UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Vermont Electric Power Company, Inc.	)	Docket Nos. ER92-284-000
	)	EL92-40-000

EXPLANATORY STATEMENT IN SUPPORT OF
OFFER OF SETTLEMENT

Vermont Electric Power Company, Inc. ("VELCO") is an electric transmission company which owns substantially all of the high voltage transmission facilities in the state of Vermont. VELCO, which does not own or operate any generation or distribution facilities, provides transmission service to 24 distribution electric systems in Vermont pursuant to a tariff on file at the FERC. Substantially all of VELCO's revenues are derived from the provision of transmission service to these customers, most of which are also VELCO shareholders.

The rate for transmission service provided by VELCO has been a cost-of-service formula rate designed to assure that VELCO will be fully compensated for all costs incurred in providing such service. On January 23, 1992, as amended thereafter, VELCO tendered for filing a revised transmission agreement entitled VELCO 1991 Transmission Agreement ("1991 Agreement") which contained a revised cost-of-service formula rate for transmission service being provided by VELCO. The revised cost-of-service formula rate resulted in small alterations in the distribution of VELCO's transmission charges among its transmission service customers, but did not affect VELCO's net revenues.

VELCO noted in its letter of transmittal that the revised cost-of-service formula rate was designed to provide more

appropriate cost signals to its customers for the purpose of promoting efficiency in the installation of transmission facilities used to serve individual customers. VELCO further noted that the revised cost-of-service formula rate was the fruition of years of discussions among its customers, including investor-owned utilities, municipal electric systems, rural electric cooperatives, and the Vermont Department of Public Service ("VDPS"). The formula represents a consensus among those customers regarding the establishment of a cost allocation structure that is both equitable and conducive to efficient transmission system development.

A Notice of Filing was issued by the Commission on February 3, 1992. Pursuant to that Notice of Filing, motions to intervene were filed by the Village of Lyndonville Electric Department, the Village of Hyde Park Electric Department, Ludlow Electric Department, Morrisville Water & Light Department, Stowe Water & Light Department, and Swanton Electric Department (the "Villages") and by the VDPS.

By order issued September 25, 1992, the FERC concluded that there were "a number of unresolved factual issues concerning the reasonableness of [VELCO's] revised transmission pricing formula," and that "VELCO's filings raise...factual issues that cannot be resolved at this time without the benefit of hearing procedures." The FERC therefore accepted VELCO's 1991 Agreement for filing, permitted it to become effective after a nominal suspension period, subject to refund, as of March 23, 1992, and ordered a

hearing. The FERC further noted that because charges to some customers would be reduced, but that further reductions might be appropriate, it would institute an investigation of the 1991 Agreement pursuant to Section 206 of the Federal Power Act, with a refund effective date as of December 8, 1992. These two matters were consolidated for the purposes of hearing and decision.

Among the issues identified by the FERC as issues to be resolved during the hearing which it ordered were:

1. Clarification of the distinction between Common Facilities, the costs of which were to be borne by all of VELCO's customers, and Specific Facilities, the costs of which are directly allocated to certain customers.

2. The propriety of a provision under which facilities originally classified as Specific Facilities will be reclassified as Common Facilities after they have been in service for ten years.

3. The applicability of transmission pricing principles enunciated by the Commission in cases such as Northeast Utilities Service Company, 58 FERC ¶ 61,070 (1992), and Consumers Power Company, 59 FERC ¶ 61,106 (1992)

4. The reasonableness of a fifty percent billing demand credit whenever a customer owns generation in Vermont.

5. The reasonableness of VELCO's proposed allocation of transmission service costs based upon each customer's peak demands on its system.

Pursuant to the procedural schedule established in this proceeding, testimony and exhibits of Richard W. Mallary and William J. Gallagher constituting the direct case of VELCO were filed on January 29, 1993. The testimony and exhibits filed by VELCO clearly establish that the 1991 Agreement is just and reasonable and consistent with applicable FERC precedent. Since

that time, representatives of VELCO and the FERC Trial Staff have engaged in settlement discussions in an effort to obviate the need for a full evidentiary hearing in order to address the concerns identified in the Commission's September 25, 1992 order. The Offer of Settlement, which primarily clarifies the manner in which transmission pricing procedures established in the 1991 Agreement are to be implemented, fully resolves those concerns.

1. Clarification of Transmission Pricing Procedures

The Offer of Settlement contains a revised pricing mechanism to be included in the 1991 Agreement that clarifies the distinction between Specific Facilities and Common Facilities, and provide as form of Exhibit A (Specific Facilities) to the 1991 Agreement to be used for listing facilities on VELCO's transmission system which have been identified as Specific Facilities and identifying the beneficiary or beneficiaries of each such facility.

