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Report of Senior Hearing Examiner in Virginia State Corporation
Commission Case No. PUE-2013-00061
File No. GR-2021-0108

SCC-62

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

APPLICATION OF

VIRGINIA ELECTRIC AND POWER COMPANY **CASE NO. PUE-2013-00061**

2014 JAN 31 P 2:53

For revision of rate adjustment clause: Rider S, Virginia City Hybrid Energy Center

REPORT OF ALEXANDER F. SKIRPAN, JR., SENIOR HEARING EXAMINER

January 31, 2014

After adjusting its request to reflect the Commission's *2013 Biennial Review Order*, Dominion Virginia Power seeks approval of an annual update for its Rider S, which is designed to recover an annual revenue requirement of $247.79 million associated with the Virginia City Hybrid Energy Center. Staff proposed a revenue requirement of $238.6 million, and offered two additional alternative calculations of $240.0 million and $238.7 million. Consumer Counsel questioned the recovery of amounts in excess of the $1.8 billion cap for the Project originally established by the Commission in its *VCHEC Order*. I find that the revenue requirement should be based upon Staff's second alternative, or $238.7 million. In addition, I find that the Company has exceeded the $1.8 billion cap for the Project, but that the additional costs are reasonable and prudent.

HISTORY OF THE CASE

On June 14, 2013, Virginia Electric and Power Company d/b/a Dominion Virginia Power ("Dominion Virginia Power" or "Company") filed an application with the State Corporation Commission ("Commission") for an annual update with respect to the Company's rate adjustment clause ("RAC"), Rider S ("Application") pursuant to § 56-585.1 A 6 of the Code of Virginia ("Code"). Through its Application, the Company seeks to recover costs associated with the Virginia City Hybrid Energy Center ("VCHEC" or "Project"), a 600 MW nominal coal-fueled generating plant and associated interconnection facilities located in Wise County, Virginia. Specifically, the Company is requesting Commission approval of a total revenue requirement of $286,962,000 for the rate year beginning April 1, 2014, and ending March 31, 2015 ("2014 Rate Year").

Concurrent with its Application, Dominion Virginia Power filed its Motion for Entry of a Protective Order. A Hearing Examiner's Protective Ruling was entered on July 3, 2013.

On June 28, 2013, the Commission entered its Order for Notice and Hearing in which, among other things, the Commission docketed the Application; scheduled a public hearing in Richmond to begin on December 11, 2013; and appointed a Hearing Examiner to conduct all further proceedings in this matter on behalf of the Commission.

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On July 11, 2013, the Office of Attorney General's Division of Consumer Counsel ("Consumer Counsel") filed a Notice of Participation. On July 15, 2013, the Virginia Committee for Fair Utility Rates ("Committee") filed a Notice of Participation.

On August 2, 2013, Dominion Virginia Power filed its Proof of Notice as required by the Commission's June 28, 2013, Order for Notice and Hearing, Ordering Paragraph (7).

On October 30, 2013, Staff filed a Motion for Extension of Time in which it requested: (i) that the deadline for the filing of Staff's testimony and exhibits be extended for one week, from Friday, November 1, 2013, to Friday, November 8, 2013; and (ii) that the deadline for the filing of any rebuttal testimony by the Company be extended, from Friday, November 22, 2013, to Tuesday, November 26, 2013. Staff's motion was granted in a Hearing Examiner's Ruling dated October 31, 2013.

On December 9, 2013, Staff filed a Motion for Continuance to permit the filing of supplemental testimony by the Company and Staff to incorporate the Commission's findings in the *2013 Biennial Review Order*[1] entered on November 26, 2013. Staff's motion was granted in a Hearing Examiner's Ruling dated December 9, 2013. The Hearing Examiner's Ruling continued the evidentiary hearing in this matter from December 11, 2103, to December 17, 2013, and retained the December 11, 2013, hearing for the sole purpose of receiving testimony from public witnesses.

A hearing to receive testimony from public witnesses was convened on December 11, 2013. Charlotte P. McAfee, Esquire, appeared on behalf of Dominion Virginia Power. C. Meade Browder, Jr., Esquire, and C. Mitch Burton, Jr., Esquire, appeared on behalf of Consumer Counsel. Arlen K. Bolstad, Esquire, and K. Beth Clowers, Esquire, appeared on behalf of Staff. No public witnesses gave testimony at this hearing.

On December 11, 2013, Staff filed its Motion for Leave to File Limited Supplemental Direct Testimony, Schedules, and Supporting Work Papers. On December 12, 2013, Dominion Virginia Power filed its Motion for Leave to File Supplemental Direct Testimony. Both motions were granted by a Hearing Examiner's Ruling dated December 13, 2013.

The evidentiary hearing in this matter was convened on December 17, 2013, as scheduled. Kristian M. Dahl, Esquire, and Joseph K. Reid, III, Esquire, of McGuire Woods, LLP; and Charlotte P. McAffe, Esquire, of Dominion Resource Services, appeared on behalf of Dominion Virginia Power. C. Meade Browder, Jr., Esquire, and C. Mitch Burton, Jr., Esquire, appeared on behalf of Consumer Counsel. Arlen K. Bolstad, Esquire, and K. Beth Clowers, Esquire, appeared on behalf of Staff.

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[1] *Application of Virginia Electric and Power Company, For a 2013 biennial review of the rates, terms and conditions for the provision of generation, distribution and transmission services pursuant to § 56-585.1 A of the Code of Virginia*, Case No. PUE-2013-00020, Final Order (November 26, 2013) ("*2013 Biennial Review Order*").

SUMMARY OF THE RECORD

In its *VCHEC Order*,[2] the Commission approved development of VCHEC and approved a RAC, designated as Rider S, which was designed to allow Dominion Virginia Power to recover its costs associated with the Project, including projected construction work in progress and an associated allowance for funds used during construction. In the *VCHEC Order*, the Commission directed that Rider S become effective for service rendered on and after January 1, 2009, and be subject to annual cost true-up proceedings beginning in 2010.[3] In this Application, Dominion Virginia Power is requesting that the Commission approve a Rider S for the 2014 Rate Year designed to recover a total revenue requirement of $286,962,000.[4] The Company advised that the VCHEC became fully operational on July 10, 2012.[5]

Dominion Virginia Power's Direct Testimony

In support of its Application, Dominion Virginia Power filed the direct testimony of Mark D. Mitchell, director – fossil and hydro projects for the Company; David W. Faison, director – contracted assets for the Company; Sidney J. Bragg, director – fossil and hydro operations for the Company; Rick L. Propst, regulatory consultant – regulatory accounting for the Company; and Edward J. Anderson, regulatory analyst III for the Company. A summary of the testimony of each witness is provided below.

Mark D. Mitchell presented the updated VCHEC budget forecasts, reflecting actual expenditures through December 31, 2012, and the estimated costs to close-out the Project.[6] Mr. Mitchell advised that the VCHEC became operational on July 10, 2012, and that the VCHEC's performance exceeded the Engineering, Procurement, and Construction ("EPC") contract guarantees, providing significant customer benefits.[7] Specifically, Mr. Mitchell confirmed the VCHEC produced a net output of 600 MW (an increase of 15 MW over its original estimate), a 6% more favorable heat rate (BTU/kwh), a 12% more favorable limestone consumption (tons/hr/unit), and an 8% more favorable availability.[8] Mr. Mitchell maintained that customers will benefit from the increased available summer capacity and from reduced fuel costs attributed to the reduced heat rate.[9] Mr. Mitchell acknowledged that the original budget for the Project was $1.8 billion.[10] Mr. Mitchell testified that the overall Project forecast has increased by approximately $45.7 million due to supplemental Project costs incurred as a result of the

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[2] *Application of Virginia Electric and Power Company, For a certificate of public convenience and necessity to construct and operate an electric generation facility in Wise County, Virginia, and for approval of a rate adjustment clause under §§ 56-585.1, 56-580 D, and 56-46.1 of the Code of Virginia*, Case No. PUE-2007-00066, 2008 S.C.C. Ann. Rep. 385 ("*VCHEC Order*").
[3] *Id.* at 395.
[4] Exhibit No. 2, at 11.
[5] *Id.* at 5.
[6] Exhibit No. 10, at 1.
[7] *Id.* at 2-3.
[8] *Id.* at 3.
[9] *Id.*
[10] *Id.*

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Project's improved performance.[11] Mr. Mitchell testified that with the addition of these supplemental costs, the total cost of the Project is now $1.826 billion, or approximately $25.7 million above the original budget for the Project of $1.8 billion.[12]

