251, 259. *See, e.g*., *Midwest ISO Transmission Owners*, 373 F.3d at 1371 (the benefits of regional entities, such as an overall reduction in the cost of transmitting energy within the region and large scale regional coordination and planning of transmission, redound to all users of the grid, and therefore are properly allocable to all users of the grid); *East Kentucky Power Cooperative, Inc. v. FERC*, 489 F.3d 1299, 1307 (D.C. Cir. 2007) (the Independent System Operator's costs of operating the regional grid may reasonably be assessed on all transmission loads delivered under the grid "because the benefits of an ISO flow to all who transact on the grid."); *Western Area Power Administration v. FERC*, 525 F.3d 40, 54 (D.C. Cir. 2008) (regional transmission entities such as the one in California generate significant benefits for all customers of a transmission system).

Because the benefits of RTO participation are enjoyed by current and future ratepayers, Dominion's RTO investments properly are allocated to Dominion's current and future wholesale ratepayers, notwithstanding that the costs were themselves incurred in the past. Rehearing Order P 41, JA 259 (citing *Public Systems v. FERC*, 709 F.2d 73, 85 (D.C. Cir. 1983) (retroactive ratemaking not implicated when the Commission attributes costs to those that benefit from cost incurrence)).

> To some degree, all utility rates reflect past costs; utilities typically expend funds today (for example, constructing generation facilities), fully expecting to recover those costs through future rates. In fact, current rates often include past costs that utilities deferred in order to avoid rate increases. Cost causation requires not that costs be incurred at the same time they are included in rates, but that the rates "reflect to some degree the costs actually caused by the customer who must pay them."

Transmission Access Policy Study Group v. FERC, 225 F.3d 667, 708 (D.C. Cir. 2000) (quoting *KN Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992)), *aff'd sub. nom, New York v. FERC*, 535 U.S. 1 (2002).

Thus, the Commission reasonably permitted deferred recovery of Dominion's RTO costs because those costs are designed to produce efficiency benefits to future ratepayers. Rehearing Order PP 19, 21, JA 249, 250. *See Western Resources, Inc. v. FERC*, 72 F.3d 147, 152 (D.C. Cir. 1995) (where customers would receive current and future benefits from transition to a competitive natural gas market, "take or pay" costs resulting from transition were properly allocated to current and future rate periods); *Public Systems*, 709 F.2d at 85 (no retroactive ratemaking where provision permitting utilities to "make up" deficiencies in their deferred tax reserves resulting from a change in tax treatment spread the burden fairly among future ratepayer generations).

The Commission further reasonably determined that permitting recovery of RTO costs within a few years of Dominion joining the RTO appropriately matched costs with benefits and caused no harm to wholesale customers. *Id*. P 26, JA 252.

Dominion's RTO costs "will be recovered during the period in which consumers are receiving the benefits of Dominion's joining PJM." *Id*. P 43, JA 260. The cost causation principle does not require allocation of costs with "'exacting precision.'" *Public Serv. Comm'n of Wisconsin v. FERC*, 545 F.3d 1058, 1067 (D.C. Cir. 2008) (quoting *Midwest ISO Transmission Owners*, 373 F.3d at 1369). Rather, it simply requires "'that all approved rates reflect *to some degree* the costs actually caused by the customer who must pay them.'" *Public Serv. Comm'n*, 545 F.3d at 1067 (quoting *Midwest ISO Transmission Owners*, 373 F.3d at 1368). *See also Transmission Access Policy Study Group*, 225 F.3d at 708 (same); *KN Energy*, 968 F.2d at 1300 (same); *Sithe/Independence Power Partners, L.P. v. FERC*, 285 F.3d 1, 5 (D.C. Cir. 2002) ("FERC is not bound to reject any rate mechanism that tracks the cost-causation principle less than perfectly.")

2. The Virginia Parties Concede That RTO Start-Up Costs Match Costs And Benefits, And Their Distinction Between RTO Start-Up Costs And RTO Administrative Fees Is Jurisdictionally Barred And Without Merit.

The Virginia Parties "do not challenge" that "retroactive ratemaking is not implicated when costs incurred in the past provide future benefits." *See* Br. 25-26. The Virginia Parties agree with the Commission that, where costs and benefits are matched, the recovery "constitutes an allocation of costs rather than an attempt to recoup asserted shortfalls under prior rates." *Id*. at 26. The Virginia Parties also agree that RTO "start-up" and "development" costs provide benefits beyond the

period for which those costs are incurred, and therefore permitting recovery of such costs does not constitute retroactive ratemaking. *Id*. at 26-27. *See also* Br. 32 ("As discussed above, RTO development, or start-up, costs provide a future benefit and therefore may not implicate the rule against retroactive ratemaking"). Thus, the Virginia Parties now agree with the Commission that the deferred recovery of RTO start-up costs does not constitute retroactive ratemaking.

The Virginia Parties now assert on brief, however, that Dominion's PJM RTO administrative fees – unlike its RTO start-up costs -- are fees for past services that provide no future benefit, and therefore their rate recovery constitutes retroactive ratemaking. Br. 26-27, 32. The Virginia Parties rely on P 52 of the Integration Order (discussing general accounting of RTO costs) to support this proposition. Br. 27.

