

VIRGINIA ELECTRIC & POWER CO  
Form 10-Q  
August 03, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

\_\_\_\_\_  
FORM 10-Q  
\_\_\_\_\_

(Mark one)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2006**

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the transition period from     to**

**Commission File Number 001-02255**

**VIRGINIA ELECTRIC AND POWER COMPANY  
(Exact name of registrant as specified in its charter)**

**VIRGINIA**

**54-0418825**

*(State or other jurisdiction of incorporation or  
organization)*

*(I.R.S. Employer Identification No.)*

**120 TREDEGAR STREET  
RICHMOND, VIRGINIA**

**23219**

*(Address of principal executive offices)*

*(Zip Code)*

**(804) 819-2000**

*(Registrant's telephone number)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Edgar Filing: VIRGINIA ELECTRIC & POWER CO - Form 10-Q

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

At June 30, 2006, the latest practicable date for determination, 198,047 shares of common stock, without par value, of the registrant were outstanding.

---

**VIRGINIA ELECTRIC AND POWER COMPANY**

**INDEX**

**PART I. Financial Information**

- Item 1. Consolidated Financial Statements  
Consolidated Statements of Income - Three and Six Months Ended June 30, 2006 and 2005  
  
Consolidated Balance Sheets - June 30, 2006 and December 31, 2005  
  
Consolidated Statements of Cash Flows - Six Months Ended June 30, 2006 and 2005  
  
Notes to Consolidated Financial Statements
- Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
- Item 3. Quantitative and Qualitative Disclosures About Market Risk
- Item 4. Controls and Procedures

**PART II. Other Information**

- Item 1. Legal Proceedings
- Item 1A. Risk Factors
- Item 4. Submission of Matters to a Vote of Security Holders
- Item 6. Exhibits
-

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS**

**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
(millions)				
<b>Operating Revenue</b>	\$ 1,323	\$ 1,285	\$ 2,656	\$ 2,643
<b>Operating Expenses</b>				
Electric fuel and energy purchases	555	505	1,112	979
Purchased electric capacity	109	114	226	242
Other energy-related commodity purchases	8	7	18	20
Other operations and maintenance:				
External suppliers	207	146	396	400
Affiliated suppliers	81	72	158	144
Depreciation and amortization	135	132	267	263
Other taxes	43	47	88	93
Total operating expenses	1,138	1,023	2,265	2,141
Income from operations	185	262	391	502
Other income	17	14	41	29
Interest and related charges:				
Interest expense	63	72	133	135
Interest expense—junior subordinated notes payable to affiliated trust	7	7	15	15
Total interest and related charges	70	79	148	150
Income from continuing operations before income tax expense	132	197	284	381
Income tax expense	46	73	101	142
Income from continuing operations	86	124	183	239
Loss from discontinued operations (net of income tax benefit of \$32 and \$89 in 2005)	—	(67)	—	(160)
<b>Net Income</b>	<b>86</b>	<b>57</b>	<b>183</b>	<b>79</b>
Preferred dividends	4	4	8	8
Balance available for common stock	\$ 82	\$ 53	\$ 175	\$ 71

The accompanying notes are an integral part of the Consolidated Financial Statements.

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited)

	<b>June 30, 2006</b>	December 31, 2005 <sup>(1)</sup>
(millions)		
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 20	\$ 54
Customer accounts receivable (less allowance for doubtful accounts of \$7 at both dates)	682	700
Other receivables (less allowance for doubtful accounts of \$9 at both dates)	46	67
Inventories	506	443
Prepayments	23	36
Other	87	66
Total current assets	<b>1,364</b>	1,366
<b>Investments</b>		
Nuclear decommissioning trust funds	1,182	1,166
Other	22	22
Total investments	<b>1,204</b>	1,188
<b>Property, Plant and Equipment</b>		
Property, plant and equipment	20,665	20,317
Accumulated depreciation and amortization	(8,249)	(8,055)
Total property, plant and equipment, net	<b>12,416</b>	12,262
<b>Deferred Charges and Other Assets</b>		
Regulatory assets	282	326
Other	273	307
Total deferred charges and other assets	<b>555</b>	633
Total assets	<b>\$ 15,539</b>	\$ 15,449

(1) The Consolidated Balance Sheet at December 31, 2005 has been derived from the audited Consolidated Financial Statements at that date.

The accompanying notes are an integral part of the Consolidated Financial Statements.

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**CONSOLIDATED BALANCE SHEETS—(Continued)**  
**(Unaudited)**

	<b>June 30,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005<sup>(1)</sup></b>
(millions)		
<b>LIABILITIES AND SHAREHOLDER'S EQUITY</b>		
<b>Current Liabilities</b>		
Securities due within one year	\$ 667	\$ 618
Short-term debt	249	905
Accounts payable	349	415
Payables to affiliates	65	42
Affiliated current borrowings	201	12
Accrued interest, payroll and taxes	440	288
Other	220	212
Total current liabilities	2,191	2,492
<b>Long-Term Debt</b>		
Long-term debt	3,584	3,256
Junior subordinated notes payable to affiliated trust	412	412
Notes payable—other affiliates	220	220
Total long-term debt	4,216	3,888
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes and investment tax credits	2,221	2,250
Asset retirement obligations	857	834
Regulatory liabilities	416	409
Other	125	86
Total deferred credits and other liabilities	3,619	3,579
Total liabilities	10,026	9,959
<b>Commitments and Contingencies (see Note 10)</b>		
<b>Preferred Stock Not Subject to Mandatory Redemption</b>	<b>257</b>	<b>257</b>
<b>Common Shareholder's Equity</b>		
Common stock—no par, 300,000 shares authorized; 198,047 shares outstanding	3,388	3,388
Other paid-in capital	887	886
Retained earnings	878	842
Accumulated other comprehensive income	103	117
Total common shareholder's equity	5,256	5,233
Total liabilities and shareholder's equity	\$ 15,539	\$ 15,449

(1) The Consolidated Balance Sheet at December 31, 2005 has been derived from the audited Consolidated Financial Statements at that date.

The accompanying notes are an integral part of the Consolidated Financial Statements.

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

	Six Months Ended June 30,		
	2006		2005
(millions)			
<b>Operating Activities</b>			
Net income	\$ 183	\$	79
Adjustments to reconcile net income to net cash provided by operating activities:			
Net realized and unrealized derivative (gains)/losses	(4)		57
Depreciation and amortization	307		298
Deferred income taxes and investment tax credits, net	(29)		(18)
Deferred fuel expenses, net	56		50
Gain on sale of emissions allowances	(20)		(53)
Other adjustments to net income	(21)		(65)
Changes in:			
Accounts receivable	37		145
Affiliated accounts receivable and payable	25		(59)
Inventories	(63)		35
Prepaid pension cost	32		28
Accounts payable	(60)		36
Accrued interest, payroll and taxes	152		5
Other operating assets and liabilities	79		79
Net cash provided by operating activities	674		617
<b>Investing Activities</b>			
Plant construction and other property additions	(421)		(361)
Purchases of nuclear fuel	(60)		(61)
Purchases of securities	(267)		(153)
Proceeds from sales of securities	256		125
Proceeds from sale of emissions allowances	20		37
Other	2		26
Net cash used in investing activities	(470)		(387)
<b>Financing Activities</b>			
Issuance (repayment) of short-term debt, net	(655)		295
Issuance (repayment) of affiliated current borrowings, net	190		(249)
Issuance of long-term debt	1,000		—
Repayment of long-term debt	(612)		(16)
Common dividend payments	(139)		(238)
Preferred dividend payments	(8)		(8)
Other	(14)		—
Net cash used in financing activities	(238)		(216)
Increase (decrease) in cash and cash equivalents	(34)		14
Cash and cash equivalents at beginning of period	54		2
Cash and cash equivalents at end of period	\$ 20	\$	16
<b>Noncash Financing Activities:</b>			
	\$ —	\$	62

Assumption of debt related to the acquisition of a non-utility  
generating facility

Issuance of debt in exchange for electric distribution assets

—

8

The accompanying notes are an integral part of the Consolidated Financial Statements.