Mr. Mitchell provided explanations for cost categories that varied by more than 5% from the original Project budget, including: (i) the budget for land increased by 9.5% based on final land acquisition costs; (ii) soft costs are 13.3% over the original budget due primarily to extending the Project staffing over the one-year warranty period and the updated capital overhead allocation of indirect project support costs to capital projects beginning in January 2012; (iii) the current budget for start-up costs is higher than the original budget; (iv) construction expenditures will exceed the original budget by 1.5%, primarily due to permit delays offset by variances in other subcategories; (v) electrical interface category is currently forecast to be approximately 10% below budget due to a reduction in station transmission and switchyard costs, and the PJM interconnection cost; and (vi) the budget for contingency funds decreased by 99.1% as a result of offsets in other categories.[13]

In summary, Mr. Mitchell asserted that "the Project expenditures are progressing in line with overall budgetary expectations."[14]

Sidney J. Bragg sponsored VCHEC's: (i) actual deferred operation and maintenance ("O&M) and capital expenditures for the pre-commercial operation date ("COD") period of January 1, 2012, through July 9, 2012; (ii) actual O&M and capital expenditures for the post-COD period beginning July 10, 2012, through December 31, 2012; (iii) the projected O&M and capital expenditures beginning January 1, 2013, and ending March 31, 2014; and (iv) the projected O&M and capital expenditures for the 2014 Rate Year.[15]

Mr. Bragg provided the Company's current Five-Year O&M Budget Plan and Five-Year Capital Budget Plan for the VCHEC. The total for each year is presented in the table below:[16]

Year	Total O&M Budget	Total Capital Budget
2013	$39,783,585	$31,573,376
2014	43,964,282	39,122,710
2015	48,480,580	31,750,256
2016	50,676,289	22,699,688
2017	54,139,139	15,937,846

Mr. Bragg testified that the basis for the budgeted O&M and capital expenditures for the Project is consistent with the approach presented by the Company in previous Rider S annual

[11] *Id.* at 4.
[12] *Id.*
[13] *Id.* at 5-7.
[14] *Id.* at 7.
[15] Exhibit No. 6, at 1-2.
[16] *Id.* Attached Schedule 1.

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update filings.[17] Mr. Bragg confirmed that where possible, Dominion Virginia Power relied upon existing contracts for third-party goods and services.[18] Mr. Bragg stated that the Company also based its projections on a review of actual expenditures for similarly sized units, such as Clover Power Station.[19] Mr. Bragg advised that the Company included Shared Services costs associated with the labor and support cost of the on-site warehouse employees and vehicle expenses based on the actual on-site vehicles.[20]

Mr. Bragg reported that the actual pre-COD O&M expenses for the period beginning January 1, 2012, through July 9, 2012, were $6,011,044, or about 6.5% lower than previously projected.[21] Mr. Bragg confirmed that the actual post-COD O&M expenses for the period beginning July 10, 2012, through December 31, 2012, were $15,974,140, and are lower (within 1%) than the amount projected in the 2012 Rider S Annual Update.[22] Mr. Bragg stated that the Project's projected post-COD O&M expenses for the period beginning January 1, 2013, and ending March 31, 2014, total $54,479,893; and the projected O&M expenditures for the 2014 Rate Year total $43,247,323.[23]

Mr. Bragg reported that the actual pre-COD capital expenditures for the period beginning January 1, 2012, through July 9, 2012, were $85,144, or about 99% lower than previously projected due to changes in the delivery date for the spare station service transformer and lower than expected landfill costs.[24] Mr. Bragg advised that the actual post-COD capital expenditures for the period beginning July 10, 2012, through December 31, 2012, were $2,144,582, which is 173% higher than previously forecast, and reflect the change in delivery date for the spare station service transformer.[25] Mr. Bragg stated that the Project's projected post-COD capital expenditures for the period beginning January 1, 2013, and ending March 31, 2014, total $42,517,555; and the projected capital expenditures for the 2014 Rate Year total $36,871,095.[26]

Mr. Bragg asserted that the station expenditures he identified are reasonable and prudently incurred for the operation of the Project.[27]

Rick L. Propst developed the revenue requirement for the Project to be recovered in the Rider S, including recovery of projected costs for the 2014 Rate Year, and the true-up of calendar year 2012.[28] Mr. Propst confirmed that for purposes of this proceeding, Dominion Virginia Power used an enhanced return on equity ("ROE") of 12.50%.[29] Nonetheless,

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[17] *Id.* at 3.
[18] *Id.*
[19] *Id.*
[20] *Id.* at 3-4.
[21] *Id.* at 4.
[22] *Id.* at 5.
[23] *Id.*
[24] *Id.* at 6.
[25] *Id.* at 7.
[26] *Id.*
[27] *Id.* at 8.
[28] Exhibit No. 14, at 1.
[29] *Id.* at 2.

Mr. Propst requested that the general rate of return on common equity, before addition of the 100 basis point equity adder, be the rate approved by the Commission in the 2013 Biennial Review.[30] Mr. Propst stated that both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor include an allocated amount of capital overhead costs, based on the capital overhead cost methodology presented by the Company in the 2013 Biennial Review.[31] Mr. Propst advised that for purposes of setting rates during the Rate Year, the Company used the end-of-test period capital structure and cost of capital as of December 31, 2012.[32]

Mr. Propst testified that the Projected Cost Recovery Factor will consist of: (i) the projected financing costs on invested capital for the 2014 Rate Year; (ii) income taxes on the equity component of the return; and (iii) projected operating costs of the plant during the 2014 Rate Year.[33] Mr. Propst calculated the Projected Cost Recovery Factor Virginia jurisdictional revenue requirement to be $258,471,000.[34]

As for the Actual Cost True-Up Factor, Mr. Propst stated that the Actual Revenue Requirement for the 2012 calendar year is $225,842,000, and the sum of the monthly actual revenues collected from Virginia jurisdictional customers during 2012 is $198,373,000.[35] Thus, the net-under recovery for 2012 is $27,469,000.[36] Mr. Propst calculated the net monthly financing costs for the year 2012 to be $1,022,000, which produces the Actual Cost True-Up Factor for recovery in the 2014 Rate Year of $28,491,000.[37]

Mr. Propst testified that the total aggregate revenue requirement associated with the Project for the 2014 Rate Year is $286,962,000.[38] Mr. Propst advised that this revenue requirement represents an increase of approximately $39.2 million for Rider S.[39]

Edward J. Anderson presented Dominion Virginia Power's proposed Rider S rates.[40] Mr. Anderson testified that the proposed Rider S rates were calculated using the same methodology as approved by the Commission in the Company's most recent revision to Rider S,[41] as well as for Rider W,[42] Rider R,[43] and for Rider B.[44] Mr. Anderson developed the

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[30] *Id.* at 3.
[31] *Id.* at 3-4.
[32] *Id.* at 4.
[33] *Id.* at 5.
[34] *Id.*
[35] *Id.* at 8.
[36] *Id.*
[37] *Id.* at 9.
[38] *Id.* at 11.
[39] *Id.*
[40] Exhibit No. 8, at 1.
[41] *Application of Virginia Electric and Power Company, For revision of rate adjustment clause: Rider S, Virginia City Hybrid Energy Center*, Case No. PUE-2012-00071, Final Order (March 12, 2013).
[42] *Application of Virginia Electric and Power Company, For revision of rate adjustment clause: Rider W, Warren County Power Station, for the rate year commencing April 1, 2013*, Case No. PUE-2012-00067, Final Order (February 19, 2013).

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proposed Rider S rates for the 2014 Rate Year by first forecasting kWh sales for each rate level of each customer class.[45] Mr. Anderson confirmed that the next step was to allocate the Virginia jurisdictional revenue requirement to each customer class based on the 2012 Production Demand Allocation Factor ("Factor 1").[46] Mr. Anderson calculated the proposed Rider S rates for most customer classes by dividing the class revenue requirements by their respective customer class forecasted kWh sales.[47] Mr. Anderson advised that Rate Schedule GS-3, GS-4 (Primary), GS-4 (Transmission), and the Special Contract rates are billed on a demand basis rather than an energy basis; and Rate Schedules GS-2 and GS-2T reflect both demand and energy.[48] More specifically, for Rate Schedule GS-2 and GS-2T the Company applies a kWh energy charge to monthly bills with a monthly load factor of 50% or less, and a kW demand charge to monthly bills with a monthly load factor of greater than 50%.[49]

The table below provides a summary of the Company's proposed Rider S rates by rate schedule:

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[43] *Application of Virginia Electric and Power Company, To revise a rate adjustment clause: Rider R, Bear Garden Generating Station*, Case No. PUE-2012-00068, Final Order (February 19, 2013).