The Court lacks jurisdiction to consider this new argument because it was never raised before the Commission on rehearing. As this Court has recognized, its review of FERC orders "is limited by 16 U.S.C. § 825*l*, which provides, 'No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure to do so.'" *Mt. Lookout-Mt. Nebo Property Protection Ass'n v. FERC*, 143 F.3d 165, 173 (4th Cir. 1998) (citing *Escondido Mut. Water Co. v. La Jolla Band of Mission Indians*, 466 U.S.

765, 779 n.23 (1984) (where licensees did not raise an argument in their petition for rehearing before FERC, they may not raise the argument before the Court)). *See also County of Halifax v. Lever*, 718 F.2d 649, 653 (4th Cir. 1983) (same). The Court "will not consider a contention not presented to, or considered by, the Commission." *Aquenergy Systems, Inc. v. FERC*, 857 F.2d 227, 230 (4th Cir. 1988). *See also Consolidated Gas Supply Corp. v. FERC*, 611 F.2d 951, 958-59 (4th Cir. 1979) (refusing to consider "the two grounds most strenuously urged" by petitioner where they were never raised to the Commission on rehearing).

On rehearing before the Commission, the Virginia Consumer Counsel argued that the Commission's approval of *all* of Dominion's requested RTO costs (RTO start-up costs *and* RTO administrative costs) constituted unlawful retroactive ratemaking because it allowed Dominion to adjust future rates to make up for a shortfall in prior rates. *See* Virginia Consumer Counsel Request for Rehearing at 11-12, JA 207-08.[2] Indeed, the Virginia Consumer Counsel Rehearing Request refers throughout the pleading to all of Dominion's costs collectively as "RTO costs," with no differentiation between start-up and administrative costs. *See id*. n. 1, JA 197. The rehearing request made no suggestion whatever that the rate treatment of RTO start-up costs was or should be in any way distinguishable from

[2] The Virginia State Corporation Commission's Request for Rehearing (found at JA 233-41) made no argument regarding retroactive ratemaking.

the treatment of RTO administrative costs. Nor did the rehearing request cite to P 52 of the Integration Order, on which the Virginia Parties now rely. Br. 27.

In effect, in their brief before this Court, the Virginia Parties are arguing for a different result than that urged before the Commission. Before the Commission, the Virginia Consumer Counsel sought to bar recovery of *all* Dominion deferred RTO costs as retroactive ratemaking, whereas before this Court the Virginia Parties now concede that recovery of RTO start-up costs is not retroactive ratemaking, but assert that recovery of RTO administrative costs is retroactive ratemaking. *See* Br. 27 (arguing it is arbitrary and capricious for FERC to approve recovery of *all* RTO costs when only *some* of those costs, RTO start-up costs, benefitted future periods). As the Virginia Parties never argued to the Commission this alternative result – part of the costs are recoverable and part not – the Virginia Parties are jurisdictionally barred from raising it now. Having failed to assert a distinction between RTO start-up costs and administrative costs on rehearing, the Virginia Parties cannot now be heard to argue that the Commission erred in failing to make that distinction.

Further, the Virginia Parties incorrectly assert that the Commission found only that RTO start-up costs provide future benefits, and made no finding with regard to administrative costs. Br. 26-27 (quoting Rehearing Order P 41, JA 258). To the contrary, the Commission found that all of Dominion's costs – start-up and

administrative – provided current and future benefits, and were properly allocable to current and future ratepayers. "The costs Dominion proposes to recover here, including its ongoing administrative fee costs, are related to its initially-failed but ultimately successful effort to joint an RTO." Tariff Order P 28, JA 191. The Commission specifically permits recovery through special surcharges of both start-up and administrative costs, Tariff Order P 27, JA 190; Rehearing Order P 23, JA 251, and the Commission has not required that any of these costs be recovered within any specific time period. Rehearing Order P 29, JA 254. All of Dominion's costs "will be recovered during the period in which consumers are receiving the benefits of Dominion's joining PJM." Rehearing Order P 43, JA 260. Thus, all of Dominion's costs were "attributable to Dominion's commitment to join an RTO (the policy warranting deferred cost treatment), and appropriately allocated to ratepayers responsible for these costs under the amortization schedule Dominion proposed in its filing." Rehearing Order P 27, JA 253. *See, e.g., Midwest ISO Transmission Owners*, 373 F.3d at 1371 (the administrative costs of having a regional transmission entity are appropriately recoverable from all users of the system).

Integration Order P 52 is not to the contrary. Br. 27. Paragraphs 51 and 52 of the Integration Order explained when RTO costs are recognized for purposes of general accounting requirements: deferred start-up costs begin amortization on the

date the transmission owner is integrated into the RTO (P 51) and administrative fees are charged to expense in the period when incurred (P 52). However, P 53 explained that, "notwithstanding the general accounting requirements for RTO related costs" discussed in PP 51 and 52, the Commission's Uniform System of Accounts also provides for recognition of regulatory assets. Integration Order P 53. If costs are treated as a regulatory asset, rate recovery is provided "in periods other than the period [the costs] would otherwise be charged to expense under the general accounting requirements for costs." *Id*. P 54.