**VIRGINIA ELECTRIC AND POWER COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 1. Nature of Operations**

Virginia Electric and Power Company (the Company), a Virginia public service company, is a wholly-owned subsidiary of Dominion Resources, Inc. (Dominion). We are a regulated public utility that generates, transmits and distributes electricity within an area of approximately 30,000 square miles in Virginia and northeastern North Carolina. We serve approximately 2.3 million retail customer accounts, including governmental agencies and wholesale customers such as rural electric cooperatives and municipalities. The Virginia service area comprises about 65% of Virginia's total land area but accounts for over 80% of its population. On May 1, 2005, we became a member of PJM Interconnection, LLC (PJM), a regional transmission organization (RTO). As a result, we integrated our control area into the PJM wholesale electricity markets.

As discussed in Note 7, on December 31, 2005, we completed a transfer of our indirect wholly-owned subsidiary, Virginia Power Energy Marketing, Inc. (VPEM), to Dominion through a series of dividend distributions, in exchange for a capital contribution. VPEM provides fuel and price risk management services to us and other Dominion affiliates and engages in energy trading activities. Through VPEM, we had trading relationships beyond the geographic limits of our retail service territory and bought and sold natural gas, electricity and other energy-related commodities. As a result of the transfer, VPEM's results of operations are no longer included in our Consolidated Financial Statements, and our Consolidated Statements of Income for periods prior to the transfer have been adjusted to reflect VPEM as a discontinued operation. In addition, the discontinued operations of VPEM are now included in our Corporate segment results.

We manage our daily operations through three primary operating segments: Delivery, Energy and Generation. In addition, we report our corporate and other functions as a segment. Our assets remain wholly owned by us and our legal subsidiaries.

The terms "Company," "we," "our" and "us" are used throughout this report and, depending on the context of their use, may represent any of the following: the legal entity, Virginia Electric and Power Company, one of Virginia Electric and Power Company's consolidated subsidiaries or operating segments or the entirety of Virginia Electric and Power Company, including our Virginia and North Carolina operations and our consolidated subsidiaries.

**Note 2. Significant Accounting Policies**

As permitted by the rules and regulations of the Securities and Exchange Commission (SEC), our accompanying unaudited Consolidated Financial Statements contain certain condensed financial information and exclude certain footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). These unaudited Consolidated Financial Statements should be read in conjunction with our Consolidated Financial Statements and Notes in our Annual Report on Form 10-K for the year ended December 31, 2005 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

In our opinion, our accompanying unaudited Consolidated Financial Statements contain all adjustments, including normal recurring accruals, necessary to present fairly our financial position as of June 30, 2006, our results of operations for the three and six months ended June 30, 2006 and 2005, and our cash flows for the six months ended June 30, 2006 and 2005.

We make certain estimates and assumptions in preparing our Consolidated Financial Statements in accordance with GAAP. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of

contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the periods presented. Actual results may differ from those estimates.

Our accompanying unaudited Consolidated Financial Statements include, after eliminating intercompany transactions and balances, our accounts and those of our majority-owned subsidiaries and those variable interest entities (VIEs) where we have been determined to be the primary beneficiary.

---

We report certain contracts and instruments at fair value in accordance with GAAP. Market pricing and indicative price information from external sources are used to measure fair value when available. In the absence of this information, we estimate fair value based on near-term and historical price information and statistical methods. For individual contracts, the use of differing assumptions could have a material effect on the contract's estimated fair value. See Note 2 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2005 for more discussion of our estimation techniques.

The results of operations for the interim periods are not necessarily indicative of the results expected for the full year. Information for quarterly periods is affected by seasonal variations in sales, electric fuel and energy purchases and other factors.

Certain amounts in our 2005 Consolidated Financial Statements and Notes have been reclassified to conform to the 2006 presentation.

### Note 3. Recently Issued Accounting Standards

#### FIN 48

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 establishes standards for measurement and recognition in financial statements of positions taken by an entity in its income tax returns. In addition, FIN 48 requires new disclosures about positions taken by an entity in its tax returns that are not recognized in its financial statements, information about potential significant changes in estimates related to tax positions and descriptions of open tax years by major jurisdiction. The provisions of FIN 48 will become effective for us beginning January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to retained earnings. We are currently evaluating the impact that FIN 48 will have on our results of operations and financial condition.

### Note 4. Operating Revenue

Our operating revenue consists of the following:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
(millions)				
Regulated electric sales	\$ 1,283	\$ 1,245	\$ 2,581	\$ 2,567
Other	40	40	75	76
Total operating revenue	\$ 1,323	\$ 1,285	\$ 2,656	\$ 2,643

### Note 5. Comprehensive Income

The following table presents total comprehensive income:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
(millions)				
Net income	\$ 86	\$ 57	\$ 183	\$ 79
Other comprehensive income (loss):				
Net other comprehensive loss associated with	—	(2)	(7)	(15)

effective portion of changes in fair  
value of  
derivatives designated as cash flow  
hedges, net  
of taxes and amounts reclassified to  
earnings

Other <sup>(1)</sup>	(17)	8	(7)	(8)
Other comprehensive income				
(loss)	(17)	6	(14)	(23)
Total comprehensive income	\$ 69	\$ 63	\$ 169	\$ 56

(1) Primarily represents unrealized gains (losses) on investments held in nuclear decommissioning trusts.

**Note 6. Hedge Accounting Activities**

We are exposed to the impact of market fluctuations in the price of natural gas, electricity and other energy-related products, as well as currency exchange and interest rate risks of our business operations. We use derivative instruments to manage our exposure to certain of these risks and designate derivative instruments as either fair value or cash flow hedges for accounting purposes as allowed by Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Selected information about our hedge accounting activities follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
(millions)				
Portion of gains (losses) on hedging instruments determined to be ineffective and included in net income:				
Fair value hedges	\$	—	\$	2
Cash flow hedges		(1)		—
Net ineffectiveness	\$	(1)	\$	2

Gains and losses on hedging instruments that were excluded from the measurement of ineffectiveness and included in net income for the three and six months ended June 30, 2006 and 2005 were not material.

The following table presents selected information related to cash flow hedges included in accumulated other comprehensive income (AOCI) in our Consolidated Balance Sheet at June 30, 2006:

	AOCI After-Tax	Portion Expected to be Reclassified to Earnings During the Next 12 Months After-Tax	Maximum Term
(millions)			
Electricity	\$	(2)	3 months
Gas		(4)	3 months
Interest rate		1	112 months
Foreign currency		18	17 months
Total	\$	13	2

The amounts that will be reclassified from AOCI to earnings will generally be offset by the recognition of the hedged transactions (e.g., anticipated purchases) in earnings, thereby achieving the realization of prices contemplated by the underlying risk management strategies and will vary from the expected amounts presented above as a result of changes in market prices, interest rates and foreign exchange rates.