As set forth in the revised pricing mechanism, Specific Facilities are defined as:

> those high-voltage transmission lines, substations and other appurtenances constituting a direct physical interconnection to the VELCO system and not constituting part of VELCO's looped transmission facilities, that are requested, used, and installed to benefit a requesting Purchaser of transmission service.

This revised definition thus assures that Specific Facilities are intended to be non-network facilities such as interconnection facilities or radial lines that benefit one or more of the customers but that provide no significant system benefit. The revised pricing mechanism also delineates specific FERC accounts

to be utilized in calculating charges under VELCO's cost-of-service formula rate.

In addition, the Offer of Settlement adopts as a Supplement to the 1991 Agreement a sample billing format that details the manner in which charges under the cost-of-service formula rate are to be computed. This billing format is intended to dispel any confusion or misunderstanding regarding application of the formula rate and to permit verification of the accuracy of bills calculated by VELCO for transmission service rendered under the 1991 Agreement.

As noted above, the testimony and exhibits filed by VELCO in this proceeding establish that the rates and charges set forth in the 1991 Agreement, as filed, are just and reasonable. Because the 1991 Agreement is intended to provide a basis for compensation of VELCO for its total costs of providing transmission service, a reduction in charges to one transmission service customer would necessarily require an offsetting increase in charges to other transmission service customers.

Because the revised pricing mechanism to be included in the 1991 Agreement and the sample billing format to be included as a Supplement to the 1991 Agreement do not modify the allocation of charges under the 1991 Agreement, VELCO believes it would be confusing, unduly burdensome, and otherwise inappropriate to make those changes effective prior to the date of approval of the Offer of Settlement and to require VELCO to rebill its customers for service rendered since March 1992 on the basis of those changes.

For this reason, the changes to the 1991 Agreement are to be made effective prospectively from the date of approval of the Offer of Settlement, and VELCO is to have no responsibility to recalculate charges for transmission service rendered prior to that time.

2. Applicability of Transmission Pricing Principles

In Northeast Utilities Service Company, 58 FERC ¶ 61,070 (1992), the Commission stated:

> We find the three broad goals stated in the Staff's pricing proposal to be appropriate in deciding pricing for NU's transmission service. First, the native load customers of the utility providing transmission service should be held harmless. Second, transmission customers should be charged the lowest reasonable cost-based rate for third party firm transmission service. Third, the pricing should prevent the collection of monopoly rents by the transmission owner and promote efficient transmission owner and promote efficient transmission decisions. In ruling on specific proposed rates, we will balance these goals in light of the facts and circumstances presented at that time.

The FERC further noted in Northeast Utilities and in Consumers Power Company, 59 FERC ¶ 61,106 (1992), that in addition to establishing rates for transmission service that conform to these general principles, utilities would be permitted to charge transmission service customers directly for the costs of certain facilities, such as generation leads and radial lines between the system of the customer and the general transmission system of the transmitting utility when such lines are not otherwise integral to the transmitting utility's system.

It may be appropriate to note here that VELCO is different in a number of important respects from the traditional, vertically integrated utilities that were involved in the Northeast Utilities

line of cases. VELCO does not own, operate, or dispatch any generation resources. Because it is not in the business of selling power, either at retail or wholesale (except in the limited sense described in the testimony of Richard W. Mallary, filed on January 29, 1993 -- see question and answer number 4) VELCO does not compete with its transmission service customers in the sale of electricity. It also has no exclusive franchise. Finally, most of VELCO's transmission service customers are also owners of the company. These considerations suggest that a somewhat modified, if not relaxed, measure of regulatory scrutiny may be warranted in this case.

Those same considerations notwithstanding, however, the 1991 VELCO Transmission Agreement complies fully with the Commission's pricing guidelines as set forth in Northeast Utilities and subsequent cases. In particular, as noted above, the Specific Facilities charge is limited to high voltage transmission lines, substations and other appurtenances that constitute a direct physical connection to the VELCO system, that are installed to benefit a requesting purchaser of transmission service, and that do not constitute part of VELCO's looped transmission facilities. Specific Facilities may be either facilities installed to add a new point of interconnection to VELCO's transmission system or upgrades and improvements to facilities installed at an existing point of interconnection. Upgrades and improvements on VELCO's transmission system that benefit all of VELCO's transmission

customers will be treated as Common Facilities, the costs of which are recovered through a general allocation to all customers.

The Specific Facilities Charge, therefore, appropriately places the major cost responsibility for facilities serving less than all of VELCO's customers on those Purchasers that benefit from such facilities in a way that is intended to promote efficient transmission decisions. In specifically allocating these costs, moreover, the 1991 Agreement does not double-charge any Purchaser. These matters are more fully addressed in VELCO's July 28, 1992 Request for Rehearing, a copy of which is attached hereto as Attachment A.