In other words, a regulatory asset is by definition an amount that is being charged in a period other than the one in which it would ordinarily be expensed. Integration Order P 52 describes when administrative fees would *ordinarily* be expensed, but PP 53 and 54 explain that regulatory asset treatment permits recovery in other periods. *See* Br. 9 (citing Integration Order P 50 as stating that "[t]he costs of providing regulated electric service will normally be expensed in the period in which they are incurred or, under certain circumstances (as in the case for regulatory assets), 'deferred and then amortized to expense over the anticipated benefit period'"). Thus, Integration Order P 52 does not support a finding that RTO administrative costs are unrecoverable in periods after they are incurred.

Indeed, the Rehearing Order expressly stated that P 52 of the Integration Order was not properly interpreted to require that utilities file for rate recovery

immediately upon joining the RTO. Rehearing Order P 26, JA 252 (citing Integration Order P 52). To the contrary, there is no such requirement in the Commission's regulations or policy. *Id*. Rather, the Commission has not required that such costs be recovered within any specific time period after the utility joins an RTO. *Id*. PP 22, 25, 29, JA 251, 252, 254.

3. Ratepayers Had Ample Notice That Dominion Sought Deferred Recovery Of Costs Generally Allowed By The Commission.

The Virginia Parties also recognize that rates are not retroactive where ratepayers are on notice that the costs in question may be subject to future recovery. Br. 29. *See* Rehearing Order P 42, JA 259 (retroactive ratemaking does not apply when the customers are on notice that rates may be increased) (citing *Columbia Gas*, 895 F.2d at 797 (notice does not relieve the Commission from the prohibition against retroactive ratemaking but, instead, "changes what would be purely retroactive ratemaking into a functionally prospective process")). *See also Natural Gas Clearinghouse v. FERC*, 965 F.2d 1066, 1075 (D.C. Cir. 1992) (same).

Ratepayers had ample notice here. Rehearing Order P 42, JA 259. Order No. 2000 put all parties on notice at the outset that RTO costs would be recoverable in transmission rates. *Id*. Order No. 2000 expressly "assure[d] utilities that they will not be penalized for RTO participation," Order No. 2000 at 31,172,

and clarified that "the reasonable costs of developing an RTO may be included in transmission rates." *Id*. at 31,196. Such statements provide broad notice of a policy to hold utilities harmless for the costs of RTO participation.

Transwestern Pipeline Co. v. FERC, 897 F.2d 570, 580 (D.C. Cir. 1990) (cited Br. 29), is not to the contrary. In *Transwestern*, the preamble to FERC regulations stated a general policy of assuring pipeline recovery of all purchased gas costs, but a regulation specifically provided that customers leaving a pipeline were no longer responsible for purchased gas adjustments. *Id*. at 580. In light of the regulation, pipeline customers were not on notice that their purchased gas adjustment balances would follow them if the pipeline's purchased gas adjustment program ended. *Id*. Here, no contrary language in regulations or anywhere else contradicts the Commission's express policy of compensating transmission owners for the costs of participating in an RTO.

The Alliance RTO Order and Dominion's 2004 Filing further provided notice that Dominion's RTO costs would be deferred for later recovery. Rehearing Order P 42, JA 259. The Alliance RTO Order, 99 FERC at 61,442, stated that the Commission would allow recovery of "all costs prudently incurred by any Alliance GridCo participant to establish an RTO once it is a member of an RTO." Thus, the Commission specifically required deferral of the costs incurred in attempting to form the Alliance RTO, until the transmission owners that had incurred these costs

became members of a Commission-approved RTO. Tariff Order P 27, JA 190; Rehearing Order P 19, JA 249.

Dominion's 2004 Filing, moreover, provided notice that Dominion intended to defer its PJM RTO start-up and administrative costs, as well as the Alliance start-up costs, for later collection following termination of the Virginia retail rate cap. Rehearing Order P 42, JA 259. As Dominion explained at the time of its filing:

> Dominion requests that the Commission authorize for deferral as a regulatory asset all costs incurred by Dominion and its affiliate during the period of June 1, 1998 to May 1, 2003 related to the establishment of the Alliance RTO. Dominion will also incur, for the period of December 21, 2001 to the end of the state imposed rate cap, expenditures related to the establishment and operation of PJM South. Dominion respectfully requests that the Commission authorize Dominion to capture and defer the aforementioned expenditures as a regulatory asset until the existing Virginia retail rate cap ends.

2004 Filing, JA 22. Dominion expressly requested deferral of: (1) costs associated with developing the Alliance RTO; (2) costs associated with integrating with PJM and (3) PJM administrative fees. *Id*. *See* Br. 9 (Dominion's 2004 Filing sought regulatory asset treatment for Alliance and PJM start-up costs and PJM administrative fees).

In the Integration Order, the Commission found that Dominion may give its RTO start-up costs and administrative fees regulatory asset treatment, provided that Dominion first determines that these costs qualify for such treatment, and the

Commission would determine in a future rate case whether the deferred costs were recoverable. Tariff Order P 5, JA 182 (citing Integration Order PP 53-54). *See also PJM Interconnection, L.L.C.*, 109 FERC ¶ 61,302 P 24 (2004) (stating that, in the Integration Order, "the Commission accepted Dominion's proposal to provide for regulatory asset treatment for PJM administrative costs"). Thus, following the Alliance RTO Order and Dominion's 2004 Filing, ratepayers had ample notice that the Alliance start-up costs, and the PJM start-up costs and administrative costs, would be deferred in the expectation of future recovery.