**Note 7. Discontinued Operations—VPEM Transfer**

On December 31, 2005, we completed the transfer of VPEM to Dominion through a series of dividend distributions. This resulted in a transfer of our negative investment in VPEM to Dominion in exchange for a capital contribution of \$633 million. No gain or loss was recognized on the transfer.

VPEM provides fuel and price risk management services to us by acting as an agent for one of our indirect wholly-owned subsidiaries. VPEM also engages in energy trading activities and provides price risk management services to other Dominion affiliates through the use of derivative contracts. While we owned VPEM, certain of these derivative contracts were reported at fair value on our Consolidated Balance Sheets, with changes in fair value reflected in earnings. These price risk management activities performed on behalf of Dominion affiliates generated derivative gains and losses that affected our Consolidated Financial Statements.

---

As a result of the transfer, VPEM's results of operations are no longer included in our Consolidated Financial Statements, and our Consolidated Statements of Income for the three and six months ended June 30, 2005 have been adjusted to reflect VPEM as a discontinued operation, on a net basis. In the three and six months ended June 30, 2005, our discontinued operations included operating revenue of \$190 million and \$429 million, respectively, and a loss before income taxes of \$99 million and \$249 million, respectively.

VPEM's 2005 results included the following affiliated transactions:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
(millions)		
Purchases of natural gas, gas transportation and storage services from affiliates	\$ 206	\$ 487
Sales of natural gas to affiliates	275	498
Net realized gains on affiliated commodity derivative contracts	2	13
Affiliated interest and related charges	4	7

#### **Note 8. Variable Interest Entities**

Certain variable pricing terms in some of our long-term power and capacity contracts cause those contracts to be considered potential variable interests in the counterparties. As discussed in Note 14 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2005, three potential VIEs with which we have existing power purchase agreements (signed prior to December 31, 2003), have not provided sufficient information for us to perform our evaluation under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R).

As of June 30, 2006, the requested information has not been received from the three remaining potential VIEs. We will continue our efforts to obtain information and will complete an evaluation of our relationship with each of these potential VIEs if sufficient information is ultimately obtained. We have remaining purchase commitments with these three potential VIE supplier entities of \$2.0 billion at June 30, 2006. We paid \$44 million and \$48 million for electric generation capacity and \$41 million and \$34 million for electric energy to these entities in the three months ended June 30, 2006 and 2005, respectively. We paid \$94 million and \$101 million for electric generation capacity and \$77 million and \$80 million for electric energy to these entities in the six months ended June 30, 2006 and 2005, respectively.

During 2005, we entered into four long-term contracts with unrelated limited liability corporations (LLCs) to purchase synthetic fuel produced from coal. Certain variable pricing terms in the contracts protect the equity holders from variability in the cost of their coal purchases, and therefore, the LLCs were determined to be VIEs. After completing our FIN 46R analysis, we concluded that although our interests in the contracts, as a result of their pricing terms, represent variable interests in the LLCs, we are not the primary beneficiary. We paid \$104 million and \$43 million to the LLCs for coal and synthetic fuel produced from coal in the three months ended June 30, 2006 and 2005, respectively, and \$215 million and \$63 million in the six months ended June 30, 2006 and 2005, respectively. We are not subject to any risk of loss from the contractual arrangements, as our only obligation to the VIEs is to purchase the coal and synthetic fuel that the VIEs provide according to the terms of the applicable purchase contracts.

In accordance with FIN 46R, we consolidate a variable interest lessor entity through which we have financed and leased a power generation project. Our Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005 reflect net property, plant and equipment of \$342 million and \$348 million, respectively, and \$370 million of debt related to this entity. The debt is nonrecourse to us and is secured by the entity's property, plant and equipment.

**Note 9. Significant Financing Transactions**

***Joint Credit Facilities and Short-term Debt***

We use short-term debt, primarily commercial paper, to fund working capital requirements and as a bridge to long-term debt financing. The level of our borrowings may vary significantly during the course of the year, depending

---



upon the timing and amount of cash requirements not satisfied by cash from operations. In February 2006, we entered into a \$3.0 billion five-year revolving credit facility with Dominion and Consolidated Natural Gas Company (CNG), a wholly-owned subsidiary of Dominion. The credit facility is scheduled to terminate in February 2011. This credit facility is being used for working capital, as support for the combined commercial paper programs of Dominion, CNG and us and other general corporate purposes. This credit facility can also be used to support up to \$1.5 billion of letters of credit.

At June 30, 2006, total outstanding commercial paper supported by the joint credit facility was \$998 million, of which our borrowings were \$249 million. At June 30, 2006, total outstanding letters of credit supported by the joint credit facility were \$653 million, of which less than \$1 million was issued on our behalf.

At June 30, 2006, capacity available under the credit facility was \$1.3 billion.

#### ***Long-term Debt***

In January 2006, we issued \$450 million of 5.4% senior notes that mature in 2016 and \$550 million of 6.0% senior notes that mature in 2036. We used the proceeds from this issuance to repay short-term debt incurred to redeem our \$512 million callable mortgage bonds and a portion of our maturing long-term debt.

In February 2006, we entered into a \$200 million five-year stand-alone credit facility. This credit facility is used to support our long-term variable rate tax-exempt financings and is scheduled to terminate in February 2011.

During the six months ended June 30, 2006, we repaid \$612 million of our long-term debt.

#### **Note 10. Commitments and Contingencies**

Other than the matters discussed below, there have been no significant developments regarding commitments and contingencies as disclosed in Note 21 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2005, or Note 9 to the Consolidated Financial Statements in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, nor have any significant new matters arisen during the quarter ended June 30, 2006.

#### ***Environmental Matters***

In 1987, we and a number of other entities were identified by the Environmental Protection Agency (EPA) as potentially responsible parties (PRPs) at two Superfund sites located in Kentucky and Pennsylvania. In 2003, the EPA issued its Certificate of Completion of remediation for the Kentucky site. Future costs for the Kentucky site will be limited to minor operations and maintenance expenditures. Regarding the Pennsylvania site, in March 2006, a federal district court approved three consent decrees between the United States and the PRPs, under which we and certain other PRPs, all of which are utilities, will perform the site remediation. The remediation costs are expected to be in the range of \$11 million to \$18 million, the majority of which are to be paid by the non-utility site owners. After evaluating the impact of these actions, we have reduced our current reserve from \$2 million to less than \$1 million to meet our potential obligations at these two sites. We generally seek to recover our costs associated with environmental remediation from third party insurers. At June 30, 2006, no pending or possible insurance claims were recognized as an asset or offset against obligations.

#### ***Guarantees and Surety Bonds***

As of June 30, 2006, we had issued less than \$1 million of guarantees primarily to support commodity transactions of our subsidiaries. We had also purchased \$16 million of surety bonds for various purposes, including providing workers' compensation coverage and obtaining licenses, permits and rights-of-way. Under the terms of surety bonds, we are obligated to indemnify the respective surety bond company for any amounts paid.

**Note 11. Credit Risk**

We maintain a provision for credit losses based on factors surrounding the credit risk of our customers, historical trends and other information. We believe, based on our credit policies and our June 30, 2006 provision for credit losses, that it is unlikely that a material adverse effect on our financial position, results of operations or cash flows would occur as a result of counterparty nonperformance.

We sell electricity and provide distribution and transmission services to customers in Virginia and northeastern North Carolina. Management believes that this geographic concentration risk is mitigated by the diversity of our

---

customer base, which includes residential, commercial and industrial customers, as well as rural electric cooperatives and municipalities. Credit risk associated with trade accounts receivable from energy consumers is limited due to the large number of customers.