[44] *Application of Virginia Electric and Power Company, For revision of rate adjustment clause: Rider B, Biomass Conversions of the Altavista, Hopewell, and Southampton power stations for the rate year commencing April 1, 2013*, Case No. PUE-2012-00072, Final Order (March 22, 2013).

[45] *Id.* at 2-3.

[46] *Id.* at 3.

[47] *Id.*

[48] *Id.* at 3-4.

[49] *Id.* at 4.

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Rate Schedule	April 1, 2013 – March 31, 2014[50]
Schedule 1	$0.00531 kWh
Schedule 1P	$0.00531 kWh
Schedule 1S	$0.00531 kWh
Schedule 1T	$0.00531 kWh
Schedule 1W	$0.00531 kWh
Schedule DP-R	$0.00531 kWh
Schedule 1EV	$0.00531 kWh
Schedule EV	$0.00531 kWh
Schedule GS-1	$0.00385 kWh
Schedule DP-1	$0.00385 kWh
Schedule GS-2	$0.00406 kWh/ $1.471/kW
Schedule GS-2T	$0.00406 kWh/ $1.471/kW
Schedule DP-2	$0.00345 kWh
Schedule GS-3	$1.441/kW
Schedule GS-4 (Primary)	$1.459/kW
Schedule GS-4 (Transmission)	$1.421/kW
§ 56-235.2 Contract	$6.974/kW
Schedule 5	$0.00344 kWh
Schedule 5C	$0.00479 kWh
Schedule 5P	$0.00479 kWh
Schedule 6	$0.00305 kWh
Schedule 6TS	$0.00301 kWh
Schedule 7	$0.00391 kWh
Schedule 8	$0.00249 kWh
Schedule 10 (Secondary)	$0.00300 kWh
Schedule 10 (Pri and Trans)	$0.00249 kWh
Schedule 25	$0.00449 kWh
Schedule 27	$0.00449 kWh
Schedule 28	$0.00449 kWh
Schedule 29	$0.00449 kWh

Mr. Anderson calculated that the proposed Rider S for the 2014 Rate Year will increase a residential customer's monthly bill by $0.65, based on monthly usage of 1,000 kWh.[51]

Staff Direct Testimony

On November 8, 2013, Staff filed the direct testimony of Paul M. McLeod, senior utility accountant for the Commission's Division of Utility Accounting and Finance; Lawrence T.

[50] *Id.* Attached Schedule 2.
[51] *Id.* at 5.

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Oliver, deputy director of the Commission's Division of Utility Accounting and Finance; and Mark A. Tufaro, senior utilities analyst in the Commission's Division of Energy Regulation. A summary of the testimony of each witness is provided below.

Paul M. McLeod confirmed that the VCHEC began commercial operations in July 2012.[52]

Mr. McLeod recommended a total Rider S revenue requirement for the 2014 Rate Year of $224.7 million, which is approximately $62.3 million less than requested by Dominion Virginia Power.[53] Mr. McLeod advised that Staff's revenue requirement is based on a Projected Cost Recovery Factor of $220.1 million, and an Actual Cost True-Up Factor of $4.6 million.[54] Mr. McLeod outlined the differences between Staff and the Company's Rider S revenue requirement as follows:[55]

- The appropriate capital structure and cost of capital, including the return on equity ("ROE"), for use in determining the Projected [Cost Recovery] Factor;

- The appropriate equity ratio for use in determining the 2012 [Actual Cost] True-Up Factor;

- The proper level of ADIT associated with liberalized depreciation (referred to herein as, "Liberalized Depreciation ADIT") to include in rate base for determining the [Actual Cost] True-Up Factor and the Projected [Cost Recovery] Factor components of Rider S;

- The treatment of current and deferred income taxes, interest expense, preferred dividends, and accounts payable associated with construction work in progress in the CWC allowance;

- The practice of calculating the CWC allowance prior to commercial operations and deferring the carrying costs for recovery after commercial operations begin;

- The amount of indirect overhead costs allocated to the VCHEC project; and

- The recalculation of the 2011 True-Up Factor based on corrections to the 2011 capital structure.

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[52] Exhibit No. 18, at 2.
[53] *Id.* at 5.
[54] *Id.* at 5-6.
[55] *Id.* at 6-7.

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Mr. McLeod addressed the following differences: (i) prorated accumulated deferred income taxes ("ADIT"), (ii) cash working capital ("CWC") allowance, (iii) overall cost of capital, (iv) generation overhead allocation methodology, and (v) 2011 Rider S true-up factor recalculation. Mr. McLeod's testimony on these topics is summarized below:

Prorated ADIT

Mr. McLeod testified that for public utilities, depreciation expense is one of the most common differences between book income before taxes and taxable income.[56] Mr. McLeod pointed out that under the IRC[57] generally, depreciation expense is accelerated, or liberalized, as compared to depreciation expense for financial reporting purposes.[58] Mr. McLeod stated that such differences create the need to recognize Liberalized Depreciation ADIT.[59] Furthermore, Mr. McLeod pointed out that the *Normalization Rules*[60] prohibit the flow-through of the tax benefits associated with liberalized depreciation for ratemaking purposes.[61]

Mr. McLeod advised that in this proceeding, Dominion Virginia Power has changed the calculation of ADIT in rate base from using projected Liberalized Depreciation ADIT balances to a proration of Liberalized Depreciation ADIT activity ("Proration Methodology") for both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor.[62] Mr. McLeod maintained that the Proration Methodology, for ratemaking, recognizes the timing of deferred tax accruals throughout a projected period.[63] Mr. McLeod reported that the Company asserts that it is required to use Proration Methodology, pursuant to Treasury Regulation 1.167(l)-1(h)(6)(ii) when projecting rate base beyond the rate effective date.[64] Mr. McLeod testified that in this case, the rate effective date is April 1, 2014, and rate base for the Projected Cost Recovery Factor is based on the projected thirteen-month average balances beginning on March 31, 2014, through March 31, 2015.[65] Mr. McLeod stated that Dominion Virginia Power applied the Proration Methodology to both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor.[66]

Mr. McLeod calculated that use of the Proration Methodology will increase revenue requirements by approximately $8.8 million in this proceeding.[67] Mr. McLeod contended that under the Proration Methodology, customer rates will be higher than under current methodology until the early 2030s, and will then produce lower rates until 2067.[68] Mr. McLeod determined

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[56] *Id.* at 8.
[57] Title 26 of the United States Code ("IRC").
[58] Exhibit No. 18, at 8.
[59] *Id.* at 8-9.
[60] IRC § 168(i)(9) ("*Normalization Rules*"); *See* Exhibit No. 18 Attached Appendix A.
[61] Exhibit No. 18, at 10.
[62] *Id.* at 9.
[63] *Id.* at 10.
[64] *Id.* at 11.
[65] *Id.*
[66] *Id.* at 12.
[67] *Id.* at 13.
[68] *Id.* at 14.

that on a net present value basis, the Proration Methodology will provide the Company with a $9.0 million net benefit.[69]

Mr. McLeod pointed out that the Proration Regulations "will apply to all rate proceedings in which rate base is projected subsequent to the effective date of the proposed rates."[70] This extends to base rate, biennial review, and RAC proceedings for Dominion Virginia Power and other water, natural gas, and electric utilities regulated by the Commission.[71]

Mr. McLeod took the position that because Rider S is subject to a true-up, it does not result in the flow-through of tax benefits and will not cause a normalization violation.[72] Mr. McLeod recommended that the Commission continue using thirteen-month average projected and actual balances to calculate the revenue requirement.[73] In addition, Mr. McLeod recommended that the Commission order Dominion Virginia Power to request a private letter ruling ("PLR") from the IRS, with Staff's assistance.[74] Mr. McLeod recommended that the Commission order the request of a PLR regardless of the method the Commission directs to be used to calculate Liberalized Depreciation ADIT in this proceeding.[75]

Mr. McLeod provided two alternatives to the Commission if the Commission does not adopt Staff's recommendation to continue using the currently approved methodology.[76] Mr. McLeod stated that under the first alternative, the Projected Cost Recovery Factor would be based on rate base balances as of March 31, 2014.[77] Mr. McLeod testified that under the second alternative, the Proration Methodology would be applied only to the Projected Cost Recovery Factor.[78] Mr. McLeod calculated that both of these alternatives will increase revenue requirements in this proceeding by approximately $0.2 million.[79] Furthermore, the impacts of the alternatives will be trued-up, including any associated carrying costs.[80]

Mr. McLeod argued that Staff's recommendation, or its alternatives provides for a timely and current recovery of costs, while the Proration Methodology results in an overstatement of revenue requirements until the early 2030s.[81]

[69] *Id.* at 15.
[70] *Id.*
[71] *Id.*
[72] *Id.* at 16.
[73] *Id.* at 18.
[74] *Id.*
[75] *Id.*
[76] *Id.* at 19.
[77] *Id.*
[78] *Id.* at 20.
[79] *Id.* at 21.
[80] *Id.* at 23.
[81] *Id.* at 22.