4. The Virginia Parties' Attempts To Discount The Notice Provided Are Unavailing.

The Virginia Parties complain that Order No. 2000 and the Alliance RTO Order gave notice only of the costs of "developing" or "establishing" an RTO, and did not give notice that administrative fees would also be recovered. Br. 29. As discussed previously, however, any argument that the Commission erred in failing to distinguish between RTO start-up costs and administrative costs is jurisdictionally barred as the Virginia Parties failed to argue on rehearing before the Commission that administrative costs were a separate category – to be treated differently – from RTO start-up costs. *See supra,* Argument Section II(B)(2). As no argument was made that administrative costs were or should be separable from start-up costs for purposes of rate recovery, the Virginia Parties are jurisdictionally barred now from arguing that the Commission erred in failing to require specific

notice that such administrative costs – as distinct from start-up costs – would be subject to future collection.

Further, Dominion did not begin to incur PJM administrative costs until May 2005. *See* 2008 Filing Exh. DVP-1 at 17, JA 62. Prior to that time, Dominion had already made its 2004 Filing seeking deferred rate treatment for RTO costs *expressly including the PJM administrative costs*, and the Commission had accepted such accounting treatment. Integration Order PP 53-54 (October 5, 2004); *PJM Interconnection, L.L.C.*, 109 FERC ¶ 61,302 P 24 (Dec. 21, 2004); Integration Rehearing P 29 (March 4, 2005).

The Virginia Parties assert that notice must come from the Commission, and therefore Dominion's 2004 Filing cannot suffice to provide notice that Dominion's RTO costs would be deferred and may be subject to later recovery. Br. at 31, citing *Columbia Gas*, 895 F.2d at 797, and *OXY USA, Inc. v. FERC*, 64 F.3d 679, (D.C. Cir. 1995), for the proposition that there is no retroactive ratemaking when *the Commission* places parties on notice of potential rate changes.

First, the Virginia Parties disregard the Commission's acceptance of deferred regulatory asset rate treatment for Dominion's RTO costs – including the PJM administrative fees – prior to the time that Dominion began to incur, and to defer, PJM administrative fees. Therefore, the Commission as well as Dominion placed ratepayers on notice that such costs were being deferred for potential future

collection in a Dominion rate filing. *See* Integration Order P 54 (rate recovery of Dominion's deferred costs will be determined in a future rate proceeding); Integration Rehearing P 29 (same); *PJM Interconnection L.L.C.*, 109 FERC ¶ 61,302 P 24 (Commission accepted regulatory asset accounting treatment in the Integration Order, but rate recovery will be determined in a future rate case).

Further, while certainly notice by the Commission suffices to avoid charges of retroactive ratemaking, "notice from FERC is not always required." *Public Utils. Comm'n v. FERC*, 988 F.2d 154, 165 (D.C. Cir. 1993). Rather, sufficient notice of a potential rate change may be provided by the utility's request for a rate action, particularly where the request is made in the context of a Commission policy of granting such requests. *Id*., 988 F.2d at 165 (notice from pipeline filing seeking additional take-or-pay costs and FERC's policy of permitting recovery of take-or-pay costs); *Natural Gas Clearinghouse*, 965 F.2d at 1075 (notice from pipeline tariff sheets and other filings reserving the right to seek a surcharge if a FERC order were reversed on appeal); *Consolidated Edison Co. v. FERC*, 958 F.2d 429, 434-35 (D.C. Cir. 1992) (notice from pipeline filing requesting a retroactive effective date and FERC's policy of granting such requests); *Louisiana Pub. Serv. Co. v. FERC*, 482 F.3d 510, 520 (D.C. Cir. 2007) (notice from filing of a complaint against a rate). Such notice is sufficient even where ratepayers do not

know whether FERC will grant the rate request. *Public Utils. Comm'n*, 988 F.2d at 165.

Here, Dominion's 2004 Filing requested recovery of deferred RTO costs – including both start-up and administrative costs – and existing Commission policy following Order No. 2000 permitted recovery by transmission owners through special surcharges of their costs in seeking to form and join an RTO, as well as their ongoing administrative costs related to their participation in the RTO. Tariff Order P 27, JA 190 (citing *Idaho Power Co*., 123 FERC ¶ 61,104 P 10 (2008); *Entergy Services, Inc*., 117 FERC ¶ 61,320 (2006); *Illinois Power Co*., 108 FERC ¶ 61,258 (2004); *Alliance Cos*., 99 FERC ¶ 61,105 (2002)); Rehearing Order P 23, JA 251. Prior to the challenged orders, the Commission had permitted deferred recovery of RTO costs past the date that the utility had joined an RTO. Tariff Order P 30, JA 191 (citing *Northeast Utils. Serv. Co*., 121 FERC ¶ 61,308 P 19 (2007) (permitting deferred recovery of RTO costs subject only to an analysis of whether delay in recovery would result in rate impact to wholesale customers); *Northeast Utils. Serv. Co.,* 124 FERC ¶ 61,098 P 19 (2008) (accepting compliance filing showing no rate impact from delay); *Central Maine Power Co*., 116 FERC ¶ 61,129 P 11 (2006) (accepting transmission owner's proposal for rate recovery of deferred RTO formation costs)); Rehearing Order P 29, JA 254. *See also Midwest ISO*, 373 F.3d at 1365, 1371 (permitting regional Midwest transmission operator to

defer recovery of administrative costs exceeding a cap during a six-year transition period until the end of the transition period, and to be repaid on a five-year amortization schedule through a surcharge to all customers). Thus, Dominion's request for deferred rate recovery and the Commission's policy of granting recovery of RTO costs, including deferred costs – both start-up and administrative – constituted sufficient notice of the Deferral Recovery Charge to avoid any issues of retroactive ratemaking.