Our exposure to potential concentrations of credit risk results primarily from sales to wholesale customers. Our gross credit exposure for each counterparty is calculated as outstanding receivables plus any unrealized on or off-balance sheet exposure, taking into account contractual netting rights. Gross credit exposure is calculated prior to the application of collateral. At June 30, 2006, our gross credit exposure totaled \$77 million. Of this amount, 87% related to a single counterparty; however, the entire balance is with investment grade entities. We held no collateral for these transactions at June 30, 2006.

### Note 12. Related Party Transactions

We engage in related party transactions primarily with affiliates (Dominion subsidiaries). Our accounts receivable and payable balances with affiliates are settled based on contractual terms on a monthly basis, depending on the nature of the underlying transactions. We are included in Dominion's consolidated federal income tax return and participate in certain Dominion benefit plans. A discussion of significant related party transactions follows.

#### Transactions with Affiliates

We transact with affiliates for certain quantities of natural gas and other commodities in the ordinary course of business.

At June 30, 2006, our Consolidated Balance Sheets includes derivative liabilities with affiliates of \$7 million. There were no derivative liabilities with affiliates at December 31, 2005. Unrealized gains or losses, representing the effective portion of the changes in fair value of those derivative contracts that have been designated as cash flow hedges, are included in AOCI on our Consolidated Balance Sheets.

Dominion Resources Services, Inc. (Dominion Services) provides accounting, legal and certain administrative and technical services to us. In addition, we provide certain services to affiliates, including charges for facilities and equipment usage.

The transactions with Dominion Services and other affiliates are detailed below:

	Three Months Ended June 30,		Six Months Ended June 30,	
(millions)	2006	2005	2006	2005
Commodity purchases from affiliates	\$ 46	\$ 73	\$ 80	\$ 121
Commodity sales to affiliates	—	—	3	4
Services provided by affiliates	81	72	158	144
Services provided to affiliates	6	6	12	13

#### Transactions with Dominion

We have borrowed funds from Dominion under both short-term and long-term borrowing arrangements. At June 30, 2006 and December 31, 2005, our outstanding borrowings, net of repayments, under the Dominion money pool for our nonregulated subsidiaries totaled \$201 million and \$12 million, respectively. There were no short-term demand note borrowings at June 30, 2006 or December 31, 2005. At June 30, 2006 and December 31, 2005, our borrowings from Dominion under a long-term note totaled \$220 million. We incurred net interest charges related to our borrowings from Dominion of \$1 million and \$2 million in the three months ended June 30, 2006 and 2005, respectively, and \$3 million for each of the six month periods ended June 30, 2006 and 2005.

**Note 13. Operating Segments**

We are organized primarily on the basis of products and services sold in the United States. The majority of our revenue is provided through tariff rates. Generally, such revenue is allocated for management reporting based on an unbundled rate methodology among our Delivery, Energy and Generation segments. We manage our operations through the following segments:

---

**Delivery** includes our regulated electric distribution and customer service business. The Delivery segment is subject to cost-of-service rate regulation and accordingly, applies SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*.

**Energy** includes our tariff-based electric transmission operations, which are subject to cost-of-service rate regulation and accordingly, applies SFAS No. 71.

**Generation** includes our portfolio of electric generating facilities and our energy supply operations.

**Corporate** includes our corporate and other functions, as well as the discontinued operations of VPEM. The contribution to net income by our primary operating segments is determined based on a measure of profit that executive management believes represents the segments' core earnings. As a result, certain specific items attributable to those segments are not included in profit measures evaluated by executive management in assessing the segments' performance or allocating resources among the segments and are instead reported in the Corporate segment. For the six months ended June 30, 2006 and 2005, we reported net expenses of \$4 million and \$213 million, respectively, in our Corporate segment.

The net expenses in 2006 reflect a \$7 million (\$4 million after-tax) charge resulting from the write-off of certain assets no longer in use at one of our electric generating facilities, attributable to our Generation segment.

The net expenses in 2005 included \$160 million of losses incurred in the six months ended June 30, 2005 relating to the discontinued operations of VPEM, as well as the following items attributable to our Generation segment:

- A \$77 million (\$47 million after-tax) charge resulting from the termination of a long-term power purchase agreement; and
- A \$13 million (\$8 million after-tax) charge related to our interest in a long-term power tolling contract that was divested in 2005.

The following table presents segment information pertaining to our operations:

	Delivery	Energy	Generation	Corporate	Consolidated Total
(millions)					
<b><u>Three Months Ended June 30, 2006</u></b>					
Operating revenue	\$ 287	\$ 52	\$ 983	\$ 1	\$ 1,323
Net income (loss)	66	16	8	(4)	86
<b><u>Three Months Ended June 30, 2005</u></b>					
Operating revenue	\$ 272	\$ 47	\$ 965	\$ 1	\$ 1,285
Loss from discontinued operations, net of tax	—	—	—	(67)	(67)
Net income (loss)	59	13	54	(69)	57
<b><u>Six Months Ended June 30, 2006</u></b>					
Operating revenue	\$ 576	\$ 104	\$ 1,976	\$ —	\$ 2,656
Net income (loss)	133	33	21	(4)	183
<b><u>Six Months Ended June 30, 2005</u></b>					
Operating revenue	\$ 571	\$ 102	\$ 1,965	\$ 5	\$ 2,643
	—	—	—	(160)	(160)

Edgar Filing: VIRGINIA ELECTRIC & POWER CO - Form 10-Q

Loss from discontinued operations,  
net of tax

Net income (loss)	141	28	123	(213)	79
-------------------	-----	----	-----	-------	----

---

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**  
**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) discusses the results of operations and general financial condition of Virginia Electric and Power Company. MD&A should be read in conjunction with our Consolidated Financial Statements. The terms "Virginia Power," "Company," "we," "our" and "us" are used throughout this report and, depending on the context of their use, may represent any of the following: the legal entity, Virginia Electric and Power Company, one of Virginia Electric and Power Company's consolidated subsidiaries or operating segments, or the entirety of Virginia Electric and Power Company and its consolidated subsidiaries. We are a wholly-owned subsidiary of Dominion.

**Contents of MD&A**

Our MD&A consists of the following information:

- Forward-Looking Statements
  - Accounting Matters
  - Results of Operations
- Segment Results of Operations
  - Sources and Uses of Cash
- Future Issues and Other Matters

**Forward-Looking Statements**

This report contains statements concerning our expectations, plans, objectives, future financial performance and other statements that are not historical facts. These statements are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. In most cases, the reader can identify these forward-looking statements by such words as "anticipate," "estimate," "forecast," "expect," "believe," "should," "could," "plan," "may" or other words.