VELCO would also observe that the purpose of the principles enunciated in <u>Northeast Utilities</u> and its progeny is to provide guidance for the development of rates for transmission service, based in part on an allocation of a utility's transmission-related costs between its transmission service customers and its other customers (or its shareholders). In the case of VELCO, there are no customers other than transmission service customers. Therefore, in contrast to the <u>Northeast Utilities</u> line of cases, this case primarily involves the establishment of a fair and equitable allocation of VELCO's costs <u>among</u> transmission service customers rather than <u>between</u> transmission service customers and other customers.

3. <u>Reasonableness of Credit For Generation In Vermont</u>

The Internal Generation Adjustment (IGAP) is intended to recognize and account for the fact that internal generation, by

supplying load locally, relieves burdens on the VELCO transmission system.

The IGAP applies both to in-state generation and to external sources of supply -- e.g. Citizens Utilities' block-loaded supply from Hydro Quebec, which is discussed below -- that are directly connected to a Purchaser's system. It adjusts a Purchaser's peak demand by one half of the accredited capacity of internal generation or directly connected supply that can serve local load without using the VELCO system, with the adjustment capped at one-half of the billing peak of the Purchaser in question.

While all parties participating in the development of the 1991 Agreement agreed that it would be equitable to provide an adjustment for internal generation, it was readily apparent that an absolutely accurate accounting would be impossible or would be so administratively complex as to be impracticable. The VELCO system is dynamic, as flows change with each change in generation and load, both within and without the system. Furthermore, different kinds of internal generation have different effects on the system. Some, such as dispersed hydro, operate fairly regularly. Even so, they operate at varying levels of output. Others, such as peaking units, operate infrequently. Off-system, but directly connected sources, might be unavailable when their capacity is most needed.

Given these complexities, the parties decided to adopt a formula that does not purport to be completely scientific (i.e., does not attempt to achieve the unachievable) but that was agreed

to represent an equitable recognition of the contribution of internal generation. In other words, the parties concluded that whether or not the IGAP precisely captures the effects of internal generation, it is markedly preferable to failing to recognize those effects at all or to adopting a system that would be excessively expensive and time-consuming to operate and control.

4. <u>Reclassification of Specific Facilities As Common Facilities</u>

The reason for distinguishing between Specific Facilities and Common Facilities, and for charging the beneficiaries of Specific Facilities for most of their costs, was to induce proponents (prospective beneficiaries) of Specific Facilities to make economically efficient choices. If a Purchaser can obtain all of the benefits of a Specific Facility, while the costs thereof are postage-stamped to all Purchasers, the beneficiary may advocate Specific Facilities that, while useful to it, are not economically efficient from the perspective of the system as a whole.

To be fully consistent with generally accepted economic theory, the beneficiary of a Specific Facility should pay all of its costs, but the 1991 Agreement provides that, after ten years of service, Specific Facilities become Common Facilities and are thereafter paid for by all Purchasers. Considerations of history, equity and practicality led to the adoption of this hybrid treatment.

The VELCO system, as it exists today, was built without a Specific Facilities/Common Facilities distinction. If prospective Specific Facilities were to be supported entirely by the

benefitting utilities, then, some parties contended, existing facilities that would be classified as Specific Facilities, but for the ten year conversion, should be reclassified as Specific Facilities and charged to the benefitting utilities indefinitely. Because the VELCO system was developed under different rules and assumptions, such a retroactive assignment was completely unacceptable to those Purchasers who would have been adversely affected. A compromise solution was thus necessary if agreement among all Purchasers was to be achieved.

The ten-year conversion resolved the gridlock. Because it provides that there will be some contribution to the costs of Specific Facilities by non-benefitting utilities, it induced those Purchasers who may need Specific Facilities in the future to accept a change from the system in which no costs were specifically assigned. Conversely, it avoided the necessity of making a retroactive change in pricing policy for any existing facilities, thus making possible the agreement of those Purchasers who would have been injured by an _ex post facto_ change.

Although it is a compromise with theoretically pure economics, the ten-year conversion will not compromise the goals that the Common Facilities/Specific Facilities distinction was designed to achieve, that is, to send reasonably accurate price signals to prospective Specific Facilities proponents and thereby to induce economically efficient decision-making. VELCO's capital projects are typically amortized over a twenty-year period. Thus, if the beneficiary of a Specific Facility must support it entirely

for ten years, that utility will ultimately pay in excess of one-half of the total costs. Roughly one-half will be paid during the first ten years, and the present value of those payments will substantially exceed the present value of the payments (made by all Purchasers) over the balance of the amortization period. Moreover, the benefitting utility will, during the balance of the amortization period, continue to pay its prorated share of VELCO's costs, based on demand.