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CWC Allowance

Mr. McLeod confirmed that Staff's CWC allowance for the Projected Cost Recovery Factor is $8.8 million less than the CWC allowance of the Company; while Staff's CWC allowance for the Actual Cost True-Up Factor is $9.5 million greater than the CWC allowance of the Company.[82] Mr. McLeod attributed these differences to the following three modifications made by Staff: (i) Staff distinguished between current and deferred income tax expense – Dominion Virginia Power classified all income tax expense as current; (ii) Staff included interest expense and preferred dividends in its lead/lag study – Dominion Virginia Power did not include interest expense and preferred dividends in its lead/lag study; and (iii) Staff included accounts payable related to the VCHEC construction work in progress ("CWIP") in the balance sheet analysis portion of the lead/lag study – Dominion Virginia Power did not include any accounts payable related to VCHEC CWIP.[83] Mr. McLeod maintained that each of Staff's adjustments is consistent with the lead/lag methods used in the 2013 Biennial Review.[84]

Mr. McLeod acknowledged that to this point, the Company has not calculated a CWC allowance prior to the commercial operations date.[85] Nonetheless, Mr. McLeod testified that in the 2013 Biennial Review, CWC allowances related to Subsection A6 RACs were eliminated, regardless of whether the facility was under construction or operational.[86] Mr. McLeod recommended that "the practice of calculating the CWC allowance prior to commercial operations and deferring the carrying costs be approved effective January 1, 2012."[87]

Cost of Capital

Mr. McLeod stated that Staff's Projected Cost Recovery Factor includes a pre-tax overall cost of capital of 10.814% based on the testimony of Staff witness Oliver.[88] Mr. McLeod calculated that the change in overall cost of capital reduced the Company's Projected Cost Recovery Factor by $36.2 million.[89] Similarly, for the Actual Cost True-Up Factor, Mr. McLeod testified that the 11.602% pre-tax cost of capital presented by Staff witness Oliver reduces the Company's revenue requirement by $15.4 million.[90]

Generation Overhead Allocation Methodology

Mr. McLeod testified that in January 2012, Dominion Virginia Power revised its allocation of indirect overhead costs to generation capital projects.[91] Mr. McLeod advised that in Company RAC cases decided subsequent to the revised allocation of indirect overhead costs, the

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[82] *Id.* at 23.
[83] *Id.* at 24.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.* at 25.
[88] *Id.*
[89] *Id.*
[90] *Id.* at 26.
[91] *Id.*

parties agreed to: (i) defer the issue to the 2013 Biennial Review; (ii) use an effective date of January 1, 2012, for implementation of the methodology for allocating indirect overheads; and (iii) use the former allocation methodology to allocate indirect overhead costs for the Projected Cost Recovery Factor, subject to true-up to the methodology approved by the Commission in the 2013 Biennial Review.[92]

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Mr. McLeod advised that in this case, the Company has reflected the adoption of its new methodology for the allocation of indirect overhead costs and Staff has used the former allocation methodology.[93] Mr. McLeod calculated that Staff's use of the former allocation methodology reduces the Company's revenue requirement by $480,000.[94]

2011 Rider S True-Up Factor Recalculation

Mr. McLeod testified that Staff recalculated the 2011 actual cost due to certain corrections to the 2011 capital structure that were agreed to by the Company in the 2013 Biennial Review.[95] Mr. McLeod stated that the impact of this adjustment is that "the deferred balance of over/under recovery of actual costs during 2011 in Staff's rate base is $0.7 million less than in the Company's rate base."[96]

Lawrence T. Oliver disagreed with Dominion Virginia Power's use of its actual December 31, 2012, ratemaking capital structure and cost of capital in this case.[97] Consistent with Staff's position in the 2013 Biennial Review, Mr. Oliver contended that an equity ratio in excess of 55% is unreasonable.[98] Mr. Oliver recommended that rates in this case be based on a capital structure containing a 48% equity ratio.[99] Mr. Oliver supported the use of a placeholder 10.4% ROE for determining the revenue requirement in this case.[100] In addition, Mr. Oliver recommended use in this case of the base ROE the Commission finds reasonable in the 2013 biennial review case, plus the 100 basis point adder.[101] Mr. Oliver supported the Company's use of its currently authorized ROE of 10.4%, plus the 100 basis point adder for the Actual Cost True-Up Factor for 2012.[102] Mr. Oliver's recommended capital structures and costs of capital are shown below:

[92] *Id.* at 26-27.
[93] *Id.* at 28-29.
[94] *Id.* at 30.
[95] *Id.*
[96] *Id.*
[97] Exhibit No. 23, at 2-3.
[98] *Id.* at 3.
[99] *Id.* at 4.
[100] *Id.*
[101] *Id.* at 6.
[102] *Id.* at 7.

Projected Cost Recovery Factor[103]

Component	Weight	Cost Rate	Weighted Cost
Short-Term Debt	3.5%	0.468%	0.016%
Long-Term Debt	47.1%	5.235%	2.466%
Preferred Stock	1.3%	6.529%	0.085%
Common Equity	48.0%	10.400%	4.993%
Investment Tax Credits	0.1%	7.824%	0.006%
Total Capitalization	100.0%		7.567%

Actual Cost True-Up Factor[104]

Component	Weight	Cost Rate	Weighted Cost
Short-Term Debt	3.5%	0.468%	0.016%
Long-Term Debt	47.1%	5.235%	2.466%
Preferred Stock	1.3%	6.529%	0.085%
Common Equity	48.0%	11.400%	5.473%
Investment Tax Credits	0.1%	8.322%	0.007%
Total Capitalization	100.0%		8.047%

Marc A. Tufaro provided a summary of the Company's development of its proposed Rider S charges.[105] Mr. Tufaro agreed with the methodology used by Dominion Virginia Power. Mr. Tufaro testified that if the Commission approves a revenue requirement that differs from the Company's requested revenue requirement of $286,962,000 for the 2014 rate year, then "the Rider S surcharges [should] be adjusted proportionately."[106] Mr. Tufaro stated that "[t]his recommendation is intended to maintain the revenue apportionment and rate design methodology proposed by the Company in this case."[107]

Dominion Virginia Power's Rebuttal Testimony

On November 26, 2013, Dominion Virginia Power filed the rebuttal testimony of Rick L. Propst, and James I. Warren, a member of the law firm of Miller & Chevalier Chartered. A summary of the testimony of each witness is provided below.

Rick L. Propst responded to Staff witness McLeod's proposals regarding (i) indirect overhead costs; (ii) CWC; and (iii) ADIT.[108] Mr. Propst also addressed Staff witness Oliver's proposals related to the cost of capital and ROE used for calculating revenue requirements in this case.[109]

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[103] *Id.* at Attached Schedule 5.
[104] *Id.* at Attached Schedule 4.
[105] Exhibit No. 27, at 3-6.
[106] *Id.* at 7.
[107] *Id.*
[108] Exhibit No. 30, at 1.
[109] *Id.*

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While he disagreed with Mr. Oliver's base ROE of 9.4% for calculating the Projected Cost Recovery Factor in this proceeding, Mr. Propst agreed with Mr. Oliver's recommendation that the base ROE in this proceeding be the rate authorized in the 2013 Biennial Review plus a 100 basis point adder.[110] In addition, Mr. Propst disagreed with Staff's capital structure and recommended the use of the actual December 31, 2012, year-end capital structure containing an equity ratio of 55.019% for calculating the Actual Cost True-Up Factor, and a pro-forma capital structure containing an equity ratio of 53.102% for calculating the Projected Cost Recovery Factor.[111] Mr. Propst asserted that such capital structures are consistent with Subsection A 10 and Commission precedent.[112] Mr. Propst calculated that use of the proforma capital structure for the Projected Cost Recovery Factor would reduce the Rider S revenue requirement by $4.2 million.