We make forward-looking statements with full knowledge that risks and uncertainties exist that may cause actual results to differ materially from predicted results. Factors that may cause actual results to differ are often presented with the forward-looking statements themselves. Additionally, other factors may cause actual results to differ materially from those indicated in any forward-looking statement. These factors include but are not limited to:

- Unusual weather conditions and their effect on energy sales to customers and energy commodity prices;
- Extreme weather events, including hurricanes and winter storms, that can cause outages and property damage to our facilities;
- State and federal legislative and regulatory developments, including deregulation and changes in environmental and other laws and regulations to which we are subject;
  - Cost of environmental compliance;
  - Risks associated with the operation of nuclear facilities;
- Fluctuations in energy-related commodity prices and the effect these could have on our earnings, liquidity position and the underlying value of our assets;
  - Capital market conditions, including price risk due to marketable securities held as investments in nuclear decommissioning and benefit plan trusts;
    - Fluctuations in interest rates;
  - Changes in rating agency requirements or credit ratings and the effect on availability and cost of capital;
    - Changes in financial or regulatory accounting principles or policies imposed by governing bodies;
- Employee workforce factors including collective bargaining agreements and labor negotiations with union employees;
  - The risks of operating businesses in regulated industries that are subject to changing regulatory structures;

Edgar Filing: VIRGINIA ELECTRIC & POWER CO - Form 10-Q

- Changes to our ability to recover investments made under traditional regulation through rates; and
- Political and economic conditions, including the threat of domestic terrorism, inflation and deflation.

Additionally, other risks that could cause actual results to differ from predicted results are set forth in Item 1A. Risk Factors in this report and in our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

---



Our forward-looking statements are based on our beliefs and assumptions using information available at the time the statements are made. We caution the reader not to place undue reliance on our forward-looking statements because the assumptions, beliefs, expectations and projections about future events may, and often do, differ materially from actual results. We undertake no obligation to update any forward-looking statement to reflect developments occurring after the statement is made.

## Accounting Matters

### Critical Accounting Policies and Estimates

As of June 30, 2006, there have been no significant changes with regard to critical accounting policies and estimates as disclosed in MD&A in our Annual Report on Form 10-K for the year ended December 31, 2005. The policies disclosed included the accounting for: derivative contracts at fair value, long-lived asset impairment testing, asset retirement obligations, regulated operations and income taxes.

## Other

### FIN 48

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 establishes standards for measurement and recognition in financial statements of positions taken by an entity in its income tax returns. In addition, FIN 48 requires new disclosures about positions taken by an entity in its tax returns that are not recognized in its financial statements, information about potential significant changes in estimates related to tax positions and descriptions of open tax years by major jurisdiction. The provisions of FIN 48 will become effective for us beginning January 1, 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to retained earnings. We are currently evaluating the impact that FIN 48 will have on our results of operations and financial condition.

## Results of Operations

Presented below is a summary of our consolidated results for the quarter and year-to-date periods ended June 30, 2006 and 2005:

	Second Quarter			Year-To-Date		
	2006	2005	\$ Change	2006	2005	\$ Change
(millions)						
Net income	\$ 86	\$ 57	\$ 29	\$ 183	\$ 79	\$ 104

## Overview

### Second Quarter 2006 vs. 2005

Net income increased 51% to \$86 million. Favorable drivers include an increase in regulated electric sales revenue resulting from customer growth and other factors and the absence of \$67 million of after-tax losses incurred in 2005 by the discontinued operations of VPEM. Unfavorable drivers include the impact of higher commodity prices on fuel and purchased power expenses and a decrease in gains recognized from the sale of emissions allowances.

### Year-To-Date 2006 vs. 2005

Net income increased 132% to \$183 million. Favorable drivers include the absence of \$160 million of after-tax losses incurred in 2005 by the discontinued operations of VPEM and the absence of a 2005 charge resulting from the termination of a long-term power purchase agreement. Unfavorable drivers include the impact of higher commodity prices on fuel and purchased power expenses and a decrease in gains recognized from the sale of emissions allowances.

**Analysis of Consolidated Operations**

Presented below are selected amounts related to our results of operations:

(millions)	Second Quarter			Year-To-Date		
	2006	2005	\$ Change	2006	2005	\$ Change
Operating Revenue	\$ 1,323	\$ 1,285	\$ 38	\$ 2,656	\$ 2,643	\$ 13
Operating Expenses						
Electric fuel and energy purchases	555	505	50	1,112	979	133
Purchased electric capacity	109	114	(5)	226	242	(16)
Other energy-related commodity purchases	8	7	1	18	20	(2)
Other operations and maintenance	288	218	70	554	544	10
Depreciation and amortization	135	132	3	267	263	4
Other taxes	43	47	(4)	88	93	(5)
Other income	17	14	3	41	29	12
Interest and related charges	70	79	(9)	148	150	(2)
Income tax expense	46	73	(27)	101	142	(41)
Loss from discontinued operations, net of tax	—	(67)	67	—	(160)	160

An analysis of our results of operations for the second quarter and year-to-date periods of 2006 compared to the second quarter and year-to-date periods of 2005 follows:

**Second Quarter 2006 vs. 2005**

**Operating Revenue** increased 3% to \$1.3 billion, reflecting the combined effects of:

- A \$22 million increase attributable to variations in rates resulting from changes in customer usage patterns and sales mix and other factors;
  - An \$18 million increase due to new customer connections; and
- A \$15 million increase due to the impact of a comparatively higher fuel rate in certain customer jurisdictions which was offset by a comparable increase in *Electric fuel and energy purchases expense*; partially offset by
  - A \$16 million decrease associated with milder weather.

**Operating Expenses and Other Items**

**Electric fuel and energy purchases expense** increased 10% to \$555 million, primarily due to higher commodity prices, including purchased power.

**Other operations and maintenance expense** increased 32% to \$288 million, primarily reflecting:

- A \$40 million decrease in gains from the sale of emissions allowances;
- A \$17 million increase in outage costs primarily due to scheduled outages of certain of our electric generating facilities;
- A \$12 million increase resulting from higher incentive-based compensation, wages and pension and medical benefits; and
- A \$7 million charge resulting from the write-off of certain assets no longer in use at one of our electric generating facilities.

**Other income** increased 21% to \$17 million, primarily reflecting a \$5 million increase in net realized gains (including investment income) associated with nuclear decommissioning trust fund investments.

**Interest and related charges** decreased 11% to \$70 million, primarily due to a reduction in interest accrued on tax deficiencies reflecting the resolution of certain issues with tax authorities.

**Loss from discontinued operations** reflects the losses incurred in 2005 by the discontinued operations of VPEM.

---

**Year-To-Date 2006 vs. 2005**

**Operating Revenue** increased 1% to \$2.7 billion, reflecting the combined effects of:

- A \$39 million increase due to new customer connections;
- A \$36 million increase due to the impact of a comparatively higher fuel rate in certain customer jurisdictions which was offset by a comparable increase in *Electric fuel and energy purchases expense*; and
- A \$24 million increase attributable to rate variations resulting from changes in customer usage patterns and sales mix and other factors; largely offset by
  - An \$82 million decrease associated with milder weather.

**Operating Expenses and Other Items**

*Electric fuel and energy purchases expense* increased 14% to \$1.1 billion, primarily due to higher commodity prices, including purchased power.

*Purchased electric capacity expense* decreased 7% to \$226 million, primarily due to scheduled capacity reductions for certain long-term power purchase contracts, as well as the termination of a long-term power purchase agreement in connection with the purchase of the related generating facility in February 2005.

*Other operations and maintenance expense* increased 2% to \$554 million, primarily reflecting:

- A \$33 million decrease in gains from the sale of emissions allowances;
- A \$23 million increase in outage costs primarily due to scheduled outages of certain of our electric generating facilities;
- A \$16 million increase resulting from higher incentive-based compensation, wages, and pension and medical benefits;
  - A \$7 million increase related to storm restorations associated with our distribution operations; and
- A \$7 million charge resulting from the write-off of certain assets no longer in use at one of our electric generating facilities; partially offset by
- A \$31 million benefit related to financial transmission rights (FTRs) granted by PJM used to offset congestion costs associated with PJM spot market activity, which are included in *Electric fuel and energy purchases expense*; and
  - A net benefit from the absence of the following items recognized in 2005:
- A \$77 million charge resulting from the termination of a long-term power purchase agreement; partially offset by
- A \$25 million net benefit resulting from the establishment of certain regulatory assets in connection with the settlement of a North Carolina rate case.