The Virginia Parties point out that the 2004 Filing only signaled Dominion's intention to seek a future surcharge, and the filed tariff did not itself address the potential surcharge. Br. 31. *See also* Br. 29 (arguing that there was no provisional rate in place that might be changed). A tariff filing reserving the right to impose surcharges is not required in order to avoid retroactive ratemaking. *Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289, 299 (D.C. Cir. 2001). "So long as the parties had adequate notice that surcharges might be imposed in the future, imposition of surcharges does not violate the filed rate doctrine." *Id*. "'The filed rate doctrine simply does not extend to cases in which buyers are on adequate notice that resolution of some specific issue may cause a later adjustment to the rate being collected at the time of service.'" *Id*. (quoting *Natural Gas Clearinghouse*, 965 F.2d at 1075). In *Canadian Ass'n*, the pipeline's initial rate filing – combined with ongoing litigation and absence of a final, non-appealable

order – provided the necessary notice to shippers. *Id*. Similarly here, Dominion's 2004 Filing and the Commission's Integration Orders, combined with Order No. 2000 and the Alliance RTO Order, provided the necessary notice to ratepayers that Dominion's deferred RTO costs – including administrative fees – may be subject to recovery in a future rate case.

C. The Commission Reasonably Determined That Dominion Was Not Required To Show That The RTO Costs Were Unrecovered Or Unrecoverable In Dominion's Retail Rates.

1. The Commission Reasonably Declined To Consider Retail Rate Recovery Issues As The Commission Lacks Statutory Jurisdiction To Regulate Retail Rates.

The Virginia Parties assert that "FERC's failure to ensure that Dominion's historic RTO costs were not (i) as a factual matter, already recovered or (ii) unrecoverable as a legal matter violates FERC's duty under FPA § 205, [16 U.S.C. § 824d] to set 'just and reasonable' rates." Br. 36. FERC's alleged failure to require "an evidentiary showing that Dominion's retail rates in effect applicable to that period prevented recovery of those costs in that period" purportedly "permits the unlawful double recovery of costs." *Id*. 37.

The Virginia Parties thus would require that the Commission undertake a full rate case inquiry into whether Dominion's retail rate revenues were sufficiently high to cover the RTO costs, *see* Br. 36-39 -- even though the RTO costs were not

included in Dominion's retail rate design.[3] *See* Br. 34-35 (the "prior standard required Dominion to demonstrate the recoveries under 'retail rates' during the historic period when the RTO costs were incurred"); Br. 39 (arguing that an "examination" of Dominion's "overall rate and all cost components" was required). The Virginia Parties also require an inquiry into whether Virginia law presented a regulatory barrier to recovery of the RTO costs at the time they were incurred. Br. 40-41.

The Commission reasonably found it was not required to determine whether the RTO costs were unrecovered or unrecoverable under state law. Tariff Order P 32, JA 193; Rehearing Order P 31, JA 255. The Commission does not regulate retail rates, and the issue of whether these costs were recovered or were recoverable at retail is properly left to the state regulator to determine. Tariff Order P 32, JA 193; Rehearing Order P 36, JA 257.

Accordingly, the Commission made no determinations as to the effect of a retail rate freeze on recovery of previously-incurred wholesale costs. Tariff Order P 32, JA 193; Rehearing Order P 31, JA 256. The Commission determined only that Dominion's costs, as filed, were properly recoverable wholesale costs. Tariff Order P 32, JA 193; Rehearing Order P 31, JA 256. Dominion was not required to

[3] None of the RTO costs at issue were included in Dominion's retail rates because Dominion's retail rates were frozen as of July 1, 1999, before Dominion had incurred any of the RTO costs. 2008 Filing at 3, JA 31; 2008 Filing Exh. DVP-1 at 3, 13, JA 48, 58.

provide evidence of its earnings under its capped retail rates because the issue of rate recovery at retail is not germane to the Commission's consideration of whether wholesale rate recovery is appropriate. Rehearing Order P 49, JA 261. *See also Midwest ISO Transmission Owners*, 373 F.3d at 1372 (state retail considerations "do not circumscribe FERC's authority;" rather, principles of federal preemption and supremacy "operate to prevent the states from taking regulatory action in derogation of federal regulatory objectives"). As the Commission does not regulate retail rates, any issue of double recovery at the retail rate level is a question for the state regulator to determine. Rehearing Order P 36, JA 257.