In regard to the allocation of indirect overhead costs, Mr. Propst maintained that Dominion Virginia Power supported its proposed methodology in the 2013 Biennial Review.[113] Mr. Propst stated that "[i]f appropriate, the Company will seek leave to file supplemental testimony to reflect the Commission-approved methodology pursuant to the Final Order in the 2013 Biennial Review."[114]

Mr. Propst agreed, in part, with Staff's proposed changes to CWC.[115] Mr. Propst noted that the one area of disagreement was Staff's treatment of the CWIP accounts payable ("A/P") component of the CWC calculation.[116] Mr. Propst contended that the use of the two-month averaging methodology effectively recognizes a working capital impact for the various rate base components, such as CWIP.[117]

Mr. Propst stated that Company witness Warren would address the ADIT normalization issues.[118] Nonetheless, Mr. Propst took issue with Staff's first alternative recommendation, which would be contrary to the long-standing practice of projecting rate base beyond the rate effective date in Subsection A6 proceedings and would result in the substantial under-recoveries of costs.[119]

Mr. Propst testified that Company is now seeking a Projected Cost Recovery Factor revenue requirement of $251,811,000, and an Actual Cost True-Up Factor revenue requirement of $26,272,000, or an overall revenue requirement in this proceeding of $278,083,000.[120]

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[110] *Id.* at 2-3.
[111] *Id.* at 4.
[112] *Id.*
[113] *Id.* at 7.
[114] *Id.*
[115] *Id.*
[116] *Id.* at 8.
[117] *Id.*
[118] *Id.* at 9.
[119] *Id.*
[120] *Id.* at 10.

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James I. Warren supported the Company's ADIT Proration Methodology and warned that the consequences of failing to adopt such methodology "may be severely punitive."[121]

Mr. Warren testified that ADIT represents cost-free capital loaned to a utility by the federal government.[122] Mr. Warren disagreed with Staff witness McLeod's characterization of ADIT as "customer provided capital."[123] Mr. Warren advised that for a utility to receive the benefits of accelerated tax depreciation, normalization accounting must be allowed by the regulators.[124] Mr. Warren stated that the penalty for violating the depreciation normalization rules would be the loss of the opportunity to use liberalized tax depreciation in the future and an accelerated repayment of existing ADIT.[125]

Mr. Warren stated that the normalization rules prescribe: (i) how to implement normalization; (ii) what can be done with the deferred tax benefit once it is deferred; and (iii) when the deferred tax benefit can be reversed.[126] Mr. Warren maintained that the second of these requirements is at issue in this proceeding.[127] Mr. Warren pointed to Treasury Regulation § 1.167(l)-1(h)(6) and advised that this section provides limitations on the amount of ADIT used to reduce rate base for historical test periods and future test periods.[128] Mr. Warren testified that for tax law purposes, a future test period is a period beyond the effective date of the rates being set.[129] Because the rates in this proceeding will become effective on April 1, 2014, and rate base is based on the projected thirteen-month average balances beginning March 31, 2014, and ending March 31, 2015, Mr. Warren argued that from a tax perspective, the test period used in this proceeding is a future test period.[130] Based on the use of a future test period, Mr. Warren advised that the Company's proposed Proration Methodology is prescribed by the Treasury Regulation.[131]

Mr. Warren acknowledged that Staff witness McLeod does not dispute the proration requirement or how it operates.[132] Rather, Mr. Warren stated that Staff does not believe the proration requirement is required due to the nature of this rate mechanism.[133] Mr. Warren disagreed with Mr. McLeod's assertions that: (i) the normalization rules are satisfied because the Rider S deferral mechanism prevents any flow-through of tax benefits; and (ii) proration does not apply to the Actual Cost True-Up Factor because it is based on historic data.[134] Mr. Warren asserted that the use of deferral accounting has nothing to do with the proration formula's

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[121] Exhibit No. 29, at 3.
[122] *Id.* at 5.
[123] *Id.* at 6.
[124] *Id.* at 9.
[125] *Id.* at 10.
[126] *Id.*
[127] *Id.*
[128] *Id.* at 11.
[129] *Id.* at 12.
[130] *Id.*
[131] *Id.* at 13-14.
[132] *Id.* at 14.
[133] *Id.*
[134] *Id.*

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limitation on the benefit provided to customers.[135] Mr. Warren argued that the introduction of the Rider S deferral mechanism into the normalization analysis is "misguided."[136] Moreover, Mr. Warren contended that the Actual Cost True-Up Factor of the Rider S "simply refines the data used in the original future test year."[137] Mr. Warren testified that the Actual Cost True-Up Factor does not convert a future test year into an historic one.[138] Mr. Warren maintained that "[t]he substitution of actual data for projected data does not alter the effective date of the rates and, consequently, does not change the character of the test period."[139]

Mr. Warren asserted that Staff's second alternative, applying the Proration Methodology to the Projected Cost Recovery Factor, but not to the Actual Cost True-Up Factor, would conflict with the requirements of the normalization rules.[140] Mr. Warren provided an example that showed that if the Proration Methodology is not used for both the projected and the eventual true-up, the results will be inconsistent.[141]

Staff Supplemental Testimony

On December 11, 2013, Staff filed the supplemental testimony of Paul M. McLeod and Lawrence T. Oliver. A summary of each supplemental testimony is provided below.

Paul M. McLeod provided updated calculations of the Projected Cost Recovery Factor and Actual Cost True-Up Factor for the 2014 Rate Year, and made a recommendation regarding the treatment of deferred income tax expense in calculating CWC.[142] Mr. McLeod asserted that the *2013 Biennial Review Order* should be incorporated into the revenue requirement calculations in this proceeding, including:[143]

- A base [ROE] of 10.0% is applicable to the Company's rate adjustment clauses effective November 30, 2013;
- An equity ratio of 50% is reasonable for ratemaking; and
- Staff's modified labor-based methodology should be used to capitalize generation overhead costs.

Based on the supplemental testimony of Staff witness Oliver, Mr. McLeod stated that the pre-tax overall cost of capital for the Projected Cost Recovery Factor is 11.543%, and the pre-tax overall cost of capital for the Actual True-Up Factor is 11.862%.[144]

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[135] *Id.* at 15-16.
[136] *Id.* at 16.
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.* at 17-18.
[141] *Id.* at 18-19.
[142] Exhibit No. 20, at 1-2.
[143] *Id.* at 2-3.
[144] *Id.* at 3.

Mr. McLeod confirmed that in addition to applying Staff's modified labor-based methodology in this proceeding to CWIP balances as of January 1, 2012, the modified labor-based methodology was also used to calculate accumulated depreciation, ADIT, and depreciation expense in Staff's supplemental revenue requirement.[145]

Mr. McLeod corrected Staff's lead/lag studies to reflect the following:[146]

- Annualize current income tax expense, deferred income tax expense, interest expense, preferred dividends, and accounts payables related to construction work in progress in the [Actual Cost] True-[U]p Factor lead/lag study;

- Correct the expense lead days used for deferred income tax expense in calculating the CWC allowance in Staff's second alternative.

In regard to the expense lead days used for deferred income tax expense in calculating the CWC allowance in Staff's second alternative, Mr. McLeod took the position that because the ADIT balances are calculated using the proration methodology, zero net lead/lag days are appropriate for liberalized depreciation deferred income tax expense.[147]

The table below provides a summary of Staff's revised 2014 Rate Year Rider S revenue requirements:[148]

	Proposal	Alternative 1	Alternative 2
Projected Cost Recovery Factor	$229.5 million	$230.9 million	$229.6 million
Actual Cost True-Up Factor	$9.1 million	$9.1 million	$9.1 million
Total Revenue Requirement	$238.6 million	$240.0 million[149]	$238.7 million[150]

Lawrence T. Oliver updated his recommendation to reflect the *2013 Biennial Review Order* concerning ROE and capital structure.[151] Specifically, Mr. Oliver noted that the *2013 Biennial Review Order* found a base ROE of 10.0% applicable to the Company's RACs effective November 30, 2013.[152] Thus, Mr. Oliver recommended the use of an ROE of 11.0% for the

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[145] *Id.* at 4.
[146] *Id.*
[147] *Id.* at 5.
[148] *Id.*
[149] $240.0 million = $230.9 million + $9.1 million.
[150] $238.7 million = $229.6 million + $9.1 million.
[151] Exhibit No. 24, at 1.
[152] *Id.* at 2.