*Other income* increased 41% to \$41 million, primarily reflecting an \$11 million increase in net realized gains (including investment income) associated with nuclear decommissioning trust fund investments.

*Loss from discontinued operations* reflects the losses incurred in 2005 by the discontinued operations of VPPEM.

**Segment Results of Operations**

Presented below is a summary of contributions by our operating segments to net income for the quarter and year-to-date periods ended June 30, 2006 and 2005:

	Second Quarter			Year-To-Date		
	2006	2005	\$ Change	2006	2005	\$ Change
(millions)						
Delivery	\$ 66	\$ 59	\$ 7	\$ 133	\$ 141	\$ (8)
Energy	16	13	3	33	28	5
Generation	8	54	(46)	21	123	(102)
Primary operating segments	90	126	(36)	187	292	(105)

Edgar Filing: VIRGINIA ELECTRIC & POWER CO - Form 10-Q

Corporate		<b>(4)</b>		(69)		65		<b>(4)</b>		(213)		209
Consolidated	\$	<b>86</b>	\$	57	\$	29	\$	<b>183</b>	\$	79	\$	104

---

**Delivery**

Delivery includes our electric distribution system and customer service operations. Presented below are operating statistics related to our Delivery operations:

	Second Quarter			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Electricity delivered (million mwhrs)	<b>18.7</b>	18.6	1%	<b>38.2</b>	38.5	(1)%
Degree days (electric service area):						
Cooling <sup>(1)</sup>	<b>396</b>	370	7	<b>409</b>	370	11
Heating <sup>(2)</sup>	<b>245</b>	355	(31)	<b>2,041</b>	2,466	(17)
Electric delivery customer accounts <sup>(3)</sup>	<b>2,325</b>	2,283	2	<b>2,325</b>	2,283	2

mwhrs = megawatt hours

(1) Cooling degree days are the differences between the average temperature for each day and 65 degrees, assuming the average temperature is greater than 65 degrees.

(2) Heating degree days are the differences between the average temperature for each day and 65 degrees, assuming the average temperature is less than 65 degrees.

(3) In thousands, at period end.

Presented below, on an after-tax basis, are the key factors impacting Delivery's net income contribution:

(millions)	Second Quarter		Year-To-Date	
	2006 vs. 2005		2006 vs. 2005	
	Increase (Decrease)		Increase (Decrease)	
Regulated electric sales:				
Weather	\$	(2)	\$	(11)
Customer growth		3		6
2005 North Carolina rate case settlement		—		(6)
Other <sup>(1)</sup>		6		3
Change in net income contribution	\$	7	\$	(8)

(1) Other factors including changes in customer usage.

**Energy**

Energy includes our electric transmission operations. Presented below, on an after-tax basis, are the key factors impacting Energy's net income contribution:

(millions)	Second Quarter		Year-To-Date	
	2006 vs. 2005		2006 vs. 2005	
	Increase (Decrease)		Increase (Decrease)	
RTO start-up and integration costs <sup>(1)</sup>	\$	—	\$	4

Regulated electric sales:

Weather		—	(2)
Customer growth		—	1
Other <sup>(2)</sup>		3	2
Change in net income contribution	\$	3	\$ 5

(1) Reflects the absence of a charge incurred in 2005 for the write-off of certain previously deferred start-up and integration costs associated with joining an RTO.

(2) Other factors including changes in customer usage.

**Generation**

Generation includes our portfolio of electric generating facilities, power purchase agreements and energy supply operations. Presented below are operating statistics related to our Generation operations:

	Second Quarter			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Electricity supplied (million mwhrs)	18.7	18.6	1%	38.2	38.5	(1)%

mwhrs = megawatt hours

Presented below, on an after-tax basis, are the key factors impacting Generation's net income contribution:

(millions)	Second Quarter		Year-To-Date	
	2006 vs. 2005	Increase (Decrease)	2006 vs. 2005	Increase (Decrease)
Sale of emissions allowances	\$	(25)	\$	(21)
Fuel expenses in excess of rate recovery		(18)		(50)
Energy supply margin <sup>(1)</sup>		(7)		(2)
Outage costs		(4)		(14)
Regulated electric sales:				
Weather		(5)		(24)
Customer growth		5		11
2005 North Carolina rate case settlement		—		(10)
Interest expense		4		—
Other <sup>(2)</sup>		4		8
Change in net income contribution	\$	(46)	\$	(102)

(1) Primarily reflects a reduced benefit from FTRs in excess of congestion costs.

(2) Other factors including a reduction in capacity expenses and an increase in net realized gains (including investment income) associated with nuclear decommissioning trust fund investments.

**Corporate**

Corporate includes our corporate and other functions, as well as the discontinued operations of VPEM. Presented below are the Corporate segment's after-tax results.

(millions)	Second Quarter		Year-To-Date					
	2006	2005	2006	2005				
VPEM discontinued operations	\$	—	\$	(67)	\$	—	\$	(160)
Specific items attributable to operating segments		(4)		(2)		(4)		(53)
Net expense	\$	(4)	\$	(69)	\$	(4)	\$	(213)

**Second Quarter 2006 vs. 2005**

In 2006 and 2005, we reported net expenses of \$4 million and \$69 million, respectively, in our Corporate segment. The net expenses in 2006 reflect a \$7 million (\$4 million after-tax) charge resulting from the write-off of certain assets



no longer in use at one of our electric generating facilities, attributable to our Generation segment. In 2005, the net expenses primarily reflect \$67 million of losses incurred in 2005 related to the discontinued operations of VPEN.

**Year-To-Date 2006 vs. 2005**

In 2006 and 2005, we reported net expenses of \$4 million and \$213 million, respectively, in our Corporate segment. The net expenses in 2006 reflect a \$7 million (\$4 million after-tax) charge resulting from the write-off of certain assets no longer in use at one of our electric generating facilities, attributable to our Generation segment. In 2005, the net expenses included \$160 million of losses incurred in 2005 related to the discontinued operations of VPEN, as well as the following items attributable to our Generation segment:

---

- A \$77 million (\$47 million after-tax) charge resulting from the termination of a long-term power purchase agreement; and
- A \$13 million (\$8 million after-tax) charge related to our interest in a long-term power tolling contract that was divested in 2005.

### Sources and Uses of Cash

We depend on both internal and external sources of liquidity to provide working capital and to fund capital requirements. Short-term cash requirements not met by cash provided by operations are generally satisfied with proceeds from short-term borrowings. Long-term cash needs are met through sales of securities and additional long-term debt financings.

### Operating Cash Flows

As presented on our Consolidated Statements of Cash Flows, net cash flows provided by operating activities were \$674 million and \$617 million during the six months ended June 30, 2006 and 2005, respectively. We believe that our operations provide a stable source of cash flow sufficient to contribute to planned levels of capital expenditures and provide dividends to Dominion.

Our operations are subject to risks and uncertainties that may negatively impact the timing or amounts of operating cash flows. See discussion of such factors in *Operating Cash Flows* in MD&A in our Annual Report on Form 10-K for the year ended December 31, 2005.