Moreover, the Virginia Parties provided no evidence that Dominion would recover its RTO costs twice. Rehearing Order P 36, JA 257. The RTO costs at issue were not previously included in designing Dominion's currently effective rates, but rather were accumulated in a regulatory asset account for future recovery. *Id*. PP 25, 36, JA 252, 257; n.3, *supra*. *See also, e.g., Western Area Power Admin*., 525 F.3d at 54 (the benefits produced by regional transmission entities reflect new services not previously provided by utilities, and therefore the cost of the regional entity benefits is not included in pre-existing contract rates); *East Kentucky*, 489 F.3d at 1307 (same). Because the RTO cost categories at issue had never been included in Dominion's rates, there was no basis to believe that these costs were being double-recovered, and the Virginia Parties provided no evidence to the

contrary. Rehearing Order P 36, JA 257. Speculation that Dominion's retail rates may have been sufficient to recover the RTO costs – even though those costs were not included in the rate design – would not in any event suffice as grounds for requiring an evidentiary hearing. *City of Ukiah v. FERC*, 729 F.2d 793, 799 (D.C. Cir. 1984) ("'Mere allegations of disputed facts are insufficient to mandate a hearing; petitioners must make an adequate proffer of evidence to support them.'") (quoting *Cerro Wire & Cable Co. v. FERC*, 677 F.2d 124, 129 (D.C. Cir. 1982)). *See also, e.g., Kansas Power and Light Co. v. FERC*, 851 F.2d 1479, 1484 (D.C. Cir. 1988) (same).

Likewise, the Commission did not determine whether retail rate recovery was precluded under Virginia law during the retail rate freeze period. *See* Br. 40. The question of wholesale recovery of costs does not depend on a determination of whether these costs were recoverable in retail rates. Rehearing Order P 22, PP 30-31, JA 251, 254-55. For example, wholesale costs can appropriately be passed through to transmission owners regardless of whether the transmission owners can pass those costs on to consumers in retail rates. *Id*. P 30, JA 254 (citing *Midwest ISO Transmission Owners*, 373 F.3d at 1372). As the D.C. Circuit recognized, where the Commission's rate recovery authorizations result in trapped costs, the transmission owners' "initial recourse is to their state regulators and contractual partners armed with principles of federal preemption and the Supremacy Clause –

not to FERC." *Id*. (quoting *Midwest ISO Transmission Owners*, 373 F.3d at 1372). As the issue of retail rates is beyond the Commission's statutory authority, the Commission properly declined to decide retail rate issues arising under state law. *Id*. P 50, JA 262.

Because the Commission lacks statutory authority to decide state law retail rate issues, failing to require evidence of retail rate recovery does not "unlawfully sidestep[]" Dominion's burden of proof under the Federal Power Act for rate requests or accounting entries. Br. 37-38. Dominion fully met its statutory burden of proof requirements. Tariff Order P 28, JA 191; Rehearing Order P 48, JA 261. The RTO costs that Dominion proposed to recover, including its ongoing administrative costs, were related to its initially-failed but ultimately successful effort to join an RTO. Tariff Order P 28, JA 191. The costs were fully itemized in Dominion's filing, in prepared testimony, exhibits and supporting work papers. *Id*. Dominion sufficiently demonstrated both the nature of the costs and how they were incurred in furtherance of its RTO commitments. *Id*. Further, the prudence of Dominion's costs was not challenged. *Id*. Accordingly, the Commission found Dominion's costs properly recoverable through the proposed surcharge. *Id*.; Rehearing Order P 48, JA 261.

2. The Regulatory Asset Accounting Standard Does Not Support The Virginia Parties' Claims.

The Virginia Parties assert that FERC's regulatory accounting standard required Dominion to provide evidence of past earnings under its retail rates to obtain rate recovery. Br. 33. This argument fails for a number of reasons.

First, the regulatory asset standard is an accounting standard, which is not controlling for ratemaking purposes. Rehearing Order P 34, JA 256; Tariff Order P 31 n.33, JA 192. As this Court has recognized, "an item may be treated differently for accounting than for ratemaking purposes." *Consolidated Gas Supply Corp. v. FERC*, 653 F.2d 129, 135-36 (4th Cir. 1981). The determination of whether costs are appropriately recoverable is made not by the accounting treatment these costs may have been given, but in a Federal Power Act § 205, 16 U.S.C. § 824d, proceeding in which the applicant seeks to recover the costs in its wholesale rates. Tariff Order P 31, JA 192; Rehearing Order P 22, JA 251. Thus the issue of rate recovery is not whether Dominion could or should have chosen a different account in which to book the costs at issue, but whether these costs are properly recoverable as wholesale costs under the FPA. Tariff Order P 31, JA 192. When Dominion filed to recover its RTO costs, the Commission determined consistent with its precedent that amortization of these costs to future periods was appropriate and consistent with the Commission's treatment of RTO costs. Tariff

Order P 31, JA 192; Rehearing Order P 34, JA 256. *See also* Rehearing Order PP 23, 47-48, JA 251, 261.

Accordingly, whether or not the costs at issue are properly categorized as regulatory assets for accounting purposes does not control the issue of their recoverability, and, therefore, the Virginia Parties' arguments regarding this accounting standard do not address, let alone undermine, the Commission's rate determination regarding recoverability of these costs. For this same reason, the D.C. Circuit dismissed the Virginia Parties' appeal of the Commission's accounting determination in the Integration Orders for failure to show aggrievement, as the accounting treatment provided the RTO costs at issue does not control the question of whether the costs are recoverable in Dominion's rates. *Virginia State Corp. Comm'n*, 468 F.3d at 847.