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Projected Cost Recovery Factor, and an ROE of 11.4% for the Actual Cost True-Up Factor.[153] Further, based on the *2013 Biennial Review Order* that found that the use of an equity ratio of 50% was reasonable for ratemaking, Mr. Oliver recommended that an equity ratio of 50% be used for both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor.[154] Mr. Oliver's recommended capital structures and costs of capital are shown below:

Projected Cost Recovery Factor[155]

Component	Weight	Cost Rate	Weighted Cost
Short-Term Debt	3.905%	0.468%	0.018%
Long-Term Debt	44.497%	5.235%	2.329%
Preferred Stock	1.509%	6.529%	0.098%
Common Equity	50.000%	11.000%	5.500%
Investment Tax Credits	0.090%	8.258%	0.007%
Total Capitalization	100.000%		7.954%

Actual Cost True-Up Factor[156]

Component	Weight	Cost Rate	Weighted Cost
Short-Term Debt	3.905%	0.468%	0.018%
Long-Term Debt	44.497%	5.235%	2.329%
Preferred Stock	1.509%	6.529%	0.098%
Common Equity	50.000%	11.400%	5.700%
Investment Tax Credits	0.090%	8.466%	0.008%
Total Capitalization	100.000%		8.154%

Dominion Virginia Power's Supplemental Testimony

On December 12, 2013, Dominion Virginia Power filed the supplemental testimony of Rick L. Propst and Edward J. Anderson. A summary of each supplemental testimony is provided below.

Rick L. Propst calculated that use of the Staff's modified labor-based method to allocate capital overhead costs to the Project reduces the Rider S revenue requirement for the 2014 Rate Year by approximately $0.5 million.[157] Mr. Propst confirmed that the Company has used an enhanced ROE of 11.0% for purposes of calculating the revised revenue requirement over the Rate Year in this case.[158]

In regard to the equity ratio, Mr. Propst testified that for calculating the Actual Cost True-Up Factor for calendar year 2012, the Company used an equity ratio of 50.0%, but used the actual equity ratio as of September 30, 2013, of 51.8% for the Projected Cost Recovery Factor.[159]

[153] *Id.*
[154] *Id.* at 3.
[155] *Id.* at Attached Schedule 1, at 2.
[156] *Id.* at Attached Schedule 1, at 1.
[157] Exhibit No. 16, at 2.
[158] *Id.*
[159] *Id.* at 3.

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Mr. Propst advised that Dominion Virginia Power is now requesting a Projected Cost Recovery Factor of $231,622,000, and an Actual Cost True-Up Factor of $16,168,000, for a total 2014 Rate Year revenue requirement of $247,790,000.[160]

Edward J. Anderson presented revised proposed Rider S rates based on the Company's supplemental revenue requirements as shown in the table below.[161]

Rate Schedule	April 1, 2013 – March 31, 2014[162]
Schedule 1	$0.00458 kWh
Schedule 1P	$0.00458 kWh
Schedule 1S	$0.00458 kWh
Schedule 1T	$0.00458 kWh
Schedule 1W	$0.00458 kWh
Schedule DP-R	$0.00458 kWh
Schedule 1EV	$0.00458 kWh
Schedule EV	$0.00458 kWh
Schedule GS-1	$0.00333 kWh
Schedule DP-1	$0.00333 kWh
Schedule GS-2	$0.00351 kWh/ $1.270/kW
Schedule GS-2T	$0.00351 kWh/ $1.270/kW
Schedule DP-2	$0.00298 kWh
Schedule GS-3	$1.245/kW
Schedule GS-4 (Primary)	$1.260/kW
Schedule GS-4 (Transmission)	$1.227/kW
§ 56-235.2 Contract	$6.022/kW
Schedule 5	$0.00297 kWh
Schedule 5C	$0.00414 kWh
Schedule 5P	$0.00414 kWh
Schedule 6	$0.00263 kWh
Schedule 6TS	$0.00260 kWh
Schedule 7	$0.00338 kWh
Schedule 8	$0.00215 kWh
Schedule 10 (Secondary)	$0.00259 kWh
Schedule 10 (Pri and Trans)	$0.00215 kWh
Schedule 25	$0.00388 kWh
Schedule 27	$0.00388 kWh
Schedule 28	$0.00388 kWh
Schedule 29	$0.00388 kWh

[160] *Id.* at 4.
[161] Exhibit No. 9, at 1.
[162] *Id.* at Attached Schedule 2.

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Mr. Anderson calculated that the revised proposed Rider S for the 2014 Rate Year will decrease a residential customer's monthly bill by $0.08, based on monthly usage of 1,000 kWh.[163]

DISCUSSION

At the conclusion of the evidentiary proceeding, Dominion Virginia Power sought a Projected Cost Recovery Factor revenue requirement of $231,622,000, and an Actual Cost True-Up Factor revenue requirement of $16,168,000, for a total Rider S revenue requirement of $247,790,000.[164] Staff recommended a Projected Cost Recovery Factor revenue requirement of $229,486,000, and an Actual Cost True-Up Factor revenue requirement of $9,122,000, for a total Rider S revenue requirement of $238,608,000.[165] The issues between Dominion Virginia Power and Staff include: (i) prorating liberalized depreciation ADIT for both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor; (ii) the capital structure and cost of capital for the Projected Cost Recovery Factor; and (iii) CWC. Each of these issues will be discussed separately below.

In addition, during the hearing Consumer Counsel raised an issue concerning the reasonableness of the Project's overall cost of $1.826 billion.[166] Consumer Counsel pointed out that in its *VCHEC Order*, the Commission capped the VCHEC's overall cost at $1.8 billion.[167] Much of the testimony and argument on this issue was treated as confidential. Thus, most of the discussion of this issue is included as a confidential attachment to this report. As explained more fully in the confidential attachment, I find that Dominion Virginia Power has demonstrated that the additional costs of the Project are reasonable and prudent, and provide additional benefits to customers.

Prorating Liberalized Depreciation ADIT

The issues concerning prorating liberalized depreciation ADIT in this proceeding include: (i) whether the Commission should direct Dominion Virginia Power, with Staff's assistance, to seek a PLR from the IRS on the prorating of ADIT associated with liberalized depreciation in RAC cases; (ii) whether ADIT associated with liberalized depreciation should be prorated for the Projected Cost Recovery Factor; (iii) whether ADIT associated with liberalized depreciation should be prorated for the Actual Cost True-Up Factor; (iv) if the Company is required by IRS normalization rules to prorate ADIT associated with liberalized depreciation, is the Company in violation of Subsection A 6; and (v) if ADIT is prorated, does the use of a zero net lead day violate normalization requirements.

There is general agreement between Dominion Virginia Power and Staff in regard to the benefits of liberalized depreciation for income tax calculations and the IRS normalization

[163] *Id.* at 2.

[164] Exhibit No. 16, at 4.

[165] Exhibit No. 20, at Attached Schedule 1 Supplement.

[166] Dahl, Tr. at 168; Clowers, Tr. at 33.

[167] Burton, Tr. at 25.

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requirements, which are designed to prevent regulatory agencies from prematurely passing such benefits to customers. Staff witness McLeod explained the need for liberalized depreciation ADIT as follows: "During the tax life of the asset, companies take larger depreciation deductions on the income tax return than on the books, and realize current income tax savings."[168] Company witness Warren emphasized that "the funds will have to be paid back to the government over time."[169] Mr. Warren referred to ADIT as "a loan from the government."[170] For ratemaking purposes, income tax expense has "current" and "deferred" components to recognize the timing differences between "book" and "tax" income, and ADIT is deducted from rate base to reflect that deferred taxes are cost-free capital.[171]

Mr. Warren also stressed the penalty for violating the IRS normalization rules is the loss of the ability of a utility to use accelerated methods of tax depreciation.[172] Mr. Warren also stated that existing ADIT would have to be repaid on a more rapid basis.[173]

In calculating the Projected Cost Recovery Factor for Rider S, rate base generally is determined by forecasting an amount for each month of the projected period, which in this case is March 2014 through March 2015.[174] Until this case, there was no controversy that the rate base included monthly projections for ADIT, along with the monthly projections for the other rate base items such as capital expenditures, accumulated depreciation, etc. However, Dominion Virginia Power now asserts that IRS normalization rules require the implementation of a Proration Methodology. Treasury Regulation § 1.167(l)-1(h)(6)(ii) describes the Proration Methodology as follows:

> For the purpose of determining the maximum amount of the reserve to be excluded from the rate base . . . . If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. . . . The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period . . . .[175]

[168] Exhibit No. 18, at 8-9.
[169] Exhibit No. 29, at 5.
[170] *Id.*
[171] Exhibit No. 18, at 9; Exhibit No. 29, at 6-8.
[172] Exhibit No. 29, at 9.
[173] *Id.* at 10.
[174] Exhibit No. 18, at 11.
[175] *See* Exhibit No. 18, Appendix B, at 13; Exhibit No. 29, at 13.