### Credit Risk

Our exposure to potential concentrations of credit risk results primarily from sales to wholesale customers. Presented below is a summary of our gross exposure as of June 30, 2006 for these activities. Our gross credit exposure for each counterparty is calculated as outstanding receivables plus any unrealized on or off-balance sheet exposure, taking into account contractual netting rights. Gross credit exposure is calculated prior to the application of collateral. We held no collateral for these transactions at June 30, 2006.

	<b>Gross Credit Exposure</b>
(millions)	
Investment grade <sup>(1)</sup>	\$ 9
Non-investment grade	—
No external ratings:	
Internally rated—investment grade	68
Internally rated—non-investment grade	—
Total	\$ 77

(1) Designations as investment grade are based on minimum credit ratings assigned by Moody's Investors Service (Moody's) and Standard & Poor's Ratings Services (Standard & Poor's). The five largest counterparty exposures, combined, for this category represented approximately 12% of the total gross credit exposure.

(2) The five largest counterparty exposures, combined, for this category represented approximately 88% of the total gross credit exposure.

### Investing Cash Flows

During the six months ended June 30, 2006 and 2005, investing activities resulted in net cash outflows of \$470 million and \$387 million, respectively. Significant investing activities in the six months ended June 30, 2006 included:

Edgar Filing: VIRGINIA ELECTRIC & POWER CO - Form 10-Q

\$421 million for environmental upgrades, routine capital improvements of generation facilities and construction and improvements of electric transmission and distribution assets;

- \$267 million for purchases of securities held as investments in our nuclear decommissioning trusts; and
    - \$60 million for nuclear fuel expenditures; partially offset by
  - \$256 million of proceeds from sales of securities held as investments in our nuclear decommissioning trusts; and
    - \$20 million of proceeds from the sale of emissions allowances.
-

**Financing Cash Flows and Liquidity**

We rely on banks and capital markets as significant sources of funding for capital requirements not satisfied by the cash provided by our operations. As discussed in *Credit Ratings and Debt Covenants*, our ability to borrow funds or issue securities and the return demanded by investors are affected by our credit ratings. In addition, the raising of external capital is subject to meeting certain regulatory requirements, including obtaining regulatory approval from the Virginia State Corporation Commission (Virginia Commission).

As presented on our Consolidated Statements of Cash Flows, net cash flows used in financing activities were \$238 million and \$216 million, respectively, for the six months ended June 30, 2006 and 2005.

See Note 9 to our Consolidated Financial Statements for further information regarding our credit facilities, liquidity and significant financing transactions. Also see Note 12 to our Consolidated Financial Statements for further information regarding our borrowings from Dominion.

**Credit Ratings and Debt Covenants**

Credit ratings are intended to provide banks and capital market participants with a framework for comparing the credit quality of securities and are not a recommendation to buy, sell or hold securities. In *Credit Ratings and Debt Covenants* of MD&A in our Annual Report on Form 10-K for the year ended December 31, 2005, we discussed our use of capital markets and the impact of credit ratings on the accessibility and costs of using these markets, as well as various covenants present in the enabling agreements underlying our debt. As of June 30, 2006, there have been no changes to or events of default under our debt covenants. As of June 30, 2006, there have been no changes in our credit ratings other than the matters discussed in MD&A in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

**Cash Flows from Discontinued Operations**

The impact of VP EM's operations on our 2005 Consolidated Statement of Cash Flows is presented below. We do not expect the transfer of VP EM to Dominion to have a negative impact on our future liquidity.

	Year-To-Date 2005
(millions)	
Operating cash flows	\$ 35
Investing cash flows	110
Financing cash flows	(145)

**Future Cash Payments for Contractual Obligations**

As of June 30, 2006, there have been no material changes outside the ordinary course of business to the contractual obligations disclosed in MD&A in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Future Issues and Other Matters**

The following discussion of future issues and other information includes current developments of previously disclosed matters and new issues arising during the period covered by and subsequent to our Consolidated Financial Statements. This section should be read in conjunction with *Future Issues and Other Matters* in MD&A in our Annual Report on Form 10-K for the year ended December 31, 2005 and in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

**Virginia Fuel Factor**

In May 2006, the Governor of Virginia signed into law Senate Bill 262, a substitute energy bill with a provision that changes the way our Virginia jurisdictional fuel factor is set during the three and one-half year period beginning July

1, 2007. The bill became law effective July 1, 2006.

The fuel factor amendment:

- Allows annual fuel rate adjustments for three twelve-month periods beginning July 1, 2007 and one six-month period beginning July 1, 2010 (unless capped rates are terminated earlier under the Virginia Restructuring Act);
  - Allows an adjustment at the end of each of the twelve-month periods to account for differences between projections and actual recovery of fuel costs during the prior twelve months; and
-

- Authorizes the Virginia Commission to defer up to 40% of any fuel factor increase approved for the first twelve-month period, with recovery of the deferred amount over the two and one-half year period beginning July 1, 2008 (under prior law, such a deferral was not possible).

The amendment does not allow us to collect any unrecovered fuel expenses incurred prior to July 1, 2007.

### **PJM Rate Design**

In May 2005, the Federal Energy Regulatory Commission (FERC) issued an order finding that PJM's existing transmission service rate design may not be just and reasonable, and ordered an investigation and hearings into the matter. Hearings were held in April 2006, and in July 2006, the Presiding Administrative Law Judge issued an Initial Decision. The Initial Decision concluded that the existing PJM transmission service rate design has been shown to be unjust and unreasonable, and should be replaced with a new rate design effective April 2006. To avoid sudden rate increases, under the Initial Decision, the new rate design would be phased-in so that no customer receives greater than a 10% annual rate increase. The Initial Decision also concluded that other rate designs proposed in the hearing could be considered by FERC as alternatives to the new rate design recommended in the Initial Decision. Our position is that the existing rate design remains just and reasonable, as supported by a broad coalition of PJM stakeholders. After submission of briefs by the parties, FERC will review the Initial Decision and make a determination whether to agree with it or to overrule the decision and issue a different ruling. At this time, we are unable to predict the ruling by FERC; however, we continue to monitor this matter.

### **Transmission Expansion Plan**

In June 2006, PJM, as part of its latest Regional Transmission Expansion Plan, authorized construction of numerous electric transmission upgrades through 2011. We are involved in two of the major construction projects. The first project is an approximately 240-mile 500-kilovolt transmission line from southwestern Pennsylvania to Virginia, of which we will construct approximately 30 miles in Virginia and a subsidiary of Allegheny Energy, Inc. (Allegheny) will construct the remainder. The second project is an approximately 56-mile 500-kilovolt transmission line that we will construct in southeastern Virginia. These transmission upgrades are designed to improve the reliability of the PJM transmission system, including service to our customers. Construction of these transmission lines will be subject to applicable state and federal permits and approvals.

---

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES**  
**ABOUT MARKET RISK**

The matters discussed in this Item may contain “forward-looking statements” as described in the introductory paragraphs under Part I, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q. The reader’s attention is directed to those paragraphs for discussion of various risks and uncertainties that may affect our future.

**Market Risk Sensitive Instruments and Risk Management**

Our financial instruments, commodity contracts and related financial derivative instruments are exposed to potential losses due to adverse changes in commodity prices, interest rates, foreign currency exchange rates and equity security prices as described below. Commodity price risk is due to our exposure to market shifts for prices received and paid for natural gas, electricity and other commodities. Interest rate risk is generally related to our outstanding debt. We are exposed to foreign currency exchange rate risks related to our purchases of fuel and fuel services denominated in foreign currencies. In addition, we are exposed to equity price risk through various portfolios of equity securities.