This point further answers the assertion that the Commission improperly relied on Dominion's belief that the deferred costs would be recoverable. Br. 34. Dominion's subjective belief regarding the future recoverability of rates is relevant only to the issue of whether the RTO costs were properly recorded as regulatory assets, not whether they were properly recoverable in Dominion's wholesale rates. Tariff Order P 31, JA 192; Rehearing Order P 47, JA 261. *See also* Rehearing Order PP 23-24, JA 251-52. The utility in the first instance determines whether a particular cost is likely to be recoverable in future rates and therefore should be

accounted for as a regulatory asset. Rehearing Order P 22, JA 251. *See, e.g., Virginia State Corp. Comm'n*, 468 F.3d at 848 (finding that FERC's Integration Order "calls upon Dominion to assess whether its start-up costs meet the requirements of a regulatory asset"). This initial determination can be made by the utility's accountants and auditors, without prior Commission approval. Rehearing Order P 34, JA 256 (citing Integration Order P 40). If the utility determines that the cost is not included in existing rates and it is probable that such cost will be included in future rates it can book the cost as a regulatory asset. *Id*. P 22, JA 251.

Here, Dominion chose to treat these RTO costs as a regulatory asset because it believed that Commission policy permitted recovery of such costs in wholesale rates in later periods. *Id*. P 23, JA 251. Dominion's subjective belief as to recoverability thus was only relevant to the finding that Dominion properly booked the costs as regulatory assets; *i.e*., the Commission found that the costs were properly booked as regulatory assets because Dominion had a reasonable expectation that its RTO investments could be recovered in future periods. Tariff Order P 31, JA 192; Rehearing Order P 47, JA 261. *See also* Rehearing Order PP 23-24, JA 251-52.

Moreover, the Commission fully explained why the Virginia Parties' interpretation of the regulatory asset accounting standard – as requiring a showing that costs are not recoverable in current retail rates -- misinterprets Commission

policy and is not an accurate statement of the requirements for regulatory asset treatment. Rehearing Order PP 25, 28, 30, JA 252-54. "Regulatory Assets" are defined in the Commission's regulations as: "'specific revenues, expenses, gains, or losses that would have been included in net income determination in one period under the general requirements of the Uniform System of Accounts but for it being probable: A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services.'" Rehearing Order P 20, JA 250 (quoting 18 C.F.R. Part 101, Definitions (31)). Thus, regulatory asset costs include non-recurring costs that a utility determines are probable of recovery in periods other than the period in which they are incurred. *Id*. P 22, JA 251. Here, the RTO costs at issue were properly treated as regulatory assets because such costs "were an investment in a more efficient transmission system with ongoing benefits to customers." *Id*. P 24, JA 252.

The Virginia Parties rely on the Integration Orders for the proposition that a cost must be shown to be unrecoverable in existing rates for regulatory asset treatment. *See* Br. 33-35; Integration Order P 53; Integration Rehearing PP 40-41. However, when the Commission referred to costs being "unrecoverable in existing rates," Integration Order P 53, this was an expression of the proposition that a cost incurred to benefit future periods that has not been included in determining the utility's currently effective rates, *i.e*. is not recoverable in current rates, should be

amortized over the period in which the benefits are realized. Rehearing Order P 25, JA 252. In other words, the issue is not whether a regulatory prohibition prevented Dominion from recovering its RTO start-up costs; the issue is whether the benefits of these costs accrue to a later accounting period. *Id*. P 28, JA 253.

The Integration Order itself explained that costs incurred prior to customers receiving the commercial benefits of integration into the RTO should be allocated to the period when the related benefits are expected to be realized. Integration Order P 50. This conclusion is based on the matching principle, which assigns costs to the periods in which benefits are expected to be realized. *Id*. P 50 n.50. This rate treatment is *not* based upon the contention that the costs, if not deferred, would be trapped under retail rate caps. *Id*.

As evidenced by the foregoing, therefore, the Commission has consistently applied the matching principle to justify its policy permitting deferral of RTO costs to time periods in which customers enjoy the benefits of RTO participation. Integration Order P 50 n.50; Rehearing Order PP 25, 28, 30, JA 252-254. However, even if the Commission "shift[ed] course" on the standard for regulatory asset accounting treatment, Br. 35, the Commission in any event fully explained its reasons for its holding here. "An agency must be given ample latitude to 'adapt their rules and policies to the demands of changing circumstances.'" *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 42 (1983) (quoting

Permian Basin Area Rate Cases, 390 U.S. 747, 784 (1968)). An agency may deviate from prior precedent if it provides a reasoned explanation for the deviation. *See, e.g., Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs*., 545 U.S. 967, 1001 (2005) (an agency is free within the limits of reasoned interpretation to change course if it adequately justifies the change); *Baltimore Gas & Elec. Co. v. Heintz*, 760 F.2d 1408, 1418 (4th Cir. 1985) (an agency must provide a reasoned explanation for the failure to follow its own precedents). Thus, even if the Commission's explanation here constituted more than a clarification of policy, the Commission orders should nevertheless be upheld because the Commission provided a reasoned explanation for any change in policy. *Entergy Servs. v. FERC*, 319 F.3d 536, 542 (D.C. Cir. 2003) (Commission did not impermissibly depart from prior precedent where, in the challenged orders, the Commission was clarifying inadvertent statements in prior orders, and even if the orders constituted more than a clarification, the Commission provided a "reasoned explanation for the change in policy").