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Treasury Regulation § 1.167(l)-1(h)(6)(ii) also provides for the maximum ADIT in rate base for "solely an historic period" and for "both to an historical portion and to a future portion of a period." For the "solely an historic period" this regulation provides:

> [I]f solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period.

And for a period with both an historical portion and a future portion, the regulation states:

> If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Company witness Warren maintained that "[f]or tax law purposes, a future test period is a period beyond the effective date of the rates being set in the proceeding."[176] Mr. Warren contended that because rates from this proceeding will become effective on April 1, 2014, and because "[t]he Company's rate base is calculated based on the projected thirteen-month average balances beginning on March 31, 2014 and ending March 31, 2015," Rider S is based on a "future test period" subject to the Proration Methodology for ADIT.[177]

Indeed, Mr. Warren applied the Proration Methodology for ADIT to both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor in this proceeding.[178] Mr. Warren testified that the Actual Cost True-Up Factor:

> converts an imperfect future test year to a perfect future test year. It does not, however, convert a future test year into an historic one.[179]

Staff witness McLeod testified that Rider S is a two-step mechanism designed to provide for recovery of actual costs pursuant to Subsection A6.[180] Mr. McLeod calculated that the Company's proposed Proration Methodology would ultimately yield Dominion Virginia Power $9 million in extra benefits, at the expense of customers, than the current ADIT methodology that is designed to comply with the actual cost provisions of Subsection A6. Mr. McLeod acknowledged uncertainty concerning normalization rules and a Subsection A6 RAC, and argued that the Commission should: (i) direct Dominion Power, with Staff's assistance, to request a

[176] Exhibit No. 29, at 12.
[177] *Id.* at 12-14.
[178] *Id.* at 16.
[179] *Id.*
[180] McLeod, Tr. at 89.

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PLR from the IRS to clarify whether a normalization violation exists; and (ii) continue using projected liberalized depreciation ADIT balances for both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor.[181]

During oral arguments, Staff and Consumer Counsel both recommended that the Commission direct Dominion Virginia Power to seek a PLR.[182] Dominion Virginia Power maintained that its Proration Methodology is "the safe route."[183] Nonetheless, the Company stated:

> If there is that need to go that additional step and seek a PLR we can do that and include the Staff in the process, that would allow for a safe approach, and would avoid any possibility of a violation and still the true-up mechanism [is] there if the answer is different.[184]

The ADIT normalization issue extends beyond this case to all RACs that include a forecasted period, with rates becoming effective before the end of such period. Furthermore, neither Staff nor the Company were able to present a PLR that addressed a situation similar to the two-step, actual cost processes established pursuant to Subsection A6. Therefore, I find that the recommendations of Staff and Consumer Counsel concerning the seeking of a PLR should be adopted.

As for the approach to take in the interim, I agree with Staff that the Subsection A6 RACs are the product of a two-step process that is designed to provide both the current recovery of actual costs and incentives for the Company to undertake the development of facilities such as the Project. The provision of incentives to promote capital investment under Subsection A6 is in harmony with the investment incentives to promote capital investment associated with liberalized tax depreciation.[185] More importantly, the use of the Actual Cost True-Up Factor ensures that the revenues ultimately collected from customers recover only the actual cost, as determined on an historic basis. In this case, the effective date for rates is April 1, 2014. The Actual Cost True-Up Factor is based on the actual results for calendar year 2012. Regardless of how much revenue was collected from customers during 2012 through the Projected Cost Recovery Factor, ultimately that amount is adjusted to the actual costs determined on an historical basis.

Company witness Warren provided a simple example to support his conclusions in which he assumed that for the Projected Cost Recovery Factor, in June 2014 the Company forecasted that the ADIT balance would increase by $100,000.[186] Using the Proration Methodology, only $50,411 of this amount would be recognized as a reduction to rate base.[187] Mr. Warren then

[181] *Id.* at 90.
[182] Bolstad, Tr. at 153-54; Burton, Tr. at 151.
[183] Dahl, Tr. at 163.
[184] *Id.*
[185] *See* Exhibit No. 29, at 8.
[186] Exhibit No. 29, at 18.
[187] *Id.*

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assumed that in June 2014 the actual ADIT balance increased by only $99,000.[188] Mr. Warren testified:

> Thus, for purposes of the True-up Factor, the ADIT rate base reduction attributable to June would be the entire $99,000 of actually created ADIT. The result would be that, because the Company produced $1,000 *less* ADIT in June than it projected it would, its ADIT balance is *increased* by $48,589. This result defies rational explanation.[189]

I disagree. The Proration Methodology is driven by recognition of a "factor of time," which attempts to account for the fact that rates reflecting the new ADIT will become effective before the ADIT is actually realized. Thus, in the example, because the rates become effective in April 2014, the new ADIT does not exist until June 2014; the new ADIT is prorated to reflect that the ADIT will actually exist for only a part of the Rate Year. Consequently, even though ADIT is projected to increase by $100,000 in June 2014, only $50,411 would be used to calculate rate base for the Projected Cost Recovery Factor. However, the Actual Cost True-Up Factor covering the month of June 2014 will be reflected in rates that will become effective April 1, ***2016***. In 2016, there will no longer be a need to apply the Proration Methodology to account for any "factor of time" as there may be for when rates are placed into effect before the ADIT is produced. In this example, all of the $99,000 has been produced before rates reflecting this amount become effective. This example also illustrates that regardless of the Projected Cost Recovery Factor, the ultimate amount of revenues collected from customers is determined by the Actual Cost True-Up Factor, and that is based on actual costs determined in an historical period.

Consequently, I find that if this case is decided on the basis of the most likely outcome of a requested PLR, then Staff's recommended approach should be adopted.

However, I agree with Company witness Warren that the penalties associated with violating the IRS normalization rules are "draconian."[190] It is possible that the IRS may view the Projected Cost Recovery Factor and the Actual Cost True-Up Factor as two separate rates, or as rates derived for a period with both an historical portion and a future portion. Under such an interpretation, the result would follow Staff's second alternative, which is depicted in Mr. Warren's example above. The Proration Methodology would be used for the "future period" or the Projected Cost Recovery Factor; and actual amounts would be used for the "historical period" or the Actual Cost True-Up Factor. Because this result tracks well with the language of the normalization rules, and does not rely upon an accurate assessment of the two-step rate process implemented pursuant to Subsection A6, I find that until the Company receives its PLR, the Commission should use the Proration Methodology for the Projected Cost Recovery Factor and actual results for the Actual Cost True-Up Factor.

During the hearing, Staff raised concern that the Proration Methodology may "run[] afoul of [Subsection] A6's requirement that the Company really recover only its actual costs accrued

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[188] *Id.*

[189] *Id.* at 18-19 (emphasis in original).

[190] Exhibit No. 29, at 10.

against interest."[191] Because of the uncertainty regarding the result of the PLR process, and because it may be possible to negate most of the effects of the use of the Proration Methodology used for the Projected Cost Recovery Factor when determining the Actual Cost True-Up Factor, I find that such concerns need not be addressed before Dominion Virginia Power obtains a PLR.

Finally, Staff witness McLeod testified that when the Proration Methodology is used for ADIT, "[u]nless zero cash working capital is allowed for liberalized depreciation deferred taxes in the lead lag study the Company's needs will be overstated."[192] Company witness Warren expressed concern that Staff's adjustment could be construed as offsetting, in part, the normalization rules and the use of the Proration Methodology.[193] Staff's CWC lead/lag study is designed to measure the level of cash needed by the Company based on the timing of the collection of its revenues and the payment of its costs and expenses.[194] Staff's adjustment recognizes that the use of the Proration Methodology changes the timing of cash flows and cash requirements. Rather than negating or offsetting the Proration Methodology, the adjustment recognizes that in its CWC calculation, Staff had made some allowance for the "factor of time." Thus, Staff's adjustment is necessary to keep such factors from being counted twice, and overstated. Consequently, I find that Staff's adjustment to CWC to eliminate liberalized depreciation deferred taxes is appropriate if the Proration Methodology is used. Dominion Virginia Power may include this issue when requesting its PLR.