The following sensitivity analysis estimates the potential loss of future earnings or fair value from market risk sensitive instruments over a selected time period due to a 10% unfavorable change in commodity prices, interest rates and foreign currency exchange rates.

***Commodity Price Risk***

To manage price risk, we primarily hold commodity-based financial derivative instruments for nontrading purposes associated with the purchase of electricity and natural gas. As discussed in Note 8 to our Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2005, we completed the transfer of VPEM to Dominion on December 31, 2005. As a result, at December 31, 2005, we did not have significant exposure to commodity price risk associated with financial derivative instruments. As part of VPEM’s strategy to market energy and manage related risks prior to its transfer to Dominion on December 31, 2005, it maintained commodity-based financial derivative instruments held for both trading and nontrading purposes.

The derivatives used to manage our commodity price risk are executed within established policies and procedures and may include instruments such as futures, forwards, swaps and options that are sensitive to changes in the related commodity prices. For sensitivity analysis purposes, the fair value of commodity-based financial derivative instruments is determined based on models that consider the market prices of commodities in future periods, the volatility of the market prices in each period, as well as the time value factors of the derivative instruments. Prices and volatility are principally determined based on actively quoted market prices.

A hypothetical 10% unfavorable change in commodity prices would have resulted in a decrease of approximately \$17 million in the fair value of our non-trading commodity-based financial derivatives as of June 30, 2006. At December 31, 2005, we did not have significant exposure to commodity price risk associated with financial derivative instruments.

The impact of a change in energy commodity prices on our non-trading commodity-based financial derivative instruments at a point in time is not necessarily representative of the results that will be realized when such contracts are ultimately settled. For example, our expenses for power purchases when combined with the settlement of commodity derivative instruments used for hedging purposes, will generally result in a range of prices for those purchases contemplated by the risk management strategy.

***Interest Rate Risk***

We manage our interest rate risk exposure predominantly by maintaining a portfolio of fixed and variable rate debt. We also enter into interest rate sensitive derivatives, including interest rate swaps and interest rate lock agreements. For financial instruments outstanding at June 30, 2006 and December 31, 2005, a hypothetical 10% increase in market interest rates would decrease annual earnings by approximately \$5 million and \$6 million, respectively.

---



***Foreign Currency Exchange Risk***

We have foreign currency exchange risk exposure associated with anticipated future purchases of nuclear fuel and nuclear fuel processing services denominated in foreign currencies. We manage certain of these risks by utilizing currency forward contracts. As a result of holding these contracts as hedges, our exposure to foreign currency risk for these purchases is minimal. A hypothetical 10% unfavorable change in relevant foreign exchange rates would have resulted in a decrease of approximately \$4 million and \$6 million in the fair value of currency forward contracts held by us at June 30, 2006 and December 31, 2005, respectively.

***Investment Price Risk***

We are subject to investment price risk due to marketable securities held as investments in nuclear decommissioning trust funds. These marketable securities are reported on our Consolidated Balance Sheets at fair value. We recognized net realized gains (including investment income) on nuclear decommissioning trust investments of \$25 million and \$13 million for the six months ended June 30, 2006 and 2005, respectively, and \$32 million for the year ended December 31, 2005. We recorded, in AOCI, net unrealized losses on decommissioning trust investments of \$11 million and \$12 million for the six months ended June 30, 2006 and 2005, respectively, and net unrealized gains on decommissioning trust investments of \$10 million for the year ended December 31, 2005.

Dominion sponsors employee pension and other postretirement benefit plans, in which our employees participate, that hold investments in trusts to fund benefit payments. To the extent that the values of investments held in these trusts decline, the effect will be reflected in our recognition of the periodic cost of such employee benefit plans and the determination of the amount of cash that we will contribute to the employee benefit plans.

---

**VIRGINIA ELECTRIC AND POWER COMPANY**

**ITEM 4. CONTROLS AND PROCEDURES**

Senior management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation process, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In accordance with FIN 46R, we have included in our Consolidated Financial Statements a VIE through which we have financed and leased a power generation project. Our Consolidated Balance Sheet as of June 30, 2006 reflects \$344 million of net property, plant and equipment and deferred charges and \$370 million of related debt attributable to the VIE. As this VIE is owned by unrelated parties, we do not have the authority to dictate or modify, and therefore cannot assess, the disclosure controls and procedures or internal control over financial reporting in place at this entity.

---

**VIRGINIA ELECTRIC AND POWER COMPANY**  
**PART II. - OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

From time to time, we are alleged to be in violation or in default under orders, statutes, rules or regulations relating to the environment, compliance plans imposed upon or agreed to by us, or permits issued by various local, state and federal agencies for the construction or operation of facilities. Administrative proceedings may also be pending on these matters. In addition, in the ordinary course of business, we are involved in various legal proceedings. Management believes that the ultimate resolution of these proceedings will not have a material adverse effect on our financial position, liquidity or results of operations. See *Future Issues and Other Matters* in MD&A and *Environmental Matters* in Note 10 to our Consolidated Financial Statements for discussions on various environmental and regulatory proceedings to which we are a party.

**ITEM 1A. RISK FACTORS**

Our business is influenced by many factors that are difficult to predict, involve uncertainties that may materially affect actual results and are often beyond our control. We have identified a number of these risk factors in our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, which should be taken into consideration when reviewing the information contained in this report. With respect to our previous disclosure regarding our exposure to cost-recovery shortfalls because of capped rates and amendments to the fuel factor statute in effect in Virginia, we note that in May 2006, the Governor of Virginia signed into law Senate Bill 262, which became effective July 1, 2006. Other than this event there have been no material changes with regard to the risk factors previously disclosed in our most recent Forms 10-K and 10-Q. For other factors that may cause actual results to differ materially from those indicated in any forward-looking statement or projection contained in this report, see *Forward-Looking Statements* in MD&A.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

On April 28, 2006, by consent in lieu of the annual meeting, Dominion Resources, Inc., the sole holder of all the voting common stock of the Company, elected the following persons to serve as Directors: Thomas F. Farrell, II and Thomas N. Chewning.

---

**ITEM 6. EXHIBITS**

**(a) Exhibits:**

- 3.1 Restated Articles of Incorporation, as in effect on October 28, 2003 (Exhibit 3.1, Form 10-Q for the quarter ended September 30, 2003, File No. 1-2255, incorporated by reference).
  - 3.2 Bylaws, as amended, as in effect on April 28, 2000 (Exhibit 3, Form 10-Q for the quarter ended March 31, 2000, File No. 1-2255, incorporated by reference).
  - 4 Virginia Electric and Power Company agrees to furnish to the Securities and Exchange Commission upon request any other instrument with respect to long-term debt as to which the total amount of securities authorized does not exceed 10% of its total consolidated assets.
  - 12.1 Ratio of earnings to fixed charges (filed herewith).
  - 12.2 Ratio of earnings to fixed charges and preferred dividends (filed herewith).
  - 31.1 Certification by Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
  - 31.2 Certification by Registrant's Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
  - 32 Certification to the Securities and Exchange Commission by Registrant's Chief Executive Officer and Chief Financial Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
  - 99 Condensed consolidated earnings statements (unaudited) (filed herewith).
-

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**VIRGINIA ELECTRIC AND POWER  
COMPANY**  
Registrant

August 3, 2006

/s/ Steven A. Rogers  
Steven A. Rogers  
Senior Vice President  
(Principal Accounting Officer)