CONCLUSION

For the reasons stated, the petitions for review should be denied and the Commission's orders affirmed in all respects.

REQUEST FOR ORAL ARGUMENT

Because this case presents significant issues of Commission policy and rate regulation, the Commission respectfully requests that oral argument be held in this case.

Respectfully submitted,

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February 9, 2010

Office of the Attorney General of Virginia, *et al*. v. FERC
4th Cir. Nos. 09-2052, *et al.*

CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

1. This brief complies with the type-volume limitation of Fed. R. App. P 32(a)(7)(B) because this brief contains 11,742 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed. R. App. P 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Times New Roman in Microsoft Office Word 2003 14-point and Normal.

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February 9, 2010

ADDENDUM

STATUTES
AND
REGULATIONS

ADDENDUM

PAGE

Statutes:

Federal Power Act

Regulations:

Section 205 of the Federal Power Act, 16 U.S.C. § 824d provides as follows:

(a) Just and reasonable rates
All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) Preference or advantage unlawful
No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission,
(1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or
(2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Schedules
Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Notice required for rate changes
Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after sixty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Suspension of new rates; hearings; five-month period
Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

(f) Review of automatic adjustment clauses and public utility practices; action by Commission; "automatic adjustment clause" defined
(1) Not later than 2 years after November 9, 1978, and not less often than every 4 years thereafter, the Commission shall make a thorough review of automatic adjustment clauses in public utility rate schedules to examine—
(A) whether or not each such clause effectively provides incentives for efficient use of resources (including economical purchase and use of fuel and electric energy), and
(B) whether any such clause reflects any costs other than costs which are—
(i) subject to periodic fluctuations and

(ii) not susceptible to precise determinations in rate cases prior to the time such costs are incurred.
Such review may take place in individual rate proceedings or in generic or other separate proceedings applicable to one or more utilities.
(2) Not less frequently than every 2 years, in rate proceedings or in generic or other separate proceedings, the Commission shall review, with respect to each public utility, practices under any automatic adjustment clauses of such utility to insure efficient use of resources (including economical purchase and use of fuel and electric energy) under such clauses.
(3) The Commission may, on its own motion or upon complaint, after an opportunity for an evidentiary hearing, order a public utility to—
(A) modify the terms and provisions of any automatic adjustment clause, or
(B) cease any practice in connection with the clause,
if such clause or practice does not result in the economical purchase and use of fuel, electric energy, or other items, the cost of which is included in any rate schedule under an automatic adjustment clause.
(4) As used in this subsection, the term "automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include any rate which takes effect subject to refund and subject to a later determination of the appropriate amount of such rate.

Section 313(b) of the Federal Power Act, 16 U.S.C. § 825*l*(b) provides as follows:

(b) Judicial review
Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the United States court of appeals for any circuit wherein the licensee or public utility to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28.

18 C.F.R. Part 101 Definitions (31) provides as follows:

Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act

Definitions

When used in this system of accounts:

31. *Regulatory Assets and Liabilities* are assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains, or losses that would have been included in net income determination in one period under the general requirements of the Uniform System of Accounts but for it being probable:

A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services; or

B. in the case of regulatory liabilities, that refunds to customers, not provided for in other accounts, will be required.

18 C.F.R. Part 101, Account 182.3 provides as follows:

182.3 Other regulatory assets.

A. This account shall include the amounts of regulatory-created assets, not includible in other accounts, resulting from the ratemaking actions of regulatory agencies. (See Definition No. 30.)

B. The amounts included in this account are to be established by those charges which would have been included in net income, or accumulated other comprehensive income, determinations in the current period under the general requirements of the Uniform System of Accounts but for it being probable that such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services. When specific identification of the particular source of a regulatory asset cannot be made, such as in plant phase-ins, rate moderation plans, or rate levelization plans, account 407.4, regulatory credits, shall be credited. The amounts recorded in this account are generally to be charged, concurrently with the recovery of the amounts in rates, to the same account that would have been charged if included in income when incurred, except all regulatory assets established through the use of account 407.4 shall be charged to account 407.3, regulatory debits, concurrent with the recovery in rates.

C. If rate recovery of all or part of an amount included in this account is disallowed, the disallowed amount shall be charged to Account 426.5, Other Deductions, or Account 435, Extraordinary Deductions, in the year of the disallowance.

D. The records supporting the entries to this account shall be kept so that the utility can furnish full information as to the nature and amount of each regulatory asset included in this account, including justification for inclusion of such amounts in this account.

Virginia State Corporation, et al., v. FERC **Docket No. ER08-1540**
4th Cir. No. 09-2052, *et al*.

CERTIFICATE OF SERVICE

I hereby certify that on February 9, 2010, I electronically filed the foregoing with the Clerk of Court using the CM/ECF System, which will send notice of such filing to the following registered CM/ECF users:

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