Capital Structure

There are two capital structure related issues in this case. The first issue concerns the capital structure to be used for the Projected Cost Recovery Factor. Dominion Virginia Power has used its actual capital structure as of September 30, 2013, which has an equity ratio of 51.8%.[195] Based on the Commission's *2013 Biennial Review Order*, Staff used a capital structure that has an equity ratio of 50%.[196] The second issue concerns the calculation of the cost of debt, when the capital structure is adjusted to reflect a 50% equity ratio. Based on the Commission's *2013 Biennial Review Order*, both the Company and Staff used a capital structure with an equity ratio of 50% for calculating the Actual Cost True-Up Factor. Nonetheless, the Company derived the cost of debt by assuming all additional debt would have a cost equal to the embedded cost of senior notes, while the Staff used the actual weighted cost of debt for the adjusted capital structure.[197]

In its *2013 Biennial Review Order*, for ratemaking purposes, the Commission reduced the Company's equity ratio to 50%.[198]

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[191] Bolstad, Tr. at 154.
[192] McLeod, Tr. at 99-100.
[193] Warren, Tr. at 120-21.
[194] *See* McLeod, at 99.
[195] Exhibit No. 16, at 3.
[196] Exhibit No. 24, at 3.
[197] Oliver, Tr. at 107-09.
[198] *2013 Biennial Review Order* at 23; n.63.

> Based on the record, we find that a common equity percentage of 50% on a ratemaking basis is reasonable and prudent for the purpose of setting rates.[63]
>
> . . . .
>
> [63] Under the facts of this case, we have found that, at this time, a common equity percentage of 55% for ratemaking is unreasonably high, and that 50% is reasonable for such purposes.

In its *2013 Biennial Review Order*, the Commission also addressed the equity ratio to be used in Subsection A5 and A6 RACs, which (as in this case) include true-ups for 2012. Rather than using the actual equity ratio of 55.02% for 2012, or Dominion Virginia Power's "voluntary" equity ratio of 53.1% for the 2012 RAC true-ups, the Commission affirmed the use of an equity ratio of 50%.[199]

> Having found that a reasonable equity ratio for 2012 is 50%, not 53.1%, we reject the Company's proposal in this regard.

The *2013 Biennial Review Order* set the equity ratio at 50% for 2012. Thus, the Company and Staff have both used a 50% equity ratio for purposes of the Actual Cost True-Up Factor. For purposes of the Projected Cost Recovery Factor, the Company proposes the use of a 51.8% equity ratio based on its actual September 30, 2013, capital structure. Dominion Virginia Power asserted that going forward, a 51.8% equity ratio "is a recent and reasonable approximation for its overall capital costs over the rate year and consistent with that goal in minimizing any over or under recovery from customers."[200]

Consumer Counsel and Staff maintained that a 50% equity ratio should be used for both the Projected Cost Recovery Factor and the Actual Cost True-Up Factor in this case. Consumer Counsel argued that the *2013 Biennial Review Order* "requires the Company to use a 50% equity ratio for ratemaking purposes."[201] Staff contended that the use of a 50% equity ratio is consistent with the *2013 Biennial Review Order* and the Commission's finding that a 50% equity ratio is reasonable for ratemaking.[202]

I agree with Staff that a 50% equity ratio is consistent with the *2013 Biennial Review Order* and the Commission's finding that a 50% equity ratio is reasonable for ratemaking. While the *2013 Biennial Review Order* requires the use of a 50% equity ratio for the Actual True-Up Factor, the Commission also found that an equity ratio of 50% "is reasonable and prudent for the purpose of setting rates."[203] In addition, the Commission found an equity ratio of 55.02% "is neither reasonable nor prudent for the purpose of setting rates," and rejected the use of an equity

[199] *Id.* at 24.
[200] Dahl, Tr. at 166.
[201] Burton, Tr. at 152.
[202] Bolstad, Tr. at 158.
[203] *2013 Biennial Review Order* at 23.

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ratio of 53.1%.[204] Consistent with these findings, since the Commission has found that a reasonable equity ratio for the purposes of setting rates is 50%, I find that the Projected Cost Recovery Factor should be based on an equity ratio of 50%, not 51.8%. Based on the Commission's findings in the *2013 Biennial Review Order*, the use of an equity ratio of 50% should produce results that minimize any over- or under-recovery from customers.

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As for the weighted cost of debt to be used when the capital structure is adjusted to reflect an equity ratio of 50%, both the Company and Staff contended that they had followed the methodology used by the Commission in its *2013 Biennial Review Order.*[205] Nonetheless, the Company adjusted the weighted cost of debt by increasing a subpart to the cost of debt, or senior notes, and assumed that the equity to be replaced in the capital structure would be replaced by senior notes at a cost equal to the Company's embedded average cost or 5.701%.[206] Staff increased total long-term debt and used the overall average cost of long-term debt or 5.235%.[207]

In the *2013 Biennial Review Order*, the Commission specified that the adjustment to equity should be applied to the long-term debt ratio.

> In addition, in order to maintain the Company's total ratemaking capitalization and rate base investment at its current level, the decrease in the equity ratio shall be matched with a corresponding increase in the long-term debt ratio.[208]

Based on the language of the *2013 Biennial Review Order*, I find that Staff's methodology matches the methodology adopted by the Commission in its *2013 Biennial Review Order.*

CWC

In this case, Staff proposed changes to the calculation of CWC that differ from prior RAC cases.[209] Staff witness McLeod maintained that each of Staff's recommended changes to CWC was consistent with CWC in the 2013 Biennial Review.[210] Company witness Propst took issue with Staff's treatment of A/P associated with CWIP.[211] Mr. Propst asserted that there is no need to include A/P associated with CWIP in the balance sheet portion of the lead/lag study because the use of the two-month averaging methodology effectively recognizes a working capital impact.[212] Dominion Virginia Power argued that Staff's proposal is a double counting of CWC.[213]

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[204] *Id.* at 22, 24.
[205] *See*, Oliver, Tr. at 113; Dahl, Tr. at 168.
[206] Exhibit No. 16, Supplemental Schedule 1, at 16, 16a.
[207] Oliver, Tr. at 109.
[208] *2013 Biennial Review Order* at 21, n.58.
[209] Exhibit No. 18, at 24.
[210] *Id.*; Exhibit No. 20, at 2.
[211] Exhibit No. 30, at 8.
[212] *Id.*
[213] Dahl, Tr. at 161-62.

Staff contended that A/P associated with CWIP represents unpaid amounts accrued to CWIP.[214] Such unpaid amounts represent cost-free capital. Mr. McLeod testified:

> In the Company's biennial review proceeding both Staff and the Company excluded rider related accounts payable CWIP from the calculation of cash working capital. Therefore, unless accounts payable CWIP is included in the cash working capital calculation for Rider S the Company will earn a return on this source of cost-free capital.[215]

In addition, Mr. McLeod explained that rather than accounting for CWC, the two-month averaging of rate base, like the use of a 13-month average for rate base, recognizes that plant investments are made throughout a month and throughout the test year.[216]

I agree with Staff on this issue. The use of the two-month averaging of rate base does not account for amounts in both the beginning balance and the month ending balance that are unpaid and payable as of that point in time. If using an averaging methodology for rate base accounted for the A/P associated with plant investments, then all A/P associated with CWIP would have been eliminated in the 2013 Biennial Review. However, in the Biennial Review only the A/P associated with RAC related CWIP was eliminated.[217] I find that Staff's treatment of A/P associated with CWIP in this RAC is consistent with the treatment of A/P associated with CWIP in the *2013 Biennial Review Order.*

In summary, based on the above discussions, I find that the 2014 Rate Year Rider S revenue requirements should be based on Staff's Alternative 2 calculations. Therefore, I find that the 2014 Rate Year Rider S Project Cost Recovery Factor revenue requirement is $229.6 million, and the 2014 Rate Year Rider S Actual True-Up Factor revenue requirement is $9.1 million.[218] Thus, I find that the total 2014 Rate Year Rider S revenue requirement is $238.7 million.

Accordingly, **I RECOMMEND** the Commission enter an order that:

1. ***ADOPTS*** the findings of this Report;

2. ***GRANTS*** the Company a Rider S revenue requirement of $238.7 million for the 2014 rate year beginning April 1, 2014; and

2. ***DISMISSES*** this case from the Commission's docket of active cases.

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[214] McLeod, Tr. at 95.
[215] *Id.*
[216] *Id.* at 95-96.
[217] *Id.* at 95.
[218] Exhibit No. 20, at 5.

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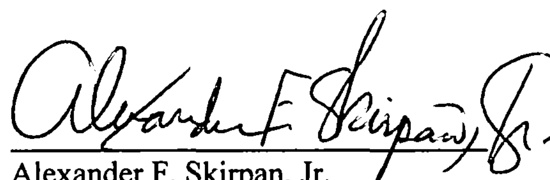
COMMENTS

The parties are advised that pursuant to Commission Rule 5 VAC 5-20-120 C of the Commission's Rules of Practice and Procedure, any comments to this Report must be filed with the Clerk of the Commission in writing, in an original and five copies, within twenty-one calendar days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,



Alexander F. Skirpan, Jr.
Senior Hearing Examiner

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