VELCO and its Purchasers believe that this is a sufficient incentive to discourage attempts to have VELCO add uneconomic Specific Facilities to its system. Furthermore, the uncertainties inherent in planning beyond a ten-year horizon (more probably, twelve years or more, taking into account the time necessary for planning, engineering, regulatory approval and construction) tend to mitigate any potential for abuse. A utility that proposes Specific Facilities that it calculates will be economic to it because other parties will be making contributions to its costs ten years after the facilities go in services is probably standing on fairly shaky ground.

There is one further reason why the ten-year conversion is unlikely to result in uneconomic decision-making with respect to facilities additions, and that is that the Vermont Public Service Board has approval authority over all transmission facilities in Vermont. Before granting approval, the Board must find that the facility "will result in an economic benefit to the state and its residents," that it "will promote the general good of the state,"

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and that it is consistent with the state's electric energy plan, a plan that specifically calls for the equitable treatment of all ratepayers. 30 V.S.A. § 248. The Board is not likely, under these standards, to approve a facility that will benefit one utility and its ratepayers, but will diminish the economic well-being of all utilities and all ratepayers in the aggregate.

The last factor in support of the compromise is a practical one. The method of allocating the costs of Specific Facilities among two or more benefitting utilities when their proportionate usage changes over time engendered a good deal of controversy. But major changes in usage are less likely to have occurred early in the life of a facility than later. By converting Specific Facilities into Common Facilities after ten years, usage changes would be of relatively little consequence. Thus, VELCO and its Purchasers were able to agree that special provisions for dealing with such changes could be omitted (unless the changes necessitated the construction of improvements or additions -- see Section III of Supplement No. 1 to the 1991 Agreement). Eliminating this problem contributed to reaching consensus on the 1991 Agreement as a whole.

5. Reasonableness of Transmission Cost Allocation

One of the goals of the 1991 Agreement, of course, was to provide for an equitable allocation of the costs of Common Facilities. The tariffs replaced by the 1991 Agreement allocated costs on the basis of Purchasers' theoretical peak transmission utilization, as established by the aggregate of their power

contracts. Since those contracts do not necessarily reflect actual transmission demand, and since the VELCO system has been designed to accommodate demands that actually are made on it, or are likely to be made on it, the level of the utilities' peak loads was judged to be a more equitable allocator.

Each Purchaser's annual peak establishes that Purchaser's maximum (retrospective) usage of the system. One Purchaser, however, Citizens Utilities, can be and frequently is disconnected from the VELCO system and block-loaded from Hydro Quebec. Since it often makes no demand whatever on the VELCO system, and because de-loading the system by block-loading to Canada can relieve the burdens on parts of the VELCO system, Citizens contended that the use of an annual peak load allocator would be inequitable to it.[1] Citizens argued that each Purchaser's coincident share of the VELCO peak would be more equitable. Other Purchasers would probably be as well off using coincident peak as non-coincident peak or, at least, they could probably not determine in advance which method would be more advantageous over time. These Purchasers were willing to give some recognition to Citizen's unique circumstances, but it was also apparent that the use of the coincident peak method alone could confer a completely unjustified advantage on Citizens: Citizens might be block-loaded at the time of the VELCO peak and thus have a zero allocator. The formula

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1 Plans have been made, but never implemented, to block-load a portion of the Central Vermont Public Service Corporation load from Hydro Quebec. Should this occur, CVPSC could, presumably, advance the same argument as to that portion of its load.

ultimately adopted, the average of each Purchaser's coincident share of the VELCO peak and its share of the aggregate of all Purchaser's individual peaks, was settled on as a fair balancing of the equities.

Nothing in the Offer of Settlement constitutes an admission of the correctness or applicability of any claim, defense, rule or interpretation of law, allegations of fact, principle or method of ratemaking. The Offer of Settlement is expressly contingent upon its approval by the FERC without modification, unless such modification(s) as the Commission may require are agreed upon by the parties. If the Offer of Settlement is not accepted and approved by the Commission, then (i) it shall not be binding on the parties, (ii) the parties will in that event be deemed to have reserved all their respective rights and remedies in this proceeding; and (iii) the Offer of Settlement shall not be part of the record in this proceeding, and all discussions and negotiations relating thereto shall be privileged.

WHEREFORE, for the foregoing reasons, VELCO respectfully requests that the Offer of Settlement be found to be just and reasonable, and in the public interest, and that it be certified to the Commission and approved promptly following expiration of the comment period prescribed by the Commission's rules.

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